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**U.S. Agency
for International Development
Financial Sector Development Project**

USAID/New Delhi

**OVER THE COUNTER EXCHANGE OF INDIA
ANSWERS TO THE QUESTIONS IN THE SCOPE OF WORK**

ATTACHMENT 2

May 29, 1992

MEMORANDUM

TO: J. Richard Breen
Price Waterhouse

FROM: Frank J. Wilson

DATE: May 29, 1992

RE: What OTC Exchange of India Wants to Know

Following are responses to questions raised in the documents supplied to us by the OTCEI and titled "What OTC Exchange of India Wants to Know".¹

SERVICES & PUBLICATIONS AND TRADING & SEMINARS

We have covered this subject in the Attachment to our Report.

INTERNAL CODE

1. Are there any laws/code of conduct, ethics for employees trading on the exchange?
2. Other internal/inhouse regulations?

The NASD has a "Personnel Policies and Procedures Guidelines" document which covers various administrative matters and the responsibility of employees to the company. In addition and more pertinent to OTCEI, it has guidelines entitled *NASD Policy and Procedures - Employee Guidelines* which describe specific required standards of employee conduct. This document codifies ethical principles governing the conduct of NASD and NASDAQ employees, including conflict-situations. More strict standards are applied to employees in the regulatory area. A copy of this document is attached in answer to questions one and two. Attachment 1.

¹Throughout the responses many references are made to NASD Manual. Copies of the Manual were left with OTCEI when the Price Waterhouse team was in Moscow. If necessary, additional copies will be made available.

3. Monitoring for possible insider trading and regulatory measures.

Employees must have the broker/dealer firms with which they execute transactions in securities agree to send a copy of the confirmation of all transactions to the Executive Vice President in charge of their division. He or his delegate reviews them for compliance with all requirements. Review procedures for insider trading in the Market Surveillance Department (which surveils for insider trading) are uniform as to all situations and if an employee's name arose in such an investigation, appropriate action would be taken.

4. Personnel and assigned jobs.

Attached are current organizational charts of the NASD and in particular the Compliance Division. Attachments 2A and 2B.

COMPANY

1. What are the disclosure requirements of Nasdaq, SEC?

Disclosure requirements are extensive and apply to a number of areas i.e., a primary offerings of securities, ongoing disclosure requirements for companies traded in the secondary market, disclosures to Nasdaq or the exchanges upon application for listing, ongoing disclosure after a company is listed including disclosure of material events, and disclosure requirements by a salesman to potential investors as to particular security.

As to primary offerings, the disclosure requirements are primarily those of the SEC. They require disclosure of all pertinent information, both good and bad, upon which investors may base investment decisions. These decisions are required to be made in Registration Statements filed with the SEC, and Prospectuses also filed with the SEC and distributed to potential investors in connection with offerings of securities. These requirements are contained in the Securities Act of 1933 and regulations promulgated thereunder.

Ongoing periodic reporting requirements to investors and the SEC are required of all companies who have 300 or more stockholders and total assets of \$5,000,000 or more. These requirements are contained in the Securities and Exchange Act of 1934 and regulations promulgated thereunder. Together these two categories of disclosure requirements are part of what is referred to as the integrated disclosure system mandated by the U.S. securities laws i.e., initial disclosure requirements contained in the 1933 Act and regulations thereunder, and subsequent disclosure requirements for companies being traded in the secondary market contained in the 1934 Act and regulations thereunder. The latter requirements mandate periodic reports, annual reports and disclosure of material events, among other things.

Companies listed on Nasdaq on an ongoing basis are required to file with Nasdaq three copies of all reports or documents required to be filed with the SEC, or any other regulatory agency, on or before the date on which they are so filed. Annual reports filed are required to have audited financial statements. There is a substantial similarity between the exchanges and Nasdaq as to these subsequent filings. Other regulations require issuers to distribute to investors annual and interim reports including statements of operating results, to have annual shareholder meetings with a quorum of 1/3 of the outstanding shareholders of the company's common stock and to solicit proxies and provide agendas for all meetings of shareholders. Notification to and approval by shareholders of certain corporate activities is also required in connection with Nasdaq/NMS listed companies in situations covered on pages 1575-2 and 1575-3 of the NASD Manual. Generally, these are in connection with the establishment of stock options or purchase plans, instances where the issuance of securities will result in change of control of the issuer, and the acquisition of stock or assets of another company under certain circumstances, among other things. These are referred to as Corporate Governance Standards.

Nasdaq's filing requirements are contained in Schedule D of the By-Laws, Part II, Section 1 (14) through (17) at page 1566 of the NASD Manual, Section 2 (13) through (16) or page 1567-3 and 1568, and Part III, Section 5(b) on page 1574 and 1575 of the Manual.

All Nasdaq issuers are also required to make prompt disclosure to the public through the press of any material information that may effect the value of the company's securities or influence investors or potential investors investment decisions. Prior to the release of that information, they are required to provide notice of such to the NASD Market Surveillance Section, and to provide full and prompt information in response to all requests for information by the NASD. These provisions are contained in Schedule D, Part II, Section 5(b) at page 1569 of the Manual. The exchanges have similar though not identical requirements.

Various other rules regulate disclosure in connection with recommendations to customers for securities transactions. These are contained in the NASD's Rules of Fair Practice, NASD Manual commencing at page 2001 and in regulations of the Securities and Exchange Commission (SEC). Pertinent in this respect is the Penny Stock Reform Act of 1990 and regulations promulgated thereunder.

2. How are Nasdaq's disclosure requirements different from those of other exchanges?

As stated, there is a substantial similarity between exchange and Nasdaq requirements though there are undoubtedly variances.

3. What are the Guidelines for entry to Nasdaq and other exchanges?

The qualification requirements for Nasdaq appear in Part II and Part III of Schedule D of the NASD By-Laws and are divided into requirements for the regular Nasdaq System

and requirements for the Nasdaq National Market System (NMS). Specific requirements are also specified for non-Canadian foreign securities and American Depositary Receipts. Pages 1564 through 1575-5 of the NASD Manual. Also included in these sections are the quantitative maintenance criteria and, as to Nasdaq/NMS securities, qualitative corporate governance standards, referred to in the response to question 1 of this section of questions. Termination procedures which include the right of an appeal to the Board of Governors are also included in those provisions. Attached is a listing of Nasdaq and Nasdaq/NMS criteria and the criteria of certain U.S. exchanges. Attachments 3 and 4.

4. What is the expected shareholding pattern?

The listings standards of Nasdaq and the other exchanges have certain shareholder requirements but I am not certain what is meant by "shareholding pattern". As to Nasdaq securities, there must be at least 300 beneficial holders of the security and at least 100,000 publicly held shares. Nasdaq/NMS has alternative standards. Under Alternative 1, 500,000 publicly held shares are required with a minimum of 800 shareholders if the issuer has between 500,000 and 1,000,000 shares publicly held, or a minimum of 400 shareholders if the issuer has either (a) Over 1,000,000 shares publicly held or (b) Over 500,000 shares publicly held and average daily trading volume of 200,000 shares per day for the six months preceding the application. Under Alternative 2, there must be at least 1,000,000 publicly held shares and a minimum of 400 shareholders. These requirements are contained in Schedule D of the By-Laws and Attachment 3.

5. Is there any stipulation of promoters shareholding?

The only relevant provisions in this area are contained in the Association's Interpretation with respect to Review of Corporate Financing which appears commencing at page 2023 of the Manual. This Interpretation is of Section 1 of Article III of the Association's Rules of Fair Practice. Its primary thrust is to prohibit members from participating in the distribution of an offering of securities when the underwriting or other arrangements in connection with or related to the distribution, or the terms or conditions relating thereto, including underwriter's compensation, are unfair or unreasonable. The Association evaluates all public offerings, with certain exceptions, pursuant to this standard. It does not attempt to pass upon or evaluate the merits of an issue or the fairness of the public offering price. The Association notifies the appropriate member of its determination.

One of the factors reviewed in determining fairness and reasonableness is contained under the Arrangement Factors section of the interpretation entitled "Restrictions on Securities Received or to be Received". In this connection, the Association reviews the circumstances surrounding the purchase of securities by an underwriter and related persons during the 12 month period prior to the filing of the registration statement. Different levels of valuation are applied as to such in ascertaining the reasonableness of compensation. The next section entitled "Stock Numerical Limitation on Securities Received or to be Received" restricts the shares of stock underlying warrants, options

or convertible securities and/or all stock acquired by an "underwriter and related persons" whether acquired prior to, at the time of, or after, but which is determined to be in connection with or related to, the offering. Such may not be more than 10% of the total number of shares being offered in the proposed offering. "Underwriter and related persons" is defined to include "underwriters, underwriters counsel, financial consultants and advisors, finders, members of the selling or distribution group, and any and all other persons associated to any of the forementioned persons". This is interpreted to include promoters when underwriting related services are performed.

The Corporate Financing Interpretation is very detailed and the referred to provisions are only a very small part thereof.

6. What are continuing requirements of listing on Nasdaq and other exchanges?

See answer to question 3 and Attachments 3 and 4.

7. Are there any advertisement norms for companies seeking listing?

In connection with the distribution of securities, the only advertising permitted is what is referred to as a tombstone advertisement which may be inserted in the newspapers and contains little more than the name of offering, the underwriters thereof and the price of the securities. These advertisements are regulated by Rule 134 under the Securities Act of 1933. A prospectus containing full disclosure is required to be delivered to investors prior to or at the time they purchase securities pursuant to SEC Rule 15 c2-8 under the 34 Act and Section 5 of the 33 Act. These requirements are the same irrespective of where the security will subsequently be listed on an exchange or on Nasdaq, or not listed at all.

Article III, Section 35 of the Association's Rules of Fair Practice regulates members advertising and use of sales literature and other communications with the public. NASD Manual, commencing at page 2168. The Compliance Division of the NASD has an Advertising Department with which advertising and sales literature must be filed by members for evaluation in accordance with fairness and full disclosure standards. Advertising or sales literature inconsistent with such violate the rule. Where such is found disciplinary action is taken.

8. What are the reporting requirements for companies to the exchange?

See answer to questions one and two.

9. What deviations are generally made by companies and what exceptions are allowed?

I assume this means deviations from listing and/or maintenance standards. Deviations could occur as to any of the listing requirements. Where the company is discovered to be deficient in connection with the maintenance requirements referred to the answer to in question 2 above, it is notified that if it doesn't conform within a stated period, it will

be delisted. The company is thereafter given an opportunity for a hearing before a committee of the Association. Many times a company argues that it should be permitted to remain on the system until such time as it is able to come back into compliance based upon a proposed business plan.

Termination hearings are held pursuant to Article IX of the Association's Code of Procedure, NASD Manual commencing at page 3271. An appeal is provided from any determination by the Hearing Committee to the Board of Governors of the NASD, and thereafter to the SEC if an adverse determination is made by the Board. Oftentimes where an issuer has a good business plan for, say, bringing its required capital and surplus back up to the prescribed level the Committee will grant a specified amount of time, perhaps 90 days to six months, to do so. Each situation is handled on a case by case basis; however, the NASD strictly enforces the Initial and Maintenance Requirements for the Nasdaq System within a concept of "substantial compliance".

10. Are there any accounting standards prescribed by SEC or Nasdaq?

Nasdaq does not prescribe any accounting standards. The SEC has certain accounting standards pursuant to its Regulation SX which requires financial statements certified pursuant to Generally Accepted Accounting Principles (GAAP) to be presented in a specific disclosure format.

11. Are there any obligations on companies for specific disclosures for investors knowledge in addition to all statutory obligations?

See answers to questions 1 and 2 above. Schedule D of the Association's By-Laws on page 1566 under Part II, Section 1 (15) and Section 2 (14) on page 1567-3 requires an issuer to make prompt disclosure to the public through the press of any material information that may affect the value of its securities or influence investors decisions. Prior to the release of such information, the NASD Market Surveillance Section must be notified. Issuers are also required to provide full and prompt responses to all requests for information by the NASD.

PRICING

Note: An experienced investment banker should be consulted for answers to these points; however, the following responds, at least in part, to questions 4, 5 and 7.

4. Which are the agencies involved in determining the price?

5. What role does the exchange play in pricing of issue?

7. How does SEC monitor the prices? If it monitors, at what stage does it step in?

Neither the NASD, the exchanges nor the SEC participate in establishing the price of securities to be distributed. This is done entirely as a result of negotiations between the underwriter and the issuer. It is unclear what is intended by question 7 concerning monitoring of prices. All SRO's monitor the transactions in the aftermarket looking for instances of manipulation or insider trading or other violations; however, aside from these activities it has nothing to do with price. Anyone of these agencies could step in when it discerns or suspects something is amiss in respect to a security over which it has jurisdiction. Also, in connection with certain initial public offerings subsequently to be listed on Nasdaq or included in the non-Nasdaq Bulletin Board, the NASD may question the basis upon which the quotations were established but cannot mandate a change in the price. Quotations must be reasonably related to the market. It can institute action if manipulation is involved or the price is away from the market.

In the secondary market, the NASD regulates the amount of a mark-up or commission a member may charge a customer for executing a transaction. This is known as the 5% or Mark-up Policy. See Rules for Fair Practice, Section 4 and Interpretation thereof, NASD Manual, commencing at page 2154.

ISSUES - LAWS AND PRACTICES

1. What are the different methods of public offer?

The most prevalent methods of public offering are firm commitment and best efforts underwritings. Best efforts underwritings have several variations, such as, all or none (that is, all securities must be sold or the offering is rescinded), or a minimum amount is required to be sold for the offering to be consummated. If the minimum isn't achieved, the offering is rescinded. If the minimum is achieved, the underwriter uses its best efforts to sell the remainder. This isn't always accomplished. There can also be direct issuer distributions, dutch auctions, private offerings pursuant to Sections 144 of the 33 Act Regulations, and Regulation 144A offerings, among others. The most pertinent for OTCEI's purpose are the firm commitment and best efforts offerings.

A firm commitment offering is the usual approach in the United States wherein an underwriter or co-underwriters (with a designated managing underwriter), assisted by a distribution syndicate (selling group) distributes the securities to the public. Pursuant to this method, on the offering date the underwriter purchases the securities from the issuer. At that point the underwriter owns the securities and it is at market risk until the distribution is completed. In most cases this is done almost immediately. The issuer is then paid the proceeds less the underwriters and distribution expenses.

A best efforts underwriting has several variations as indicated above. In a best efforts offering the underwriter does not purchase the securities from the issuer; rather, it

merely uses its "best efforts" to sell the securities according to the procedures agreed upon. It, thus, has no market risk and gives the proceeds to the issuer less underwriting and distribution expenses. In best efforts offerings the proceeds are required to be held in escrow for the benefit of the issuer until the deal is closed pursuant to SEC Rule 15c2-4 under the 34 Act.

2. What is the procedure/formality involved in public offer?

See answer to number 1.

3. What are the steps involved in seeking listing on an exchange?

As to Nasdaq and Nasdaq/NMS, an application for listing and a listing agreement (Attachments 5 and 6) are required to be executed and filed with the NASD for approval before listing can be effectuated. Listing will not be approved if the listing criteria referred to above are not met.

4. What are the pre-requisites specified by different exchanges for listing any company?

See answer to question 3 under Company and Attachments 3 and 4.

5. What are pre issue and post issue responsibilities of various agencies involved in issue by a company?

The SEC reviews all registration statements and prospectuses to insure that full disclosure of all material matters has been made. In this connection both the good and the bad must be stated and both sides of an issue discussed in most cases. The NASD is also involved prior to the offering in connection with the review for fairness of underwriting arrangements and compensation discussed above.

After the issue has been disseminated the responsibilities of the SEC and the NASD, in addition to the exchanges, is to monitor aftermarket trading in the issue for instances of manipulation, insider trading and sales practice abuses. These surveillance functions are performed at the NASD by automated surveillance of the market by the Market Surveillance Department and by field examination of members' offices by the examining staff.

6. What is the process of allotment and refund?

This apparently refers to the distribution methodology extant in India which does not exist in the United States.

7. How does the exchange fix and monitor the norms, to ensure fairness in allotments?

It doesn't.

8. What is the average time required to complete issue and allotment?

The average time required to complete a distribution from effectiveness to completion of the issue is usually the same day. The issuer is usually paid the proceeds within 5 days.

9. What is the role of merchant bankers?

The pure merchant banker does not exist in U.S. but most financial services firms, including banks and broker/dealers, have active venture capital affiliates and engage in substantial merger and acquisition activity.

10. What is the average issue cost?

The average issue cost of an equity offering of more than \$15 million is usually from 6 - 12% of the offering amount.

11. What are the compliances required on the part of the companies, both pre and post issue?

The requirements for company's listed on Nasdaq or Nasdaq/NMS are contained in Schedule D of the NASD By-Laws and have been discussed above.

INVESTORS

1. What are the protections given to investors in case of transfer delays; refund loss; rights loss; allotment letter loss; consolidation, subdivision; and interest, dividend payment loss under the various acts, regulations of the exchange and of any other agencies?

I'm not sure what exactly is meant by transfer delays. It could be transfer to the customer of securities purchased, or the transfer of a customer account from one broker/dealer to another, or perhaps other things. Generally speaking, however, all over the counter secondary market transactions in securities between NASD members are subject to the provisions of the NASD's Uniform Practice Code, except certain categories of securities not here pertinent and transactions in securities between members which are compared, cleared or settled through the facilities of a registered clearing agency. Thus, as to Nasdaq and Nasdaq/NMS securities transactions, the regulations of the clearing agency, in most cases the National Securities Clearing Corporation, would be applicable and not the Uniform Practice Code because they are required to be so cleared. See Schedule D of NASD's By-Laws. As to all other transactions, the Uniform Practice Code applies. This Code has requirements concerning delivery dates, transactions in securities ex-dividends, ex-rights or ex-warrants, comparisons and confirmations, the delivery of securities, reclamation and rejection of securities, close-out and buy-in procedures, and numerous other requirements including provisions covering erroneous

trades. All of these provisions are contained in the NASD Manual under the title of Uniform Practice Code commencing at page 3501.

That part of this question relating to refund loss, rights loss and allotment letter loss apparently relate to the distribution system in India and do not apply here. I am uncertain what it is meant by "consolidation, subdivision".

As to interest and dividend payment loss, the NASD has an Arbitration Procedure which is available to members of the public (and members when they have disputes with other members). See Code of Arbitration Procedure, NASD Manual commencing on page 3701.

In cases where improper member activity is discerned in connection with interest and dividend payments, or any other activity of a member, a disciplinary complaint can be filed by an investor and disciplinary action taken. However, most disciplinary actions result from complaints filed by the Association. These actions may result from complaints initially made by investors or as a result of field examinations, Market Surveillance Department reviews or activity of the NASD's Anti-Fraud Department of the Compliance Division.

2. How are the complaints attended to? How are the problems sorted out and claims settled?

Initially, if customers have complaints they are generally made to the firm itself. In the large percentage of the cases, a resolution is reached at the firm level and the SRO does not get involved. If however, it does get involved and a complaint is received, it is evaluated by regulatory personnel and depending of the nature thereof an investigation is conducted to determine whether any violations of rules have occurred. If so, a complaint is filed and disciplinary action is taken pursuant to the provisions of the NASD's Code of Procedure. NASD Manual, commencing at page 3001. Irrespective of whether a disciplinary complaint is filed, a "Submission" could be filed with the NASD's Arbitration Department by a customer against a member, or a member against another member. The referred to Code of Arbitration Procedure is then pursued. It is possible to have a disciplinary proceeding and an arbitration proceeding ongoing at the same time though this does not often occur.

3. Are there separate grievance cells, arbitration mechanism available?

Yes, as discussed above. In addition it should be noted that in each of the 14 District Offices of the NASD, which offices are charged with the regulatory oversight of members in their respective District, a Customer Complaint Section exists to which all complaints from customers are referred for investigation. When disciplinary action is called for, it is taken pursuant to the Code of Procedure.

4. **How does the SEC give cover to investors, in case of any misrepresentation by company/issuer?**

In cases of misrepresentation by a company/issuer discovered prior to the distribution of an offering, the SEC would insist that it be corrected and that proper and full disclosure be made. Subsequent to the offering, if there are misrepresentations by the company/issuer the SEC may institute action to halt trading of the issue and file a complaint seeking a preliminary injunction against the company from further misrepresentation. It also has the authority to revoke the company's registration and has recently received authority to impose fines up to stated amounts. See Attachment 7.

SECURITIES

1. **What are the different instruments, issue mechanisms and trading methods of these instruments?**

There are many different trading instruments in the U.S. However, the only instruments traded on Nasdaq are common stock, preferred stock, convertible bonds, warrants and American Depository Receipts. As to Nasdaq, the trading mechanism is similar for all of them -- they need two market makers to be on the system and substantially all other trading and the qualification rules contained in Schedule D of the By-Laws apply. The issue mechanism is similar as to all in that a Registration Statement must be filed with the SEC and a Prospectus supplied to customers.

2. **What are the qualifications/standards/basis for the classification and registration requirements for different instruments?**

See Schedule D and discussions in response to various questions above.

3. **What are the qualifications/standards/basis for the classification and registration requirements for Nasdaq's International List and Nasdaq's national market securities?**

The qualifications for Nasdaq National Market Securities is discussed above. See also Attachment 3. The reference to "international list", apparently refers to securities qualified for inclusion in Nasdaq International. Technically that is not called the "international list". Nasdaq International commenced operation in January of this year. Securities qualified for inclusion in Nasdaq International are any Nasdaq/NMS security, any non-Canadian foreign security or ADR that is included in Nasdaq but not designated a Nasdaq/NMS security, and any equity security that is listed on a registered U.S. National securities exchange.

TECHNOLOGY & INFORMATION DISSEMINATION

- 1. What is the access time and the response time of the Nasdaq system under peak load conditions, average conditions, no load conditions?**

The Nasdaq system actually consists of a number of on-line transaction processing systems with varying service level and response time requirements. Within this on-line environment, all service levels and response times are specified in terms of peak processing loads. In addition, users access all of the Nasdaq applications via a full period private wire network in a connection-less manner. This means that terminal access is dedicated, with no dial-up or log-on connection establishment.

The benchmark transaction for response time purposes is the Nasdaq security quotation update. Its response time target under peak conditions is two seconds 90% of the time. Most requests for security quotation data are serviced at the desktop unit through a distributed data base supplied by information broadcast by the host system. These requests are satisfied instantaneously even under peak loads. Other transactions generally achieve two second response time, but certain complex transactions can take several seconds to complete under load. During average or lighter conditions, the response time for all transactions is generally under two seconds.

- 2. What are the peak, average, and no load volumes in terms of number of users, number of transactions, extent of time usage.**

Because of the private wire nature of the network, the number of users tends to be stable over periods of time. At present, there are approximately 3,000 interactive terminal users. Various transactions, however, may be entered directly by a computer interface with members firms' in-house systems, so there are aspects of system volume that cannot be easily predicted from terminal populations. For this reason, together with the fact that peak loads tend to occur in a consistent pattern, we determine system capacity in terms of the traffic associated with overall market volume. At present, daily market volume ranges between 150 and 200 million shares traded. This is easily handled by the system which we believe can handle between 350 and 400 million shares traded per day, depending upon the number of computer transactions involved. The maximum share volume handled by the system to date has been 327 million shares.

The meaning of "extent of time usage" raised in the question is unclear thus it is not addressed.

3. **What are the hardware and software configuration of system and technical specifications? In case different modules operate under different environments, then what are the specifics of modules and environments?**

The Nasdaq quotation system operates on Unisys 1100/94. All other systems operate on Tandem equipment, in either the VLX or Cyclone configuration (the exception is Portal, which is operated on Stratus equipment). The on-line systems are generally backed up with a minimum of 75% of normal capacity at a second processing center 300 miles distant from the primary center. The network processors are Unisys DCP/40 and DCP/50 systems using the SDLC protocol to control subscriber terminals.

4. **Do performance parameters depend on number of users logged on? Number of users actively using the system? Volume of data being transmitted/accessed? Volume of transactions? Extent of use and type, i.e., query, deal, report, etc.?**

As described above, performance is generally dependent on all of the factors mentioned.

5. **How is the software and hardware integrated with the communications system and what are the technical features of the communications interface?**

The network is effectively a stand-alone element linking all subscriber terminals to all application hosts at both the primary and backup processing centers. Traffic may be switched between primary and alternate hosts on a dynamic basis. There is, therefore, very little integration between application and network software.

6. **What is the extent of the network? Is there a select user group of Nasdaq members and/or can they interact with other outsiders?**

The network serves approximately 3,000 terminal subscribers, of which under 300 are not NASD members. Non-members (Level 2 users) are restricted to viewing information only, and may not enter quotation updates or report transactions. Member firms receive full service through a single terminal, including quotation update, transaction reporting and order routing.

7. **What are the various automated services available? What is the nature and how are they being conducted?**

The key Nasdaq services are listed below. All are provided on an on-line basis.

- | | |
|-----------|---|
| Level 3 | Market maker services (quote update, transaction reporting, etc.) |
| Level 2 | Interactive information (display only) |
| SelectNet | Order routing, screen negotiations, locked-in executions |

SOES	Small order automatic execution against market maker quote
ACT	On-line trade comparison and confirmation (trade lock-in)
TARS	On-line trade reconciliation and correction system
CAES	Automated executions in exchange-listed stocks
MFUND	Mutual fund pricing service
ACES	Proprietary execution system
Level 1	
NQDS	
NMTS	Broadcast services distributing information to market data vendors. This information is redistributed by vendors to approximately 200,000 terminals in 37 countries around the world. These services disseminate inside quotations in all securities in the Nasdaq system and transaction prices of all transactions executed in Nasdaq and Nasdaq NMS securities.

8. What are the other networks which a user of the Nasdaq network can access?

Nasdaq terminal users can only access Nasdaq application hosts through the network. While on-line to Nasdaq, terminals are dedicated and may not be used for other purposes. However, a recent service enhancement allows subscribers to interconnect an in-house local area network (LAN) to a server acting as a Nasdaq network gateway. This enables limited shared use of Nasdaq terminals.

9. How does the Electronic Bulletin Board service operate with respect to quotation display, indication of interest by market makers?

The OTCBB is a service similar to Nasdaq for display of quotations in a tier of issues that do not qualify for Nasdaq listing. The manner of quote update and display is dynamic and very similar to the comparable Nasdaq functions, with the exception that foreign issues may be updated only twice daily.

10. What are the international linkages of Nasdaq with other automated markets like SEAQ, SESDAQ, etc.?

Nasdaq has operated a linkage for the exchange of quotation and trade data with the London Stock Exchange since April, 1986. In this linkage, Nasdaq transmits market maker quotes and transaction reports in the top 100 NMS issues and top 100 financial issues, along with all Nasdaq listed ADRs, to SEAQ for display on Topic terminals. The LSE similarly transmits data on the SEAQ International issues, stocks in the FT/SE 100 index, and other UK domestic issues underlying ADRs traded in the US. Nasdaq has also operated a one-way linkage with the Stock Exchange of Singapore (SES) for display

of 35 Nasdaq issues of local trading interest in a reserved section on SESDAQ. At the end of the trading day in Nasdaq, the closing price and volume of the linkage securities is transmitted SES. At the end of the trading day in Singapore, equivalent information is transmitted back to Nasdaq. These are Nasdaq's only linkages at present.

11. **What is the extent and nature of data stored in active memory which may be accessed without a need for retrieval of achieved data?**

If I interpret archived data to refer to unmounted volumes (i.e. tape reels or disk packs not kept on-line at all times) then the answer is that no archived data are needed by the on-line system. All daily data are stored in active memory, but are retained in archive storage for record-keeping purposes and off-line processing.

12. **What are the modes of nationwide networking and what are the equipment, circuits, etc.?**

Nasdaq operates a nationwide network of full period private lines connecting approximately 3,000 terminals to application hosts in two processing centers. Network traffic is concentrated onto high capacity backbone circuits at six node locations around the country. A seventh node in London services users of the Nasdaq International service located there. Regional circuits linking terminals to network processors are multi-drop, with 15 to 20 devices on an average line. Servers providing LAN access at subscriber sites are connected on a point-to-point basis, with the server emulating a multi-drop line of terminals to the network processor. Network processors poll each terminal on each line individually using the SDLC protocol. Data on the backbone network is carried under control of the Unisys Distributed Communication Architecture (DCA). The network itself is connected to application hosts through a local network at each processing center (HYPERchannel).

13. **What are the advantages and disadvantages of different modes of networking and related equipment?**

The question is very open ended hence difficult to answer but it can be answered with respect to one important aspect, that of cost vs. security. A full period private network like Nasdaq's has the highest cost but offers the highest level of security, as outside access is by definition excluded. This, together with a complex protocol limiting the potential for other forms of intrusion, makes the network essentially immune to the common forms of security violation such as hacking. Dial-up facilities could help contain costs by allowing for more dynamic response to peak conditions through addition of capacity as needed. However, such networks are inherently less secure, and the cost of providing security equivalent to that in a private network can be high.

- 14. How are upgrades of hardware and software to add terminals and provide faster response accomplished?**

We maintain an appropriate level of excess capacity in the system and network to accommodate peaks as well as routine expansion of service levels, e.g., addition of new subscribers. System performance and capacity along with changing market conditions are monitored continually, and incremental hardware and software changes are made as needed to maintain required service levels.

- 15. Surveillance - is it any equipment specific?**

On-line market surveillance is supported by a network of Sun servers and workstations running sophisticated monitoring applications that alert analysts to questionable market activity on real-time basis.

- 16. What happens if different computer makes are integrated - advantages, disadvantages?**

Nasdaq at present integrates applications running on Unisys, Tandem, and Stratus equipment. Individual applications are restricted to one platform, but the terminal user sees a consistent interface to all platforms. The advantages are better vendor relationships through the competition that arises, along with a wider set of choices for implementation. Disadvantages include potentially higher costs in maintaining different platforms and staffs who might not be able to transfer their skills from system to system easily.

- 17. Is the design of software different for trading of different instruments?**

In general, the answer is no, although there is not a wide variety of instruments traded on Nasdaq at present (the system is essentially an equity system with some debt in the form of convertible traded as equity). It is true, though, that trading support for options and probably bonds could require a different general software design.

- 18. What are the security aspects - intrusion, illegal use, etc.?**

The topology of the network together with its reliance on a complex control protocol make intrusion and similar forms of disruption fairly unlikely. Since there is no dial-up access and only data are transmitted to the host systems, there is no means for a virus or equivalent to enter the network.

- 19. Are the standards recommended (by G-30, FIBV, etc.) observed and to what extent?**

The G-30 standards are concerned with improving the clearance and settlement processes. The Nasdaq system is only indirectly involved with processing for clearance and settlement. Nasdaq execution systems such as SOES and SelectNet (by producing

locked-in trades), and comparison and reconciliation systems such as ACT and TARS, definitely contribute to reducing risk and shortening the settlement cycle, and so are fully consistent with the standards.

20. **Is the users' end software uniform to all users? if not, is it audited and certified as fit to be used on the system or the network?**

Nasdaq terminal software is produced by Nasdaq and distributed to users through the network or via diskette for initial installations.

21. **What are the different virus control measures?**

See answer to question 18.

MARKET - METHODS OF OPERATION & MONITORING

Note: Many of the questions in this section are answered by various attached documents entitled *NASD Compliance Checklist*, *Disciplinary Procedures*, *An Introduction to the NASD* and a newspaper article concerning the Market Surveillance Section entitled "Building Investor Confidence through Nasdaq Market Surveillance". The latter is very pertinent to that function and is accurate in its description thereof. Reference to these documents will be made in answering questions in this section. They are enclosed as Attachments 8 through 11.

1. **How is the fiscal worthiness of a member monitored? Net Business Exposure; Transaction Limit; and Number of Companies.**

See *NASD Compliance Checklist* (Attachment 8), in particular Section 1, Finances and Operational. The *NASD Compliance Checklist* is written in the form of instructions to members as to how to perform the respective functions and identifies what is required from a regulatory standpoint. The format follows the scope of NASD field examinations of member's offices. These exams are performed pursuant to procedures outlined in modular form by subject matter or activity.

2. **What qualitative criteria are adopted in evaluation of the listing application?**

This is answered above in connection with standards for admission to listing.

3. **When are listing applications rejected?**

Listing applications are rejected when minimum qualifications required by Schedule D and discussed above are not met.

4. How is trading halted if any news is disseminated?

Trading halts are specifically covered in Schedule D, Part II, Section 5 commencing on page 1569 of the NASD Manual. Mechanically the halt is effectuated by a announcement being published throughout the market in a Nasdaq "NEWS frame". Authorization for reinstatement of trading is made by a similar notice to the market. Trading halts are imposed pending dissemination of material news believed to have a potential impact on the market and when it is determined that such is necessary in the public interest. In other words, when the news to be disseminated potentially could effect an investor's, or potential investor's, investment decision.

5. How are orders matched and how does the small order execution system work?

See Attachment 12. See also SOES rules, NASD Manual commencing at page 2301.

6. How does the limit order/stop loss instructions systems work?

SOES accepts both market and limit orders for execution. In the case of a limit orders an order entry firm may enter good-till-canceled and good-till-date orders whenever the Nasdaq system is open.

The Nasdaq system processes executable orders on a first-in, first-out basis.

The system provides limit-order processing but not limit-order protection. When the market reaches or breaks a limit, SOES attempts to execute orders stored in the file. Because the file executes orders at the current inside market, it is possible that an execution may not occur for an eligible limit order. For example, if the file contains five orders to sell AAAA at 10 and the inside reaches or surpasses 10, SOES will attempt to execute all five orders at the inside quote. If the inside then falls to 9 3/4 and the file has executed only three of the five orders, the system will not execute the last two. In this case, the two orders remain on the limit-order file until the market reaches or breaks the limit again. If the inside had increased to 10 1/4 after the file executed three of the five orders, the system would have executed the last two orders at 10 1/4.

The SOES Limit-Order File is periodically purged of aged orders based on the following:

- Unexecuted day orders, purged at day's end.
- Good-till-date orders, purged at the indicated day's end.
- Good-till-date orders, where the indicated date falls on weekend or holiday, purged on the last business day preceding the expired date.
- All good-till-canceled orders, purged every three to four months. The Nasdaq NEWS frame will alert market makers of an imminent purge.

7. Is surveillance done on line? If not, when and how?

NASD surveillance mechanisms involve automated surveillance of the Nasdaq system by the Market Surveillance Department and surveillance of members activities -- financial, operational, sales practices etc. -- via periodic field examinations of members' offices.

Market Surveillance is conducted on-line throughout the trading day. Where problems are discovered, follow-up investigations are conducted and, where appropriate, disciplinary action is instituted or reference are made to the SEC. Off line surveillance procedures are also pursued. See attached article "Building Investor Confidence Through Nasdaq Market Surveillance". Attachment 11.

As to periodic field inspections, all members are examined pursuant to a predetermined cycle which differs based upon the type of business engaged in by the member. For examination purposes, the membership is divided by type of business into 13 categories. Generally, the frequency of the examination relates to the potential risk to the public because of the type of business done. Members dealing with the public are examined at least once per year. An examination for "cause" could take place at any time as to any category of member.

8. What are the methods of selecting members - criteria?

Members are not selected by the NASD. They apply on their own initiative and are accepted or rejected depending upon whether they meet the qualification standards. In order for a broker/dealer to become a member of the NASD, it must first register as such with the SEC. This is a prerequisite to a membership. The qualifications for membership in the Association are contained in Article II of the NASD By-Laws commencing on page 1101 of the NASD Manual. These provisions are further detailed in Schedule C to the By-Laws commencing on page 1531 of the NASD Manual. Detailed requirements for the registration of Principals commence on page 1533-3 of the NASD Manual and for the registration for Registered Representatives of members on page 1541 of the NASD Manual. Principals are defined generally as any person actively engaged in the management of a member's investment banking and securities business. See page 1534 of the NASD Manual, Schedule C, Part II, Section (b). There are various categories of registration as Principal and Representative.

9. How is inventory monitoring done?

Inventory monitoring is not specifically performed by the NASD. However, capital adequacy is continuously monitored by way of monthly, quarterly and annual reports. In connection therewith inventory is reviewed because of the potential impact on regulatory net capital. Inventory valuation takes into consideration market risk by haircutting the value of securities in inventory thus reducing the amount of regulatory capital available. In addition to filing with the NASD of the referenced monthly, quarterly and annual reports, periodic examinations of members offices are conducted in

which review of capital adequacy is one of the primary considerations. This necessarily involves review of inventory and haircutting for net capital purposes.

10. How is price monitoring done?

By the Market Surveillance Department as discussed above. See Attachment 11.

11. How is volume monitoring done?

By the Market Surveillance Department. Reports must be entered into the System for all transactions. See Attachment 11.

12. How is counter's monitoring done?

See Attachment 11.

13. How is performance index evaluated and measured?

I don't know precisely what is sought by this question.

14. What are the price limits - spread; opening-closing difference; and successive quotes?

Maximum allowable spreads between the bid and ask are contained in Schedule D, of the NASD By-Laws, Part VI at page 1581. There are no limitations on the differences between the opening and closing quotations in the Nasdaq system. There are no limitations as to the price of successive quotations.

15. What are the methods of settlement?

Transactions in Nasdaq and Nasdaq/NMS securities must be closed and settled through the facilities of a registered clearing agency where clearing facilities are located within 25 miles of the market maker, with certain variances. See Part VI, Section 7 of Schedule D of the NASD Manual at page 1583-3. Settlements at these agencies are on a continuous net settlement basis whereby purchases and sales by a member with another member are netted out at the end of the day and the net balance of cash or securities is either paid or delivered. Delivering of securities is by book entry at a depository, usually the Depository Trust Company. Clearance and settlement activities are governed by the rules of the National Securities Clearing Corporation (NSCC) and other U.S. clearing corporations. NSCC is 1/3 owned by each of the NASD, NYSE and AMEX. Settlement in non-Nasdaq over the counter transactions are governed by NASD's Uniform Practice Code commencing on page 3501 of the NASD Manual with certain exceptions noted therein at Section 1.

16. How does the quotation system operate? (Time entered, depth of stock prices etc.)

Attachment 13 *Nasdaq: The Stock Market for the Next 100 Years* describes the Nasdaq system and its operation. See also Schedule D to the NASD By-Laws for the governing rules. NASD Manual commencing on page 1561.

17. How is the price justified by the market maker?

The only justification the market maker must have for its prices is that they be reasonably related to the prevailing market. Should it appear that a market maker's quotation - is no longer reasonably related to the prevailing market, the Association may require the market maker to reenter its quotation. If it fails to do so, the NASD may suspend its quotations in that security or in all securities. Schedule D, Part VI Section 2(c), page 1581 of the NASD Manual. See also NASD Rules of Fair Practice, Section 5, page 2063. This "reasonably related" standard is very general and puts a great deal of discretion in the market maker but it necessarily takes into consideration the demand or the lack thereof in the market, the quality of the market and other factors relating to market conditions.

18. How do two counters interact?

Market makers interact by telephone to negotiate deals which are consummated as a result of these discussions. In the automatic execution systems, such as SOES, SelectNet and CAES, telephone interaction is not required. In SOES and CAES, orders entered are automatically executed at the inside price quoted in the system at that time up to the stated size. In the SelectNet system orders in excess of 1,000 shares can be negotiated over the system itself with interaction between market makers being via the screen. Offers and counter offers can be made and a final deal arrived at. In each of these systems, the transaction is automatically reported, that is publicly disseminated, and sent to the NSCC for clearing and settlement. Transactions not executed over the automatic execution systems must be reported within 90 seconds of execution.

19. How is prelisting trade carried out?

Pre-listing trading is carried out over the telephone. The non-Nasdaq OTC Bulletin Board and the Pink Sheets carry quotations and indications of interest by broker/dealers in non-Nasdaq listed securities. The Bulletin Board is available to all members participating in the Nasdaq system and can be accessed through Nasdaq facilities.

20. How is sponsorship defined? Role and functions of sponsor?

"Sponsor" is not defined. While the term is sometimes used it does not have the same meaning in the United States as it does in India or at OTCEI where it connotes an advisor to a company which is to make a public offering and carries with it the obligation to make a market in the security for three years. However, the term "Sponsor" could

be likened to the role of an underwriter whose responsibility is to advise an issuer in connection with a distribution, establish its price and to purchase and distribute securities to the public, or to participate in a "best efforts offering".

An underwriter contracts with the issuer and, as a result of a due diligence investigation by the underwriter and negotiations with the issuer arrives at the price to be charged for the securities to be distributed. An underwriter, for business reasons and a desire to have a continuing relationship with the Company, will usually make a market in the security on an ongoing basis but it is not required to do so either by U.S. law or the Nasdaq system. However, once a member has indicated its willingness to make a market in the security in Nasdaq it must continue to do so unless it receives an excused withdrawal by the NASD. If it does not receive an excused withdrawal and it nevertheless withdraws, it is prohibited from re-entering as a market maker in that security for a period of 20 business days. Part VI of Schedule D contains all the requirements applicable to Nasdaq market makers. Page 1580 of the NASD Manual et seq. Market makers in Bulletin Board securities may commence or cease market making at will.

21. **What is expected of market making - compulsory, voluntary? Period minimum - maximum?**

See answer to question 20.

22. **Can market making be delegated - only function and/or the responsibility?**

The responsibilities of a market maker can not be delegated. However, Part VI of Schedule D provides for the concept of "access market makers", that is a firm which desires to make a market in a Nasdaq security on Nasdaq but does not subscribe to Nasdaq Level 3 Service which is required in order to do so. Another market maker may act on its behalf in the system. Such arrangements must be preapproved by the NASD and the Nasdaq screen must carry a symbol so indicating. The entering market maker is responsible for all transactions entered as a result thereof but both are subject to and responsible for compliance with the provisions of Schedule D.

23. **What are the different types of agreement between market constituents? Agreement with company; Agreements with member; Agreements with depository/registrar?**

An underwriter usually has an "agreement to underwrite" or "underwriting agreement" with the issuer, an "agreement among underwriters" with the underwriting syndicate and a "selling group agreement" with selling group members. To clear and settle through a clearing corporation, it must be a member thereof and have executed a membership agreement and made a clearing deposit. It must also have an account with a depository facility, normally the Depository Trust Company and have executed appropriate agreements with it.

- 24. What are the infrastructure requirements for maintaining counters in a particular way?**

The thrust of this question is unclear, however, the only rules relating to the activities of market makers in the Nasdaq system are contained Schedule D. Certain of these provisions prohibit a member from allowing use of any of its computer terminals by unauthorized persons, that is, persons that are not qualified employees of the market maker. The public cannot be permitted access to market maker terminals. Schedule D, Section 1(a); SOES Rules, Section b) D, page 2306 of NASD Manual.

- 25. What are the different fees payable by a company? What are the different fees payable by a member? What are the different fees payable by an investor?**

Nasdaq issuer fees are contained in Attachment 14. Fees payable by members are contained in Schedule A of the Association's By-Laws, commencing at page 1772 of the NASD Manual. The NASD does not impose fees on investors; rather, these fees are imposed by members in connection with transaction and other services rendered.

- 26. What is the actual trading mechanism - movement of documents?**

Aside from the automatic computer system executions discussed above, transactions are executed over the telephone. Document movement is governed by SEC Rules, Clearing Corporations rules and the NASD's Uniform Practice Code to the extent pertinent.

- 27. How market reacts to selling pressure? How market reacts to buying pressure? How market reacts to panic situation?**

Obviously, where selling pressure exists the market usually goes down. Where buying pressure exists the market usually goes up. Panic situations are usually characterized by excessive volume in a down market. This puts great pressure on market participants in terms of their ability to consummate all transactions as well as the potential impact on their capital situation. Because their quotations are firm, a market maker is obligated to purchase at his published quotations with the result he will be accumulating inventory in a down market at decreasing prices. The result is that it would be developing an inventory of increasing size that would not be valued at the price paid for it. The impact on capital that this would cause is obvious especially since in valuing inventory for capital purposes haircuts are applied to the market value.

- 28. Is modification in monitoring systems/method made quite often?**

I assume this relates to the surveillance system utilized by the Market Surveillance Department. Modifications in the monitoring systems are not made very often. The NASD within the past two years installed a totally new, highly sophisticated system in place of that which existed for several years. While there may be minor modifications made within the system from time to time, the system itself will not be changed. The NASD anticipates that its current system will be used for many years. Attachment 15

A through C contains the price and volume parameters that were utilized in the old system, and an overview of the operation of the market watch system at that time.

29. How is manipulation by players to their benefit traced?

It is traced by a combination of Market Surveillance review of price changes and volume activity as well as field investigations conducted by examiners. Identifying and proving manipulation is a difficult and time consuming task and involves much follow-up and review of members' records and documentation of transactions. The NASD has an Anti-Fraud Department in the Compliance Division which concentrates on this kind of violation.

30. Are there any surprise checks?

Yes, all NASD examinations of firm's offices are unannounced irrespective of whether they are periodic or "for cause" examinations.

31. What are the signs of problems that occur generally in market? Unexplained change in price, volume; deviation from trend; lopsided index; and any others?

The referenced article on the Market Surveillance system speaks to these issues. See Attachment 11.

32. How is the trend/pattern set and how does one identify the break from trend?

The trend pattern is set pursuant to certain parameters built into the system. See Attachment 15. A break from a trend (price or volume) is automatically triggered ("kicked out") by the system pursuant to the trend pattern parameters.

33. How is the action point decided to initiate any investigations?

If a "kick out" has occurred and the action is still unexplained after initial review, an investigation is pursued until such time as the action is either satisfactorily explained, or disciplinary action is instituted by the NASD, or a referral is made to the SEC. A referral is made to the SEC if there are participants in the violative scheme over which the NASD does not have jurisdiction. This almost always occurs in insider trading cases.

34. What are the different steps to control the market and in what circumstances are they useful?

I don't know what the thrust of this question is other than perhaps a reference to the "circuit breakers" which were instituted after the market break of 1987. A copy of the Circuit Breakers Guidelines adopted by the various marketplaces in the United States is attached (Attachment 16). The intent behind them is to give the market a pause, some breathing room, in times of market crises i.e., heavy selling volume resulting in steep price declines.

35. Are there any set models/methods of surveillance?

If this refers to automated market surveillance, the NASD does have a model which it has built into its system; however, it is proprietary in nature. As to field examinations they are done pursuant to a modular system which spells out the areas to be examined by the examiners depending on the nature of the member's business activities. The NASD is willing to give in depth instruction in the periodic modular system to whomever OTCEI sends to the US for training. It will also instruct in use of the Market Surveillance system and how to take follow-up action.

36. How are restrictions imposed and when?

I don't know what kind of restrictions are referred to or upon whom. If it refers to restrictions placed upon persons because of improper activity, this is done only after a formal complaint is filed, a hearing held and a determination made by a disciplinary committee. See *Disciplinary Guidelines*, Attachment 9.

37. What is the allowable deviation and how is it determined?

I believe this refers to deviations from price or volume which causes a "kick out". Attachment 15 contains a list of price deviations utilized in the old Market Surveillance system. The new system is much more complicated, takes into consideration many factors and is proprietary.

38. Explanation of the jargon used in trading. Front running; Up-tick; Circuit breaker; and Others.

"Front running" usually means execution by a member for its own account with knowledge of an order pending in the market, or with the order in hand. The broker/dealers, in effect, "runs in front" of that order with expectation of gain because of a price movement the order may cause when executed.

Up-tick means an increase in price over the last sale, usually of 1/8 of a point.

Circuit breakers as referred to in question 34 above and Attachment 16.

39. What are the awards for performance, if any?

If this means awards by the market operator, the answer is none. Good performance by a securities firm will usually result in additional business and success, however.

40. What are the implications of being recognized investment exchange of the British Government/Any other foreign government?

Nasdaq is qualified as a Recognized Overseas Investment Exchange (ROIA) in the United Kingdom and is the only U.S. stock market so recognized. Being recognized as such

means that Nasdaq is authorized to do business therein. If it was not so authorized and it was determined that it was conducting business in the UK it could be charged with failure to be properly authorized. This is a criminal offense in violation of the United Kingdom's Financial Services Act of 1986. Nasdaq was recognized as an ROIA in the U.K. in 1987 and it is still so recognized. It determined to seek recognition because of the agreement it entered into in 1987 with the London Stock Exchange to exchange quotations in certain securities and to publish them over the system in the opposite country. Future activity in the U.K. was anticipated at that time. This ultimately resulted in Nasdaq International which commenced operations in the U.K. in January 1992.

The UK is the only country that recognizes foreign exchanges in the context described. Other countries have provisions for recognizing exchanges for securities listings purposes (Japan), for investment purposes (Germany and the UK) and for certain tax considerations (Canada). Nasdaq has been recognized for these purposes in these countries.

REGULATORY MEASURES, PENALTIES

1. What are the various types of committees for the purpose of market control? Investor protection? Funds management? Arbitration?

The NASD has a system of about 20 committees of experts in various subject areas of the securities business, i.e., trading, corporate financing, arbitration etc. They are responsible for preparing regulations in their areas of expertise where abuses are found or improvements in operations are needed.

As to investor protection see Attachment 9 discussed above entitled *Disciplinary Procedures*.

The NASD has no committee concerning funds management because it does not regulate funds. (This assumes that the term "funds" means mutual funds or other kinds of investment funds.) It does regulate distribution of those funds. An Investment Companies Committee oversees this area.

The National Arbitration Committee oversees the arbitration area. Members of this Committee are, for the most part, attorneys that have experience in arbitration proceedings as either plaintiffs or defendants counsel, academics, members of the securities industry and the public. It proposes appropriate rules for adoption by the Association's Board of Governors and approval by the SEC.

2. What is the nature of the Self-Regulatory Organization (SRO) and how do they operate?

See Attachment 10, *An Introduction to the NASD*. See also Attachments 8 and 9.

3. **What are the different kinds of penalties? What are the different conditions when these penalties may be imposed?**

See Attachment 9, *Disciplinary Procedures*, discussed above.

4. **What are the mechanisms used to detect defaults, insider trading or any deviation from normal practice?**

Primarily Market Surveillance Department surveillance activities discussed above and follow-up investigations.

5. **Who initiates actions and what actions are taken against the defaulters?**

See Attachment 9, *Disciplinary Procedures*, discussed above.

6. **What are the circumstances for a company to get delisted?**

Failure to maintain the "Maintenance requirements" of Schedule D as discussed above.

7. **How does the SEC view insider trading and what are the actions taken to curb it? How is it defined?**

The SEC views insider trading as a very serious violation of the law and requirements of the securities industry. It could result in imprisonment of perpetrators, significant fines and barring of the perpetrators from future involvement in the securities industry. There is no statutory definition of insider trading but, generally speaking, it means taking advantage of non-public material information by persons for their own or someone else's benefit.

8. **What are the laws for insider trading, who can enforce them and how?**

Attached is an excerpt from a article on various securities subjects, Attachment 17, which discusses insider trading and would appear helpful in answer to questions 7 and 8.

9. **How do stock exchanges curb the insider trading practice?**

By routinely engaging in automated market surveillance activities and follow-up investigations and taking appropriate disciplinary action when it has jurisdiction, or by making referrals to the SEC when it does not have jurisdiction. The SRO difficulty in this area is that they don't have jurisdiction over all involved i.e., customers, banks, non-securities registered people. The SEC with its subpoena authority has the ability to reach all involved. It has also entered into Agreements with numerous foreign countries to assist it in combatting this practice.

10. What are the codes of conduct, business rules, etc.?

The primary code of conduct of the NASD is contained in its By-Laws and its Rules of Fair Practice, and formal Interpretations by the Association's Board of Governors thereof.

11. What are the disclosure requirements, reporting requirements by members for market operations with respect to shareholding, takeover intention and other cases?

Pursuant to the Securities Exchange Act of 1934, Section 13(e) and regulations, thereunder, when a person accumulates more than 5% of the securities of a company it must make a public filing of such with the SEC within 10 days of acquisition. Subsequent filings are also required if greater accumulations are made. Other filings by insiders of companies are required by Section 16 of the Act in certain instances of purchase and sale of their own company's securities. Other disclosure and reporting requirements are discussed above.

12. How are market makers/dealers penalized/suspended scripwise and timewise?

See *Disciplinary Procedures* booklet, Attachment 9.

13. What is suspension in trading of scrips of any company imposed?

Normally, in the case of Nasdaq, suspension of trading in a security is usually imposed when material news is pending dissemination. The suspension (called a "halt") is temporary in nature. Announcement of the "halt" is made over a Nasdaq NEWS frames. When a reasonable period of time has elapsed after dissemination in the media, currently usually one half hour, trading is again commenced.

Material news is information that would potentially affect the investment decision of an investor or potential investor. The halt is imposed so, theoretically at least, investors and potential investors have an opportunity to be informed of such and to take it into consideration in making their investment decisions.

14. How is the suspension renamed and trading restored?

See answer to 13. Upon restoration of trading, a announcement is made in Nasdaq NEWS frame.

15. What are the provisions for settlement of any dispute?

Disciplinary cases can be settled by agreement of the parties (the respondent and the SRO or the SEC) to the imposition of appropriate penalties for the violation alleged. Specific provisions of a settlement would relate to the facts of the case and the allegations made. Many times a respondent in settlement of a case is permitted to state that it neither admits

nor denies the allegations, but agrees to the penalties imposed. In all such cases, findings of violation are made.

Arbitration cases can also be settled. Similarly, the provisions of such would relate to the nature of the dispute and the wishes of the parties.

16. If the powers to penalize of various agencies overlap, which agency has the final say in the matter?

Usually, the agency with primary jurisdiction processes the case. But if an SRO has jurisdiction it can take action irrespective of whether action is being taken by another SRO or the SEC.

17. What is the relation between Nasdaq and SEC?

The NASD as a self-regulatory organization, and Nasdaq as a market place, are registered with the SEC pursuant to the appropriate provisions of the Securities Exchange Act of 1934. The SEC has total oversight over the NASD and other exchanges, all of whom must file proposed rules and rule changes with the SEC for approval before they become effective. As part of its statutory obligations the SEC oversees activities of the NASD on a continuous basis and inspects its offices and appropriate departments on a periodic basis. There is daily interaction between the NASD and the SEC. Often the NASD conducts joint investigations with the SEC where concentrated violative activity is suspected.

18. How are the areas of operations and demarcated?

By the Securities Exchange Act of 1934 and regulations thereunder.

19. When do the rules of Nasdaq prevail over rules of the SEC and vice versa?

The rules of the SEC always prevail over inconsistent rules of any of the self-regulatory organizations.

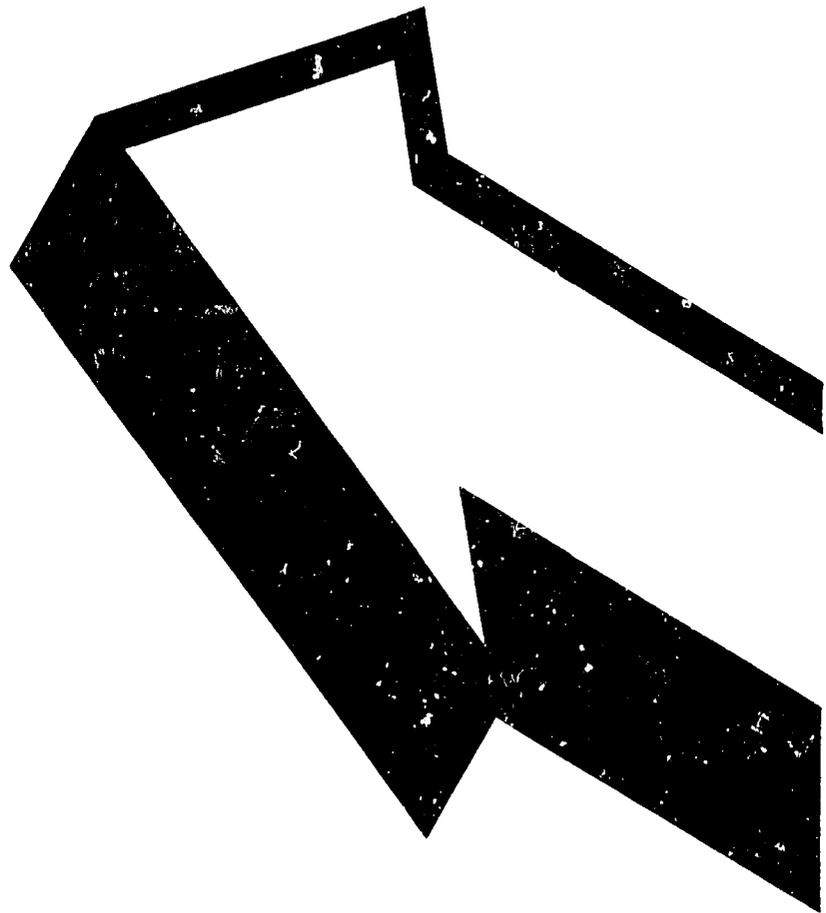
20. What are the different cells for imposing the penalties and for monitoring their compliance?

See *Disciplinary Procedures* book, Attachment 9.

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NASD POLICY &
PROCEDURES:

EMPLOYEE GUIDELINES



NASD POLICY AND PROCEDURES: EMPLOYEE GUIDELINES

Introduction

The purpose of the *Employee Guidelines* is to codify the ethical principles which have and will continue to govern the conduct of employees of the National Association of Securities Dealers, Inc. ("NASD" or "Association"). They have been designed to assist the employee in avoiding situations which might result in actual or apparent misconduct or conflicts of interest. The Association always has and will continue to expect exceptionally high standards of honesty, integrity, impartiality and conduct from each of its employees. The publication of these *Employee Guidelines* does not in any way represent a lack of confidence in the staff or their dedication to professionalism. Their purpose is simply to eliminate any ambiguities concerning the ethical standards to be observed by Association employees.

Each new employee of the Association shall be given a copy of the *Employee Guidelines* by the Human Resources Department or by his or her supervisor. The employee's immediate supervisor shall review and fully discuss all applicable aspects of the *Employee Guidelines* with the employee within the first few days of employment. Particular emphasis shall be given to the areas associated with the employee's job functions.

The employee shall sign a Statement on *Employee Guidelines* (Attachment A) indicating that he has received, read, understands and agrees to comply with the *Employee Guidelines*. In addition, the employee will complete an Employee Account(s) Report Form (Attachment B) indicating any securities or commodities accounts beneficially owned or controlled by the employee or member of his immediate family, as defined in the *Employee Guidelines*. This form is required to be completed annually or whenever a new account is opened.

Interpretations and Counseling

These *Employee Guidelines* are applicable to all employees of the Association. For purposes of the *Employee Guidelines*, an employee is defined as any individual who is employed by the NASD in a full-time, part-time or hourly capacity. The text has been written in the masculine gender to facilitate reading and understanding of the guidelines. However, any reference to "he," "him" or "his" should also be interpreted to mean "she," "her" or "hers." Although these *Employee Guidelines* describe in considerable detail the ethical standards to be observed by Association employees, they do not, and indeed cannot, cover all of the possible or probable situations that may arise. In any instance in which an interpretation of the *Employee Guidelines* is needed or in the event that questions arise as to areas not covered by these *Employee Guidelines*, the employee shall promptly seek the advice and counsel of the Division Executive Vice President.

Any employee who believes that the application of any part of these *Employee Guidelines* will result in undue hardship in a particular case may make a written statement to the Executive Vice President of his Division (through his District/Department Director, copied to Internal Review) setting out, in detail, the reasons for that belief and requesting a waiver.

Guidelines Concerning the Conduct of Employees of the National Association of Securities Dealers, Inc.

**Effective December 4, 1974
As amended October 1990**

The Certificate of Incorporation of the National Association of Securities Dealers, Inc., states that its objectives and purposes, among others, are:

1. To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote therein high standards of commercial honor, and to encourage and promote among members observance of federal and state securities laws; and,
2. To adopt, administer and enforce rules of fair practices and rules to prevent fraudulent and manipulative acts and practices and, in general, to promote just and equitable principles of trade for the protection of investors.

Thus, the underlying purposes of the Association recognize the need for strict adherence by its members to a code of ethics and conduct in order to bring about a high level of investor confidence and a continuation of those essential services required by our nation's capital-raising industries. A code of ethics and rules governing employee conduct is no less important. In fact, the rules pertaining to employees of a self-regulatory organization, such as the NASD, must go beyond those of the regulated in order that the integrity and credibility of the Association as well as its reputation for fair dealing is not compromised.

More specifically, in view of the effect which the Association's actions frequently have upon the securities industry and the general public, it is important that employees maintain exceptionally high standards of honesty, integrity and impartiality in their conduct. It is also important that employees have a conscious awareness of the need to avoid situations which could result in actual misconduct, conflicts of interest or those most likely to raise an appearance of impropriety and to conduct themselves in their professional and personal relationships in a manner which commands the respect and confidence of both the securities industry and the public.

Finally, the Association is cognizant of its responsibility to its employees and the need to provide a guide for them to follow. This is particularly evident for an inexperienced, unseasoned employee who could unwittingly or unknowingly commit an indiscretion and place his career in jeopardy. These *Employee Guidelines* have been designed to prevent this from occurring and should be considered a help and not a hindrance in terms of an individual's activities.

For these reasons, employees should at all times abide by the standards of conduct set forth hereafter. Many areas of activity are treated specifically, others generally, but a short rule that could apply to all situations and be of great benefit in resolving questionable activities in an employee's mind is, "When in doubt, don't," or, at a minimum, ask your Department/District Director.

PART I

General Rules and Regulations

A. Employee Conduct

No employee of the Association shall:

1. Act in any Association matter in respect to which there exists a personal interest without the prior submission of a request to the Department/District Director, who shall record the reasons for approval or disapproval in writing and provide a copy to the Division Executive Vice President;
2. Engage directly or indirectly in any personal business transaction or private arrangement, including but not limited to securities transactions, for personal profit which accrues from or is based upon the employee's position, authority or upon confidential or other information not generally available to the public or that which the employee gains by reason of such position or authority;
3. Have direct or indirect personal, business or financial interests which conflict, or appear to conflict with the business, duties and responsibilities of the Association;
4. Act in any manner in respect to the business of the Association, whether or not specifically prohibited, which might result in:
 - a. giving or accepting preferential treatment to or from any member or individual;
 - b. impeding the expeditious processing of Association actions;
 - c. losing independence, impartiality or objectivity; or,
 - d. affecting adversely the confidence of the members of the public in the integrity or credibility of the Association;
5. Act on behalf of the Association in any capacity in any matter that, to the employee's knowledge, affects even indirectly any member or person outside the NASD with whom the employee is seeking, discussing or entertaining an offer for future employment except with the approval of the Department/District Director, who shall record the reasons for approval in writing and provide a copy to the Division Executive Vice President.
6. Engage in criminal, dishonest or any other conduct prejudicial to the Association; or
7. Engage directly or indirectly in any personal, business or financial transaction with a member or person associated with a member which is outside the scope of the customary business of the member without prior notification to the Department/District Director.

B. Confidentiality of Information

Due to the confidential nature of a large majority of the Association's business, it is extremely important that employees are cognizant of restrictions placed on disclosure of information. In this regard, no employee shall disclose to or discuss with any unauthorized person any information not generally available to the public unless prior approval is obtained from his immediate supervisor.

1. No employee may disclose non-public information concerning examinations, complaints, decisions, disciplinary action or economic data or other information contained on application forms on members or registered representatives except for those employees of the Association as may be

authorized by the President to disclose to the public in accordance with procedures established by the General Counsel's Office.¹

2. The transmission of information within the Association itself shall be on a need-to-know basis. This is especially true in respect to examinations and investigations either in process or completed. Merely working for the Association does not automatically entitle employees to such information. Such requests for information by persons who obviously have no need for it in the daily performance of their jobs shall be reported immediately to the Department/District Director and if an impropriety is determined, thereafter to the Division Executive Vice President.
3. Inquiries received from the news media shall be referred immediately to the NASD Corporate Communications Department, unless otherwise directed or required under the NASD's Media Relations Guidelines which became effective March 8, 1989. No one other than appropriate individuals in Corporate Communications or those individuals designated in the Media Relations Guidelines shall discuss Association business with the news media.
4. Any employee who is served with a subpoena or a legal pleading of any kind which relates to his employment with the Association and requires the employee's appearance or the disclosure of information or documents prepared and/or maintained by the Association shall immediately thereafter notify the General Counsel's Office and await instructions concerning compliance therewith from that office.
5. No employee shall testify in any proceeding in respect to securities or Association matters without prior notification to the Division Executive Vice President and subsequent approval of the General Counsel's Office.

C. Outside or Private Employment and Other Activities

1. No employee shall have outside or private employment or affiliation, or engage in activities, incompatible with concurrent employment by the Association. Incompatible activities include, but are not limited to:
 - a. employment or association with a registered broker-dealer, municipal securities broker or dealer, investment company or investment advisor;
 - b. outside employment which tends to impair the employee's mental or physical capabilities to perform his job duties with the Association in an acceptable manner; or,
 - c. legal, accounting, consulting, training or other activities regarding securities matters involving any broker-dealer, associated person or organization unless a waiver is granted pursuant to the provisions of paragraph C.3. below.
2. No employee shall engage in professional teaching, lecturing or writing activities in respect to securities matters, with or without compensation, unless a waiver is granted pursuant to the provisions of paragraph C.3. below. Any honoraria received in connection with such activity should be remitted to the Association.
3. The restrictions specified in paragraphs C.1.c. and C.2. may be waived by the Department/District Director or the Division Executive Vice President upon

¹See Resolution of the Board of Governors re: Release of Certain Information, dated May 1973, as amended September 1978 and January 1988 (Attachment C).

written request by the employee. Such a request shall include a full and complete description of the nature of the intended employment or other activity, including the teaching of courses, and a statement as to why it would not be inappropriate.

4. All employees shall notify their immediate supervisor of any contemplated outside temporary or part-time employment.
5. The employment by a registered broker-dealer, municipal securities broker or municipal securities dealer, investment company or investment advisor or employment directly or indirectly related to the issuance, sale or purchase of securities by a member of an employee's immediate family² shall be promptly reported to the employee's immediate supervisor.
6. No employee shall hold office in or be a director of any company without prior approval of the President of the Association unless such company is a not-for-profit partnership or corporate entity formed for athletic, civic, religious, political or social purposes. Requests for such approval shall be made in writing through the Department/District Director to the Division Executive Vice President.
7. If any employee is uncertain as to the application of these rules to a prospective employment situation or area of activity, before proceeding, he shall discuss such matters with his immediate supervisor who, in turn, shall apprise the Department/District Director of any situation which seemingly or actually conflicts with the requirements of this part.

D. Gifts and Gratuities

1. The solicitation of gifts or gratuities of any kind is prohibited.
2. The acceptance by an employee or a member of his immediate family, either directly or indirectly, of any cash, securities or other *valuable* gifts, gratuity, favor, entertainment, loan, service or other item from any member, person associated with a member or any person with whom the Association transacts business is prohibited.
3. If there is no reasonable likelihood or appearance that the employee will be improperly influenced in the performance of his duties to the Association, the following do not constitute inappropriate gifts:
 - a. normal business courtesies (lunch, dinner, a golf game or sporting event) involving no more than ordinary amenities;
 - b. token non-cash gifts of nominal value which in most situations should not exceed \$50.
4. All offers exceeding \$50 in value or cumulative offers from a single party exceeding \$50 in a year, whether accepted or rejected, must be recorded in a log maintained by the employee's supervisor.
5. The provisions of paragraph D do not apply: (a) when the circumstances make it clear and obvious that family relationships rather than the business of the persons concerned which are motivating factors; (b) when, on infrequent occasions, free food and refreshments of nominal value are offered in the ordinary course of a luncheon or dinner meeting or other meetings hosted by a regulatory or self-regulatory agency or any nationally recognized industry

² "Immediate family," for purposes of the *Employee Guidelines*, shall mean the employee's spouse, children, relatives or others living in the employee's immediate household to whose support the employee contributes.

group or organization where attendance is official and/or proper; (c) when unsolicited advertising or promotional material of nominal intrinsic value such as pens, pencils, note pads, calendars, etc. are offered; (d) when the employee's Department/District Director determines that an exception is warranted and appropriate in a particular situation and the Division Executive Vice President is appropriately notified; and, (e) when a Division Executive Vice President has specified in writing any exceptions that apply to specific functions within his Division.

E. Securities Transactions

This section applies to all transactions effected by or on behalf of an employee. This includes transactions for the accounts of other persons effected by the employee, directly or indirectly, under a power of attorney or otherwise. In addition, an employee is considered to have sufficient interest in the securities transactions of his spouse or unemancipated minor child³ or other member of his immediate household to whose support the employee contributes so that transactions effected by or on behalf of such persons must be reported and are subject to all the terms of this section.

1. No employee or member of an employee's immediate family shall purchase or sell or recommend the purchase or sale of securities based on information, not generally available to the public, which is gained in the course of conducting Association business.
2. No employee or member of an employee's immediate family shall knowingly purchase or sell a security at a price or commission which is more favorable than the price or commission afforded a similarly situated member of the general public.
3. No employee or member of an employee's immediate family shall directly or indirectly:
 - a. purchase any security during its initial or secondary public offering or distribution or within 30 calendar days of its offering date. This does not preclude the purchase of unit investment trusts, redeemable shares of registered investment companies, U.S. government securities, municipal debt instruments or variable contracts;
 - b. purchase or maintain a beneficial interest in any broker-dealer, registered investment adviser or Association member through ownership of securities or otherwise. An employee who wishes to purchase or maintain ownership of securities of a corporation which has a broker-dealer or registered investment adviser subsidiary or affiliate should make a written request of his Division Executive Vice President through his Department/District Director which sets forth the reasons for making the investment;
 - c. knowingly purchase or maintain a beneficial interest through ownership of securities or otherwise in any company with which the Association has a contract or a business relationship that represents a significant contribution to the business of such company. A list of such companies will be maintained by Internal Review and distributed periodically to all employees. Executive Vice Presidents will determine which companies should be restricted for employees of their respective divisions.

³This section shall not apply to securities transactions of a legally separated spouse living apart from the employee, including transactions for the benefit of a minor child, if the employee has no power to control and does not, in fact, advise or control with regard to such transactions.

- d. engage in excessive trading in any securities or commodities account;
 - e. purchase any low-priced security (selling under \$3 per share) except with the intention of holding such security for bona fide investment defined for purposes of this section to be a period of six months or longer;
 - f. sell any security purchased pursuant to paragraph E.3.e. above if held for a period of less than six months without first discussing the reasons for said sale with his Department/District Director; or,
 - g. participate in any venture capital investments with a broker-dealer or associated person.
4. In order to monitor employee transactions the following procedures shall be followed:
- a. no later than January 31 of each year each employee shall submit to the Department/District Director, who shall forward to the Division Executive Vice President, an "Employee Account Report Form" (Attachment B) which shall identify the existence of any securities and/or commodities account(s) as of January 1 that is owned by the employee, a member of his immediate family or in which a beneficial interest is maintained. In the event that a blind trust is maintained on behalf of an employee or member of his immediate family, the employee shall request the fiduciary handling the account to confirm the existence of such trust in writing to the employee's Department/District Director;
 - b. each employee shall report on an "Employee Account Report Form" the opening of any new securities or commodities account(s) specified in paragraph E.4.a. above to the Department/District Director or Division Executive Vice President within five business days;
 - c. duplicate confirmation of transactions and monthly or quarterly statements (depending upon the broker-dealer's practice) shall be furnished as to each account specified in paragraph E.4.a. above by the broker-dealer handling the account to the Department/District Directors; to the Internal Review Department for Division Executive, Senior and Vice Presidents and Department/District Directors; and to the Treasurer for the President, at the same time as sent to the employee. Notification to the broker-dealer of this requirement shall be made in conformity with Attachment D. These reporting requirements do not apply to confirmations or statements of accounts furnished by a registered investment company or its designated agent. Likewise, they do not pertain to blind trusts established on behalf of an employee or member of his immediate family;
 - d. prior approval shall be requested in writing by an employee and obtained of an employee's Division Executive Vice President for the following types of accounts:
 - 1. securities options or derivative products and financial instruments;
 - 2. commodities futures;

3. commodities options; and,
4. margin.

For an employee who desires to trade options, his request for approval should include a clear and concise explanation of the specific type of activity or strategy contemplated, the name of the broker-dealer to carry the account, the dollar amount to be committed to options trading, and an acknowledgment that, if this amount is dissipated, a subsequent request to continue dealing in options, specifying a new dollar commitment, will be submitted prior to the resumption of such trading.

- e. The writing of "naked" options by employees of the Association is prohibited;
- f. prior approval shall be requested and obtained of an employee's Division Executive Vice President in respect to any participation in a venture capital investment other than those specifically prohibited above;
- g. all information concerning employees' accounts and transactions effected therein shall be maintained for two years on a confidential basis and secured to prevent access to such records by unauthorized personnel; and,
- h. all records relating to employees' securities and commodities transactions shall be maintained as follows: by the Department/District Director for all Department/District employees, respectively; by the Internal Review Department for all Executive, Senior and Vice Presidents and Department/District Directors; and by the Treasurer on behalf of the Chairman of the Management Compensation/Development Committee for the President.

F. Other Matters

1. Any employee assigned or otherwise working on matters in which he or a member of his immediate family has had past or current professional, personal or financial relationships shall promptly advise his immediate supervisor of such fact.
2. Any correspondence, personal or otherwise, by an employee to an individual or organization outside of the Association which directly or indirectly could render an appearance of establishing, amending or rescinding existing Association policies or procedures is prohibited unless prior authorization is received from the Division Executive Vice President.
3. Any additional guidelines for employee conduct initiated by a Department/District Director shall receive the approval of the Division Executive Vice President prior to implementation.
4. Any employee who obtains knowledge of possible violations of these *Employee Guidelines* by another Association employee shall report such information to his immediate supervisor, who shall thereupon report such to his Department/District Director.
5. All matters of employee impropriety or alleged impropriety shall be promptly reported by the Department/District Director in writing to the Division Executive Vice President, who shall refer the matter to the Internal Review Department, if deemed appropriate.
6. All matters involving potential litigants must be referred to and discussed with the Office of the General Counsel before responding.

PART II

Specific Rules and Regulations

Due to the confidential nature of reports, financial data and other information received, produced or obtained by certain Departments of the Association and the District Offices, the following additional guidelines have been established to delineate the responsibilities and prohibitions relating to the employees of such Departments and District Offices.

Compliance Division

1. No employee or member of an employee's immediate family shall open a securities account with any NASD broker-dealer that is subject to Tier I or Tier II financial or operational surveillance. This information is incorporated in the monthly Special Surveillance list prepared by Financial Responsibility. Additionally, with regard to Tier III firms, written approval must be obtained from the District Director prior to opening a securities account with a firm whose main office is within the jurisdiction of that District which is subject to Tier III reporting.
2. Special care is to be exercised with regard to lunches, dinners and gifts and gratuities of any amount. All such offers must be rejected if known to be from firms or employees of firms: (a) which are subject to Tier I or II financial or operations surveillance; (b) whose self-liquidation is being monitored by the Association; and, (c) which are the subject of formal DBCC disciplinary proceedings. Careful consideration should be given to accepting any such offers from firms on other levels of closer-than-normal surveillance, especially those which are experiencing potentially serious financial or operational problems.
3. In connection with Part I, paragraph D above, all offers of any kind, whether accepted or rejected, must be recorded in a "Gifts and Gratuities Log" (see Attachment E), which shall be maintained by each District and Department. Supervisors shall maintain these logs for their examiners; for all other District/Department personnel, these logs shall be maintained by the individual's immediate supervisor. All entries to the log shall be made promptly by the employee receiving the offer. In all cases, appropriate supervisory personnel are required to review the logs at least quarterly and to evidence such review in writing. District Directors and Department Heads also must review the logs at least quarterly and evidence the review in writing. Within 30 days following the end of the calendar year, District Directors and Department Heads shall forward copies of those logs to the Division Executive Vice President. All District, Deputy, Associate and Assistant Directors and Department Heads must submit their logs to the Executive Vice President, Compliance Division, by the 15th business day following the end of each calendar quarter.
4. Special care must be exercised by employees when discussing investigations, members, problem situations or other sensitive information in a public place, such as a restaurant or elevator. As mentioned elsewhere in these guidelines, such discussions are prohibited entirely if there are individuals present who are not employed by the NASD. However, even when such discussions involve only NASD employees, employees must be extremely discreet to avoid confidential information inadvertently overheard by outsiders.

A. District Office and Anti-Fraud Personnel

1. Examinations of members shall be performed on a surprise basis only except for bona fide reasons upon specific determination by the Department/District Director or his designee.
2. Without the authorization of the Department/District Director, who shall record his reasons for approval in writing, no employee shall knowingly participate in an examination of a member (or its clearing firm) in any case in which:
 - a. he or a member of his immediate family maintains or has an interest in any securities or commodities accounts with that member;
 - b. he or a member of his immediate family has now, or in the past three years had, any business relationship with that member or any employee thereof;
 - c. he has a close personal relationship with the member or any employee thereof;
 - d. such member clears for a member where the employee or a member of his immediate family maintains a securities or commodities account;
 - e. such member makes a market in the securities being held by the employee or a member of his immediate family; or
 - f. he or a member of his immediate family was employed within the preceding three years by that member.

B. Market Surveillance Department

1. No employee in the Market Surveillance Department shall:
 - a. purchase any security except with the intention of holding such security for a period of six months or more;
 - b. conduct any review or investigation involving any security which is owned by him, or to his knowledge, by a member of his immediate family;
 - c. purchase, sell or recommend the purchase or sale of any security on the basis of non-public information or on the basis of information obtained in the course of conducting Market Surveillance business;
 - d. utilize market surveillance systems in a manner contrary to the regulatory and/or surveillance purposes for which they were designed; or,
 - e. disclose his individually assigned password to any other employee or outside person, directly or indirectly, nor grant access to any person not authorized to use the system.
2. Any decision on the part of any employee in the Market Surveillance Department to sell a security owned by him for a period of less than six months must be discussed in advance with the Department Vice President or Director.
3. No employee shall without prior approval disclose to or discuss with anyone outside of the Department any material non-public information that is not in accordance with the normal functions and responsibilities of his position.

Law and Regulatory Policy Division

A. Advertising Department Personnel

1. Unless prior approval of the Department Director has been obtained, advertising and sales literature filed by a mutual fund underwriter shall not be reviewed or commented upon by any employee who owns shares of a fund distributed by that member. An exception is granted for the investment company currently managing the NASD Savings Plus Plan.
2. Advertising and sales literature filed by a member shall not be reviewed by any employee who maintains an account with the member or who has relatives employed by that member.
3. Advertising and sales literature, including research reports, regarding a specific security shall not be reviewed by personnel who own such security.

B. Arbitration Department

This section applies to employees of the Arbitration Department who may, in the course of conducting Association business, engage in activity which might result in actual or apparent misconduct or conflicts of interest.

1. Unless authorized by the Director, no employee shall:
 - a. accept meals, gifts or gratuities from attorneys or other parties to a pending arbitration proceeding;
 - b. disclose to third parties any information relative to pending or closed NASD arbitration matters, including but not limited to the names of arbitrators that are to be used in specific matters, that is outside the scope of that which is regular and necessary for the employee's position.
 - c. act on behalf of the Association in any matter that affects even indirectly any member or entity outside the NASD that employs a member of the employee's immediate family; or,
 - d. act on behalf of the Association in any matter that affects even indirectly any member or entity outside the NASD with which the employee was previously employed within the last two years.

C. Corporate Financing Department Personnel

1. No employee shall:
 - a. review all or a substantial portion of the public offerings filed for review by a specific member firm; or
 - b. make available to any unauthorized person information regarding a proposed public offering of a company's securities which is not public information available in the prospectus or other supplemental sales literature or advertising material.
2. Any public offering filed for review shall not be reviewed or commented upon by personnel who own securities of the registrant or any sponsor or management company of the registrant.

Marketing & Market Operations Division

A. NASDAQ Qualifications

1. Use of Terminals and NASDAQ Data
 - a. Use of the NASDAQ terminals and the NASDAQ system regulatory reports is restricted to authorized personnel for

official NASD business.

- b. The regulatory reports and NASDAQ files shall be retained in a secure location and the terminals locked when not in use.

Administration Division

A. Membership Department

1. No employee shall disclose information concerning member firm examinations, complaints, decisions or disciplinary actions or information related to any unauthorized person, nor may information relating thereto on application forms of members or registered personnel be disclosed, except for those employees of the Department who have been authorized by the Division Executive Vice President through the Department Director to disclose to the public in accordance with procedures established by the General Counsel's Office, the following:
 - a. the names of those members with which a person who is or has been associated with a member has been employed and the dates of such employment(s);
 - b. all final disciplinary actions resulting in the imposition of a censure and/or monetary sanction and/or a suspension or expulsion upon the member or person associated with the member taken by the Association or other self-regulatory organizations, the Securities and Exchange Commission or any other federal agency authorized to discipline broker-dealers, commodity brokers or investment advisers and state securities administrators or other duly authorized state agencies; and
 - c. all criminal convictions.
2. The NASD provides data processing services to the Federal Reserve Board and the Office of the Comptroller of the Currency. Such services involve the receipt, data capture and dissemination of information about the personal and professional qualifications of named individuals to act as municipal securities principals or representatives. This information is contained on Form MSD-4 and/or MSD-5. No employee shall disclose information on these forms or computer printouts containing this information to any unauthorized persons.

B. Qualifications Department

1. Except with the authorization of the Vice President, Qualifications or the Division Executive Vice President, and as provided in Part I B.1. hereof, no employee shall disclose the specific contents or provide hard copy of any qualification examination administered or graded by the Association to any unauthorized person.
2. The above paragraph does not apply to information supplied to any person regarding the general subject matter contents of examinations administered by the Association, which information is publicly available in study outlines or other training material published by the Association or other regulatory organizations for which the Association administers qualification examinations.
3. Except with the prior approval of the Vice President, Qualifications or the Division Executive Vice President, no employee shall attend classes of training schools which provide instructional guidance for member-firm employees preparing to take securities industry qualifications examinations.

Attachment A
Statement on Employee Guidelines

Name of Employee _____ Position _____

Division/Department _____ Date of Employment _____

I have read, understand and agree to comply with the requirements contained in the *Employee Guidelines*, Part I and, if applicable, Part II, as amended. I further agree to promptly notify my supervisor of any situation coming within the purview of these *Employee Guidelines* and to provide appropriate written notice as required therein.

Employee Signature _____ Date _____

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Attachment C

Resolution Regarding Release Of Certain Information

WHEREAS, it is the intent of the Board of Governors that certain information concerning (1) the disciplinary and employment histories and criminal records of persons associated with members and (2) the disciplinary histories of members, all as set forth on the records of the Central Registration Depository system, be provided to the public, be it hereby

RESOLVED, that such employees of the Association as may be authorized by the President may disclose to the public, in accordance with procedures to be established by the Association's Office of the General Counsel, the following information:

- (a) the names of those members with which a person who is or has been associated with a member has been employed and the dates of such employment(s);
- (b) all final disciplinary actions resulting in the imposition of a censure and/or monetary sanction and/or a suspension or expulsion upon the member or person associated with the member taken by:
 - (i) the Association or other self-regulatory organizations;
 - (ii) the Securities and Exchange Commission, the Commodity Futures Trading Commission, or any other federal agency authorized to discipline broker-dealers, commodity brokers, or investment advisers; and
 - (iii) state securities administrators or other duly authorized state agencies; and
- (c) all criminal convictions.

Attachment D

Date:

Name of Member

Address

RE: Account No. _____

Name _____

Address _____

Dear Sir:

NASD policy requires that all employees arrange with their brokers to have copies of confirmations and statements of account sent to the NASD at the same time as sent to the employee. In the case of the referenced account, these copies should be stamped "personal" or "confidential" and sent to the attention of:

(Department/District Director or Internal Review Department) NASD

(Street Address)

(City, State, ZIP)

Please acknowledge receipt of this request and signify your intention to comply with its requirements on the attached copy of this letter. In this regard, you are requested to forward such acknowledgment to the attention of the NASD official referenced above. Thank you for your cooperation.

Very truly yours,

(Signature of Employee)

Enclosure

cc: Mr./Ms. _____

(Department/District Director or Internal Review Department)

We acknowledge receipt of the above instructions and will comply.

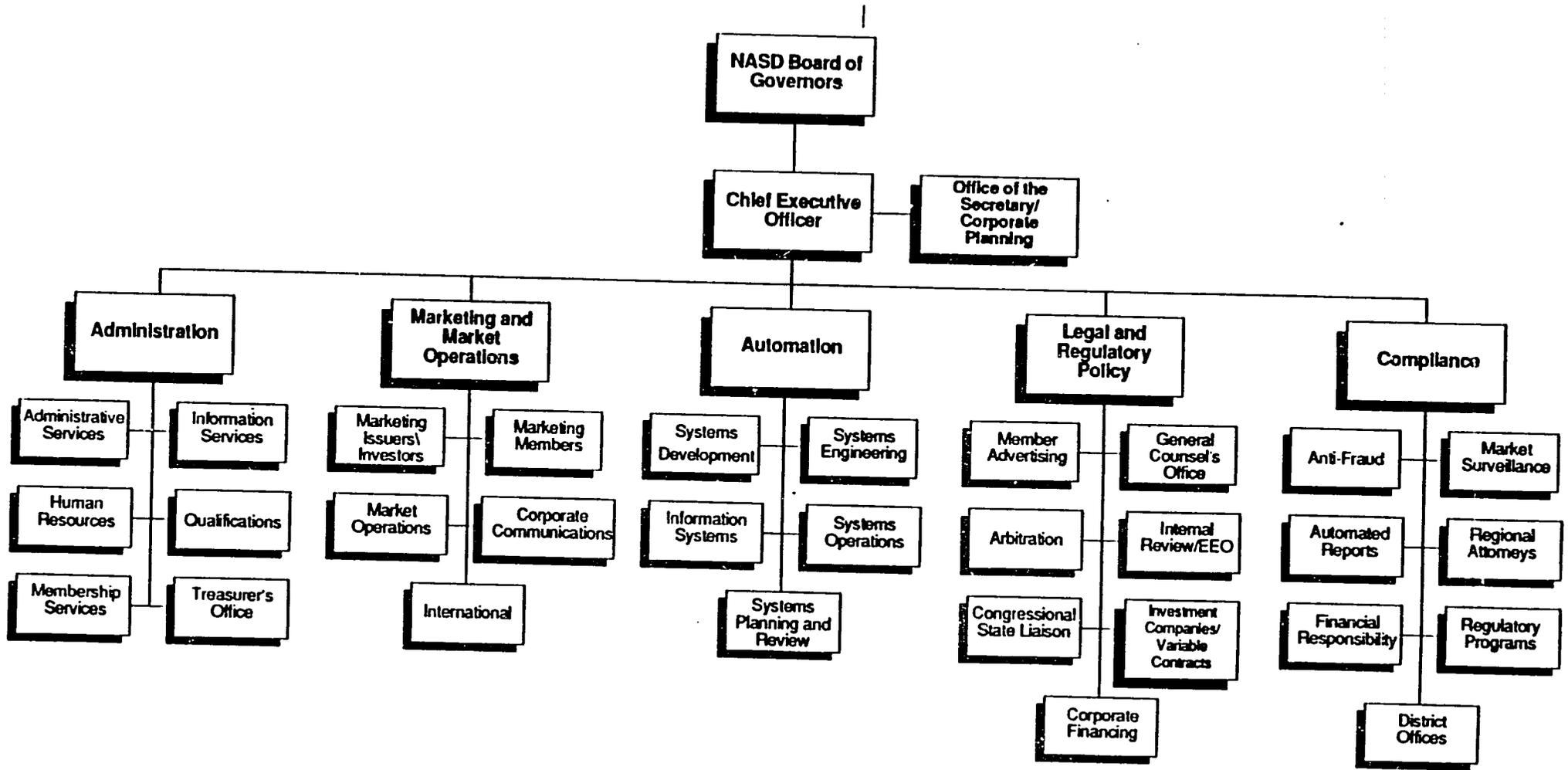
Firm Name: _____

By: _____

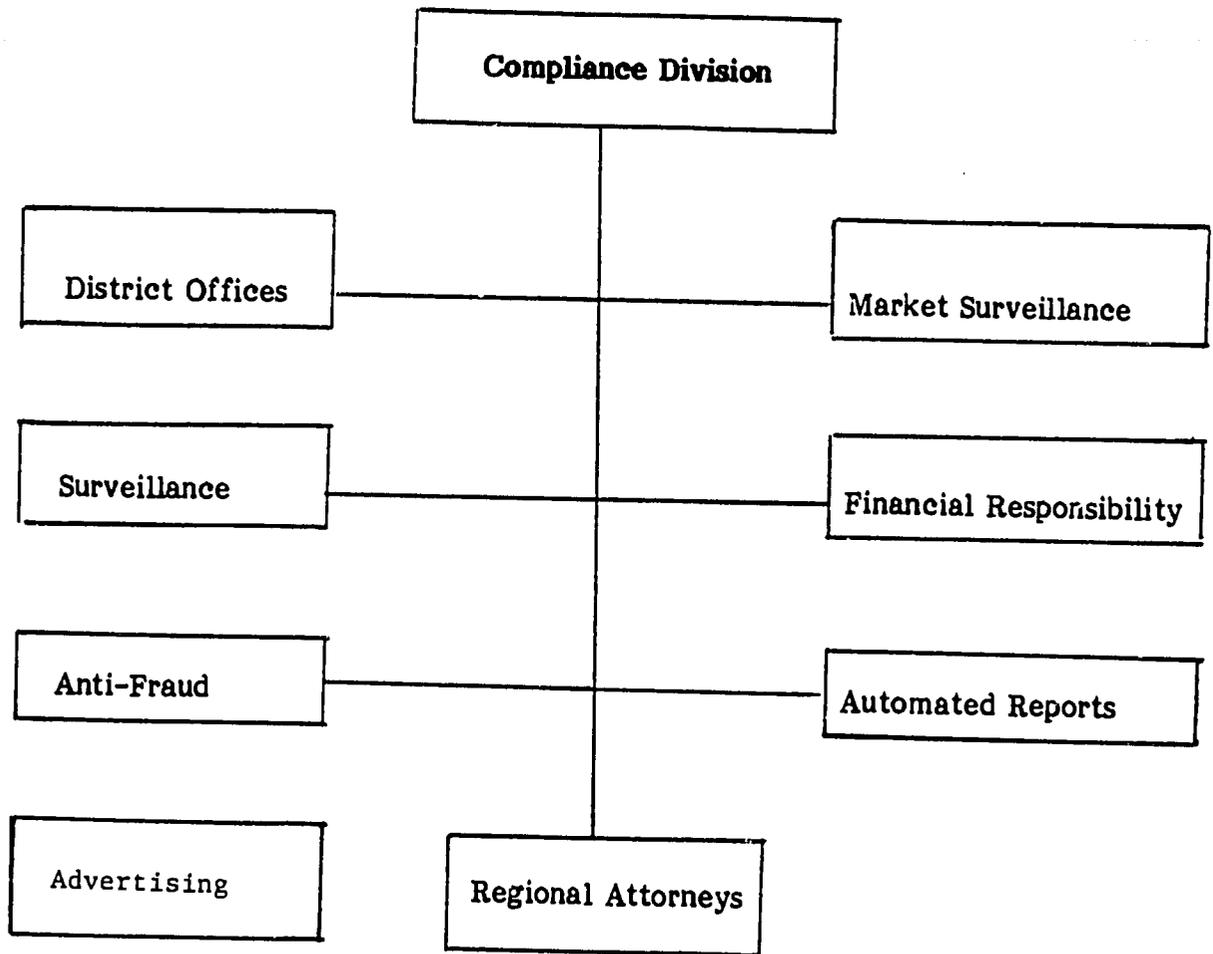
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Organization Chart

National Association of Securities Dealers, Inc.



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Summary of Financial Requirements for Initial Listing

Nasdaq Market

Total Assets	\$4 million
Total Stockholders Equity	\$2 million
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent ¹	Yes
Public Float (Shares) ²	100,000
Market Value of Public Float	\$1 million
Shareholders	300
Minimum Bid Price	\$3
Number of Market Makers	2

¹A temporary, automatic exemption exists for initial public offerings.

²Public float is defined as shares that are not "held directly or indirectly by any officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding . . ."

Nasdaq National Market

	Alternative 1	Alternative 2
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent	Yes	Yes
Net Tangible Assets ¹	\$4 million	\$12 million
Net income (in latest fiscal year or 2 of last 3 fiscal years)	\$400,000	N/A
Pretax Income (in latest fiscal year or 2 of last 3 fiscal years)	\$750,000	N/A
Public Float (Shares) ²	500,000	1 million
Operating History	N/A	3 years
Market Value of Float	\$3 million	\$15 million
Minimum Bid	\$5	\$3
Shareholders		
— if between 0.5 and 1 million shares publicly held	800	N/A
— if more than 1 million shares publicly held	400	N/A
— if more than 0.5 million shares held and average daily volume in excess of 2,000 shares	400	N/A
Number of Market Makers	2	2

¹Net Tangible Assets means total assets (excluding goodwill) minus total liabilities.

²Public float is defined as shares that are not "held directly or indirectly by any officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding . . ."

COMPARISON OF LISTING CRITERIA
NASDAQ NATIONAL MARKET, NYSE, AMEX, AMEX ECM, AND REGULAR NASDAQ

	Nasdaq National Market Alt. 1	Nasdaq National Market Alt. 2	NYSE	AMEX Alt. 1	AMEX Alt. 2	ECM (Non-Nasdaq Companies)	ECM (Companies Presently Traded in Nasdaq)	Regular Nasdaq
Total Assets	N/A	N/A	N/A	N/A	N/A	\$4,000,000 ⁴	\$2,000,000	\$4,000,000
Net Tangible Assets ¹	\$4,000,000	\$12,000,000	\$18,000,000	None	None	None	None	None
Stockholders Equity	See Footnote 1		None	\$4,000,000	\$4,000,000	\$2,000,000	\$1,000,000 ⁵	\$2,000,000
Public Float	500,000	1,000,000	1,100,000	500,000	500,000	250,000 ⁴	250,000	100,000
Pre-Tax Income	\$750,000	None	\$2,500,000 ²	\$750,000	None	None	None	None
Net Income	\$400,000	None	None	None	None	None	None	None
Shareholders ³	800/400	400	2,000	800/400	800/400	300	300	300
Market Value of Float	\$3,000,000	\$15,000,000	\$18,000,000	\$3,000,000	\$15,000,000	None	None	\$1,000,000
Total Market Value	N/A	N/A	N/A	N/A	N/A	\$2,500,000 ⁴	\$2,500,000	N/A
Bid Price	\$5	\$3	None	\$3	None	\$3 ⁴	\$1 ⁵	\$3
Market Makers	2	2	N/A	N/A	N/A	N/A	N/A	2
Operating History	N/A	3 years	N/A	3 years	N/A	None	None	None

¹ Net Tangible Assets shall mean total assets (excluding goodwill) minus total liabilities.

² Pre-tax earnings of \$2 million in each of preceding two years are also required.

³ The issuer has a minimum of 800 shareholders if the issuer has between 500,000 and 1 million shares publicly held, or a minimum of 400 shareholders if the issuer has either (i) over 1 million shares publicly held or (ii) over 500,000 shares publicly held and average daily trading volume in excess of 2,000 shares per day for the six months preceding the date of application.

⁴ The ECM permits companies to list with \$3 million in total assets and only a \$2 price per share if the public float is 400,000 shares and the total market capitalization is \$10 million.

⁵ The ECM permits companies to list with a price of less than \$1 per share if they have equity of \$2 million.

Nasdaq Market Application

THE NASDAQ STOCK MARKET

NASDAQ

Nasdaq Market Check List

PROCEDURE	RESPONSIBLE PARTY	TIMING	MAILING ADDRESS
Submit application for inclusion.	Issuer or Issuer's Counsel (Application must be signed by issuer and may not be submitted by Underwriter or Underwriter's Counsel.)	Concurrent to filing of registration statement with SEC or other regulatory authority; no later than four weeks prior to anticipated effective date.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Market Listing Qualifications
Submit entry fee payable to The National Association of Securities Dealers, Inc. An estimated entry fee will be calculated upon request.	Issuer or Issuer's Counsel	Concurrent to filing application for inclusion.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Market Listing Qualifications
Submit copy of any amendments to registration statement.	Issuer or Issuer's Counsel	Concurrent to filing with SEC or other regulatory authority.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Market Listing Qualifications
Notify Nasdaq of anticipated SEC approval of registration statement.	Issuer's Counsel or Underwriter	At least three business days before the anticipated effective date of offering.	Telephone contact with Market Listing Analyst (see cover letter)
File stabilization letter, if necessary, indicating whether bid will be with or without penalty.	Underwriter	At least three business days before the effective date of offering.	The Nasdaq Stock Market Financial Center 33 Whitehall Street New York, NY 10004 Attn: Nasdaq Operations (212) 858-4235
Monitor Nasdaq News Screen for security addition and register as market maker.	Underwriter	Generally one business day before the anticipated trading date.	N/A
Notify both Nasdaq offices to release security for trading.	Issuer or Issuer's Counsel	On the effective date of the registration statement.	Telephone contact with Market Listing Analyst (see cover letter) and Nasdaq Operations in New York at (212) 858-4235
Send three copies of final registration statement or prospectus.	Issuer or Issuer's Counsel	Within five days after registration statement is declared effective.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Market Listing Qualifications

FACSIMILE NUMBERS

Business Development (202) 728-8147
Nasdaq Operations (212) 509-5799

Market Listing Qualifications (202) 785-1804

Nasdaq Market Application for Initial Inclusion

Part I

A. General Corporate Information:

COMPLETE CORPORATE NAME _____

ADDRESS OF PRINCIPAL EXECUTIVE OFFICES _____

TELEPHONE _____

STATE OF INCORPORATION _____

DATE OF INCORPORATION _____

I.R.S. EMPLOYER IDENTIFICATION NUMBER _____

SEC FILE NUMBER _____

STANDARD INDUSTRIAL CLASSIFICATION (SIC) CODE _____

B. Corporate Contacts:

Please list the name and full title of individual(s) to be designated as corporate contact(s) in the following areas:

CHIEF EXECUTIVE OFFICER _____

SENIOR FINANCIAL OFFICER _____

INVESTOR RELATIONS OFFICER _____

OTHER _____

OTHER _____

Please indicate where the address for a designated contact person is different than the address of principal executive offices.

C. Investment Banker Contacts:

Please list the name, full title, firm name, address, and telephone number of the investment banker for applicant.

INVESTMENT BANKER _____

TITLE _____

FIRM NAME _____

TELEPHONE _____

ADDRESS _____

Part II

A. Security Information:

1. Issue(s) to be listed:

Security Class

Issue Description*

Security Class	Issue Description*
_____	_____
_____	_____
_____	_____
_____	_____

*Include par or stated value, warrant expiration date, components of units, conversion ratio for American Depositary Receipts, face amount and interest rate on convertible debt, and other relevant information.

2. List three (3) proposed trading symbols in order of preference:

All choices must be composed of four alpha characters.

3. Does the company have any class of common stock or equity security entitling the holder(s) to differential voting rights, dividend payments, or other preferences?

Yes No

If "yes," please provide a complete description of preferences. _____

4. Is this issue also listed on a stock exchange?

Yes No

If "yes," identify the exchange(s). _____

5. Is there an existing public market for the issue(s) covered by this application?

Yes No

If "yes," please complete Part II B and Part II C. If "no," please complete the remainder of this section and Part II C.

6. Method by which securities are being offered:

Initial Public Offering

Exchange Offer

Secondary Offering

Distribution

Merger

Conversion

Reorganization

Other (please specify): _____

7. Type of offering:

Firm Commitment

Best Efforts - all or none

Best Efforts - minimum/maximum

Other (please specify): _____

8. Expected effective date of registration statement, if applicable: _____

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9. Expected closing date, if applicable: _____

10. Number of business days required for delivery of stock certificates to the members of the underwriting group for distribution: _____. If this schedule changes, please notify your Listing Analyst immediately.

11. Will the stock certificates contain any restrictive legends?

Yes No

If "yes," please describe: _____

12. Please indicate the number of beneficial shareholders expected after the offering: _____

B. Seasoned Security Information:

1. Please designate the appropriate registration category for each issue:

- 15(d) of '34 Act Investment Act of 1940
 12(b) of '34 Act Other (please specify): _____
 12(g) of '34 Act

A copy of the appropriate document evidencing registration must accompany this application.

2. Has the company filed a Form 10 registration statement, or equivalent document, within the past 12 months, for purposes of registering a class of securities under section 12(g) of the '34 Act with the SEC or other appropriate regulatory authority?

Yes No

If "yes," please provide a copy of the complete filing including any comments from the SEC or appropriate regulatory authority and the company's responses thereto.

3. Number of beneficial shareholders: _____ Date: _____

Please attach confirmation from transfer agent, proxy solicitation firm, or other independent source.

C. CUSIP Number and Transfer Agent:

1. Please list the CUSIP* number for each issue for which application is being made:

Issue	CUSIP Number
_____	_____
_____	_____
_____	_____

*CUSIP Service Bureau can be reached at (212) 208-8346.

If CUSIP number(s) is (are) unavailable, has application been made to the CUSIP Service Bureau?

Yes No

2. Please list the name and address of transfer agent:

NAME _____

ADDRESS _____

3. For American Depositary Receipts (ADRs) list the name and address of Depositary Bank:

NAME _____

ADDRESS _____

Please indicate whether the ADR is issued on sponsored or unsponsored basis.

() Sponsored () Unsponsored

Part III

A. Other:

The fact that an applicant may meet Nasdaq numerical guidelines does not necessarily mean that its application will be approved. In connection with the review of any application, the NASD reserves the right to request additional information or documentation, public or non-public, deemed necessary to make a determination regarding a security's initial inclusion, including, but not limited to any material provided for or received from the Securities and Exchange Commission or other appropriate regulatory authority.

B. Corporate Affirmations:

In consideration for the acceptance of _____ 's
COMPANY NAME

application for listing on the Nasdaq Market, it hereby certifies: At the time of its inclusion it is in compliance with, and will continue to comply with, the requirements for inclusion in the Nasdaq Market as set forth in Schedule D of the NASD By-Laws; The company agrees to forward to Nasdaq three (3) copies of all reports and other information it is required to file with the Securities and Exchange Commission or other regulatory authorities; The company acknowledges and agrees to pay, in accordance with the prescribed terms, any and all fees associated with its inclusion in the Nasdaq Market.

I, _____, as _____
NAME OF INDIVIDUAL TITLE

of _____,
COMPANY NAME

do hereby certify, to the best of my knowledge and belief, that the information contained in this application is true and correct as of _____, 19_____, and that I have read and understand the conditions of this application.

Signature of Corporate Officer _____
TITLE DATE

CORPORATE SEAL
(Optional)

Addendum: Nasdaq Market Application Amendment

(This form to be filed by current Nasdaq listed company seeking to list an additional class of security(ies) on Nasdaq.)

Part I

General Corporate Information:

COMPLETE CORPORATE NAME _____

ADDRESS OF PRINCIPAL EXECUTIVE OFFICES _____

TELEPHONE _____

NASDAQ SYMBOL(S) _____

Part II:

A. Security Information:

1. Issue(s) to be listed:

Security Class

Issue Description*

*Include par or stated value, warrant expiration date, components of units, conversion ratio for American Depositary Receipts, face amount and interest rate on convertible debt, and other relevant information.

2. Does the company have any class of common stock or equity security entitling the holder(s) to differential voting rights, dividend payments, or other preferences?

Yes No

If "yes," please provide a complete description of preferences. _____

3. Is there an existing public market for the issue(s) covered by this application?

Yes No

If "yes," please complete Part II B and Part II C. If "no," please complete the remainder of this section and Part II C.

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4. Method by which securities are being offered:

- Initial Public Offering Exchange Offer
 Secondary Offering Distribution
 Merger Conversion
 Reorganization Other (please specify): _____

5. Type of offering:

- Firm Commitment Best Efforts - all or none
 Best Efforts - minimum/maximum Other (please specify): _____

6. Expected effective date of registration statement, if applicable: _____

7. Expected closing date, if applicable: _____

8. Number of business days required for delivery of stock certificates to the members of the underwriting group for distribution: _____. If this schedule changes, please notify your Listing Analyst immediately.

9. Will the stock certificates contain any restrictive legends?

- Yes No

If "yes," please describe: _____

10. Please indicate the estimated number of beneficial shareholders expected after the offering: _____

B. Seasoned Security Information:

1. Please designate the appropriate registration category for each issue:

- 15(d) of '34 Act Investment Act of 1940
 12(b) of '34 Act Other (please specify): _____
 12(g) of '34 Act

A copy of the appropriate document evidencing registration must accompany this application.

2. Has the company filed a Form 10 registration statement, or equivalent document, within the past 12 months, for purposes of registering a class of securities under section 12(g) of the '34 Act with the SEC or other appropriate regulatory authority?

- Yes No

If "yes," please provide a copy of the complete filing including any comments from the SEC or appropriate regulatory authority and the company's responses thereto.

3. Number of beneficial shareholders: _____ Date: _____

Please attach confirmation from transfer agent, proxy solicitation firm, or other independent source.

C. CUSIP Number and Transfer Agent:

1. Please list the CUSIP* number for each issue for which application is being made:

Issue	CUSIP Number
_____	_____
_____	_____
_____	_____

*CUSIP Service Bureau can be reached at (212) 208-8346.

If CUSIP number(s) is (are) unavailable, has application been made to the CUSIP Service Bureau?

Yes No

2. Please list the name and address of transfer agent:

NAME _____

ADDRESS _____

3. For American Depositary Receipts (ADRs) list the name and address of Depositary Bank:

NAME _____

ADDRESS _____

Please indicate whether the ADR is issued on sponsored or unsponsored basis.

Sponsored Unsponsored

Part III

A. Other:

The fact that an applicant may meet Nasdaq numerical guidelines does not necessarily mean that its application will be approved. In connection with the review of any application, the NASD reserves the right to request additional information or documentation, public or non-public, deemed necessary to make a determination regarding a security's initial inclusion, including, but not limited to any material provided for or received from the Securities and Exchange Commission or other appropriate regulatory authority.

B. Corporate Affirmations:

In consideration for the acceptance of _____ 's
COMPANY NAME

amendment to its previous application for listing on the Nasdaq Market, it hereby certifies: At the time of its inclusion it is in compliance with, and will continue to comply with, the requirements for inclusion in the Nasdaq Market as set forth in Schedule D of the NASD By-Laws; The company agrees to forward to Nasdaq three (3) copies of all reports and other information it is required to file with the Securities and Exchange Commission or other regulatory

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authorities; The company acknowledges and agrees to pay, in accordance with the prescribed terms, any and all fees associated with its inclusion in the Nasdaq Market.

I, _____, as _____

NAME OF INDIVIDUAL

TITLE

of _____,

COMPANY NAME

do hereby certify, to the best of my knowledge and belief, that the information contained in this application is true and correct as of _____, 19_____, and that I have read and understand the conditions of this application.

Signature of Corporate Officer _____

TITLE

DATE

CORPORATE SEAL
(Optional)

THE NASDAQ STOCK MARKET™
NASDAQ

Nasdaq National Market Check List

PROCEDURE	RESPONSIBLE PARTY	TIMING	MAILING ADDRESS
Submit application for inclusion. Application includes three copies of registration statement.	Issuer or Issuer's Counsel (Application must be signed by Issuer and may not be submitted by Underwriter or Underwriter's Counsel)	Applications can be submitted at any time; pre-approvals can be issued on draft registration materials. Application should be made no later than four weeks prior to effective date.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Business Development
Submit two copies of registration statement with Nasdaq in New York	Issuer or Issuer's Counsel	Concurrent to filing of application with Business Development in Washington, D.C.	The Nasdaq Stock Market Financial Center 33 Whitehall Street New York, NY 10004 Attn: S. Brian Wilson
Submit entry fee payable to The National Association of Securities Dealers, Inc. An estimated entry fee will be calculated by your Business Development Representative upon request.	Issuer or Issuer's Counsel	Concurrent to filing application for inclusion.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Business Development
Submit three copies of any amendments to registration statement.	Issuer or Issuer's Counsel	Concurrent to filing with SEC or other regulatory authority.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Business Development
Submit copy of Form 8-A that has been filed with the SEC.	Issuer or Issuer's Counsel	Concurrent to filing with SEC.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Business Development
Submit copy of letter to SEC requesting that Form 8-A effectiveness be accelerated to be simultaneous or concurrent with the effectiveness of the 1933 Act registration statement. Inclusion of language such as "or as soon as practicable thereafter" is not acceptable.	Issuer or Issuer's Counsel	Concurrent to filing with SEC.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Business Development
File commitment letter concurring with company's request for National Market designation on first day of Nasdaq trading and the recommended SOES Execution Level (1,000, 500, or 200 shares).	Underwriter	Concurrent with or following submission of Nasdaq National Market Application and Listing Agreement, but no later than 10 business days prior to first day of trading.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Business Development

Nasdaq National Market Application for Initial Inclusion

Part I

A. General Corporate Information:

COMPLETE CORPORATE NAME

ADDRESS OF PRINCIPAL EXECUTIVE OFFICES

TELEPHONE

STATE OF INCORPORATION

DATE OF INCORPORATION

I.R.S. EMPLOYER IDENTIFICATION NUMBER

SEC FILE NUMBER

STANDARD INDUSTRIAL CLASSIFICATION (SIC) CODE

B. Corporate Contacts:

Please list the name and full title of individual(s) to be designated as corporate contact(s) in the following areas:

CHIEF EXECUTIVE OFFICER

SENIOR FINANCIAL OFFICER

INVESTOR RELATIONS OFFICER

OTHER

OTHER

Please indicate where the address for a designated contact person is different than the address of principal executive offices.

C. Investment Banker Contacts:

Please list the name, full title, firm name, address, and telephone number of the investment bankers in the underwriting group.

INVESTMENT BANKER

TITLE

FIRM NAME

TELEPHONE

ADDRESS

INVESTMENT BANKER

TITLE

FIRM NAME

TELEPHONE

ADDRESS

Part II

A. Security Information:

1. Issue(s) to be listed:

Security Class

Issue Description*

Security Class	Issue Description*
_____	_____
_____	_____
_____	_____
_____	_____

*Include par or stated value, warrant expiration date, conversion ratio for American Depositary Receipts, and other relevant information.

2. List three (3) proposed trading symbols in order of preference:

All choices must be composed of four alpha characters. If already assigned a Nasdaq symbol, list that symbol first.

3. Does the company have any class of common stock or equity security entitling the holder(s) to differential voting rights, dividend payments, or other preferences?

Yes No

If "yes," please provide a complete description of preferences. _____

4. Is this issue also listed on a stock exchange?

Yes No

If "yes," identify the exchange(s). _____

5. Is there an existing public market for the issue(s) covered by this application?

Yes No

If "yes," please complete Part II B and Part II C. If "no," please complete the remainder of this section and Part II C.

6. Method by which securities are being offered:

- Initial Public Offering Exchange Offer
 Secondary Offering Distribution
 Merger Conversion
 Reorganization Other (please specify): _____

7. Type of offering:

- Firm Commitment Best Efforts - all or none
 Best Efforts - minimum/maximum Other (please specify): _____

8. Expected effective date of registration statement, if applicable: _____

9. Expected closing date, if applicable: _____

10. Number of business days required for delivery of stock certificates to the members of the underwriting group for distribution: _____. If this schedule changes please notify your Business Development Representative immediately.

11. Will the stock certificates contain any restrictive legends?
 Yes No

If "yes," please describe: _____

12. Please indicate the estimated number of beneficial shareholders expected after the offering: _____

B. Seasoned Security Information:

1. Please designate the appropriate registration category for each issue:

- 15(d) of '34 Act Investment Act of 1940
 12(b) of '34 Act Other (please specify): _____
 12(g) of '34 Act

A copy of the appropriate document evidencing registration must accompany this application.

2. Has the company filed a Form 10 registration statement, or equivalent document, within the past 12 months, for purposes of registering a class of securities under section 12(g) of the '34 Act with the SEC or other appropriate regulatory authority?

Yes No

If "yes," please provide a copy of the complete filing including any comments from the SEC or appropriate regulatory authority and the company's responses thereto.

C. CUSIP Number and Transfer Agent:

1. Please list the CUSIP* number for each issue for which application is being made:

Issue	CUSIP Number
_____	_____
_____	_____
_____	_____

*CUSIP Service Bureau can be reached at (212) 208-8346.

If CUSIP number(s) is (are) unavailable, has application been made to the CUSIP Service Bureau?

Yes No

2. Please list the name and address of transfer agent:

NAME _____

ADDRESS _____

3. For American Depositary Receipts (ADRs) list the name and address of Depository Bank:

NAME _____

ADDRESS _____

Please indicate whether the ADR is issued on sponsored or unsponsored basis.

() Sponsored () Unsponsored

Part III

A. Other:

The fact that an applicant may meet Nasdaq numerical guidelines does not necessarily mean that its application will be approved. In connection with the review of any application, the NASD reserves the right to request additional information or documentation, public or non-public, deemed necessary to make a determination regarding a security's initial inclusion, including, but not limited to any material provided for or received from the Securities and Exchange Commission or other appropriate regulatory authority.

B. Corporate Affirmations:

In consideration for the acceptance of _____'s
COMPANY NAME

application for listing on the Nasdaq National Market, it hereby certifies: At the time of its inclusion it is in compliance with, and will continue to comply with, the requirements for inclusion in the Nasdaq Market and the Nasdaq National Market as set forth in Schedule D of the NASD By-Laws; The company agrees to forward to Nasdaq three (3) copies of all reports and other information it is required to file with the Securities and Exchange Commission or other regulatory authorities; The company acknowledges and agrees to pay, in accordance with the prescribed terms, any and all fees associated with its inclusion in the Nasdaq Market, or the Nasdaq National Market.

I, _____, as _____
NAME OF INDIVIDUAL TITLE

of _____,
COMPANY NAME

do hereby certify, to the best of my knowledge and belief, that the information contained in this application is true and correct as of _____, 19____, and that I have read and understand the conditions of this application.

Signature of Corporate Officer _____
TITLE DATE

CORPORATE SEAL
(Optional)

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Addendum: Nasdaq National Market Application Amendment

(This form to be filed by current NMS issuers seeking to include an additional class of securities on the Nasdaq National Market.)

Part I

General Corporate Information:

COMPLETE CORPORATE NAME _____

ADDRESS OF PRINCIPAL EXECUTIVE OFFICES _____

TELEPHONE _____

NASDAQ SYMBOL(S) _____

Part II:

A. Security Information:

1. Issue(s) to be listed:

Security Class

Issue Description*

Security Class	Issue Description*
_____	_____
_____	_____
_____	_____
_____	_____

*Include par or stated value, warrant expiration date, conversion ratio for American Depositary Receipts, and other relevant information.

2. Does the company have any class of common stock or equity security entitling the holder(s) to differential voting rights, dividend payments, or other preferences?

Yes No

If "yes," please provide a complete description of preferences. _____

3. Is there an existing public market for the issue(s) covered by this application?

Yes No

If "yes," please complete Part II B and Part II C. If "no," please complete the remainder of this section and Part II C.

4. Method by which securities are being offered:

- Initial Public Offering Exchange Offer
 Secondary Offering Distribution
 Merger Conversion
 Reorganization Other (please specify): _____

5. Type of offering:

- Firm Commitment Best Efforts - all or none
 Best Efforts - minimum/maximum Other (please specify): _____

6. Expected effective date of registration statement, if applicable: _____

7. Expected closing date, if applicable: _____

8. Number of business days required for delivery of stock certificates to the members of the underwriting group for distribution: _____. If this schedule changes please notify your Business Development Representative immediately.

9. Will the stock certificates contain any restrictive legends?

- Yes No

If "yes," please describe: _____

10. Please indicate the estimated number of beneficial shareholders expected after the offering: _____

B. Seasoned Security Information:

1. Please designate the appropriate registration category for each issue:

- 15(d) of '34 Act Investment Act of 1940
 12(b) of '34 Act Other (please specify): _____
 12(g) of '34 Act

A copy of the appropriate document evidencing registration must accompany this application.

2. Has the company filed a Form 10 registration statement, or equivalent document, within the past 12 months, for purposes of registering a class of securities under section 12(g) of the '34 Act with the SEC or other appropriate regulatory authority?

- Yes No

If "yes," please provide a copy of the complete filing including any comments from the SEC or appropriate regulatory authority and the company's responses thereto.

C. CUSIP Number and Transfer Agent

1. Please list the CUSIP* number for each issue for which application is being made:

Issue	CUSIP Number
_____	_____
_____	_____
_____	_____

*CUSIP Service Bureau can be reached at (212) 208-8346.

If CUSIP number(s) is (are) unavailable, has application been made to the CUSIP Service Bureau?
 Yes No

2. Please list the name and address of transfer agent:

NAME _____

ADDRESS _____

3. For American Depositary Receipts (ADRs) list the name and address of Depositary Bank:

NAME _____

ADDRESS _____

Please indicate whether the ADR is issued on a sponsored or unsponsored basis.

Sponsored Unsponsored

Part III

A. Other:

The fact that an applicant may meet Nasdaq numerical guidelines does not necessarily mean that its application will be approved. In connection with the review of any application, the NASD reserves the right to request additional information or documentation, public or non-public, deemed necessary to make a determination regarding a security's initial inclusion, including, but not limited to any material provided for or received from the Securities and Exchange Commission or other appropriate regulatory authority.

B. Corporate Affirmations:

In consideration for the acceptance of _____'s
COMPANY NAME

amendment to its previous application for listing on the Nasdaq National Market, it hereby certifies: At the time of its inclusion, it is in compliance with, and will continue to comply with, the requirements for inclusion in the Nasdaq market and the Nasdaq National Market as set forth in Schedule D of the NASD By-Laws; The company agrees to

PROCEDURE	RESPONSIBLE PARTY	TIMING	MAILING ADDRESS
Notify Nasdaq of anticipated SEC approval of registration statement.	Issuer or Issuer's Counsel Underwriter	At least three business days before the anticipated effective date of offering.	Telephone contact with Business Development Representative (see cover letter)
File stabilization letter, if necessary, indicating whether bid will be with or without penalty.	Underwriter	At least three business days before the effective date of offering.	The Nasdaq Stock Market Financial Center 33 Whitehall Street New York, NY 10004 Attn: Nasdaq Operations (212)858-4235
Monitor Nasdaq News Screen for security addition and register as market maker.	Underwriter	Generally one business day before the anticipated trading date.	N/A
Notify both Nasdaq offices to release security for trading.	Issuer or Issuer's Counsel	On the effective date of the registration statement.	Telephone contact with Business Development Representative (see cover letter) and Nasdaq Operations in New York at (212) 858-4235
Send three copies of final registration statement or prospectus.	Issuer or Issuer's Counsel	Within five days after registration statement is declared effective.	The Nasdaq Stock Market 1735 K Street, NW Washington, DC 20006-1506 Attn: Market Listing Qualifications

FACSIMILE NUMBERS

Business Development (202) 728-8147
Nasdaq Operations (212) 509-5799

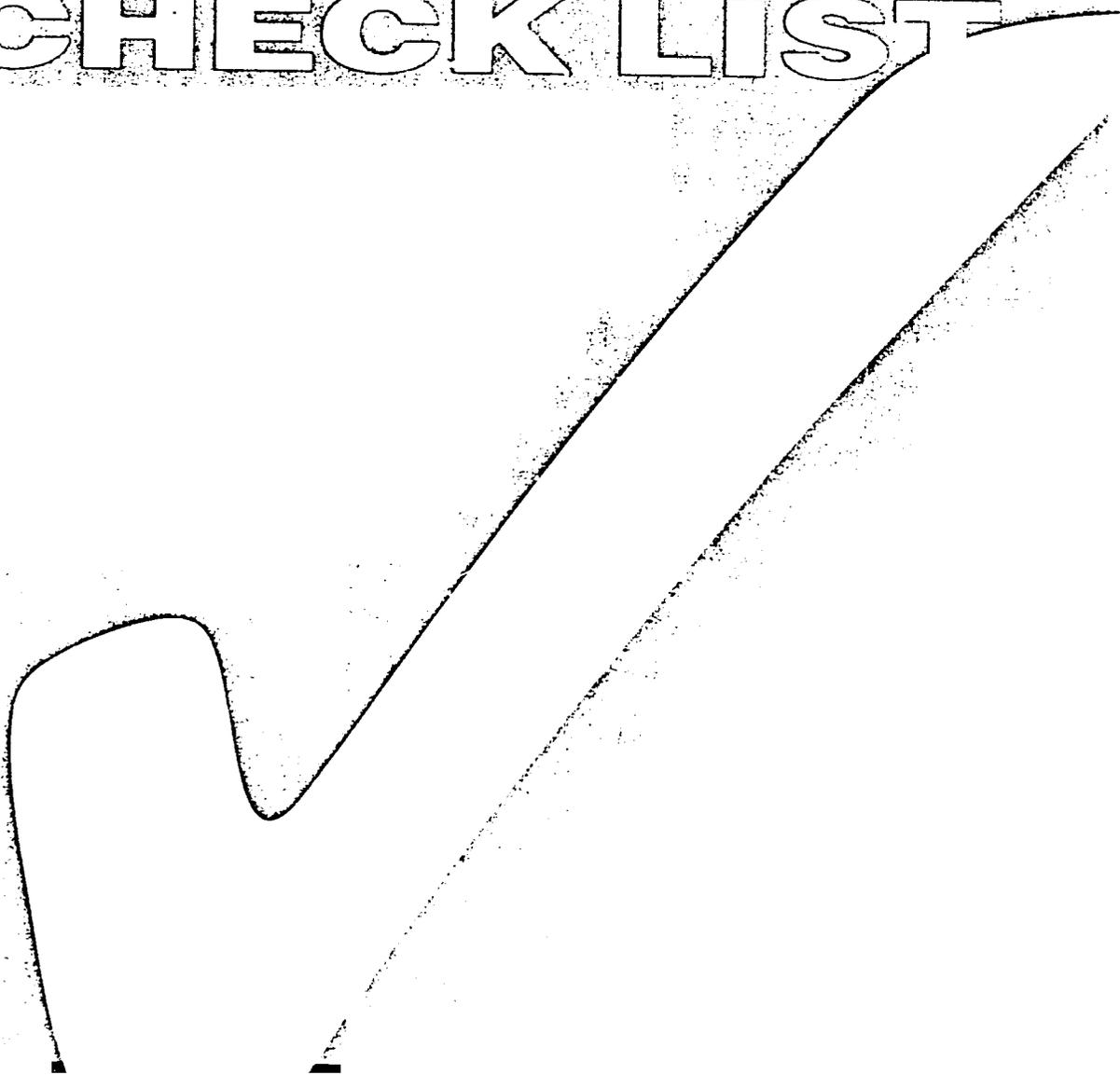
Market Listing Qualifications (202) 785-1804
Financial Center (212) 858-4087

THE NASDAQ STOCK MARKET™
NASDAQ

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NASD

COMPLIANCE CHECK LIST



Nasdaq National Market Listing Agreement

(This form to be filed by issuers seeking initial inclusion or by current NMS issuers who have changed their name.)

_____ (the "Company") in consideration of the designation of its securities as Nasdaq National Market ("Nasdaq NMS") securities hereby agrees with the National Association of Securities Dealers, Inc. (the NASD) that:

1. The Company certifies that it understands and agrees to abide by the eligibility criteria for Nasdaq NMS issuers contained in Part III of Schedule D of the NASD By-Laws. In particular, the Company agrees to comply with Part III, Section 5 as follows:

(a) Nothing in this agreement shall be construed to require the Company to do any acts in contravention of law or in violation of any rule or regulation of any governmental authority, foreign or domestic, exercising jurisdiction over the Company.

(b) The Company agrees to distribute to shareholders copies of an annual report and make available interim reports consistent with the provisions of Schedule D.

(c) The Company agrees that it shall maintain a minimum of two independent directors on its Board of Directors.

(d) The Company agrees that it shall maintain an audit committee, a majority of the members of which are independent directors.

(e) The Company shall hold an annual meeting of shareholders and provide notice of such meeting to the NASD.

(f) The Company shall specify in its By-Laws a quorum of not less than 33 1/3 percent of the outstanding voting stock of the Company.

(g) The Company shall solicit proxies and provide proxy statements for all meetings of shareholders and shall provide copies of such solicitation documents to the NASD.

(h) The Company shall conduct an appropriate review of all related party transactions and shall utilize the Company's audit committee or a comparable body for the review of potential conflict-of-interest situations.

(i) The Company shall obtain shareholder approval for transactions required by Schedule D.

(j) The Company shall not issue any class of securities or take any corporate action with the effect of nullifying, restricting, or disparately reducing the per share voting rights of the holders of an outstanding class of common stock.

2. The Company agrees that it shall notify the NASD of any corporate action or other event which shall cause the Company to cease to be in compliance with the Nasdaq NMS eligibility requirements within thirty (30) days of such act or event.

3. The Company shall comply with such rules, policies, and procedures applicable to Nasdaq NMS issuers, including those set forth in Paragraph 1 above, as they are now in effect and as they may be amended from time to time.

4. The Company understands that the NASD may remove its securities from Nasdaq NMS, pursuant to applicable procedures, if it fails to meet requirements of Paragraphs 1-3, of this agreement, or other provisions of rules, policies, or procedures applicable to Nasdaq NMS issuers.

5. The Company understands that if an exception to any of the provisions of this agreement has been granted by a committee of the NASD, such exception shall, during the time it is in effect, supercede any conflicting provision of this agreement.

As an officer of the Company, I am authorized to execute this agreement on the Company's behalf.

SIGNATURE _____

NAME _____

TITLE _____

DATE _____

CORPORATE SEAL
(Optional)

Accepted at Washington, DC, National Association of Securities Dealers, Inc.

SIGNATURE _____

NAME _____

TITLE _____

DATE _____

A countersigned copy of the Nasdaq National Market Listing Agreement is available to the issuer or the issuer's counsel upon written request to David Compton, Associate Director of The Nasdaq Stock Market, Market Listing Qualifications, 1735 K Street, NW, Washington, DC, 20006-1506.

CONCLUSION

It is difficult to imagine issues confronting management any more significant than those concerning the restructuring or reorganization of a troubled company. Management must make these critical decisions at the intersection of state corporate law, other state laws regarding insolvency, and the Bankruptcy Code. Unfortunately, neither the Bankruptcy Code nor court decisions have produced a clear road map to guide this decision making process. Until such time as courts or legislatures provide a uniform framework and standards, management and their advisors must approach these issues with a new and perhaps entirely different perspective than that to which they are accustomed.

Hardball! The SEC's New Arsenal of Enforcement Weapons

By Ralph C. Ferrara,* Thomas A. Ferrigno** and David S. Darland***

INTRODUCTION

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990¹ (Remedies Act or Act) significantly expands the enforcement authority of the Securities and Exchange Commission (SEC or Commission). By enacting the legislation, Congress sought to address two perceived deficiencies in the Commission's existing enforcement authority: the Commission's limited enforcement alternatives often prevented it from seeking a remedy commensurate with the alleged violative conduct; and its two primary enforcement measures, injunctions and administrative proceedings against securities professionals, did not provide a sufficient level of deterrence. The Remedies Act addresses these limitations by providing the Commission with a broader range of enforcement remedies and by providing for the imposition of significant penalties.

The Remedies Act amends the federal securities laws² to authorize the Commission to (1) seek civil penalties for (a) violations of the securities statutes and rules and regulations thereunder, other than violations involving insider trading, and (b) violations of cease-and-desist orders in federal district court; (2) impose monetary penalties and enter orders requiring an accounting and disgorgement in administrative proceedings against regulated entities such as broker-dealers, investment advisers and their associated persons; (3) issue cease-and-desist orders against any person, and order respondents in such proceedings

*Mr. Ferrara is a member of the District of Columbia, New York, and Florida bars and a partner of Debevoise & Plimpton in Washington, D.C. He served as General Counsel to the Securities and Exchange Commission from 1978 to 1981.

**Mr. Ferrigno is a member of the District of Columbia bar and counsel to Debevoise & Plimpton in Washington, D.C. He served as Chief Counsel to the Division of Enforcement of the Securities and Exchange Commission from 1988 to 1989.

***Mr. Darland is a member of the Virginia bar and an associate of Debevoise & Plimpton in Washington, D.C.

1. Pub. L. No. 101-429, 104 Stat. 931.

2. The Securities Act of 1933 (Securities Act), 15 U.S.C.A. §§ 77a-77aa (West 1981 & Supp. 1991); the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C.A. §§ 78a-78jj (West 1981 & Supp. 1991); the Investment Company Act of 1940 (Investment Company Act), 15 U.S.C.A. § 80a-1 to -52 (West 1981 & Supp. 1991); the Investment Advisers Act of 1940 (Investment Advisers Act), 15 U.S.C.A. §§ 80b-1 to -21 (West 1981 & Supp. 1991).

to account for and disgorge ill-gotten gains; (4) issue temporary cease-and-desist orders against regulated entities; and (5) seek orders from federal district courts prohibiting persons from serving as officers and directors of reporting companies if the person has violated certain antifraud provisions of the federal securities laws and if the person's conduct demonstrates a lack of fitness.

The expansion of the Commission's enforcement powers may result in a dramatic change in the dynamics of SEC enforcement practice. Historically, the vast majority of SEC enforcement actions have been settled. Because the Remedies Act authorizes the Commission to seek tougher sanctions, alleged violators may decide to litigate rather than settle. Furthermore, the legislation is broadly drafted and some of the provisions raise questions that only litigation can resolve.

This Article analyzes the scope and coverage of the enforcement provisions added by Titles I-IV of the Remedies Act.³ Additionally, this Article surveys the enforcement remedies available to the Commission prior to the enactment of the Remedies Act.

BACKGROUND

The enactment of the Remedies Act reflects Congress' view that a strong enforcement program is essential to investor confidence in the integrity, fairness and efficiency of the securities markets. For example, in its report on the Remedies Act, the House Committee on Energy and Commerce stated that "the legislation is designed to enable the Commission to maintain an aggressive and comprehensive program to enforce the federal securities laws."⁴ Similarly, testifying in support of the Remedies Act, the Chairman of the SEC emphasized that the Commission, over the years, has attempted to maintain a presence in each of the areas subject to its jurisdiction, while focusing upon particular problem areas.⁵ Given the distinct nature of each problem area, the Chairman noted that a range of available remedies would aid the Commission in achieving its goals of enforcing the federal securities laws.⁶

In considering legislative proposals to strengthen the Commission's enforcement program, Congress noted that the Commission's ability to continue its aggressive enforcement of the federal securities laws has become strained during

3. Title V of the Remedies Act deals with penny stock reform. Although Title V added persons involved in penny stock offerings to the list of persons subject to administrative proceedings, the remainder of the changes in Title V do not deal with Commission enforcement authority and are not addressed by this Article.

4. H.R. Rep. No. 616, 101st Cong., 2d Sess. 14 (1990) [hereinafter House Report].

5. Written Testimony of Richard C. Breeden, Chairman, Securities and Exchange Commission, Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs Concerning S. 647, The "Securities Law Enforcement Remedies Act of 1989," at 2 (Feb. 1, 1990) [hereinafter Breeden Testimony]. In recent years, the Commission has focused upon financial reporting violations and accounting fraud; insider trading; market manipulation; abuses in the penny stock market; and violations of the standards governing market professionals. *Id.*

6. *Id.* at 1-2.

the past decade.⁷ Congress observed that the number of securities professional subject to the Commission's jurisdiction increased significantly in the 1980s with the rapid growth in the number of brokerage firms, investment advisers and investment companies.⁸ Congress also noted the increasing internationalization of the securities markets.⁹ As a result, the SEC's investigations and enforcement actions had become more complex and required the expenditure of greater time, personnel and money.¹⁰ At the same time, the Commission's resources available to detect and prosecute violations had only modestly increased.¹¹

As a result of these changes, Congress determined that the risk of detection had decreased and the potential for gain had increased. According to the Senate Report:

Potential law violators have been lured by the prospects of enormous profits, in situations where the risk of detection by financial regulators has appeared small. Recent years have witnessed the biggest insider trading scandals in history, widespread incidences of fraudulent reporting by financial institutions and other corporations, illegal activity in connection with tender offers, billions of dollars of losses to small investors as a result of illegal activity in the "penny stock" market, market manipulation and other illegal trading activity, and fraudulent and misleading disclosures in the sale of securities.¹²

Congress also considered the Commission's inability to obtain relief that adequately addressed the conduct involved in many enforcement actions.¹³ This inability stemmed largely from the limitations of the Commission's existing enforcement remedies. The Commission has viewed injunctions as both ineffective with respect to certain offenders and particularly onerous for others.¹⁴ Additionally, while the Commission has expended considerable effort in obtaining disgorgement of illegal profits in its injunctive actions,¹⁵ this remedy was viewed as inadequate because it merely required the wrongdoer to return the

7. See S. Rep. No. 337, 101st Cong., 2d Sess. 2 (1990) [hereinafter Senate Report].

8. *Id.* The number of registered brokers and dealers increased from 6751 in 1980 to 12,224 by 1988. Compare United States Securities and Exchange Commission, Forty-Sixth Annual Report 100 (1980) with United States Securities and Exchange Commission, Fifty-Fourth Annual Report 139 (1988). The number of registered investment companies increased from 1507 in 1980 to 3305 by 1988. United States Securities and Exchange Commission Fifty-Fourth Annual Report 150 (1988). The total number of registered investment advisers increased from 5680 in 1980 to 14,464 by 1988. Compare United States Securities and Exchange Commission, Forty-Sixth Annual Report 102 (1980) with United States Securities and Exchange Commission, Fifty-Fourth Annual Report 140 (1988).

9. See Policy Statement on Regulation of International Securities Markets, Securities Act Release No. 6807, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,341 (Nov. 1988).

10. Senate Report, *supra* note 7, at 2.

11. See Breeden Testimony, *supra* note 5, at 2.

12. Senate Report, *supra* note 7, at 2.

13. See Breeden Testimony, *supra* note 5, at 10-11.

14. *Id.* at 11.

15. See *supra* notes 305-10 and accompanying text.

benefit. the illegal conduct and, thus, did not have a sufficient deterrent effect.¹⁶ With respect to administrative proceedings, the SEC did not possess adequate flexibility to deal with violators of the securities laws.¹⁷ In many instances, including those involving egregious conduct by a brokerage firm or its officials, the Commission was forced to refrain from imposing stiff sanctions because a revocation or suspension of a registration would have draconian consequences on innocent parties.¹⁸

In considering various methods to address the perceived deficiencies in the Commission's enforcement alternatives, Congress reviewed the Commission's exercise of its authority pursuant to the Insider Trading Sanctions Act of 1984 (ITSA).¹⁹ ITSA authorized the Commission to seek civil penalties of up to three times the profit gained or loss avoided in connection with Exchange Act violations involving insider trading.²⁰ The House Report concluded:

The Commission's experience with civil money penalties in the insider trading area has been extremely positive. . . . The Committee believes that additional authority is needed to respond to increasing violations in such areas as the fraudulent sales techniques and price manipulation of the penny stock market, violations of beneficial ownership disclosure rules including "parking," and trading violations such as those that occurred during the market break of 1987. Because many of the charges in the most prominent securities fraud cases of the 1980's have involved violations other than insider trading, the Commission believes that it needs the additional authority contained in this legislation to attack the full range of fraudulent activity in the securities markets.²¹

The Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission Report), a private sector initiative sponsored by the accounting industry, provided another significant impetus to the enactment of the Remedies Act.²² In 1987, the Treadway Commission recommended that

16. The Senate Report states that the injunction has been viewed as a "slap on the wrist" and that disgorgement imposes no real penalty upon the violator. Senate Report, *supra* note 7, at 6.

17. See House Report, *supra* note 4, at 18.

18. According to SEC Chairman Richard Breeden:

For many firms, a censure provides relatively little deterrence against future violations. However, it often is impossible to revoke the firm's registration, or even to suspend its operations temporarily, without causing severe hardship to the firm's customers, public shareholders, and innocent employees. If the Commission had the option of imposing a monetary penalty, it could appropriately sanction misconduct requiring a penalty more severe than a slap on the wrist, but where a suspension or a revocation would have unwarranted adverse consequences.

Breeden Testimony, *supra* note 5, at 11.

19. Pub. L. No. 98-376, 98 Stat. 1264 (1984), see House Report, *supra* note 4, at 16-17; Senate Report, *supra* note 7, at 6-7.

20. See *infra* text accompanying notes 330-42.

21. House Report, *supra* note 4, at 16-17.

22. See House Report, *supra* note 4, at 14-15; Senate Report, *supra* note 7, at 7-8.

Congress grant the SEC broader enforcement remedies in order to deter financial fraud. Included in the Treadway Commission Report were recommendations that the SEC request from Congress three additional enforcement powers to combat fraudulent financial reporting: (1) authority to impose civil money penalties in administrative proceedings and to seek civil money penalties in injunctive proceedings; (2) authority to issue cease-and-desist orders to prevent ongoing securities law violations; and (3) authority to bar or suspend a securities law violator from serving as an officer or director of a publicly-held company.²³

Following the publication of the Treadway Commission Report, the SEC drafted proposed legislation designed to augment its enforcement powers.²⁴ The Commission submitted its first legislative proposal to Congress on September 28, 1988 (1988 Proposal).²⁵ The scope of the proposed legislation went far beyond the Treadway Commission Report's financial fraud concerns and included sanctions for a wide range of violative conduct.²⁶ Congress, however, adjourned before the proposal could be calendared for consideration.²⁷

The Commission submitted a second legislative proposal on January 18, 1989 (1989 Proposal).²⁸ The 1989 Proposal was substantially similar to the Commission's original proposal and included provisions authorizing the Commission to seek civil money penalties in actions brought in district courts and to impose similar money penalties in administrative proceedings.²⁹ Such penalties were not to exceed the greater of \$100,000 for a natural person or \$500,000 for any other person, or the gross amount of pecuniary gain.³⁰ The 1989 Proposal

23. Senate Report, *supra* note 7, at 7.

24. Remarks of Philip Loehner, Jr., Commissioner, United States Securities and Exchange Commission, *The SEC's New Powers Under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990*, in *Securities Enforcement and Penny Stock Reform Act of 1990*, at 112, (P.L.I. Corp. Law & Practice Course Handbook Series No. 718, 1990).

25. Senate Report, *supra* note 7, at 4.

26. Senate Report, *supra* note 7, at 8; Remarks of Philip Loehner, Jr., *supra* note 24, at 112.

27. See Senate Report, *supra* note 7, at 4; Remarks of Philip Loehner, Jr., *supra* note 24, at 113 n.1.

28. Senate Report, *supra* note 7, at 4; House Report, *supra* note 4, at 15. The 1989 Proposal was submitted pursuant to § 3(c) of the Insider Trading and Securities Fraud Enforcement Act of 1988 which directed the Commission to submit "any recommendations the Commission considers appropriate with respect to the extension of the Commission's authority to seek civil penalties or impose administrative fines for violations other than [insider trading]." Senate Report, *supra* note 7, at 4. The 1989 Proposal was introduced in the Senate by Senators Dodd and Heinz on March 17, 1989 as S. 647 and introduced in the House by Representative Dingell as H.R. 975. Belt, *Legislative History of the Enforcement Remedies Act* 5, Seminar on the Enforcement Remedies and Penny Stock Reform Act (P-H Law & Business Dec. 7, 1990).

29. Senate Report, *supra* note 7, at 4; Memorandum of the Securities and Exchange Commission in Support of the Securities Law Enforcement Remedies Act of 1989, at 1-2 [hereinafter Memorandum of Securities and Exchange Commission]. The only notable substantive difference between the 1988 Proposal and the 1989 Proposal was the deletion of Commission authority to impose fines on self-regulatory organizations found in violation of the federal securities laws in proceedings under § 19(h) of the Exchange Act. See *id.* at 2 n.3.

30. Memorandum of Securities and Exchange Commission, *supra* note 29, at 8.

also sought explicit authority for courts to bar or suspend an individual from serving as an officer or director of any reporting company if the individual was found to have violated any provision, rule or regulation of the federal securities laws.³¹

Specifically, the Commission sought to enhance its administrative jurisdiction by amending section 15(c)(4) of the Exchange Act, which authorized the Commission to enter orders requiring persons subject to certain reporting and proxy provisions to comply with such provisions.³² The 1989 Proposal would have amended section 15(c)(4) in three significant respects. First, the 1989 Proposal added section 16(a)³³ to the list of provisions that may be addressed in section 15(c)(4) proceedings.³⁴ Second, the proposal provided for the imposition of money penalties in section 15(c)(4) proceedings.³⁵ Finally, the 1989 Proposal authorized the Commission to enter orders permanently or temporarily barring any individual who violated the federal securities laws from serving as an officer or director of a reporting company.³⁶

The proposed amendments authorizing courts or the Commission to issue orders barring individuals from serving as officers or directors of reporting companies raised concerns within the legal and business communities.³⁷ The 1989 ABA Section Comment Letter expressed concern that the bar provisions would constitute an unwarranted intrusion by the federal government into state corporate law and shareholder rights.³⁸ The letter further criticized the provisions because they permitted the entry of an officer or director bar order based upon a violation of any provision of the securities laws rather than only the scienter-based violations.³⁹ Furthermore, the provisions did not require a nexus between the violation and an individual's fitness to serve as an officer or director.⁴⁰

On February 1, 1990, the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs held hearings on the 1989 Proposal. At the hearings, SEC Chairman Richard Breeden proposed several substantial

31. *See id.* at 15.

32. *See supra* text accompanying notes 450-51.

33. Section 16(a) of the Exchange Act imposes stock ownership reporting requirements on officers, directors and holders of more than 10% of a class of securities. See 15 U.S.C.A. § 78p (West 1981).

34. Memorandum of the Securities and Exchange Commission, *supra* note 29, at 16.

35. *Id.* at 3.

36. *Id.* at 15.

37. *See, e.g.,* Comments of Subcommittee on SEC Practice and Enforcement Matters of the Federal Regulation of Securities Committee, Section of Business Law of the American Bar Association, to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce of the United States House of Representatives, at 10-23 (Aug. 24, 1989) [hereinafter 1989 ABA Section Comment Letter]. Written Statement of Gary G. Lynch, Before the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee Regarding the "Securities Enforcement Remedies Act of 1989," at 2-3 (Feb. 1, 1990).

38. 1989 ABA Section Comment Letter, *supra* note 37, at 6.

39. *Id.* at 7.

40. *See id.* at 7, 16-17.

modifications to the 1989 Proposal.⁴¹ The Commission's revised proposal (1990 Proposal) requested certain authority that was not sought in the 1989 Proposal and eliminated or modified other 1989 Proposal requests for enforcement authority.

First, and most significantly, the Commission requested authority to issue cease-and-desist orders.⁴² Second, the Commission requested authority to order accountings and disgorgements in administrative proceedings against regulated entities and in cease-and-desist proceedings.⁴³ Third, the Commission requested that in actions to enforce cease-and-desist orders issued for the failure to file timely reports pursuant to section 16(a) of the Exchange Act, courts be required to impose a mandatory, minimum daily fine of \$100.⁴⁴ Fourth, the Commission requested an amendment to the Federal Criminal Code providing the Commission with greater access to grand jury information relating to potential securities law violations.⁴⁵

In light of its proposal for cease-and-desist authority, the Commission determined that the proposed amendments to section 15(c)(4) were unnecessary.⁴⁶ The Commission also proposed limiting a court's authority to bar or suspend individuals from serving as officers or directors of reporting companies to certain "scienter-based fraud provisions," specifically section 17(a)(1) of the Securities Act and section 10(b) of the Exchange Act and the rules thereunder.⁴⁷

A number of interested parties, including members of the securities bar, participants in the securities industry, and members of the corporate community, either testified before Congress or submitted comments.⁴⁸ Although most of the witnesses and commentators supported the goals of the legislation, many

41. Senate Report, *supra* note 7, at 4. During questioning, Chairman Breeden also stated that the Commission would not object strongly if Congress were to impose a "tiering" process in which different levels of egregious conduct were subject to different maximum money penalties. *SEC for First Time Asks Congress to Grant it Cease-and-Desist Powers*, 22 Sec. Reg. & L. Rep. (BNA) No. 5, at 155, 156 (Feb. 2, 1990).

42. Breeden Testimony, *supra* note 5, at 4.

43. *Id.*

44. *Id.*

45. *Id.* at 5. At the time the Commission considered modifications to the 1989 Proposal, there were two vacancies on the Commission. Commissioner Fleischman voted against requesting cease-and-desist authority and judicial authority to disclose grand jury information; only two Commissioners voted in favor of these two provisions. *See* Comments of Subcommittee on SEC Practice and Enforcement Matters of the Federal Regulation of Securities Committee, Section of Business Law of the American Bar Association, to the Honorable Donald W. Riegle, Chairman, Senate Committee on Banking, Housing and Urban Affairs, at 4 n.3 (May 18, 1990) [hereinafter 1990 ABA Section Comment Letter].

46. Breeden Testimony, *supra* note 5, at 27-28.

47. *Id.* at 29. Nevertheless, concern was expressed that scienter should have been explicitly required because it is unclear whether all of the rules promulgated under § 10(b) require scienter. *See* 1990 ABA Section Comment Letter, *supra* note 45, at 98-99.

48. Belt, *supra* note 28, at 6. One of the more thorough comment letters received was a 125-page letter submitted by the Section of Business Law of the American Bar Association. *See generally* 1990 ABA Section Comment Letter, *supra* note 45.

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raise a number of concerns with respect to the necessity for and scope of certain of the powers included in the proposed legislation.⁴⁹

The proposed cease-and-desist authority generated considerable comment.⁵⁰ The most controversial aspect of this proposal was the Commission's authority to issue temporary cease-and-desist orders. The 1990 Proposal authorized temporary cease-and-desist orders against any person whenever the Commission determined that the violation would result in dissipation or conversion of assets, significant harm to investors, or substantial harm to the public.⁵¹ A temporary cease-and-desist order would become effective upon service, and remain in effect pending judicial review, unless otherwise ordered by a court or the Commission.⁵² Although the 1990 Proposal required that any temporary cease-and-desist order be subject to immediate judicial review at any time within the first ten days of service, it did not provide for notice and an opportunity for a hearing prior to the order's issuance.

The proposed civil and administrative money penalty provisions also generated substantial comment. The concerns focused largely on whether the Commission actually needed such broad fining authority in order to provide adequate deterrence, whether the legislation included adequate standards for determining the amount of the fines, and the propriety of such fines in the absence of scienter.⁵³

According to the minority counsel of the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs, "[s]ome of the criticisms were felt by Members and staff to be unfounded, simply representing parochial interests, or could be adequately addressed in legislative report language."⁵⁴ Congress, however, shared some of the concerns regarding the Commission's broad grant of authority. The 1990 Proposal, as passed by the Senate (Senate Bill), and the House of Representatives (House Bill), contained several modifications.

Both the Senate Bill and the House Bill: (1) added language to the provisions authorizing court-ordered officer and director bars to require that the person's conduct demonstrate "substantial unfitness to serve as an officer or director" of the issuer;⁵⁵ (2) modified the language empowering courts to impose a monetary penalty by requiring a "proper showing" rather than "a finding of a violation";⁵⁶ (3) limited the Commission's authority to issue temporary cease-and-desist orders by providing that such orders may be entered only against

regulated entities and associated persons;⁵⁷ and (4) rejected the proposed provision requiring courts to impose minimum daily penalties for failure to comply with a cease-and-desist order against violations of section 16(a) of the Exchange Act.⁵⁸

The two bills differed, however, in three major respects.⁵⁹ First, although both the House and Senate Bills retained the broad civil and administrative money penalty provisions, the Senate Bill adopted a tiered penalty structure setting three levels of maximum monetary penalties, depending upon the gravity of the violation.⁶⁰ The Senate's changes responded to the concerns expressed that without such limitations, substantial penalties could be imposed for minor, inadvertent violations that did not cause significant harm.⁶¹

Second, with respect to temporary cease-and-desist orders, the Senate Bill provided that the Commission must give notice to respondents⁶² unless "impracticable or contrary to the public interest."⁶³ If notice would be impracticable or contrary to the public interest, the temporary cease-and-desist order would become effective upon service.⁶⁴ As with the 1990 Proposal, the Senate Bill provided for immediate judicial review of a temporary cease-and-desist order within ten days after respondent is served with the temporary order.⁶⁵

The House Bill provided for notice and explicitly provided for an opportunity for a hearing prior to the issuance of a temporary cease-and-desist order unless impracticable or contrary to the public interest.⁶⁶ The accompanying House Report indicated that the House modeled the explicit requirement for a hearing on the procedural protections for temporary restraining orders issued pursuant to rule 65 of the Federal Rules of Civil Procedure.⁶⁷ In contrast to both the 1990 Proposal and the Senate Bill, the House Bill also required respondents subject to *ex parte* temporary orders to obtain a Commission hearing prior to seeking review by a district court.⁶⁸

57. Senate Report, *supra* note 7, at 19-20; House Report, *supra* note 4, at 25-26.

58. Senate Report, *supra* note 7, at 17; House Report, *supra* note 4, at 23. According to the Senate Banking Committee, although there were concerns over low levels of compliance with § 16(a), it was felt that the permanent cease-and-desist order along with the civil penalty provisions provided the means necessary to address violations of § 16(a). Senate Report, *supra* note 7, at 17.

59. Additionally, the Senate Bill did not contain the Penny Stock Reform Act. The Senate agreed to allow this legislation, with some modifications, to be included in the final legislation. Belt, *supra* note 28, at 7.

60. Senate Report, *supra* note 7, at 12-13.

61. See Senate Report, *supra* note 7, at 12, *see also* 1990 ABA Section Comment Letter, *supra* note 45, at 62-63.

62. Although the Senate Bill is silent on the availability of a hearing prior to the entry of a temporary cease-and-desist order, the Senate Report states that, upon notice, a respondent would have the opportunity to show cause why the order should not be issued. See Senate Report, *supra* note 7, at 20.

63. *Id.* at 20-21.

64. *Id.* at 21.

65. *Id.*

66. House Report, *supra* note 4, at 3.

67. *Id.* at 26.

68. *Id.* at 4.

49. See 1990 ABA Section Comment Letter, *supra* note 45. *But cf.* ABA Group Opposes SEC Remedies Bill: C&D Section Especially Controversial, 22 Sec. Reg. & L. Rep. (BNA) No. 15, at 548 (Apr. 13, 1990) (reporting that the American Bar Association's Federal Regulation of Securities Committee had decided to oppose S. 647).

50. See, e.g., 1990 ABA Section Comment Letter, *supra* note 45, at 77-92.

51. *Id.* at 77-78.

52. See *id.* at 83-88.

53. *Id.* at 43-62; Written Statement of Gary G. Lynch, *supra* note 37, at 2.

54. Belt, *supra* note 28, at 6.

55. Senate Report, *supra* note 7, at 21; House Report, *supra* note 4, at 27.

56. See, e.g., Exchange Act § 21(d)(3)(A), 15 U.S.C.A. § 78u(d)(3)(A) (West Supp. 1991).

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greater access to grand jury evidence.⁶⁹ This provision generated substantial concern that authorizing greater access to grand jury evidence would undermine the assurance of secrecy essential to the grand jury process.⁷⁰ Furthermore, the provision did not provide reciprocal access to the respondent.⁷¹ The House Bill did not contain a similar provision.

Conferences between the Senate and the House of Representatives resulted in a compromise that incorporated elements of the Senate Bill and the House Bill. The enacted legislation includes the provision from the Senate Bill which provides for the tiering of money penalties and the provision from the House Bill with respect to temporary cease-and-desist orders. The legislation also includes the provision from the House Bill requiring respondents subject to *ex parte* temporary orders to seek a Commission hearing prior to seeking review by a district court. The Commission's proposal with respect to access to grand jury materials which had been included in the Senate Bill was not included in the Remedies Act. A jurisdictional dispute between the House Energy and Commerce Committee and the House Judiciary Committee prevented this provision from being included in the House Bill and, consequently, the Remedies Act.⁷² The Senate passed the final version on September 27, 1990.⁷³ The House did the same on October 1, 1990.⁷⁴ President Bush signed the Remedies Act into law on October 15, 1990.⁷⁵

THE REMEDIES ACT

MONETARY PENALTIES IN CIVIL ACTIONS

The Remedies Act Civil Penalty Provisions

The Remedies Act authorizes the Commission to seek, and district courts to impose, monetary penalties for violations of the Securities Act, the Exchange Act, the Investment Company Act, and the Investment Advisers Act.⁷⁶ The Act also empowers the SEC to seek court orders imposing civil penalties for violations of cease-and-desist orders. The Act provides that "[w]henver it shall

⁶⁹ Senate Report, *supra* note 7, at 23-26.

⁷⁰ See 1990 ABA Section Comment: Letter, *supra* note 45, at 25-31.

⁷¹ *Id.*

⁷² Belt, *supra* note 28, at 7. The grand jury provision is not dead. There are indications that the Senate may attempt to enact a provision authorizing greater access to grand jury materials by the SEC in subsequent legislation. See 136 Cong. Rec. S14069 (daily ed. Sept. 27, 1990) (statement of Sen. Riegle).

⁷³ 136 Cong. Rec. S14,059 (daily ed. Sept. 27, 1990).

⁷⁴ 136 Cong. Rec. H8524 (daily ed. Oct. 1, 1990).

⁷⁵ See Pub. L. No. 101-429, 104 Stat. 931, 958.

⁷⁶ See Securities Act § 20(d), 15 U.S.C.A. § 77i(d) (West Supp. 1991), Exchange Act § 21(d)(3), 15 U.S.C.A. § 78u(d)(3) (West Supp. 1991), Investment Company Act § 42(e), 15 U.S.C.A. § 80a-41(e) (West Supp. 1991), Investment Advisers Act § 209(e), 15 U.S.C.A. § 80b-9(e) (West Supp. 1991). The amendments to the Securities Act and the Exchange Act exempt insider trading violations that are subject to penalties pursuant to § 21A of the Exchange Act from the coverage of the civil penalties provisions.

appear to the Commission that any person has violated . . . [the securities laws], the rules and regulations thereunder, or a cease-and-desist order, . . . the court shall have jurisdiction to impose, upon a proper showing, a civil penalty to be paid by the person who committed such violation."⁷⁷

The Remedies Act requires the court to determine the amount of the penalty in light of the facts and circumstances of each case.⁷⁸ As noted above, Congress adopted a three-tiered structure for determining the maximum permissible monetary penalty.⁷⁹ The gravity of the violation and the harm caused or threatened by the violation determine the applicable tier.⁸⁰

The Remedies Act specifically provides that actions seeking to impose a civil penalty may be in addition to any other action the Commission or the Attorney General is entitled to bring.⁸¹ The penalties are payable into the United States Treasury.⁸² The legislation further provides that, should a defendant fail to comply with an order of the court imposing a civil penalty, the Commission may refer the matter to the Attorney General, who may recover the amount by an action in the appropriate district court.⁸³

The Remedies Act specifically provides for civil penalties for violations of cease-and-desist orders. The Act provides that each separate violation of a cease-and-desist order shall constitute a separate offense and that each day of a continuing failure to comply with the order shall be deemed a separate offense.⁸⁴

⁷⁷ See, e.g., Exchange Act § 21(d)(3), 15 U.S.C.A. § 78u(d)(3) (West Supp. 1991).

⁷⁸ The amendments provide that "the amount of the penalty shall be determined by the court." See, e.g., Securities Act § 20(d)(2)(A), 15 U.S.C.A. § 77i(d)(2)(A). The legislative history, however, indicates that the court's discretion extends not only to the amount of the penalty but also to whether a penalty will be imposed at all. See Senate Report, *supra* note 7, at 16, House Report, *supra* note 4, at 22.

⁷⁹ See, e.g., Exchange Act § 21(d)(3)(B), 15 U.S.C.A. § 78u(d)(3)(B) (West Supp. 1991).

⁸⁰ Senate Report, *supra* note 7, at 12. The first-tier penalties are applicable to any violation of the securities statutes and rules and regulations thereunder. The amount of a first-tier penalty may not exceed the greater of: (1) \$5,000 for each violation by a natural person or \$50,000 for each violation by any other person; or (2) the gross amount of pecuniary gain to the defendant as a result of the violation(s). See, e.g., Exchange Act § 21(d)(3)(B)(i), 15 U.S.C.A. § 78u(d)(3)(B)(i) (West Supp. 1991). The second tier is applicable to violations involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement." See, e.g., *id.* § 21(d)(3)(B)(ii), 15 U.S.C.A. § 78u(d)(3)(B)(ii) (West Supp. 1991). Such violations are subject to a maximum penalty not to exceed the greater of: (1) \$50,000 for a natural person or \$250,000 for each violation by any other person; or (2) the gross amount of pecuniary gain to the defendant. *Id.* Finally, the third tier addresses violations which involve "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and result directly or indirectly in, or create a significant risk of, substantial losses to other persons. See, e.g., *id.* § 21(d)(3)(B)(iii), 15 U.S.C.A. § 78u(d)(3)(B)(iii) (West Supp. 1991). These violations are subject to maximum penalties not exceeding the greater of: (1) \$100,000 for each violation by a natural person and \$500,000 for each violation by any other person; or (2) the gross amount of pecuniary gain to the defendant. *Id.*

⁸¹ See, e.g., Exchange Act § 21(d)(3)(C), 15 U.S.C.A. § 78u(d)(3)(C) (West Supp. 1991).

⁸² *Id.*

⁸³ *Id.*

⁸⁴ See, e.g., Exchange Act § 21(d)(3)(D), 15 U.S.C.A. § 78u(d)(3)(D) (West Supp. 1991).

The Act's civil penalties provisions are extremely broad and their impact is likely to be quite dramatic. The Commission is now authorized to seek court orders imposing monetary penalties for violations of any of the provisions of the federal securities statutes or rules and regulations thereunder, including numerous technical provisions. In the view of Congress, the civil penalties provisions permit the Commission to seek a remedy that may be tailored to the offense and that increases the deterrent effect of Commission enforcement proceedings.⁸⁵

The Remedies Act civil penalty provisions require a "proper showing" in order for courts to impose a penalty.⁸⁶ The same "proper showing" requirement is employed in the provisions authorizing the Commission to seek and courts to enter injunctions.⁸⁷ It does not appear, however, that Congress contemplated a similar showing under both provisions. The Senate Report states that the district court would have the discretion to determine whether a penalty would be imposed and the amount of the penalty.⁸⁸ This discretion would permit the court to impose a civil money penalty even if the court determined that injunctive or other equitable relief against the same defendant was not warranted.⁸⁹

The Remedies Act provides a maximum penalty for each violation. The Act, however, does not define the term "violation," and the legislative history does not discuss whether a course of conduct prohibited by the securities statutes shall constitute a single violation or whether each illegal act or transaction will constitute a separate violation.⁹⁰ This issue is especially significant in light of the fact that many securities related activities and transactions involve numerous parties and are subject to various regulatory provisions.⁹¹ For example, a court may view an offering of securities by means of a materially deficient prospectus as a single course of conduct that violates the antifraud provisions of section

85 See House Report, *supra* note 4, at 17-18; Senate Report, *supra* note 7, at 9-11. The reports noted that civil penalties were particularly important for use with defendants that would not be deterred by the threat of an injunction and disgorgement, that are unwilling to incur the costs of full compliance with the securities laws, and that engage in repeated violations of the federal securities laws. *Id.*

86 See, e.g., Exchange Act § 21(d)(3)(A), 15 U.S.C.A. § 78u(d)(3)(A) (West Supp. 1991).

87 See, e.g., *id.* § 21(d)(1), 15 U.S.C.A. § 78u(d)(1) (West Supp. 1991).

88 Senate Report, *supra* note 7, at 16.

89 *Id.*, House Report, *supra* note 4, at 22.

90 The ABA Business Law Section commented on the lack of a definition of the term "violation" in the 1990 Proposal, nevertheless, a provision defining the term was not included in the Remedies Act. See 1990 ABA Section Comment Letter, *supra* note 45, at 56-57.

91 The only provisions in the Remedies Act addressing the number of violations relate to the imposition of monetary penalties for violations of cease-and-desist orders:

In an action to enforce a cease-and-desist order entered by the Commission . . . each separate violation of such order shall be a separate offense, except that in the case of violation through a continuing failure to comply with such an order, each day of the failure to comply with the order shall be deemed a separate offense.

See, e.g., Exchange Act § 21(i)(1), 15 U.S.C.A. § 78u(d)(3)(D) (West Supp. 1991).

80

17(a) of the Securities Act, and therefore, conduct that is subject to a civil penalty. Alternatively, a court may consider each offer or sale of a security by means of deficient offering materials as a separate violation. Additionally, the use of a materially false and misleading prospectus in connection with each sale of securities may constitute a violation of the antifraud provisions of section 10(b) of the Exchange Act and rule 10b-5 thereunder. Thus, characterizing a course of conduct as multiple violations of multiple provisions could increase dramatically the number of violations for which a penalty may be imposed.

Historically, the Commission's practice when seeking injunctive relief from the district courts has been to allege that a course of conduct constitutes a single violation of the applicable provision, rather than a series of separate violations. The Commission has followed a similar practice in its administrative proceedings.

Other authorities, however, including the self-regulatory organizations and criminal prosecutors, have alleged that each act or transaction that constitutes a violation of an applicable provision is a separate offense subject to a separate penalty. Both the Commission and reviewing appellate courts have affirmed decisions of the self-regulatory organizations holding that each breach of a duty constitutes a separate violation and imposing a penalty for each violation.⁹² Similarly, in criminal cases courts have held that each sale of a security may constitute a separate offense.⁹³ Further, courts have held that each separate use of the mails in the execution of a scheme to defraud constitutes a separate violation of the mail fraud statute, even though the multiple mailings may relate to essentially the same fraudulent scheme.⁹⁴

The recently adopted United States Sentencing Commission Guidelines (Guidelines) treat a "scheme to defraud more than one victim" as one violation for the purpose of imposing criminal penalties.⁹⁵ Under the Guidelines, if the defendant is convicted of multiple counts of mail fraud and wire fraud, each in furtherance of a single fraudulent scheme, the counts are grouped together and treated as a "scheme to defraud" for purposes of imposing criminal sanctions, even if the mailings and telephone calls occurred on separate days.⁹⁶

Thus far, Commission actions seeking injunctive relief and the imposition of monetary penalties have stated causes of action based upon courses of conduct rather than multiple causes of action for violations of the same provision.⁹⁷

92. See *In re First Philadelphia Corp.*, 45 S.E.C. 73, 74 (1972), *In re Voelkel*, 42 S.E.C. 674, 677 n.13 (1965); Exchange Act Release No. 12,182, 9 SEC Docket (CCH) 137 (March 9, 1976); *Svalberg v. SEC*, 876 F.2d 181, 185 (D.C. Cir. 1989).

93. *Volckmann v. Edwards*, 642 F. Supp. 109, 114-15 (N.D. Cal. 1986), see *United States v. Naftalin*, 606 F.2d 809, 810 (8th Cir. 1979).

94. *United States v. Mackay*, 491 F.2d 616, 623-24 (10th Cir. 1974), *Volckmann*, 642 F. Supp. at 114; see also *United States v. Halper*, 490 U.S. 435, 451 (1989).

95. *United States Sentencing Commission, Guidelines Manual* § 2F1.1(b)(2) (Nov. 1990).

96. *Id.* § 3D1.2, comment 4.

97. See, e.g., *SEC v. Malenfant*, SEC Litig. Release No. 12,848, 48 SEC Docket (CCH) 1274 (May 1, 1991), *SEC v. Sterns*, SEC Litig. Release No. 12,802, 48 SEC Docket (CCH) 637 (March 11, 1991), *SEC v. Slaughter*, SEC Litig. Release No. 12,826, 48 SEC Docket (CCH) 868 (Apr. 3,

Spec. with respect to monetary penalties, the Commission has requested courts to order "appropriate civil penalties" or "penalties as set forth in the Remedies Act."⁹⁹

As noted, the Remedies Act provides a three-tiered structure for determining the amount of a penalty.⁹⁹ Each of the three tiers provides that for each violation, the penalty shall not exceed the greater of a stated dollar amount or the gross pecuniary gain to the defendant as a result of the violation.¹⁰⁰ The first tier is applicable to any violation not within the second or third tiers. The second tier penalties are applicable to violations involving fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement.¹⁰¹ The third-tier penalties are applicable to violations involving fraudulent conduct or reckless disregard of a regulatory requirement, and resulting in or creating a "significant risk of substantial losses" to other persons.¹⁰² The amount of a penalty, therefore, may increase substantially if significant losses result from the violation or if the violation creates a significant risk of loss. The legislation does not, however, define the terms "substantial loss" or "significant risk," and the legislative history does not address this issue.

Courts may also impose as a penalty an amount equal to the amount of the defendant's "gross pecuniary gain." While the Remedies Act does not define this term, the legislative history states that the term means "the amount by which the defendant was unjustly enriched."¹⁰³ Unjust enrichment is a term that is often used by courts in connection with the equitable remedy of disgorgement. When determining the amount that a defendant who is unjustly enriched must disgorge, courts frequently offset expenses incurred from gross amounts improperly received.¹⁰⁴ It is unclear if courts will continue this practice when determining the amount of a defendant's gross pecuniary gain.

1991); SEC v. BFMF Corp., SEC Litig. Release No. 12,725A, 47 SEC Docket (CCH) 1136 (Dec. 6, 1990).

98. See, e.g., SEC v. First Ohio Equities, SEC Litig. Release No. 12,853, 1991 SEC LEXIS 890 (May 7, 1991) (requesting "an appropriate civil penalty"); SEC v. Slaughter, SEC Litig. Release No. 12,826, 1991 SEC LEXIS 629 (April 3, 1991) (requesting an "order imposing penalties as set forth in [the Remedies Act]").

99. See *supra* notes 78-80 and accompanying text. The Senate Report states that "[a]lthough [sic] the Committee believed that, in practice, the courts and the SEC would administer the new penalties fairly, the Committee determined that the concerns raised could be addressed by providing a penalty structure in which different maximum penalties were provided, according to the gravity of the violation." Senate Rep. 1, *supra* note 7, at 12.

100. See *supra* note 80.

101. See Senate Report, *supra* note 7, at 12.

102. *Id.*

103. Senate Report, *supra* note 7, at 13.

104. See, e.g., *Litton Indus. v. Lehman Bros. Kuhn Loeb Inc.*, 734 F. Supp. 1071, 1077 (S.D.N.Y. 1990) (permitting reduction for associated expenses and costs such as brokerage commissions); SEC v. Thomas James Assocs., Inc., 738 F. Supp. 88, 92 (W.D.N.Y. 1990) (reducing gross revenues in order to reflect setoff for necessary business expenses such as commissions, telephone charges, underwriting expenses and overhead). But see SEC v. United Monetary Servs., Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,284, at 96,303 (S.D. Fla. 1990) (finding that

A defendant in an action seeking a monetary penalty under the Remedies Act has a right to a jury trial. In *Tull v. United States*,¹⁰⁵ the United States Supreme Court stated that the seventh amendment requires a jury trial on the merits in those actions that are "analogous to 'Suits at common law'."¹⁰⁶ In *Tull*, the Supreme Court held that government-sought monetary penalties in a civil action for violations of the Clean Water Act required a jury trial.¹⁰⁷ The Court found the civil penalty suit to be an action "clearly analogous to the 18th-century action in debt" and concluded that federal courts have rightly assumed that the "Seventh Amendment required a jury trial."¹⁰⁸ Additionally, the Court held that should an equitable claim, such as one for injunctive relief be joined with the civil penalty claim, the right to a jury trial remains intact.¹⁰⁹ The Court, however, did uphold the authority of the district court judge to determine the amount of civil penalties.¹¹⁰

The imposition of monetary penalties under the Remedies Act will likely raise double jeopardy concerns if the defendant is also subject to a criminal prosecution. In *United States v. Halper*,¹¹¹ the United States Supreme Court considered the circumstances under which a civil penalty may constitute punishment for purposes of the double jeopardy clause. In *Halper*, the defendant had previously been convicted on sixty-five counts of violating the criminal false claims statute and sixteen counts of mail fraud. For these convictions, the defendant was sentenced to two years imprisonment and a \$5,000 penalty. Subsequent to the criminal prosecution, the government filed a civil action against the defendant pursuant to the civil provisions of the False Claims Act. The civil provisions authorized the imposition of a penalty of \$2,000 for each violation. Accordingly, under the civil provisions the defendant was exposed to penalties of \$130,000.

The Supreme Court, in a unanimous decision, held that under certain circumstances a civil money penalty may be so unrelated to its remedial goals that it constitutes punishment for purposes of the double jeopardy clause of the fifth amendment.¹¹² The Court stated that the purpose served by the sanction, rather than its label, is of paramount importance.¹¹³ If the sanction furthers deterrent or retributive purposes rather than remedial goals it will be characterized as punitive.¹¹⁴ The Court, however, also ruled that in seeking a civil money

defendants are not entitled to any offset because "[c]ourts have routinely required wrongdoers in securities frauds to disgorge the gross sums received from investors").

105. 481 U.S. 412 (1987).

106. *Id.* at 417.

107. *Id.* at 418-19.

108. *Id.* at 420.

109. *Id.* at 425.

110. *Id.* at 422.

111. 490 U.S. 435 (1989).

112. *Id.* at 447-48.

113. *Id.* at 447.

114. *Id.* at 448.

penalty, the government is entitled to "rough remedial justice."¹¹⁵ Thus, the government may use imprecise formulae such as reasonable liquidated damages or a fixed sum plus double damages without being deemed to have imposed punishment under the double jeopardy clause.¹¹⁶ The line between "rough remedial justice" and double jeopardy is a rule of reason.¹¹⁷

The Court's holding in *Halper*, however, does not preclude the government from seeking full civil money penalties against a defendant who has not previously been punished for the same conduct, even if the civil sanction is punitive.¹¹⁸ The *Halper* decision also does not prevent the government from seeking full civil money penalties and criminal penalties in the same proceeding, nor does the decision prevent a subsequent civil suit by a private party seeking damages.¹¹⁹

When Congress enacted the Remedies Act, it did not prescribe factors that the Commission should consider in exercising the broad grant of authority to seek civil penalties. Congress, however, did set forth its views on the exercise of the Commission's new authority. According to the House Report:

The Committee contemplates that the Commission would not seek or impose a civil money penalty in every case. When a failure to comply with Commission requirements involves isolated or unintentional conduct, the implementation of new procedures or a similar remedial measure may be the most appropriate resolution of the case. At the other end of the spectrum, when a defendant in a Commission action is also the subject of a criminal prosecution, the imposition of a civil money penalty in the Commission's action may, in some cases, be unnecessary to achieve deterrence.¹²⁰

Further, Congress expressed its view that innocent shareholders should not suffer as a result of the imposition of fines upon corporations. The Senate Report states:

115. *Id.* at 446

116. *Id.*

117. *Id.* at 449.

118. *Id.* at 450.

119. *Id.* Chairman Breeden, in testimony before Congress in support of the Remedies Act, stated, "If the holding in *Halper* were extended to actions brought by the Commission under [the Remedies Act], the Commission might have to forego a civil money penalty in certain cases." Breeden Testimony, *supra* note 5, at 12 n 10. A double jeopardy argument has already been attempted in the area of securities law enforcement. In *United States v. Marcus Schloss & Co.*, 724 F. Supp. 1123 (S.D.N.Y. 1989), a case involving insider trading, a criminal defendant argued that an ITSA penalty imposed as a result of a settlement with the Commission precluded criminal prosecution. The court initially found that neither the sequence of events nor the act of settling the civil action was determinative. *Id.* at 1126. The court found, however, that the defendant had been aware of the grand jury investigation at the time it entered into the settlement with the Commission and the settlement recognized the Commission's discretionary power to refer the matter to criminal authorities. *Id.* at 1127. The court held that these factors precluded the defendant from raising the double jeopardy claim. *Id.*

120. House Report, *supra* note 4, at 18-19.

The Committee believes that the civil money penalty provisions should be applicable to corporate issuers, and the legislation permits penalties against issuers. However, because the costs of such penalties may be passed on to shareholders, the Committee intends that a penalty be sought when the violation results in an improper benefit to shareholders. In cases in which shareholders are the principal victims of the violations, the Committee expects that the SEC, when appropriate, will seek penalties from the individual offenders acting for a corporate issuer. Moreover, in deciding whether and to what extent to assess a penalty against the issuer, the court may properly take into account whether civil penalties assessed against corporate issuers will ultimately be paid by shareholders who were themselves victimized by the violations. The court also may consider the extent to which the passage of time has resulted in shareholder turnover.

The Committee also expects that the SEC will not ordinarily seek penalties against registered investment companies. Generally, an investment company is a managed portfolio of liquid assets, with all expenses being passed on to shareholders. While the legislation permits civil penalties based on violations of the Investment Company Act, the penalties generally would be assessed against the responsible individuals.¹²¹

REMEDIES ACT CHANGES TO THE COMMISSION'S EXISTING ADMINISTRATIVE AUTHORITY

Monetary Penalties in Administrative Proceedings

The Remedies Act empowers the SEC to impose penalties in administrative proceedings against certain securities professionals, namely broker-dealers, investment advisers, municipal securities dealers, government securities dealers, transfer agents, and their associated persons.¹²² The legislation similarly permits the Commission to impose penalties against persons associated with investment companies.¹²³

The Commission may impose a penalty if it finds, on the record and after notice and an opportunity for a hearing, that the penalty is in the public interest and that the person has willfully:

1. violated any provision of the Securities Act, the Exchange Act, the Investment Company Act, the Investment Advisers Act, or the rules or regulations thereunder;
2. aided, abetted, counseled, commanded, induced or procured a violation by any other person; or
3. made or caused to be made in any registration application or report required to be filed with the SEC or in any proceeding before the

121. Senate Report, *supra* note 7, at 17.

122. *See, e.g.*, Exchange Act § 21B(a), 15 U.S.C.A. § 78u-2(a) (West Supp. 1991).

123. *See, e.g.*, Investment Company Act § 9(d), 15 U.S.C.A. § 80a-9(d) (West Supp. 1991).

omission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which was required to be stated therein.¹²⁴

Additionally, the Remedies Act permits the SEC to impose a penalty when the penalty is in the public interest, and when the person "has failed reasonably to supervise, . . . with a view to preventing violations . . . another person who commits such a violation, if such other person is subject to his supervision."¹²⁵

The amendments authorizing penalties in administrative proceedings utilize a three-tiered approach similar to the structure enacted for penalties in civil actions. Monetary penalties in administrative proceedings, however, may not be based upon the amount gained by the respondent as a result of the violation, and thus may not exceed the stated maximum dollar amount. Also, the provisions authorizing monetary penalties in administrative proceedings provide an additional basis for imposing a third-tier penalty. A third-tier penalty may be imposed if the acts or omissions "resulted in substantial pecuniary gain to the person who committed the act or omission."¹²⁶

The Remedies Act sets forth several factors the Commission may consider in determining whether a monetary penalty is in the public interest. The SEC may consider the following:

1. whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
2. the harm to other persons resulting either directly or indirectly from such act or omission;
3. the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;
4. whether such person previously has been found by the Commission, other appropriate regulatory agency, or a self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, has been enjoined by a court of competent jurisdiction from violations of such laws or rules, or has been convicted . . . of any felony or misdemeanor described in [Sections 15(b)(4)(B) of the Securities Exchange Act or 203(e)(2) of the Advisers Act];
5. the need to deter such person and other persons from committing such acts or omissions; and

124. See, e.g., *id*

125. See, e.g., Exchange Act § 21B(a), 15 U.S.C.A. § 78u-2(a) (West Supp. 1991). Congress did not authorize the Commission to impose penalties based upon the entry of an injunction or a criminal conviction, both of which constitute grounds for the imposition of other administrative sanctions. Such authority would not be necessary because the Commission, when appropriate, would impose monetary penalties in the civil or criminal proceedings.

126. See, e.g., *id* § 21B(b), 15 U.S.C.A. § 78u-2(b) (West Supp. 1991)

b. such other matters as justice may require."¹²⁷

The legislation also provides that respondents may present evidence concerning their ability to pay a penalty.¹²⁸ The SEC may, in its discretion, consider such evidence in determining whether the penalty is in the public interest.¹²⁹ This evidence may relate to the extent of the respondent's ability to continue in business and the collectibility of the penalty, taking into account other claims against the respondent by the United States or third parties and the amount of the respondent's assets.¹³⁰

Analysis of the Remedies Act Regarding Monetary Penalties in Administrative Proceedings

The Remedies Act provisions providing for the imposition of monetary penalties in administrative proceedings are designed to address the deficiencies in the administrative authority previously exercised by the Commission. As noted above,¹³¹ the Commission experienced difficulty in fashioning appropriate relief. In many instances, the entry of an order censuring a securities professional was perceived as insufficient, while suspending or revoking a broker-dealer registration often would have consequences for customers, shareholders of the broker-dealer or other employees not involved in the violative conduct. The Remedies Act is intended to permit the Commission to tailor administrative sanctions in light of the relevant facts and circumstances.¹³²

The Remedies Act did not alter the substantive law with respect to the predicate offenses that may form the basis for the imposition of monetary penalties. With respect to administrative proceedings alleging a failure to supervise, Congress specifically stated that it did not intend "to expand the substantive scope of a firm's liability for misconduct of controlled or supervised persons."¹³³

The Remedies Act provisions authorizing monetary penalties in administrative proceedings raise many of the same issues as the monetary penalty provisions in civil actions. As discussed above, the manner in which the violative

127. See Exchange Act § 21B(c), 15 U.S.C.A. § 78u-2(c) (West Supp. 1991); Investment Company Act § 9(d)(3), 15 U.S.C.A. § 80a-9(d)(3) (West Supp. 1991); Investment Advisers Act § 203(i)(3), 15 U.S.C.A. § 80b-3(i)(3) (West Supp. 1991).

128. See, e.g., Investment Advisers Act § 203(i)(4), 15 U.S.C.A. § 80b-3(i)(4) (West Supp. 1991)

129. See, e.g., *id*

130. See, e.g., *id*

131. See *supra* notes 17-18 and accompanying text

132. The Remedies Act empowers the Commission in an administrative proceeding pursuant to §§ 15(b)(4) and 15(b)(6) of the Exchange Act to impose penalties for violations of the Exchange Act and the Securities Act without exception. The Remedies Act provisions for civil actions, however, specifically except insider trading violations from any civil monetary penalty. Compare Exchange Act § 21B(a), 15 U.S.C. § 78u-2(a) with Exchange Act § 21(d)(3), 15 U.S.C. § 78u(d)(3). Consequently, it appears that the Commission's power to proceed administratively against regulated entities and individuals, such as broker-dealers, may be greater than a court imposed ITSA penalty.

133. House Report, *supra* note 4, at 34

conduct alleged may significantly affect the amount of the penalty.¹³⁴ The manner in which the three-tiered penalty structure is construed may also affect the amount of the penalty. The administrative penalty provisions, like the civil penalty provisions, state that a violation may be subject to the third-tier penalty of \$100,000 for a natural person or \$500,000 for any non-natural person, if the violation results in substantial losses or creates a significant risk of substantial losses.¹³⁵ Also, as noted above, the Remedies Act provides that the Commission may impose a third-tier penalty if it finds that the act or omission resulted in substantial pecuniary gain to the offender.¹³⁶ Thus, the Commission's construction of these terms may have a significant impact on the amount of the penalty. The administrative penalty provisions do not, however, permit a penalty to be based upon the amount of a respondent's pecuniary gain. Consequently, according to Chairman Breeden:

The Commission expects that it would bring civil actions in federal court in those cases in which defendants have received illegal gains substantially in excess of these maximum amounts. [T]he maximum civil money penalty that a court could impose would be the greater of the specified amounts or "the gross amount of pecuniary gain to such defendant as a result of the violations."¹³⁷

The Remedies Act provisions authorizing monetary penalties in administrative proceedings set forth certain factors that Congress viewed as relevant to a determination of whether to impose a penalty.¹³⁸ The first factor, "whether the act or omission . . . involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," is a recognition by Congress that the Commission "may assess the violator's culpability, including whether the violator acted with scienter."¹³⁹

The second factor, the resulting harm to other persons, focuses primarily on the consequences of the violation to others and relates to the gravity of the violation.¹⁴⁰

The third factor that the Commission may consider is "the extent to which any person was unjustly enriched."¹⁴¹ The use of the phrase "any person" is designed to permit the Commission to consider those instances where persons other than the respondent are unjustly enriched as a result of the violative conduct.¹⁴²

The fourth factor the Commission may consider is whether the respondent has a prior history of securities law violations.¹⁴³ Thus, the Commission may properly impose higher civil monetary penalties on repeat offenders.¹⁴⁴

The fifth factor is the need to deter the respondent and any other person from committing the acts or omissions.¹⁴⁵ According to the Senate Report, "[t]his factor is an important consideration in cases in which the violation is one that requires strong deterrence or where assessing civil money penalties is likely to encourage better compliance."¹⁴⁶ This factor may permit the Commission to impose a significant penalty if the violation is of the type that is difficult to detect.¹⁴⁷

Finally, the sixth factor, which permits the Commission to consider "such other matters as justice may require," is designed to provide the Commission with the latitude to consider equitable factors and information similar to that specified in the other factors, such as the threat of harm in circumstances where no actual harm occurred.¹⁴⁸ For example, the Commission may consider "a history of noncompliance by a respondent even when the fourth factor is not involved because a prior adjudication has not occurred."¹⁴⁹

The factors set forth in the Remedies Act are similar to the factors the Commission has considered in determining whether to impose a remedial sanction.¹⁵⁰ However, the Remedies Act provides only that the Commission may consider such factors; it is not required to do so.¹⁵¹ Further, Congress stated that the absence of one or more factors in a particular case will not preclude the Commission from entering an order imposing a penalty.¹⁵²

An additional factor that Congress considered relevant to a determination of whether to impose a monetary penalty is the respondent's ability to pay the penalty.¹⁵³ Accordingly, the Remedies Act provides that a respondent may present evidence concerning its financial status.¹⁵⁴ In order to demonstrate an inability to pay, however, a respondent may have to present detailed financial information to the Commission. This may present a difficult choice if such information would disclose the existence of other potential securities law violations or violations of other provisions. Furthermore, Commission consideration of this evidence is discretionary, and there is no assurance that the Commission will not ultimately impose a penalty.¹⁵⁵ A respondent will have to carefully

143. *Id.* at 14-15.

144. *Id.* at 15.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. See House Report *supra* note 4, at 20.

151. *Id.*; Senate Report, *supra* note 7, at 14.

152. *Id.*

153. Senate Report, *supra* note 7, at 15.

154. See, e.g., Exchange Act § 21B(d), 15 U.S.C.A. § 78u-2(d) (West Supp. 1991).

155. See Senate Report, *supra* note 7, at 16.

134. See *supra* text accompanying notes 90-98.

135. See, e.g., Exchange Act § 21B(b), 15 U.S.C.A. § 78u-2(b) (West Supp. 1991).

136. See *supra* note 126 and accompanying text.

137. Breeden Testimony, *supra* note 5, at 16.

138. See *supra* text accompanying note 127.

139. Senate Report, *supra* note 7, at 14.

140. *Id.*

141. *Id.*

142. *Id.*

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weigh the advantages and disadvantages before presenting evidence of ability to pay a penalty.

Administrative orders imposing administrative monetary penalties, like other final administrative orders, are subject to judicial review, and may be appealed to the United States Court of Appeals "in the circuit in which the respondent resides or has his principal place of business, or in the District of Columbia Circuit."¹⁵⁶ As in the review of administrative orders generally, courts will likely show great deference to the Commission's determination.¹⁵⁷

The Remedies Act provisions authorizing monetary penalties in administrative proceedings do not include several provisions contained in the authorization for penalties in civil proceedings. The administrative penalty provisions do not include provisions expressly providing that the penalty shall be payable into the Treasury of the United States. Also, the administrative penalty provisions do not provide that a failure to pay a penalty may be referred to the Attorney General for collection. The legislative history does not specifically discuss the collection of administrative penalties. The Commission is authorized, however, to commence an action in district court to enforce its administrative orders.¹⁵⁸ Presumably, the Commission may utilize this authority to require a respondent to pay the penalty. Finally, the administrative penalty provisions do not state that an administrative proceeding imposing a penalty may be brought in addition to any other action the Commission or the Attorney General may be entitled to bring.

It is uncertain whether the principles espoused in *Tull* will enable a respondent to obtain a jury trial in an administrative penalty proceeding.¹⁵⁹ In *Atlas Roofing Co. v. Occupational Safety and Health Review Commission*,¹⁶⁰ the United States Supreme Court held that statutory provisions providing for civil penalties for violations of the Occupational Safety and Health Act may be decided by administrative tribunals.¹⁶¹ In *Atlas Roofing* the Court stated the following:

We cannot conclude that the Amendment rendered Congress powerless — when it concluded that remedies in courts of law were inadequate to cope with a problem within Congress' power to regulate—to create new public rights and remedies by statute and commit their enforcement, if it chose, to a tribunal other than a court of law—such as an administrative agency—in which facts are not found by juries.¹⁶²

156 House Report, *supra* note 4, at 21-22; Senate Report, *supra* note 7, at 16.

157 See *supra* notes 412-48 and accompanying text for a discussion of court deference to Commission determinations.

158 See, e.g., Exchange Act § 21(d)(3)(A), 15 U.S.C.A. § 78(u)(3)(A) (West Supp. 1991).

159 See *supra* notes 105-10 and accompanying text.

160 430 U.S. 428 (1977).

161 *Id.* at 455.

162 *Id.* at 460.

Moreover, the Court stated that this is the case "even if the Seventh Amendment would have required a jury where the adjudication of those rights is assigned to a federal court of law instead of an administrative agency."¹⁶³ In light of *Tull*, however, these statements may be subject to reconsideration. Although *Tull* involved a civil rather than administrative action, the Court's *Tull* analysis appears to apply readily to administrative proceedings.

Accounting and Disgorgement Orders in Administrative Proceedings

The Remedies Act authorizes the SEC to issue orders requiring an accounting and disgorgement, including reasonable interest, in an administrative proceeding in which the SEC has authority to impose money penalties.¹⁶⁴ The legislation provides that "[t]he Commission is authorized to adopt rules, regulations, and orders concerning payments to investors, rates of interest, periods of accrual, and such other matters as it deems appropriate to implement this [authority]."¹⁶⁵

Analysis of the Remedies Act Provisions Authorizing an Accounting and Disgorgement in Administrative Proceedings

Prior to the enactment of the Remedies Act, the Commission did not have express authority to order disgorgement in an administrative proceeding. To the extent the Commission determined that an order directing a person to disgorge illicit gains was necessary and appropriate, it was required to file an injunctive action in district court.¹⁶⁶ The SEC on occasion, however, effectively obtained disgorgement by conditioning the imposition of a sanction upon the respondent's compliance with an undertaking to disgorge profits or make restitution to injured customers.¹⁶⁷

As noted above, the extent to which a respondent has made restitution is one of the factors which the Commission may consider in determining whether to impose a monetary penalty.¹⁶⁸ While this factor would likely provide the respondent an incentive to voluntarily disgorge "ill-gotten gains," Congress granted the Commission express statutory authority to order disgorgement as an additional means of ensuring that "respondents in administrative proceedings do not retain ill-gotten gains."¹⁶⁹

163 *Id.* at 455.

164 See, e.g., Investment Company Act § 9(e), 15 U.S.C.A. § 80a-9(e) (West Supp. 1991).

165 *Id.*

166 See *infra* text accompanying notes 302-10.

167 House Report, *supra* note 4, at 22; Senate Report, *supra* note 7, at 16; see also, *In re Anderson & Strudwick, Inc.*, Exchange Act Release No. 22,089, 33 SEC Docket (CCH) 286 (May 29, 1985).

168 See *supra* text accompanying note 127.

169 Senate Report, *supra* note 7, at 16.

The extent of the Commission's authority to require an accounting is not set forth in the Remedies Act. Thus, while the SEC may now require a respondent to account for illegal profits or require a respondent to retain an accountant to examine his or her records, the scope of the Commission's authority to order an accounting is unclear.¹⁷⁰

Cease-and-Desist Authority

The Remedies Act significantly expands the Commission's administrative jurisdiction by authorizing the Commission to issue cease-and-desist orders. The Remedies Act authorizes the SEC to issue both permanent and temporary cease-and-desist orders.¹⁷¹ Pursuant to the Remedies Act, the SEC may enter permanent cease-and-desist orders against any person and may enter temporary cease-and-desist orders against regulated entities and associated persons.¹⁷²

Permanent Cease-and-Desist Orders

The legislation provides that if the Commission finds, after notice and an opportunity for a hearing, that a person is violating, has violated, or is about to violate any provision of the federal securities laws, or the rules or regulations thereunder, it may issue an order requiring that person to cease-and-desist from committing the violation or any future violation of the same provision, rule or regulation.¹⁷³ The Commission may also issue an order directing any person "that is, was, or would be a cause of the violation due to an act or omission that the person knew or should have known would contribute to the violation" to "cease and desist from committing or causing such violation and any future violation."¹⁷⁴

The cease-and-desist provisions also authorize the Commission to require a respondent to comply, or to take steps to effect compliance, with the relevant securities statute upon such terms and conditions and within such time as the Commission may specify.¹⁷⁵ The cease-and-desist provisions explicitly state that any cease-and-desist order may, "as the Commission deems appropriate, require future compliance or steps to effect future compliance, either permanently or for such period of time as the Commission may specify, with [the violated]

170. See Pitt & Johnson, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990: Provisions and Implications of the New Remedies Available to the SEC*, in *Securities Enforcement and Penny Stock Reform Act of 1990*, at 39 (PLI Corp. Law & Practice Course Handbook Series Number 718, 1990) (suggesting that SEC may issue orders requiring reviews of prior audits).

171. See Securities Act § 8A, 15 U.S.C.A. § 77h-1 (West Supp. 1991); Exchange Act § 21C, 15 U.S.C.A. § 78u-3 (West Supp. 1991); Investment Company Act § 9(f), 15 U.S.C.A. § 80a-9(f) (West Supp. 1991); Investment Advisers Act § 203(k), 15 U.S.C.A. § 80b-3(k) (West Supp. 1991).

172. See *id.*

173. See, e.g., Investment Advisers Act § 203(k)(1), 15 U.S.C.A. § 80b-3(k)(1) (West Supp. 1991).

174. See, e.g., *id.*

175. See, e.g., *id.*

provision, rule, or regulation with respect to any security, any issuer, or any other person."¹⁷⁶ The Remedies Act also authorizes the Commission to issue an order requiring an accounting and disgorgement in cease-and-desist proceedings.¹⁷⁷

The Remedies Act provides that a hearing on a permanent cease-and-desist order must take place before an administrative law judge no earlier than thirty days and no later than sixty days after notice is received, unless an earlier or later date is set by the Commission with the consent of the respondent.¹⁷⁸ A respondent can appeal an adverse decision by the administrative law judge to the Commission, which will consider the evidence *de novo*.¹⁷⁹ If the Commission affirms the decision of the administrative law judge, the respondent then has the right to appeal to a United States Court of Appeals.¹⁸⁰

Analysis of the Permanent Cease-and-Desist Authority

The authority to issue cease-and-desist orders constitutes a significant expansion of the Commission's administrative jurisdiction. Prior to the Remedies Act, the Commission's administrative jurisdiction extended to regulated persons,¹⁸¹ specific types of proceedings such as stop order proceedings,¹⁸² and proceedings against persons appearing or practicing before the Commission.¹⁸³ The Remedies Act cease-and-desist provisions expand the Commission's administrative jurisdiction by empowering the Commission to proceed in its own administrative forum against any person and to address any violation of any provision of the federal securities laws.

In determining to expand significantly the SEC's administrative jurisdiction, Congress considered a number of factors. Initially, Congress noted that the Treadway Commission recommended the grant of cease-and-desist authority to the Commission.¹⁸⁴ Congress also noted that a number of federal regulatory agencies exercised cease-and-desist authority, including the Commodity Futures

176. See Securities Act § 8A(a), 15 U.S.C.A. § 77h-1(a) (West Supp. 1991); Exchange Act § 21C(a), 15 U.S.C.A. § 78u-3(a) (West Supp. 1991); Investment Company Act § 9(f)(1), 15 U.S.C.A. § 80a-9(f)(1) (West Supp. 1991); Investment Advisers Act § 203(k)(1), 15 U.S.C.A. § 80b-3(k)(1) (West Supp. 1991).

177. See, e.g., Exchange Act § 21C(e), 15 U.S.C.A. § 78u-3(e) (West Supp. 1991).

178. See, e.g., *id.* § 21C(b), 15 U.S.C.A. § 78u-3(b) (West Supp. 1991). The legislation does not explicitly provide for a hearing by an administrative law judge. The legislative history, however, indicates that such a hearing is contemplated. See House Report, *supra* note 4, at 24; Senate Report, *supra* note 7, at 19.

179. House Report, *supra* note 4, at 24; Senate Report, *supra* note 7, at 19.

180. House Report, *supra* note 4, at 24-25; Senate Report, *supra* note 7, at 19.

181. See, e.g., Exchange Act § 15(b), 15 U.S.C.A. § 78o(b) (West 1981 & Supp. 1991) (administrative proceedings against broker-dealers and associated persons).

182. See Securities Act § 8, 15 U.S.C.A. § 77h (West 1981).

183. See 17 C.F.R. § 201.2(e) (1991) (rule 2(e) of the Commission's Rules of Practice).

184. Senate Report, *supra* note 7, at 7-8; House Report, *supra* note 4, at 14-15.

Trading Commission, the Federal Trade Commission and various banking agencies.¹⁸⁵

The grant of cease-and-desist authority to the Commission is intended to address a deficiency in the Commission's enforcement powers by providing the Commission with a flexible remedy that operates similar to an injunction.¹⁸⁶ Congress indicated that it viewed the cease-and-desist remedy as providing the Commission with an alternative to injunctive actions that may be used against persons "who commit isolated infractions and present a lesser threat to investors."¹⁸⁷ The House Report noted that the Commission's use of the cease-and-desist authority would be appropriate to avoid protracted litigation or settlement negotiations resulting from defendants' concerns regarding the severe collateral consequences that an injunctive action can cause.¹⁸⁸ As an example, Congress cited the statutory disqualification from serving as an officer or director of an investment company that arises from the entry of an injunction.¹⁸⁹ Similarly, a broker-dealer who has been enjoined or is the subject of an order issued in a broker-dealer proceeding may be precluded from acting as an underwriter for offerings made in reliance upon certain of the exemptions from the registration requirements.¹⁹⁰ As presently formulated, the entry of a cease-and-desist order will not result in a similar disqualification.

The cease-and-desist authority granted to the Commission is quite broad. In addition to ordering a person to cease and desist from committing or causing violations or future violations, the Commission is also authorized to order a person to comply with a provision or to take steps to effect compliance.¹⁹¹ The Commission may also prescribe specific terms and conditions that a person must observe in order to effect compliance and may specify the time frame within which compliance must be effected.¹⁹² Thus, the Commission is authorized to require a person to take action to correct an existing condition resulting from a violation and to specify the steps to be taken. Most importantly, the Commission may issue orders requiring a person to comply in the future with, or requiring the person to take steps to effect future compliance with, a provision, rule or regulation with respect to any security, any issuer or any other person.¹⁹³ The

185. See House Report, *supra* note 4, at 23.

186. *Id.*

187. *Id.* at 24.

188. See *id.* at 23-24.

189. House Report, *supra* note 4, at 23-24, see Investment Company Act § 9(a)(2), 15 U.S.C.A. § 80a-9(a)(2) (West Supp. 1991).

190. See 17 C.F.R. § 230.252(d) (1991); 17 C.F.R. § 230.505(b)(2)(iii) (1991).

191. See *e.g.*, Exchange Act § 21C(a), 15 U.S.C.A. § 78u-3(a) (West Supp. 1991).

192. See, *e.g.*, *id.*

193. See, *e.g.*, *id.* The scope of the orders are, therefore, broader than § 15(c)(4) orders. See Exchange Act § 15(c)(4), 15 U.S.C.A. § 78o(c)(4) (West Supp. 1991). In *In re George C. Kern, Jr.*, Exchange Act Release No. 29,356, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991), the Commission affirmed a holding by an administrative law judge that § 15(c)(4) does not permit the Commission to order a respondent to comply generally with the statutory provisions the respondent violated. See *infra* notes 452-68 and accompanying text. In contrast, recently, in *In re Norman G. Baker*, Exchange Act Release No. 29,108, 1991 SEC LEXIS 782 (April 22, 1991), the

Commission may order such relief permanently, or for such period as it determines appropriate.¹⁹⁴ For example, the Commission may direct a corporate respondent to add directors and to form specific committees to monitor certain corporate activities, or to resolicit proxies obtained by deficient proxy materials. Similarly, the Commission could order a brokerage firm to retain counsel to conduct a review of the firm's compliance with applicable provisions.

Neither the Remedies Act nor the legislative history discusses the extent of the Commission's authority regarding the issuance of orders directing compliance. The Commission's cease-and-desist authority is so broad that it may be used to circumvent certain of the requirements of other provisions. For example, if the Commission were to use its authority under the cease-and-desist provisions to direct a corporate respondent to terminate an officer or remove a director in order to effect compliance, the Commission would undermine the Congressional determination to vest in the district courts the power to enter orders suspending or barring persons from serving as an officer or director based only upon a violation of the antifraud provisions or proof of substantial unfitness.¹⁹⁵ The exercise of this broad power also may have a significant effect upon other persons, including shareholders of corporate respondents who may ultimately bear the costs of certain orders requiring steps to effect compliance.

The Commission's authority to issue a cease-and-desist order against any person that is a cause of a violation also raises concerns. The Remedies Act provides that the Commission may issue a cease-and-desist order against any "person that is, was or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation."¹⁹⁶ The legislative history of the Remedies Act does not discuss whether this provision requires scienter or whether negligence will suffice.

The Remedies Act formulation for secondary liability appears to be derived from section 15(c)(4) of the Exchange Act.¹⁹⁷ In *In re George C. Kern, Jr.*,¹⁹⁸ an administrative law judge addressed the issue of the mental state required by section 15(c)(4). In *Kern*, the Commission's Chief Administrative Law Judge ruled that negligence will suffice to establish liability for causing a failure to comply.¹⁹⁹ Based upon the similar formulations between section 15(c)(4) and

Commission entered into a settlement imposing a cease-and-desist order and requiring future compliance with the violated provision. The Commission alleged that Baker had made materially false and misleading statements in his Schedule 13D. The cease-and-desist order required Baker to permanently cease and desist from committing any future violation of § 13(d) of the Exchange Act.

194. See, *e.g.*, Exchange Act § 21C(a), 15 U.S.C.A. § 78u-3(a) (West Supp. 1991).

195. See 1990 ABA Section Comment Letter, *supra* note 45, at 82-83.

196. See, *e.g.*, Securities Act § 8A(a), 15 U.S.C.A. § 77h-1(a) (West Supp. 1991).

197. Section 15(c)(4), in relevant part, provides that the Commission may issue an order requiring "any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply, to comply." 15 U.S.C.A. § 78o(c)(4) (West Supp. 1991).

198. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342 (Nov. 14, 1988), *aff'd*, Exchange Act Release No. 29,356, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991).

199. *Id.* ¶ 84,342, at 89,590-91.

Remedies Act, it appears likely that the Commission will take the position that negligence will establish a person's liability as a cause of a violation in a cease-and-desist proceeding. In that event, the Commission will have a considerable incentive to proceed administratively, rather than through an injunctive action or other administrative proceedings in which the Commission would have to satisfy the elements of aiding and abetting liability.²⁰⁰

Temporary Cease-and-Desist Orders

The Remedies Act also empowers the Commission to issue temporary cease-and-desist orders against certain persons.²⁰¹ The Remedies Act provides that if, upon initiating a permanent cease-and-desist proceeding, the SEC determines that the violation or threatened violation is likely to result in "significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest," the Commission may enter a temporary order requiring a respondent to cease and desist from the unlawful conduct and to take certain actions to prevent the dissipation or conversion of assets, harm to investors, or harm to the public interest.²⁰²

The legislation provides that the Commission may issue a temporary cease-and-desist order only after notice and an opportunity for a hearing, "unless the Commission determines that notice and hearing prior to entry would be impracticable or contrary to the public interest."²⁰³ Thus, the Commission may issue *ex parte* temporary cease-and-desist orders. A temporary cease-and-desist order is effective upon service on the respondent and remains effective pending completion of the proceedings unless set aside, limited, or suspended by the Commission or by a court of competent jurisdiction.²⁰⁴

The SEC may issue temporary cease-and-desist orders only against persons registered or required to be registered with the Commission and persons who, at the time of the misconduct, were associated with or were seeking to become associated with a registered entity.²⁰⁵ Such persons are: (1) brokers; (2) dealers; (3) investment advisers; (4) investment companies; (5) municipal securities

200. Generally, an individual may be held liable as an aider and abettor only if: (1) someone has committed a violation of the securities laws; (2) the individual had knowledge of that act; and (3) the individual knowingly and substantially participated in the wrongdoing. *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987), cert. denied, 483 U.S. 1006; *Armstrong v. McAlpin*, 699 F.2d 79, 91 (2d Cir. 1983); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799, cert. denied, 439 U.S. 930 (1978); see also *Schiffke v. Seafirst Corp.*, 866 F.2d 935 (7th Cir. 1989) (in action arising out of rule 10b-5 plaintiffs required to show that alleged aider and abettor committed one of the manipulative or deceptive acts with same degree of scienter required for primary liability).

201. See Securities Act § 8A(c), 15 U.S.C.A. § 77h-1(c) (West Supp. 1991); Exchange Act § 21C(c), 15 U.S.C.A. § 78u-3(c) (West Supp. 1991); Investment Company Act § 9(f)(3), 15 U.S.C.A. § 80a-9(f)(3) (West Supp. 1991); Investment Advisers Act § 203(k)(3), 15 U.S.C.A. § 80b-3(k)(3) (West Supp. 1991).

202. See *id.*

203. See *id.*

204. See *id.*

205. See *id.*

dealers; (6) government securities brokers and dealers; and (7) transfer agents.²⁰⁶

The Remedies Act specifically provides for the review of temporary cease-and-desist orders. If the Commission entered the temporary cease-and-desist order following a Commission hearing, the respondent may, within ten days of service of the order, apply to one of the appropriate district courts for an order setting aside, limiting, or suspending the effectiveness or enforcement of the cease-and-desist order.²⁰⁷

A respondent served with an *ex parte* temporary cease-and-desist order must first exhaust his administrative remedies before seeking review by a district court.²⁰⁸ The Remedies Act provides that, within ten days of being served with the *ex parte* order, the respondent may request the SEC to hold a hearing, and that the Commission must hold a hearing and render a decision "at the earliest possible time."²⁰⁹ The respondent has ten days within which to appeal an adverse determination by the Commission to the appropriate district court.²¹⁰ At any time after the respondent has been served with a temporary cease-and-desist order, however, the respondent may apply to the Commission to have the order set aside, limited, or suspended.²¹¹

It is important to note that the commencement of an appeal, in the absence of a specific order by the court, will not operate as a stay of the Commission's order.²¹² The legislation provides that a temporary cease-and-desist order is effective upon service and, unless set aside, limited or suspended by the Commission or a court, remains "effective and enforceable pending the completion of the proceedings."²¹³

Analysis of the Temporary Cease-and-Desist Authority

The temporary cease-and-desist authority is intended to permit the Commission to act expeditiously to prevent investor losses. The House Report states that the cease-and-desist authority "would give the Commission the ability to commence enforcement proceedings rapidly, especially when ongoing conduct places investors in continuing jeopardy."²¹⁴

206. See *id.*

207. See Securities Act § 8A(d), 15 U.S.C.A. § 77h-1(d) (West Supp. 1991), Exchange Act § 21C(d), 15 U.S.C.A. § 78u-3(d) (West Supp. 1991), Investment Company Act § 9(f)(4), 15 U.S.C.A. § 80a-9(f)(4) (West Supp. 1991), Investment Advisers Act § 203(k)(4), 15 U.S.C.A. § 80b-3(k)(4) (West Supp. 1991). The appropriate district courts are the U.S. District Court for the District of Columbia, the district court where the respondent resides, or the district court where the respondent has its principal place of business. See *id.*

208. See *id.*

209. See *id.*

210. See *id.*

211. See, e.g., Exchange Act § 21C(d)(1), 15 U.S.C.A. § 78u-3(d)(1) (West Supp. 1991).

212. See, e.g., Securities Act § 8A(d)(3), 15 U.S.C.A. § 77h-1(d)(3) (West Supp. 1991).

213. See, e.g., Securities Act § 8A(c)(1), 15 U.S.C.A. § 77h-1(c)(1) (West Supp. 1991).

214. House Report, *supra* note 4, at 25.

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The cease-and-desist provisions authorize the Commission to issue a temporary order upon a determination that the respondent is engaging in, or about to engage in, a violation that is likely to result in significant dissipation of assets, conversion of property, or significant harm to investors, or that is otherwise likely to result in substantial harm to the public interest before the completion of a permanent cease-and-desist proceeding.²¹⁵ The legislation does not define the terms "significant dissipation," "conversion of assets," "significant harm to investors," or "substantial harm to the public interest," and the legislative history does not significantly add to the meaning of these terms.

The temporary cease-and-desist authority allows the Commission to take such action to prevent a violation or a threatened violation. Moreover, the provision authorizing the Commission to enter temporary cease-and-desist orders for threatened violations is extremely broad and may be construed as authorizing the Commission to require a respondent to take whatever action the Commission determines appropriate to prevent harm, even if the action required is excessive in comparison with the potential harm. A respondent's failure to comply with the order pending review may result in the imposition of significant penalties.

As originally proposed by the Commission, the authority to issue temporary cease-and-desist orders would have extended to any person.²¹⁶ After considerable comment,²¹⁷ however, the Senate and House Bills were amended to limit temporary cease-and-desist authority to regulated entities and associated persons. Nevertheless, the Commission may still use the temporary cease-and-desist authority against non-regulated persons through an order entered against a regulated person involved in the transaction. For example, upon determining that a securities transaction constitutes a violation of the federal securities laws, the Commission may enter a temporary cease-and-desist order directing a broker-dealer not to deliver funds to a customer. Similarly, the Commission may enter a temporary order directing an underwriter not to transmit funds to an issuer if the Commission determines that the issuer's offering materials were deficient. Thus, the Commission is able to freeze assets of non-regulated as well as regulated persons through an administrative order instead of having to seek recourse in the federal district courts.

The Commission's authority to issue temporary cease-and-desist orders on an *ex parte* basis is also significant. The legislation authorizes the Commission to issue a temporary cease-and-desist order without prior notice and hearing if "the Commission determines that notice and hearing prior to entry would be impracticable or contrary to the public interest."²¹⁸ The House Report states

that the entry of a cease-and-desist order on an *ex parte* basis is an extraordinary remedy and not "a wholesale substitute for the range of Commission enforcement procedures."²¹⁹ The Senate Report states that:

[P]rior notice would be contrary to the public interest when, for example, it is reasonably likely to result in a respondent's flight from prosecution, destruction of or tampering with evidence, transfer of assets or records, improper conversion of assets, impeding the SEC's ability to identify or trace the source or disposition of funds or further harm to investors.²²⁰

The Commission's ability to issue *ex parte* temporary cease-and-desist orders that will remain in effect pending a Commission hearing raises due process concerns. First, it is unclear what preliminary determinations by the Commission are required in order to issue such an order. Second, even if the issuance of an *ex parte* order does not violate due process, the lack of a prompt hearing may.

An *ex parte* temporary cease-and-desist order, such as one depriving the respondent of access to the allegedly ill-gotten funds, arguably would result in the deprivation of a property right and implicate the fifth amendment's due process clause. Recently, the United States Supreme Court addressed the prerequisites required for such a government-ordered deprivation without a prior hearing. In *Federal Deposit Insurance Corp. v. Mallen*,²²¹ the Supreme Court upheld an *ex parte* order by the FDIC prohibiting an indicted bank official from participating in the bank's affairs. The Supreme Court noted that, while the official's right to participate in the bank's affairs is a property right protected by the due process clause, "[a]n important government interest, accompanied by a substantial assurance that the deprivation is not baseless or unwarranted, may in limited cases demanding prompt action justify postponing the opportunity to be heard until after the initial deprivation."²²²

Since the legislation at issue in *Mallen* was premised on a congressional finding that prompt suspension of indicted bank officers may be necessary to protect the interests of depositors and to maintain public confidence in banking institutions, the Supreme Court found an important government interest to exist.²²³ Moreover, since there was a grand jury determination that the bank official may have committed a felony, there was sufficient assurance that the suspension was not baseless.²²⁴

As with the FDIC legislation at issue in *Mallen*, a court would likely find that there exists an important government interest in the issuance of *ex parte* temporary cease-and-desist orders. Similar to the banking legislation at issue in *Mallen*, Congress intended the temporary cease-and-desist order authority of

215. *Id.* at 19-20.

216. See *supra* text accompanying note 51.

217. See, e.g., 1990 ABA Section Comment Letter, *supra* note 45, at 77-92.

218. See, e.g., Exchange Act § 21C(c)(1), 15 U.S.C.A. § 78u-3(c)(1) (West Supp. 1991).

219. House Report, *supra* note 4, at 25.

220. Senate Report, *supra* note 7, at 27.

221. 486 U.S. 230 (1988).

222. *Id.* at 240.

223. *Id.* at 241.

224. *Id.*

the Securities Act to protect investors and maintain confidence in the securities markets. While the Remedies Act provides no explicit requirement that the Commission make a preliminary determination of whether a violation has occurred, *Mallen* indicates that the Commission should afford procedural protections to ensure that there is a "substantial assurance that the deprivation is not baseless or unwarranted."²²⁵

The constitutional principles of due process apply to administrative adjudications.²²⁶ This requires not only a fair proceeding, but also a proceeding that satisfies the appearance of justice.²²⁷ The critical constitutional determination appears to be whether the *ex parte* temporary cease-and-desist order is considered a prejudgment of the specific facts of the case when the individual making the preliminary determination also will be judging the merits of the order after the hearing.²²⁸ If the *ex parte* determination is held to constitute prejudgment, it may be possible to challenge the subsequent decision. A *de facto* determination on the merits, and the issuance of an *ex parte* cease-and-desist order by the same individual or individuals who will conduct the subsequent hearing may not comport with the appearance of justice and, therefore, might result in a judge invalidating the order.²²⁹

An unjustified delay in holding a hearing following the issuance of an *ex parte* temporary cease-and-desist order may also violate the due process clause. In *Federal Deposit Insurance Corp. v. Mallen*,²³⁰ the United States Supreme Court held the following:

In determining how long a delay is justified in affording a hearing and decision, it is appropriate to examine the importance of the private interest and the harm to this interest occasioned by delay; the justification offered by the Government for delay and its relation to the underlying governmental interest; and the likelihood that the interim decision may have been mistaken.²³¹

As noted above,²³² the Commission is required to hold the hearing and render a decision "at the earliest possible time."²³³ In the event that a Commission

225 *Id.* at 240.

226 *Antoniu v. SEC*, 877 F.2d 721, 724 (8th Cir. 1989), cert. denied, 110 S. Ct. 1296 (1990); see *Amos Treat & Co. v. SEC*, 306 F.2d 260, 263-64 (D.C. Cir. 1962).

227 See *Antoniu*, 877 F.2d at 724 (quoting *In re Murchison*, 349 U.S. 133, 136 (1955)).

228 See *Cinderella Career and Finishing Schools, Inc. v. FTC*, 425 F.2d 583, 590-91 (D.C. Cir. 1970).

229 See *Antoniu*, 877 F.2d at 724-26 (prior speech evidencing prejudgment). But see *Withrow v. Larkin*, 421 U.S. 35, 46-55 (1975) (mere prior exposure to evidence presented will not, in itself, be sufficient to impugn fairness of Commission members), *FTC v. Cement Inst.*, 333 U.S. 683 (1948), *Rumblough v. FAA*, 594 F.2d 893, 900 (2d Cir. 1979) (announced prior position about law or policy is unlikely to constitute sufficient grounds to challenge exercise of adjudicative power).

230 486 U.S. 230 (1988).

231 *Id.* at 242 (stating that 90 days to hear the case and reach a decision is not a per-se due process violation).

232 See *supra* note 209 and accompanying text.

233 See, e.g., Exchange Act § 21C(d), 15 U.S.C.A. § 78u-3(d) (West Supp. 1991).

determination is not readily forthcoming, however, it may be possible for a respondent to compel a prompt Commission determination by seeking a writ of mandamus pursuant to 28 U.S.C. § 1361²³⁴ or other relief pursuant to the Administrative Procedure Act (APA). Mandamus relief under section 1361 requires that: (1) the plaintiff have a clear right to the relief sought; (2) the defendants have a plainly defined ministerial duty to perform the act in question; and (3) no adequate alternative remedy is available and the plaintiff will suffer irreparable harm absent judicial intervention.²³⁵ The Commission's refusal to perform its duty of holding a prompt hearing and determination on the preliminary cease-and-desist order may satisfy the above requirements and justify the issuance of a writ of mandamus.²³⁶

Mandamus relief, however, presumes the absence of an adequate alternative remedy. The Third Circuit Court of Appeals, in *Thompson v. United States Department of Labor*,²³⁷ recently held that the protections afforded by the APA may preclude mandamus relief.²³⁸ The APA requires an agency to "proceed to conclude a matter presented to it" within "a reasonable time"²³⁹ and authorizes a court to compel agency action "unreasonably delayed."²⁴⁰ The *Thompson* court concluded that the APA "authorizes actions in the district court to compel agency action . . . unreasonably delayed, at least in cases where judicial review of an agency's final action would be in the district court in the first instance."²⁴¹ Consequently, if the Commission does not hold a prompt hearing within a reasonable time, it appears that one may bring a court action under the APA to compel the Commission to hold such a hearing.²⁴²

OFFICER AND DIRECTOR BARS

The Remedies Act Bar Provisions

The Remedies Act also provides that a court, in an injunctive action, may enter an order barring or suspending persons from serving as officers or directors of corporations with a class of securities registered pursuant to section 12 of the Exchange Act or corporations required to file reports under section

234 See 28 U.S.C.A. § 1361 (West 1976).

235 *United States ex rel. Girard Trust Co. v. Helvering*, 301 U.S. 540, 543-44 (1937); *Clayton Brokerage Co. v. Commodity Futures Trading Comm'n*, 548 F. Supp. 1015, 1017 (E.D. Mo. 1982); see 28 U.S.C.A. § 1361 (West 1976).

236 See, e.g., *Telecommunications Research & Action v. FCC*, 750 F.2d 70, 79-80 (D.C. Cir. 1984) (egregious agency delay may warrant mandamus).

237 813 F.2d 48 (3d Cir. 1987).

238 *Id.* at 52.

239 5 U.S.C.A. § 555(b) (West 1977).

240 *Id.* § 706(1) (West 1977).

241 *Thompson*, 813 F.2d at 52; see *Public Citizen Health Research v. Commissioner Food & Drug Admin.*, 740 F.2d 21, 32 (D.C. Cir. 1984) ("APA empowers the court to evaluate the pace of agency decisional process and to order expedition if the pace lags unreasonably").

242 See, e.g., *Las Vegas Hawaiian Dev. Co. v. SEC*, 466 F. Supp. 928, 932 (D. Haw. 1979) (APA may be used to compel SEC to make determination of whether to proceed with a stop order proceeding).

10(b) of that act.²⁴³ The Remedies Act provides that a court may bar any person who has violated section 17(a)(1) of the Securities Act, or section 10(b) of the Exchange Act, or the rules and regulations promulgated pursuant to section 10(b), and who has demonstrated "[s]ubstantial unfitness to serve as an officer or director."²⁴⁴ The bar may be unconditional or conditional, for a permanent or a fixed period of time.²⁴⁵

Analysis of the Bar Provisions

The Congressional reports accompanying the legislation state that the federal district court's inherent equitable powers permit those courts to enter orders prohibiting a person from serving as an officer or director.²⁴⁶ Nevertheless, Congress determined that it was appropriate to provide the federal district courts with express statutory authority to bar or suspend an individual from serving as an officer or director.²⁴⁷

The Senate Report noted that, while an officer and director bar is a potentially severe sanction, "persons who have demonstrated a blatant disregard for the requirements of the Federal securities laws should not be placed in a position of trust with a publicly held corporation."²⁴⁸ Congress observed that, in determining substantial unfitness, the capacity in which the violator was serving when the conduct occurred is often relevant. Congress stated that "the remedy of a bar or suspension from service as a corporate officer or director is especially appropriate in cases in which a defendant has engaged in fraudulent conduct while serving in a corporate or other fiduciary capacity."²⁴⁹ Congress also stated that the authority to bar individuals from serving as officers and directors is a remedial remedy and not designed to establish minimum qualifications for corporate officers and directors.²⁵⁰ In testimony before Congress, SEC Chairman Richard Breeden stated the following:

The Commission recognizes that corporate governance issues are generally regulated by state law. The purpose of the corporate bar provisions is not to establish federal standards governing the qualifications of corporate officers or directors. Rather, the purpose of this provision is to protect public investors from persons who have already demonstrated a propensity

243. See Securities Act § 20(e), 15 U.S.C.A. § 77t(e); Exchange Act § 21(d)(2), 15 U.S.C.A. § 78u(d)(2)

244. See *id.*

245. See *id.*

246. Senate Report, *supra* note 7, at 22; House Report, *supra* note 4, at 27.

247. The legislative history states that by granting federal district courts explicit authority to prohibit or to bar persons from serving as officers or directors, Congress did not intend to limit the federal district courts' inherent authority to order other forms of equitable relief. Senate Report, *supra* note 7, at 23; House Report, *supra* note 4, at 27.

248. Senate Report, *supra* note 7, at 21.

249. House Report, *supra* note 4, at 27, *see also* Senate Report, *supra* note 7, at 21 (stating that the breach of a fiduciary duty may give rise to an officer or director bar).

250. House Report, *supra* note 4, at 27.

to abuse a position of corporate trust. Where a person's conduct is such that the disclosure provisions of the federal securities laws, even when supplemented by the coercive power of a federal court injunction, are insufficient to protect investors from further loss, the availability of such a provision is necessary.²⁵¹

Prior to the Remedies Act, the Commission sought a bar against service as an officer or director of a publicly-held company only on those occasions where it viewed the defendant's conduct as extremely egregious.²⁵² The Commission actually obtained this relief in only one litigated case.²⁵³

The Remedies Act's officer and director bar provisions do not reflect the Commission's practice with respect to this relief. The Remedies Act permits the Commission to seek an officer or director bar against a person who was not an officer or director or seeking to become an officer or director either at the time of the violation or at the time the action was brought. Further, such relief may be sought although the defendant's alleged violative conduct did not involve a reporting corporation. Most importantly, as with other provisions of the Remedies Act, the term "substantial unfitness" is vague and may be the subject of litigation that could have been avoided through the use of a more precise term.

THE COMMISSION'S TRADITIONAL ENFORCEMENT ALTERNATIVES

The Remedies Act will provide the Commission with a substantial amount of flexibility in addressing securities law violations and should increase the deterrence level of SEC enforcement actions. The Commission's traditional enforcement alternatives, however, will continue to play an important role in the enforcement of the federal securities laws. The Commission will continue to utilize many of its traditional enforcement alternatives either in conjunction with remedies authorized by the Remedies Act or as an alternative to the Remedies Act provisions.

INJUNCTIVE ACTIONS

Temporary Restraining Orders and Preliminary Injunctions

The federal securities laws authorize the Commission to seek preliminary relief in the form of a temporary restraining order or a preliminary injunction.²⁵⁴ The Commission may seek such relief to halt ongoing violations or to

251. Breeden Testimony, *supra* note 5, at 30.

252. See, e.g., SEC v. Florafax Int'l, Inc., SEC Litig. Release No. 10,617, 1984 SEC LEXIS 238 (Nov. 27, 1984); SEC v. San Saba Nu-Tech, Inc., SEC Litig. Release No. 10,531, 1984 SEC LEXIS 700 (Sept. 19, 1984).

253. See SEC v. Techni-Culture, Inc., [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,501 (D. Ariz. Apr. 2, 1974).

254. See, e.g., Securities Act § 20(b), 15 U.S.C.A. § 77t(b) (West Supp. 1991). The standards applicable for the issuance of a temporary restraining order and the standards applicable for the

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prevent imminent violations.²⁵⁵ Additionally, the Commission may seek temporary relief to prevent the secreting or dissipation of ill-gotten gains and to preserve such assets until the Commission can establish that disgorgement of illicit gains is appropriate.²⁵⁶

To obtain preliminary injunctive relief, the Commission is required to meet the statutory standards for injunctive relief, rather than the common law standards private litigants must meet.²⁵⁷ The securities laws provide that the Commission is required to make a "proper showing."²⁵⁸ Courts have construed this provision as requiring a showing that there is a reasonable likelihood that the defendant is engaged in, or about to engage in, practices that violate the federal securities laws.²⁵⁹ Generally, courts have held that the Commission may satisfy this requirement by establishing: (1) a *prima facie* case²⁶⁰ that the defendants have engaged in,²⁶¹ or are currently engaging²⁶² in violative conduct; and (2) that there exists a reasonable likelihood that the wrongs will be repeated.²⁶³

Recently, in *SEC v. Unifund SAL*,²⁶⁴ the Second Circuit Court of Appeals held that a more substantial showing is required, both as to the *prima facie* case of a violation and the risk of recurrence, whenever the relief sought is more than

issuance of a preliminary injunction appear to be similar. See *Schwartz Constr. Co. v. New York City Transit Auth.*, 591 F. Supp. 1257, 1261 n.10 (S.D.N.Y. 1984), *see, e.g.*, *SEC v. Wellshire Sec., Inc.*, 737 F. Supp. 251 (S.D.N.Y. 1990); *SEC v. Grossman*, No. 87-1031, 1987 U.S. Dist. LEXIS 1666 (S.D.N.Y. Feb. 17, 1987). A court may issue a temporary restraining order without notice if it clearly appears to the court that immediate and irreparable injury, loss, or damage would otherwise result. See Fed. R. Civ. P. 65(b); *Arvida Corp. v. Sugarman*, 259 F.2d 428, 429 (1958) (Lumbard, J., concurring).

255 See, e.g., Securities Act § 20(b), 15 U.S.C.A. § 77(b) (West Supp. 1991).

256 See, e.g., *SEC v. Wang*, SEC Litig. Release No. 11,780, 1988 SEC LEXIS 1364 (June 27, 1988).

257 Thus, the Commission is not required to meet the standards for private litigants such as risk of irreparable injury or the unavailability of remedies at law. *SEC v. Unifund SAL*, 910 F.2d 1038, 1036 (2d Cir. 1990); *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 808 (2d Cir. 1975); *see SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963). Moreover, in *Unifund SAL*, the Second Circuit Court of Appeals expressly refused to allow the Commission to rely on standards allowed for private plaintiffs' relief. *Unifund SAL*, 910 F.2d at 1040.

258 See, e.g., Exchange Act § 21(d)(1), 15 U.S.C.A. § 78u(d)(1) (West Supp. 1991).

259 *Aaron v. SEC*, 446 U.S. 680, 700-01 (1980); *SEC v. First Fin. Group of Tex.*, 645 F.2d 429, 434 (5th Cir. 1981).

260. Although some lower courts have used the phrase "strong *prima facie* case," the Second Circuit Court of Appeals has rejected this apparently higher standard. *Unifund SAL*, 910 F.2d at 1037.

261 *Management Dynamics*, 515 F.2d at 807; *SEC v. Wellshire Sec.*, 737 F. Supp. 251, 255 (S.D.N.Y. 1990).

262 *SEC v. General Refractories Co.*, 400 F. Supp. 1248, 1255 (D.D.C. 1975).

263 See, e.g., *Management Dynamics*, 515 F.2d at 807; *First Fin. Group of Tex.*, 645 F.2d at 434; *Wellshire Sec.*, 737 F. Supp. at 255; *General Refractories*, 400 F. Supp. at 1255. The factors considered in this determination are similar to those employed in determining whether to issue a permanent injunction. See *SEC v. Carruba Au., Inc.*, 681 F.2d 1319, 1322 (11th Cir. 1982).

264 910 F.2d 1028 (2d Cir. 1990).

preservation of the status quo.²⁶⁵ The *Unifund SAL* court viewed the Commission's request for a preliminary injunction so as to prohibit future insider trading violations as having grave consequences because it would have involved more than a preservation of the status quo. The preliminary injunction could have resulted in serious collateral consequences and also subjected the defendant to contempt sanctions if subsequent trading were deemed unlawful. Accordingly, the court required the Commission to make a substantial showing of likelihood of success as to both a current violation and the risk of repetition.²⁶⁶

Permanent Injunctions

As with preliminary injunctions, the Commission is required to satisfy the statutory standards for obtaining permanent injunctive relief.²⁶⁷ The Commission must demonstrate that there exists a reasonable likelihood that the defendants, if not enjoined, will engage in future violations.²⁶⁸

The factors often cited by courts as relevant in determining the likelihood of future violations are: "(1) the egregiousness of the violations,²⁶⁹ (2) the isolated or repeated nature of the violations,²⁷⁰ (3) the degree of scienter involved,²⁷¹ (4) the sincerity of the defendant's assurances, if any, against future violations; (5) the defendant's recognition of the wrongful nature of his conduct; and (6) the likelihood that the defendant's occupation will present opportunities (or lack thereof) for future violations."²⁷² Courts have also considered the health and age

265 *Id.* at 1039.

266 *Id.* at 1040.

267 *SEC v. Youmans*, 729 F.2d 413, 415 (6th Cir. 1984), *cert. denied sub nom. Holliday v. SEC*, 469 U.S. 1034 (1984), *see, e.g.*, Exchange Act § 21(d)(1), 15 U.S.C.A. § 78u(d)(1) (West Supp. 1991).

268 *E.g., Youmans*, 729 F.2d at 415, *see also SEC v. Bonastia*, 614 F.2d 908, 912 (3d Cir. 1980); *SEC v. Murphy*, 626 F.2d 633, 655 (9th Cir. 1980); *SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978); *SEC v. Knrarcop Indus.*, 575 F.2d 692, 697 (9th Cir.) *cert. denied*, 439 U.S. 953 (1978); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100 (2d Cir. 1972); *SEC v. Advance Growth Capital Corp.*, 470 F.2d 40, 53 (7th Cir. 1972). *See generally United States v. W.T. Grant Co.*, 345 U.S. 629, 633 (1953).

269 See, e.g., *Manor Nursing Centers, Inc.*, 458 F.2d at 1102; *SEC v. Penn Central Co.*, 425 F. Supp. 593, 597 (E.D. Pa. 1976) (nature of past violation includes, "the number, seriousness and novelty of the transgressions, the motive and intent of the perpetrators, and the time elapsed since the violations were committed").

270 See, e.g., *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1228 (D.C. Cir. 1989); *SEC v. Savoy Indus.*, 587 F.2d 1149, 1168 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979), *see also SEC v. Monarch Fund*, 608 F.2d 938, 943 (2d Cir. 1979) (reviewing the lapse of time between violation and Commission enforcement action).

271 See, e.g., *Aaron v. SEC*, 446 U.S. 680, 701 (1980); *First City Fin. Corp.*, 890 F.2d at 1228 ("[w]hether the violation was flagrant and deliberate or merely technical in nature"); *SEC v. Haswell*, 654 F.2d 698, 700 (10th Cir. 1981) (even assuming securities law violation, the absence of scienter alone supports denial of injunction). *But see SEC v. American Realty Trust*, 586 F.2d 1001, 1007 (4th Cir. 1978) (proof of scienter unnecessary).

272 See, e.g., *Youmans*, 729 F.2d at 415, *see also SEC v. Carruba Au.*, 681 F.2d 1318, 1322 (11th Cir. 1982); *Bonastia*, 614 F.2d at 912; *Murphy*, 626 F.2d at 655; *Blatt*, 583 F.2d at 1334 n.29; *SEC v. American Bd. of Trade*, 750 F. Supp. 100, 104 (S.D.N.Y. 1990); *SEC v. Gallagher*,

of the defendant²⁷³ as well as any adverse collateral consequences, including personal hardship to the defendant.²⁷⁴ The issuance of an injunction will not be precluded merely because the violative activity has ceased.²⁷⁵ The courts have generally held that no one factor is determinative on the issue of likelihood of repetition²⁷⁶ and whether the court draws an inference that the defendant will engage in future violations depends on the totality of the circumstances.²⁷⁷

Recently, in *SEC v. First City Financial Corp.*,²⁷⁸ the District of Columbia Circuit Court of Appeals held that two factors should not be considered in determining whether to issue an injunction.²⁷⁹ The district court had cited as a factor the "public perception that [the] defendants have been recent and active participants in heated takeover battles and unfriendly mergers."²⁸⁰ The appellate court stated that the court may not justify an injunction, even in part, in terms of propitiating public sentiment.²⁸¹ Further, the court held that a defendant's vigorous challenge to the government's accusation may not be used as an indication of the likelihood of repeated violations.²⁸² The appellate court stated that a court may consider "lack of remorse" only if the defendant has previously violated court orders, or if the defendant otherwise indicates that he did not feel bound by the law.²⁸³

The primary purpose of enjoining a defendant from future violations of the securities laws is to protect the investing public from future misconduct, not to

No. 87-1904, 1989 U.S. Dist. LEXIS 9556 (E.D. Pa. Aug. 15, 1989); *SEC v. Davis*, 689 F. Supp. 767, 771-72 (S.D. Ohio 1988); *SEC v. Electronics Warehouse*, 689 F. Supp. 53, 68-69 (D. Conn. 1988), *aff'd sub nom. SEC v. Calvo*, 891 F.2d 457 (2d Cir.), *cert. denied*, 110 S. Ct. 3228 (1989); *SEC v. Champion Sports Management*, 599 F. Supp. 527, 534 (S.D.N.Y. 1984).

273. See, e.g., *Yonmans*, 729 F.2d at 415; *Koracorp Indus.*, 575 F.2d at 698; *SEC v. Gallagher*, No. 87-1904, 1989 U.S. Dist. LEXIS 9556 (E.D. Pa. Aug. 15, 1989); *Davis*, 689 F. Supp. at 772; *SEC v. Penn Cent. Co.*, 425 F. Supp. 593, 597-98 (E.D. Pa. 1976) (court denied injunction against defendant where, due to the state of his health, he was not likely to have an officer or director relationship with a public company in the future); *SEC v. Gaspar*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCII) ¶ 92,004, at 90,981 (S.D.N.Y. Apr. 15, 1985) (court denied request to enjoin defendant who was 64 years old and nearing end of his career).

274. See *SEC v. American Bd. of Trade, Inc.*, 751 F.2d 529, 535 (2d Cir. 1984); *Manor Nursing Centers, Inc.*, 458 F.2d at 1102; *SEC v. Ingoldsbly*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCII) ¶ 95,351, at 96,693 (D. Mass. May 15, 1990) ("[W]hile general equitable concerns such as the resultant adverse impact upon the defendant's professional reputation and business activity may also be considered, the public interest is paramount to any individual hardship."); *Electronics Warehouse*, 689 F. Supp. at 70-71.

275. *Koracorp Indus.*, 575 F.2d at 698; *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 807 (2d Cir. 1975).

276. *Yonmans*, 729 F.2d at 415.

277. *First City Fin. Corp.*, 890 F.2d at 1228; *Management Dynamics*, 515 F.2d at 807; *Ingoldsbly*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCII) ¶ 95,351, at 96,693.

278. 890 F.2d 1215 (D.C. Cir. 1989).

279. *Id.* at 1228-29.

280. *Id.*

281. *Id.* at 1229.

282. *Id.*, see also *SEC v. Electronics Warehouse*, 689 F. Supp. 53, 69 n.19.

283. *First City Finan. Corp.*, 890 F.2d at 1229.

punish the violator.²⁸⁴ Although an injunction has been referred to as a mild prophylactic, it may result in serious collateral consequences.²⁸⁵ Most importantly, a failure to comply with the injunctive decree may form the basis for contempt sanctions,²⁸⁶ or constitute the basis for barring an individual from practicing before the Commission.²⁸⁷ The issuance of an injunction may also result in the suspension or revocation of a broker-dealer's registration,²⁸⁸ or result in the disqualification from serving as a director, officer, or employee of a registered investment company.²⁸⁹

Although proof of past violations is highly suggestive of the likelihood of future violations,²⁹⁰ courts, noting the consequences, on occasion have declined to enter permanent injunctions despite the fact that the Commission has proven violations of the securities laws.²⁹¹ Two recent cases illustrate the Commission's problems. In both cases the defendants were found to have violated the prohibitions against insider trading, but the courts declined to enter permanent injunctions.

In *SEC v. Ingoldsbly*,²⁹² the Commission alleged violations of the prohibitions against insider trading contained in section 10(b) of the Exchange Act and rule 10b-5 thereunder, and sought a permanent injunction, disgorgement and a civil penalty pursuant to ITSA. The jury found that the defendant violated the relevant provisions. Although Ingoldsbly acted with the required scienter, had not publicly acknowledged the wrongfulness of his conduct, and would continue to have access to material nonpublic information, the court declined to issue a permanent injunction or impose civil penalties; rather, the court required the defendant to disgorge his ill-gotten gain.²⁹³ The court found Ingoldsbly's post-

284. *SEC v. Yonmans*, 729 F.2d 413, 415 (6th Cir.), *cert. denied sub nom. Holliday v. SEC*, 469 U.S. 1034 (1984); *SEC v. Koracorp Indus.*, 575 F.2d at 692, 697 (9th Cir.), *cert. denied*, 439 U.S. 953 (1978).

285. See *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 99 (2d Cir. 1978).

286. See, e.g., *SEC v. American Bd. of Trade*, 830 F.2d 431, 439-42 (2d Cir. 1987), *cert. denied*, 485 U.S. 938 (1988).

287. See 17 C.F.R. § 201.2(e)(3)(i) (1991).

288. See Exchange Act § 15(b)(4)(C), 15 U.S.C.A. § 78o(b)(4)(C) (West Supp. 1991); *SEC v. Geon Indus., Inc.*, 531 F.2d 39, 55 (2d Cir. 1976).

289. See Investment Company Act § 9(a)(2), 15 U.S.C.A. § 80a-9(a)(2) (West Supp. 1991).

290. See, e.g., *SEC v. Koracorp Indus.*, 575 F.2d 692, 698 (9th Cir.), *cert. denied*, 440 U.S. 913 (1978); *SEC v. Savoy Indus.*, 587 F.2d 1149, 1168 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979); *SEC v. Management Dynamics Inc.*, 515 F.2d 801, 803 (2d Cir. 1975).

291. See, e.g., *SEC v. Caterinichia*, 613 F.2d 102, 106-07 (5th Cir. 1980); *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *SEC v. Ingram*, 694 F. Supp. 1437, 1442 (C.D. Cal. 1988); *SEC v. Lund*, 570 F. Supp. 1397, 1403-04 (C.D. Cal. 1983); *SEC v. Miller*, 495 F. Supp. 465, 483-84 (S.D.N.Y. 1980); *SEC v. Texas Int'l Co.*, 498 F. Supp. 1231, 1254 (N.D. Ill. 1980); *SEC v. Penn Cent. Co.*, 425 F. Supp. 593, 597 (E.D. Pa. 1976); *SEC v. Ingoldsbly*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCII) ¶ 95,351, at 96,693 (D. Mass. May 15, 1990); *SEC v. Gaspar*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCII) ¶ 92,004, at 90,981 (S.D.N.Y. Apr. 16, 1985); *SEC v. MacDonald*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCII) ¶ 98,009, at 91,234 (D.R.I. Apr. 23, 1981), *aff'd in relevant part*, 699 F.2d 47 (1st Cir. 1983).

292. [1990 Transfer Binder] Fed. Sec. L. Rep. (CCII) ¶ 95,351 (D. Mass. May 15, 1990).

293. *Id.* ¶ 95,351, at 96,693-96.

ances that he would not again violate the securities laws to be genuine and sincere.²⁹⁴ The court also noted the severe impact the issuance of an injunction would have on the operation of Ingoldsby's business.²⁹⁵

In *SEC v. Ingram*,²⁹⁶ the Commission alleged that a broker violated rule 10b-5 by communicating material nonpublic information regarding certain securities to several of his clients who later purchased the securities. The Commission requested a permanent injunction, disgorgement of any and all commissions the broker received through the stock purchases, and civil penalties.²⁹⁷ The court denied the Commission's request for injunctive relief and civil penalties because the court found no reasonable likelihood of future securities law violations.²⁹⁸ The court found the following significant: (1) Ingram's long, otherwise unblemished career; (2) the fact that Ingram had not traded in the securities at issue; and (3) Ingram's relatively low level of scienter.²⁹⁹ Ingram was required, however, to disgorge the commissions he received on the trades.³⁰⁰

These cases may indicate a recent shift in the judiciary's view of the injunctive decree. Courts may no longer view an injunction as a mild prophylactic, but rather as a judicial decree having significant consequences. This apparent trend may encourage the Commission to utilize the cease-and-desist authority provided by the Remedies Act. Cease-and-desist proceedings provide the Commission with several advantages over injunctive actions. First, the Commission's administrative determinations will be afforded substantial deference by a reviewing appellate court. Second, violations of cease-and-desist orders may result in monetary penalties. Third, cease-and-desist proceedings may provide the Commission with the means to obtain the desired relief more quickly than the filing of an injunctive action. Presently, the federal court dockets are congested, and courts have decided many of the Commission's injunctive actions more than a year after filing.³⁰¹

Other Equitable Relief

In addition to seeking an injunction against further violations of the federal securities laws, the Commission has frequently sought additional equitable relief.³⁰² It is well settled that "once the equity jurisdiction of the district court has been properly invoked by a showing of a securities law violation, the courts

294. *Id.* ¶ 95,351, at 96,693.

295. *Id.* ¶ 95,351, at 96,694.

296. 694 F. Supp. 1437 (C.D. Cal. 1988).

297. *Id.* at 1442.

298. *Id.*

299. *Id.*

300. *Id.*

301. See Breeden Testimony, *supra* note 5 at 22-23.

302. See, e.g., *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1103 (2d Cir. 1972), see also *Mitchell v. Robert DeMarin Jewelry, Inc.*, 361 U.S. 288, 292 (1960).

possess the necessary power to fashion an appropriate remedy.³⁰³ The Commission often will ask the court to grant additional equitable relief to deny the violator the benefit of the illegal conduct or to further the protection of the public interest. Courts have frequently granted the additional equitable relief sought by the Commission as long as the requested relief is remedial and does not constitute a penalty.³⁰⁴

Disgorgement

Disgorgement has become the principal equitable remedy sought by the Commission. The purpose of disgorgement is to deny the wrongdoer the benefit of the illegal conduct.³⁰⁵ The existence of defrauded investors who may be entitled to money damages is immaterial when considering the disgorgement remedy.³⁰⁶ As with other equitable remedies, disgorgement is remedial and not punitive in nature.³⁰⁷ A court may decline to enter an injunction, but may enter an order requiring a defendant to disgorge his illicit gains.³⁰⁸ Thus, a failure by the Commission to demonstrate a likelihood of recurring violations will not prevent a court from entering an order requiring disgorgement of illicit gains.³⁰⁹

Disgorgement is often considered to be an equitable remedy utilized in insider trading cases or cases alleging other types of fraudulent conduct. The Commission, however, has sought and obtained disgorgement in cases alleging violations of the securities laws other than the antifraud provisions. For example, the District of Columbia Circuit Court of Appeals has recently upheld an order requiring disgorgement in an action alleging that the defendants violated section 13(d) of the Exchange Act.³¹⁰

303. *Manor Nursing Centers, Inc.*, 458 F.2d at 1103, see *J.I. Case Co. v. Borak*, 377 U.S. 426, 433 (1964) ("It is for the federal courts to adjust their remedies so as to grant the necessary relief where federally secured rights are invaded.").

304. *Manor Nursing Centers, Inc.*, 458 F.2d at 1104.

305. *SEC v. Tome*, 833 F.2d 1086, 1096 (2d Cir. 1987), cert. denied, 108 S. Ct. 1751 (1988); *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978), see also *SEC v. Blavin*, 760 F.2d 706, 713 (6th Cir. 1985) ("Once the Commission has established that a defendant has violated the securities laws, the district court possesses the equitable power to grant disgorgement without inquiring whether, or to what extent, identifiable private parties have been damaged . . ."), *SEC v. Matera*, 745 F.2d 197, 201 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985) ("Disgorgement of illegally obtained profits is by no means a new addition to this catalogue of permissible equitable remedies"); *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) (purpose of disgorgement is to force defendant to give up the amount by which he was unjustly enriched).

306. *Tome*, 833 F.2d at 1096.

307. *Blatt*, 583 F.2d at 1335.

308. See *SEC v. Unifund SAL*, 910 F.2d 1026, 1041 (2d Cir. 1990).

309. *Commonwealth Chem. Sec., Inc.*, 574 F.2d at 103 n.13; *SEC v. Ingram*, 694 F. Supp. 1437, 1442 (C.D. Cal. 1988).

310. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1233 (D.C. Cir. 1989).

As ancillary relief, courts may order a temporary freeze of assets to ensure that the wrongfully acquired money is available for restitution to public investors or for the payment of subsequent monetary penalties.³¹¹ Freezing assets, however, may actually harm investors if such a freeze were to cause a significant disruption of a defendant's business affairs.³¹² Thus, courts must weigh the harmful effects of a freeze against other considerations that indicate the need for such relief.³¹³

In *SEC v. Unifund SAL*,³¹⁴ the Second Circuit Court of Appeals held that although the Commission did not make a showing sufficient to warrant a preliminary injunction, the Commission's proof did warrant some form of freeze order.³¹⁵ The court indicated that, while the consequences of an asset freeze were not as grave as a preliminary injunction, a freeze order should be carefully tailored to provide reasonable security for the collection of possible civil penalties.³¹⁶ The court, therefore, required the defendants to maintain sufficient funds in their account to satisfy an order imposing penalties for alleged insider trading violations, but refused the Commission's request that would have required the defendants to obtain Commission approval prior to trading in that account.³¹⁷

Appointment of Receivers or Trustees

The Commission has sought the appointment of receivers or trustees when the defendant has engaged in a course of fraudulent conduct, and the Commission believes that the misuse of corporate assets or investor funds is pervasive, requiring a receiver to prevent the dissipation of a defendant's assets pending further action by the court.³¹⁸ A receiver or trustee will ordinarily (1) take control of the defendant's assets in order to prevent injury to investors, (2) work to prevent further violations of the federal securities laws, and (3) investigate financial improprieties.³¹⁹ A receiver or trustee also may be appointed by the court to oversee the liquidation of the defendant corporation. This last practice, however, has recently been criticized by the Second Circuit Court of Appeals as interfering with the role of the bankruptcy courts.³²⁰

311. See, e.g., *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d at 1082, 1106 (2d Cir. 1972); *Unifund SAL*, 910 F.2d at 1042.

312. See *Manor Nursing Centers, Inc.*, 458 F.2d at 1106.

313. *Id.*; *SEC v. American Bd. of Trade, Inc.*, 645 F. Supp. 1047, 1050 (S.D.N.Y. 1986), *aff'd in relevant part*, 830 F.2d 431 (2d Cir. 1987), *cert. denied* 485 U.S. 938 (1988).

314. 910 F.2d 1028 (2d Cir. 1990).

315. *Id.* at 1040-41.

316. *Id.* at 1041.

317. *Id.*

318. *SEC v. American Bd. of Trade, Inc.*, 830 F.2d 431, 436 (2d Cir. 1987), *cert. denied*, 485 U.S. 938 (1988), *see* *SEC v. First Fin. Group of Tex.*, 645 F.2d 429, 436-37 (5th Cir. 1981).

319. See, e.g., *First Fin. Group of Tex.*, 645 F.2d at 436-37; *SEC v. Koenig*, 469 F.2d 198, 202 (2d Cir. 1972).

320. *American Bd. of Trade, Inc.*, 830 F.2d at 436-37.

Other Equitable Relief

A district court's broad equitable powers permit it to mold its decree to the necessities of a particular case.³²¹ The Commission has sought, and courts have granted, various forms of relief in order to ameliorate past violations and prevent further violative conduct. Often these remedies will result from consent agreements entered into between the defendant and the Commission. The Commission may seek the appointment of a special counsel or special agent to conduct investigations into prior conduct by a corporation or its officers or directors.³²² Additionally, the Commission may seek the appointment of an audit committee composed of independent directors,³²³ or the appointment of independent directors to pursue claims on behalf of the corporation.³²⁴

In cases in which officers and directors engage in egregious violations of the securities laws, such as the misuse of corporate assets for personal benefit, the Commission has sought, and in one litigated case has obtained, an order barring persons from serving as officers or directors of public companies,³²⁵ or the neutralization of shares owned by such persons.³²⁶

Finally, courts may utilize the equitable remedy of rescission.³²⁷ For example, the Commission has requested a court to require a defendant found in violation of the Williams Act to make a rescission offer.³²⁸ Since the violation consisted solely of a failure to file materials with the Commission, the court, however, held that a rescission order would be a disproportionately severe remedy and not warranted in that instance.³²⁹

321. See, e.g., *Herbt Co. v. Bowles*, 321 U.S. 321, 329 (1944); *Handler v. SEC*, 610 F.2d 656, 659 (9th Cir. 1979).

322. See, e.g., *Handler*, 610 F.2d at 657 (9th Cir. 1979); *SEC v. Beisinger Indus. Corp.*, 552 F.2d 15, 18 (1st Cir. 1977); *SEC v. Data Access Systems, Inc.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,779, at 94,005 (D.N.J. Aug. 17, 1982).

323. See, e.g., *SEC v. Oak Indus., Inc.*, SEC Litig. Release No. 10,801, *Acct. & Auditing Enforcement Release No. 63*, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,463 (S.D. Cal. June 25, 1985) (*Acct. & Auditing Enforcement Releases*).

324. See, e.g., *Handler*, 610 F.2d at 657.

325. See, e.g., *SEC v. Techni-Culture, Inc.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,501 (D. Ariz. 1974); *SEC v. Carter*, SEC Litig. Release No. 11,040, *Acct. & Auditing Enforcement Release No. 94*, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,494 (D.D.C. Mar. 27, 1986) (*Acct. & Auditing Enforcement Releases*); *SEC v. Florafax, Int'l, Inc.*, SEC Litig. Release No. 10,617, *Acct. & Auditing Enforcement Release No. 44*, [1982-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,444 (N.D. Okla. Nov. 27, 1984) (*Acct. & Auditing Enforcement Releases*); *SEC v. Forma*, 522 F. Supp. 516 (S.D.N.Y. May 27, 1985) (*The Remedies Act explicitly provides for this power in certain circumstances. See supra text accompanying notes 243-53.*

326. See, e.g., *SEC v. Data Access Systems, Inc.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,779 (D.N.J. Aug. 17, 1982).

327. See, e.g., *Mills v. Electric Auto Lite Co.*, 396 U.S. 375, 386 (1970); *SEC v. Texas Int'l Co.*, 498 F. Supp. 1231, 1254 (N.D. Ill. 1980).

328. See *Texas Int'l Co.*, 498 F. Supp. at 1254.

329. *Id.* at 1255.

INSIDER TRADING PENALTIES

The Insider Trading Sanctions Act of 1984

In 1984, the Exchange Act was amended to authorize the Commission to seek civil penalties for violations involving insider trading through the enactment of the Insider Trading Sanctions Act of 1984 (ITSA).³³⁰ ITSA authorizes the Commission to seek, and a court to impose, a civil penalty upon any person who violates the Exchange Act by purchasing or selling a security while in possession of material non-public information.³³¹ Persons who aid and abet insider trading violations by tipping material non-public information, even though they did not trade in the securities, are also subject to penalties pursuant to ITSA.³³²

Through ITSA, Congress authorized the Commission to seek civil penalties of up to three times the profit gained or loss avoided.³³³ ITSA defines profit gained or loss avoided as the difference between the purchase or sale price of the security and the value of that security as measured by its trading price a reasonable period after public dissemination of the non-public information.³³⁴ The district court is to determine the amount of this penalty in light of the facts and circumstances of the case.³³⁵ The Commission must bring actions for civil penalties within five years of the date of the purchase or sale and the moneys realized from such actions are to be paid into the United States Treasury.³³⁶

The legislation explicitly provides that Commission authorization to seek civil penalties is in addition to existing remedies.³³⁷ Thus, a person who engages in insider trading in violation of the Exchange Act and the rules thereunder is subject to a civil penalty as well as an injunction and disgorgement.³³⁸

As originally enacted, ITSA contained several limitations on liability. First, ITSA provided that no person would be subject to civil penalties solely because he aided and abetted a violation in a manner other than by tipping.³³⁹ Thus, a broker-dealer who executed a trade was not subject to liability under ITSA.³⁴⁰ Second, ITSA provided that the Commission was precluded from utilizing section 20(a) of the Exchange Act, which provides for liability of controlling

330 Pub. L. No. 98-376, 98 Stat. 1264 [hereinafter ITSA]. The legislation also increased the maximum criminal fine established under § 32(a) of the Exchange Act, 15 U.S.C.A. § 78ff (West Supp. 1991), from \$10,000 to \$100,000. *Id.* § 3.

331. *Id.* § 2.

332. *Id.*

333. *Id.*

334. *Id.*

335. *Id.*

336. *Id.*

337. *Id.*

338. See H.R. Rep. No. 355, 98th Cong., 2d Sess. 8, reprinted in 1984 U.S. Code Cong. & Admin. News 2274, 2281.

339. ITSA § 2.

340. See H.R. Rep. No. 355, supra note 338, at 2283. The broker-dealer could still be subject to existing administrative and equitable remedies as well as injunctive actions if he was on notice of the violation. *Id.*

persons.³⁴¹ Finally, ITSA expressly rejected a *respondeat superior* theory of liability by providing that no person would be liable for a civil penalty solely by reason of employing another person who was liable for a civil penalty.³⁴²

The Insider Trading and Securities Fraud Enforcement Act of 1988

In the wake of "serious episodes of abusive and illegal practices" on Wall Street,³⁴³ Congress determined to strengthen ITSA by enacting the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).³⁴⁴ Recognizing the lack of resources available to the Commission, Congress designed ITSFEA to provide for an institutional response to the problem of insider trading.³⁴⁵ Specifically, the legislation provides for: (1) increased criminal penalties,³⁴⁶ (2) the initiation of a bounty program to aid the Commission in detecting violations,³⁴⁷ (3) the enactment of section 15(f) of the Exchange Act and section 204A of the Advisers Act to require broker-dealers and investment advisers to establish and enforce policies reasonably designed to prevent misuse of inside information,³⁴⁸ (4) the enactment of section 20A of the Exchange Act to codify a private right of action for contemporaneous traders,³⁴⁹ (5) enhanced Commission authority to cooperate with foreign governmental authorities in the investigation of international securities law violations,³⁵⁰ (6) authorization for the Commission to undertake a study of the adequacy of the present securities laws,³⁵¹ and, perhaps most significantly, (7) expansion of the scope of civil penalties under ITSA to include controlling persons who fail to take adequate steps to prevent insider trading.³⁵²

Under ITSFEA, the Commission may now seek civil penalties against persons who, at the time of a violation, directly or indirectly controlled the person who committed the violation.³⁵³ In order for the Commission to impose such liability, however, it must establish that the controlling person: (1) knew or recklessly disregarded the fact that the controlled person was likely to engage in the violative acts and failed to take appropriate steps to prevent the acts; or (2) knowingly or recklessly failed to establish, maintain, or enforce policies required

341. ITSA § 2.

342. *Id.*, see H.R. Rep. No. 355, supra note 338, at 2282.

343. See H.R. Rep. No. 910, 100th Cong., 2d Sess. 7, reprinted in 1988 U.S. Code Cong. & Admin. News 6043, 6044.

344. Pub. L. No. 100-704, 102 Stat. 4677 [hereinafter ITSFEA].

345. H.R. Rep. No. 910, supra note 343, at 5051-52.

346. ITSFEA § 4.

347. *Id.* § 3(e), see Exchange Act § 21A(e), 15 U.S.C.A. § 78u-1(e) (West Supp. 1991).

348. ITSFEA § 3(b), see 15 U.S.C.A. § 78u(f) (West Supp. 1991), 15 U.S.C.A. § 80b-4a (West Supp. 1991).

349. ITSFEA § 5, see 15 U.S.C.A. § 78u-1 (West Supp. 1991).

350. ITSFEA § 6.

351. *Id.* § 7.

352. *Id.* § 3, see Exchange Act § 21A(b), 15 U.S.C.A. § 78u-1(b) (West Supp. 1991).

353. *Id.* § 3, see Exchange Act § 21A(a), 15 U.S.C.A. § 78u-1(a)(1)(B) (West Supp. 1991).

under section 15(f) of the Exchange Act or section 204A of the Advisers Act and this failure substantially contributed to or permitted the occurrence of the violative acts.³⁵⁴

ITSFEA provides that a person will not be subject to a civil penalty solely by reason of employing a person who is subject to a penalty.³⁵⁵ Similarly, ITSFEA's civil penalty provisions do not apply to violations of section 20(a) of the Exchange Act concerning controlling person liability.³⁵⁶ A person who, at the time of the violation, directly or indirectly controls a person who engages in an insider trading violation is subject to a penalty that may not exceed the greater of three times the profit gained or loss avoided or \$1,000,000.³⁵⁷ The legislation further provides that, if the controlled person's violation involved the communication of material non-public information (i.e. tipping), the profit gained or loss avoided for purposes of calculating the penalty is limited to the profit gained or loss avoided by the person or persons to whom the controlled person directed such communication.³⁵⁸

Other Civil Money Penalties

The Exchange Act contains two additional civil penalty provisions. First, the Commission may seek civil money penalties of up to \$10,000 against an issuer, and certain persons acting on behalf of an issuer, who violate section 30A(a) of the Exchange Act, the foreign payments provisions of the Foreign Corrupt Practices Act.³⁵⁹

Second, section 32(b) of the Exchange Act authorizes penalties of \$100 per day for each day an issuer fails to file certain required periodic or supplemental reports.³⁶⁰ It appears, however, that Section 32(b) has been used to impose a penalty in only one case.³⁶¹

ADMINISTRATIVE PROCEEDINGS

Stop Order Proceedings

Section 8(d) of the Securities Act authorizes the Commission to institute administrative proceedings to suspend the effectiveness of a registration statement.³⁶² Section 8(d) provides that the Commission may issue a stop order if,

354. *Id.* § 3; see Exchange Act § 21A(b), 15 U.S.C.A. § 78u-1(b) (West Supp. 1991).

355. *Id.* § 3; see Exchange Act § 21A(b)(2), 15 U.S.C.A. § 78u-1(b)(2) (West Supp. 1991).

356. *Id.*

357. *Id.* § 3; see Exchange Act § 21A(a)(3), 15 U.S.C.A. § 78u-1(a)(3) (West Supp. 1991).

358. *Id.*

359. Exchange Act § 32(c)(2)(C), 15 U.S.C.A. § 78ll(c)(2)(C) (West Supp. 1991).

360. 15 U.S.C.A. § 78ll(b) (West Supp. 1991).

361. United States v. Mercantile Properties, Inc., SEC Litig. Release No. 360, 1946 SEC LEXIS 61 (August 27, 1946) (settlement assessing \$10,000 against an issuer who was in default for approximately 500 days).

362. 15 U.S.C.A. § 77h(d) (West 1981). See generally McClucas, *Stop Order Proceedings Under the Securities Act of 1933: A Current Assessment*, 40 Bus. Law. 515 (1985) Section 8(b) of the Securities Act provides for the issuance of refusal orders in connection with incomplete, inaccurate,

after notice and an opportunity for a hearing, the Commission determines that the registration statement contains an untrue statement of material fact, or omits to state a required material fact or a material fact necessary to make the registration statement not misleading.³⁶³ The Commission has construed section 8(d) as authorizing stop order proceedings with respect to pre-effective filings.³⁶⁴

The primary concern in whether to issue a stop order is the public interest. In this regard, stop orders provide the Commission with the opportunity to make a public record of the violation. Accordingly, stop orders have been called "the most effective means of warning the investing public that unreliable statements have been filed and counteracting the false and misleading information publicized by the filings."³⁶⁵ The registrant's good faith or lack of scienter is not a bar to the issuance of a stop order.³⁶⁶

Administrative Proceedings Against Regulated Entities and Associated Persons

Broker-Dealer Proceedings

Section 15(b)(4) and Section 15(b)(6) Proceedings

Sections 15(b)(4) and 15(b)(6) of the Exchange Act authorize the Commission, under certain conditions, to institute administrative proceedings and impose sanctions against broker-dealers and associated persons.³⁶⁷ If the Commission finds, after notice and an opportunity for a hearing, that such sanctions are in the public interest and that the individual has engaged in certain specified conduct, the Commission may censure an individual, limit the activities in which that individual may engage, suspend (for up to twelve months) or revoke a broker-dealer's registration, or suspend (for up to twelve months) or bar a person from association with a broker-dealer.³⁶⁸ Additionally, sections 15B and 15C of the Exchange Act provide similar authority with respect to municipal securities dealers, government securities brokers and dealers, and associated persons.³⁶⁹

Pursuant to section 15(b)(4), the Commission may sanction a broker-dealer if the broker-dealer or a person associated with the broker-dealer:

or false and misleading registration statements 15 U.S.C.A. § 77h(b) (West 1981). Such orders prevent the statement from becoming effective. *Id.* For two early cases in which § 8(b) was utilized, see *In re Int'l Investors Fund Sys., Inc.*, 1 S.E.C. 461 (1936); *In re Gold Producers, Inc.*, 1 S.E.C. 1 (1933).

363. 15 U.S.C.A. § 77h(d) (West 1981).

364. *In re Red Bank Oil Co.*, 20 S.E.C. 863 (1945).

365. *In re Advanced Chem. Corp.*, Securities Act Release No. 6507, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,499, at 86,635 (Feb. 9, 1984) (quoting *In re Clinton Engines Corp.*, 42 S.E.C. 353, 360-61 (1963)).

366. *In re United States Molybdenum Corp.*, 10 S.E.C. 796, 804 (1941) (quoting *Herman Hanson Oil Syndicate*, 2 S.E.C. 743, 746 (1937)).

367. 15 U.S.C.A. § 78c(b)(4), (6) (West 1981 & Supp. 1991).

368. *Id.*

369. See Exchange Act § 15B(c)(2), (4), 15 U.S.C.A. § 78o-4(c)(2), (4) (West Supp. 1991); Exchange Act § 15C(c)(1)(A), (C), 15 U.S.C.A. § 78o-5(c)(1)(A), (C) (West Supp. 1991).

- (1) has willfully violated registration or reporting requirements;
- (2) has been convicted of certain enumerated felonies and misdemeanors, including substantially equivalent foreign criminal offenses, within ten years of filing an application for registration or any time thereafter;
- (3) is subject to a permanent or temporary injunction or its foreign equivalent;
- (4) has willfully violated the securities laws, the Commodities Exchange Act or the rules and regulations thereunder;
- (5) has willfully aided and abetted the violation of another person or failed to reasonably supervise another person if that person is subject to supervision;
- (6) is subject to an order of the Commission entered pursuant to section 15(b)(6); or
- (7) has been found by a foreign financial regulatory authority to have (a) made or caused to be made in any application or report to the foreign authority, a false or misleading statement of a material fact or found to have omitted to state any material fact required, (b) committed foreign securities laws violations or violations regarding future deliveries, or (c) aided and abetted in such violations or failed to reasonably supervise persons under their supervision who commit such violations.³⁷⁰

Section 15(b)(6) authorizes the Commission to institute proceedings against associated persons, persons seeking to become associated with a broker-dealer, or persons who were associated with a broker-dealer when they committed the alleged violation.³⁷¹ Section 15(b)(6) also provides for the imposition of sanctions on associated persons that engage in conduct specified in section 15(b)(4).³⁷²

Pursuant to section 15(b)(4), the Commission may discipline a registered broker-dealer for certain willful conduct. Courts have construed the term "willful" as used in section 15(b) as meaning "no more than that the person charged with the duty knows what he is doing. It does not mean that, in addition, he must suppose that he is breaking the law."³⁷³ For example, reliance on the advice of another person with extensive experience in the securities industry has not constituted a defense.³⁷⁴

370 15 U.S.C.A. § 78o(h)(4) (West 1981 & Supp. 1991)

371 *Id.* § 78o(h)(6) (West Supp. 1991); see *In re John Kilpatrick*, 48 S.E.C. 481, 487-88 (1986).

372 *Id.*

373 *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1937); see *Steadman v. SEC*, 693 F.2d 1126, 1135 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981); *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 596 (10th Cir. 1979); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978); *Capital Funds, Inc. v. SEC*, 348 F.2d 582, 588 (8th Cir. 1965); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965); *In re Securities Exch. Corp.*, 2 S.E.C. 760, 762 (1937) See generally 6 *Loss & Seligman, Securities Regulation* 3034 n.152 (3d ed. 1990)

374 *In re Irving Grubman*, 40 S.E.C. 671, 673 (1961), see also *In re Kelly Rubenstein, Inc.*, 38 S.E.C. 582, 583-84 (1958)

Certain enumerated criminal convictions may serve as the basis for the imposition of sanctions against a broker-dealer. To form the basis for an administrative proceeding the conviction must have occurred within ten years of filing an application for registration,³⁷⁵ or at any time while the person is registered as or is associated with a broker-dealer.³⁷⁶ Sanctions for criminal convictions under section 15(b) are not precluded by the principles of *res judicata*³⁷⁷ or double jeopardy.³⁷⁸

Section 15(b)(4)(C) authorizes administrative sanctions if the broker-dealer, or an associated person, is presently, temporarily, or permanently enjoined.³⁷⁹ The Commission's ability to sanction broker-dealers who are enjoined is one of the major collateral effects of an injunction.³⁸⁰ It is important to note, however, that administrative sanctions may be based on preliminary injunctions as well as permanent injunctions. If a preliminary injunction is entered, the Commission need not wait for a final resolution in the courts; instead it may impose administrative sanctions immediately.³⁸¹ A pending appeal from the issuance of an injunction will not preclude the imposition of administrative sanctions. Should the injunction ultimately be vacated, however, the Commission may entertain an application to reconsider sanctions.³⁸²

Section 15(b)(4)(D) authorizes the Commission to impose administrative sanctions if the Commission determines that a broker-dealer is willfully violating the securities laws.³⁸³ Furthermore, as with other Commission determinations, a factual finding that a willful violation has occurred will be binding on the reviewing appellate court if there is substantial evidence for the determination.³⁸⁴

Section 15(b)(4)(E) permits administrative sanctions against broker-dealers for willfully aiding and abetting another or for failing to reasonably supervise someone subject to the broker-dealer's supervision who commits a violation.³⁸⁵ Reasonable supervision requires that a broker-dealer establish procedures designed to prevent and detect violations and to implement such procedures.³⁸⁶

375. Convictions prior to this time, however, may be used in the public interest determination analysis. See *Marketlines, Inc. v. SEC*, 384 F.2d 264, 267 (2d Cir. 1967), *cert. denied*, 390 U.S. 947 (1967); *Aigeltinger & Co., Exchange Act Release No. 4177, 1948 SEC LEXIS 483* (Oct. 15, 1948).

376 15 U.S.C.A. § 78o(b)(4)(B) (West Supp. 1991)

377 *A.J. White & Co. v. SEC*, 556 F.2d 619, 624 (1st Cir.), *cert. denied*, 434 U.S. 969 (1977).

378 *In re Walter H. T. Seager*, 47 S.E.C. 1040, 1042-43 (1984)

379 15 U.S.C.A. § 78o(b)(4)(C) (West Supp. 1991)

380 See *supra* text accompanying note 285-89

381 Sanctions entered based on a preliminary injunction may render the court action moot. See, e.g., *SEC v. Light, Wolsey & Benesch, Inc.*, Civ. No. 3645 (D. Md. April 7, 1948), cited in 14 SEC Ann. Rep. 51 (1948).

382 See *In re C. R. Richmond & Co.*, 46 S.E.C. 412, 414 n.11 (1976)

383 15 U.S.C.A. § 78o(b)(4)(D) (West Supp. 1991)

384 See *infra* text accompanying notes 412-18.

385 15 U.S.C.A. § 78o(b)(4)(E) (West Supp. 1991)

386 See, e.g., *In re Thomson McKinnon Sec., Inc.*, Exchange Act Release No. 20,908, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 83,620 (Apr. 30, 1984)

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With respect to the supervisory requirement imposed upon broker-dealers, the Commission has stated:

As broker-dealers expand their activities . . . there must be a concomitant expansion of their supervisory procedures to insure regulatory compliance and sound internal controls. Apart from adopting effective procedures broker-dealers must provide effective staffing, sufficient resources and a system of follow-up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised.³⁸⁷

Section 15(b)(4)(F) authorizes administrative sanctions if the broker-dealer is associated with a person who is subject to a disciplinary order entered pursuant to section 15(b)(6).³⁸⁸ Consequently, not only may an associated individual be disciplined pursuant to section 15(b)(6), but any broker-dealer employing that disciplined individual also faces possible sanctions under section 15(b)(4)(F).

The recently enacted International Securities Enforcement Cooperation Act of 1990 (ISECA)³⁸⁹ modified section 15(b)(4) in two respects.³⁹⁰ First, ISECA authorized the Commission to impose administrative sanctions on regulated persons, their associated persons, and individuals seeking to become associated persons of brokers or dealers on the basis of substantially equivalent misconduct in a foreign country.³⁹¹ Second, ISECA authorized the Commission to impose sanctions based on findings by a foreign securities authority that a person (1) made false or misleading statements in registration or reporting materials filed with the foreign securities authority, (2) violated foreign statutes or regulations regarding transactions in securities or commodities; or (3) aided, abetted, or caused another person's violation of the foreign countries' securities laws, or failed to supervise the violator if required to do so.³⁹²

A broker-dealer is subject to potential sanctions if any person associated with the broker-dealer satisfies any of the above criteria. Conduct prior to the person's association is explicitly included.³⁹¹

387. *In re Malon, Nugent & Co.*, 47 S.E.C. 862, 867 (1983).

388. 15 U.S.C.A. § 78o(b)(4)(F) (West 1981).

389. Pub. L. No. 101-550, 104 Stat. 2714 [hereinafter ISECA].

390. These modifications were also made to administrative proceedings brought pursuant to the Investment Advisers Act § 203(e), 15 U.S.C.A. § 80b-3 (West Supp. 1991) and the Investment Company Act § 9(b), 15 U.S.C.A. § 80a-9 (West Supp. 1991).

391. See H.R. Rep. No. 240, 101st Cong., 2d Sess., reprinted in 1990 U.S. Code Cong. & Admin. News 3888, 3899.

392. *Id.* at 3900, see 15 U.S.C.A. § 78o(b)(4)(G) (West Supp. 1991).

393. See 15 U.S.C.A. § 78o(b)(4) (West Supp. 1991). The following legislative history, however, indicates that section 15(b)(4) is not a strict liability provision:

Although a literal construction of [Section 15(b)(4)] might seem to empower the Commission to suspend, or deny, or revoke, the registration of any broker or dealer for employing a person who had committed one of the offenses prior to his employment, it is not intended that so extreme a penalty should be imposed, unless the broker or dealer knew, or in the exercise of reasonable care should have known, of the employee's past misconduct

Section 19(h) Proceedings

The Commission may also impose sanctions upon broker-dealers pursuant to section 19(h) of the Exchange Act.³⁹⁴ Section 19(h) authorizes the Commission to: (1) expel (or suspend for up to twelve months) a broker-dealer from membership in a self-regulatory organization such as the national securities exchanges or National Association of Securities Dealers; and (2) bar (or suspend for up to twelve months) any person from association with a member of a national securities exchange or registered securities organization.³⁹⁵ Section 19(h) allows the Commission to impose the above sanctions if the Commission determines that the sanction is in the public interest and that the individual: (1) is subject to an order of the Commission entered pursuant to Section 15(b)(4) of the Exchange Act; (2) has willfully violated the securities laws or rules and regulations thereunder, or (3) has effected a transaction for someone else with reason to believe that it was a violative transaction.³⁹⁶ The Commission may institute section 19(h) proceedings simultaneously with proceedings pursuant to section 15(b).³⁹⁷

Investment Advisers Act Proceedings

The Investment Advisers Act provides the Commission with administrative jurisdiction over investment advisers and persons associated with investment advisers comparable to the Commission's authority over broker-dealers and their associated persons.³⁹⁸ The conduct that forms the basis for administrative proceedings against investment advisers and their associated persons is similar to the conduct that subjects broker-dealers and their associated persons to possible sanctions.³⁹⁹

Investment Company Act Proceedings

The Investment Company Act provides the Commission with authority to prohibit, either permanently or for limited periods, any person from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company.⁴⁰⁰ The provision also applies to persons associated with such an

H.R. Rep. No. 1418, 88th Cong., 2d Sess., reprinted in 1964 U.S. Code Cong. & Admin. News 3013, 3034.

394. 15 U.S.C.A. § 78s(h) (West 1981).

395. *Id.* § 78s(h)(2)-(3) (West 1981).

396. *Id.*

397. See, e.g., *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1011 n.2 (D.C. Cir.), cert. denied, 109 S. Ct. 177 (1988).

398. Investment Advisers Act § 203(z)-(f), 15 U.S.C.A. § 80b-3(e) to -(f) (West 1981 & Supp. 1991).

399. Compare Investment Advisers Act § 203(e)-(f), 15 U.S.C.A. § 80b-3(e) to -(f) (West 1981 & Supp. 1991) with Exchange Act § 15(b)(4), (6), 15 U.S.C.A. § 78o(b)(4), (6) (West Supp. 1991).

400. Investment Company Act § 9(b), 15 U.S.C.A. § 80a-9(b) (West Supp. 1991).

impose such sanctions if, after notice and an opportunity for a hearing, it determines that it is in the public interest and that the person has: (1) willfully made a false and misleading statement of material fact or omitted to state a material fact in a registration statement or report; (2) willfully violated the securities laws; (3) willfully aided and abetted a securities law violation; (4) been found by a foreign financial regulatory authority to have committed foreign securities laws violations; (5) been convicted by a foreign court of certain crimes; or (6) been temporarily or permanently enjoined by any foreign court from engaging in violations of foreign securities laws.⁴⁰²

The Public Interest Standard

The statutory provisions authorizing the imposition of administrative sanctions require the Commission to determine that such sanctions are in the public interest. The statutes do not set forth factors that the Commission should consider in determining whether certain sanctions are in the public interest. The Commission is thus granted wide latitude in determining an appropriate sanction.⁴⁰³ As noted above, the Remedies Act adds a list of permissive factors which the Commission may consider in determining whether a penalty is in the public interest.⁴⁰⁴ The legislative history of the Remedies Act states that the SEC advised the Congressional committees that these factors generally reflect the factors that the Commission has considered in the past when determining appropriate sanctions in its administrative proceedings.⁴⁰⁵ These factors are: (1) the culpability of the individual;⁴⁰⁶ (2) the resulting harm;⁴⁰⁷ (3) any unjust

401. *Id.*

402. *Id.*

403. *Berko v. SEC*, 316 F.2d 137, 141-42 (2d Cir. 1963).

404. See *supra* text accompanying note 127.

405. Senate Report, *supra* note 7, at 14; House Report, *supra* note 4, at 20.

406. See, e.g., *Schuck v. SEC*, 264 F.2d 358, 361-62 (D.C. Cir. 1958) (whether violation was willful); *In re C.M. Loeb, Rhoades & Co.*, 38 S.E.C. 843, 855 (1959) (whether respondent acted on advice of counsel); *In re A.G. Scheidel & Co.*, 10 S.E.C. 1032, 1035-36 (1942) (violation simply due to carelessness and the respondent had taken steps to prevent future violations).

407. See, e.g., *C.M. Loeb, Rhoades & Co.*, 38 S.E.C. at 855 (whether any investors appear to have been injured).

deterrence;⁴⁰⁸ and (6) other matters that justice may require.

Judicial Review of Administrative Sanctions Findings of Fact

In *Steadman v. SEC*,⁴¹² the United States Supreme Court concluded that Commission disciplinary proceedings are governed by the APA.⁴¹³ Further, the Supreme Court held that the APA adopted the traditional preponderance-of-the-evidence standard for Commission determinations; thus, violations need not be proven by clear and convincing evidence.⁴¹⁴

The securities laws specifically provide that the Commission's findings as to the facts, if supported by substantial evidence, are conclusive.⁴¹⁵ The function of the reviewing appellate court is to determine if the Commission's factual findings are supported by "substantial evidence."⁴¹⁶ "Substantial evidence" requires "such relevant evidence as a reasonable mind might accept as adequate

408. See, e.g., *In re Reynolds & Co.*, 39 S.E.C. 902, 903 (1960) (whether restitution has been made).

409. See, e.g., *Marketlines, Inc. v. SEC*, 384 F.2d 264, 267 (2d Cir. 1967) (fact that individual failed to pass an examination to qualify as investment adviser and had been found guilty of various serious crimes and was dishared in New York is quite relevant to determination as to whether sanction is in public interest); *In re Strathmore Sec. Inc. and Turner*, Exchange Act Release No. 8207, [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,426 (Dec. 13, 1967); *In re J.H. Goddard & Co.*, Exchange Act Release No. 7618 [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,251 (June 4, 1965) (whether respondents were first offenders); *C.M. Loeb, Rhoades & Co.*, 38 S.E.C. at 855 (whether respondents have good reputation); *In re Merrill, Lynch, Pierce, Fenner & Beane*, 31 S.E.C. 494 (1950).

410. See *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). *But see Beck v. SEC*, 430 F.2d 673, 675 (6th Cir. 1970) (refusing to decide whether Commission may issue an order solely to deter members of securities industry in general).

411. This last factor would probably include hardships that revocation would cause to innocent people connected with the firm. See, e.g., *In re Shearson, Hammill & Co.*, 42 S.E.C. 811, 853 (1965); *In re Investment Registry of Am., Inc.*, 21 S.E.C. 745, 760-61 (1946).

412. 450 U.S. 91 (1981). *Steadman* involved a Commission enforcement action pursuant to the Investment Company Act and the Investment Advisers Act for conduct that included violations of the antifraud provisions of the federal securities laws.

413. *Id.* at 96.

414. *Id.* at 102; see also *Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (Commission review of § 15A determinations).

415. Exchange Act § 25(a)(4), 15 U.S.C.A. § 78y(a)(4) (West Supp. 1991); Investment Company Act § 43(a), 15 U.S.C.A. § 80a-42(a) (West Supp. 1991); Investment Advisers Act § 213(a), 15 U.S.C.A. § 80b-13(a) (West Supp. 1991); see Securities Act § 9, 15 U.S.C.A. § 77i (West Supp. 1991) (omnis reference to "substantial").

416. *Kane v. SEC*, 842 F.2d 194, 198 (8th Cir. 1988); see *Pagel, Inc. v. SEC*, 803 F.2d 942, 945 (8th Cir. 1986); *Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982); *Hughes v. SEC*, 174 F.2d 969, 974 (D.C. Cir. 1949); *Norris & Hirschberg, Inc. v. SEC*, 163 F.2d 689, 691 (D.C. Cir. 1947), *cert. denied*, 333 U.S. 867 (1948).

to support a conclusion."⁴¹⁷ The Commission's findings cannot be set aside simply because different inferences may be drawn from the evidence.⁴¹⁸

Choice of Sanctions

The Commission enjoys wide discretion in determining the sanctions to be imposed.⁴¹⁹ In an early case, the Second Circuit Court of Appeals held that it was without power to supervise the Commission's choice of sanctions.⁴²⁰ Today, however, it is accepted that a court of appeals, under certain circumstances, may review as well as modify sanctions imposed by the Commission.⁴²¹ Only rarely, however, has an appellate court actually rejected or modified the Commission's choice of sanctions.⁴²² Courts will not substitute their "untutored views" in the absence of "a gross abuse of discretion."⁴²³ The fact that a court might not have made the same determination on the same facts will not warrant a substitution of judicial for administrative discretion.⁴²⁴

In 1973, the Supreme Court restated the standard of review in agency determinations. In *Butz v. Glover Livestock Commission Co.*,⁴²⁵ the Court held that the choice of sanctions may not be overturned unless the court of appeals finds the decision unwarranted in law or without justification in fact.⁴²⁶ This standard applies to Commission decisions imposing administrative sanctions.⁴²⁷

Although the Commission has traditionally enjoyed broad discretion in determining the appropriate sanction, courts today appear more reluctant to defer entirely to the Commission's determinations, particularly if the sanction is significant such as a revocation or a bar.⁴²⁸ In *Arthur Lipper Corp. v. SEC*,⁴²⁹ the Second Circuit Court of Appeals rejected a Commission order which revoked a broker-dealer's registration and barred the broker-dealer's principal owner from association with a broker or dealer.⁴³⁰ Instead, the court suspended

417 *Archer v. SEC*, 133 F.2d 795, 799 (8th Cir.), cert. denied, 319 U.S. 767 (1943); *Steadman*, 450 U.S. at 99; *Page*, 803 F.2d at 945; *Hughes*, 174 F.2d at 974-75.

418 *Archer*, 133 F.2d at 799; *Hughes*, 174 F.2d at 974.

419 *Tager v. SEC*, 344 F.2d 5, 9 (2d Cir. 1965).

420 *Wright v. SEC*, 112 F.2d 89, 95 (2d Cir. 1940).

421 *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 183-84 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978).

422 See, e.g., *Beck v. SEC*, 430 F.2d 673, 675 (6th Cir. 1970); *Arthur Lipper*, 547 F.2d at 183-84.

423 *Tager*, 344 F.2d at 9 (2d Cir. 1965), see *Kane v. SEC*, 842 F.2d 194, 201 (8th Cir. 1988).

424 *Berko v. SEC*, 316 F.2d 137, 142 (2d Cir. 1963) (quoting *FCC v. WOKO, Inc.*, 329 U.S. 223, 229 (1946)); *Kane*, 842 F.2d at 201.

425 411 U.S. 182 (1973).

426 *Id.* at 185-86 (quoting *American Power Co. v. SEC*, 329 U.S. 90, 112-13 (1946)).

427 *Kane*, 842 F.2d at 201; *Page, Inc. v. SEC*, 803 F.2d 942, 948 (8th Cir. 1986).

428 See, e.g., *Beck v. SEC*, 430 F.2d 673 (6th Cir. 1970) (reversing the Commission's imposition of a four month suspension, finding that the sanction was punitive rather than remedial and constituted a gross abuse of discretion).

429 547 F.2d 171 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978).

430 *Id.* at 183-85.

both the broker-dealer and the individual for twelve months.⁴³¹ *Arthur Lipper* involved the use of broker "give-ups," which effectively reduce the commission paid to a broker. Although at the time the conduct occurred there was uncertainty as to whether customer-directed give-ups were permissible, the respondents' give-ups were made to an investment adviser without disclosing the payments to the shareholders of the funds and, therefore, constituted a fraudulent practice.

The court cited several factors for reducing the Commission imposed sanction. First, all customer-directed give-ups were by then prohibited, thus reducing the likelihood of future violations.⁴³² Second, although the respondents' conduct would have been impermissible even if customer-directed give-ups were lawful, the climate in which the conduct occurred reduced the egregiousness of the violation.⁴³³ Additionally, the respondents acted under the supervision of an experienced—although not disinterested—counsel, and there was no evidence that the respondents thought they were violating the law.⁴³⁴ Other factors cited by the court were the inordinately long time the proceeding had been pending and the tremendous disparity in sanctions imposed upon the respondents and two other brokers whose violations were perhaps more clear.⁴³⁵ In modifying the sanction, the court stated:

If this statute authorized suspension for a period longer than twelve months, and the Commission had exercised such authority to suspend for say another twelve months, we surely would not interfere. But with the choices limited to a suspension of not more than twelve months or a revocation or bar, we consider that, under the special circumstances of this case, selection of the latter was an abuse of discretion.⁴³⁶

More recently, the Fifth Circuit Court of Appeals specifically indicated that the use of revocations or permanent bars will warrant a higher degree of judicial scrutiny. In *Steadman v. SEC*,⁴³⁷ the court held that when the Commission imposes the most drastic sanctions at its disposal, such as a permanent bar from the industry, the Commission has a duty to articulate carefully the grounds for its decision, including an explanation of why lesser sanctions were not adequate.⁴³⁸ Although noting that the court's role is to decide only whether, under the applicable statute and findings of facts, the agency has made "an allowable judgment in its choice of the remedy,"⁴³⁹ a permanent exclusion from the

431 *Id.* at 185.

432 *Id.* at 184.

433 *Id.*

434 *Id.*

435 *Id.*

436 *Id.* at 185.

437 603 F.2d 1126 (5th Cir. 1979), aff'd on other grounds 450 U.S. 9 (1981).

438 *Id.* at 1143.

439 *Id.* at 1139 (quoting *Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 189 (1973)).

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industry without specifically articulated compelling reasons would be "without justification in fact."⁴⁴⁰

The *Steadman* court stated that possible grounds for a permanent bar include (1) a reasonable likelihood that a particular violator cannot operate in compliance with the law or (2) a violation so egregious that, even if further violations are unlikely, the nature of the conduct mandates a permanent bar as a deterrent to others in the industry.⁴⁴¹ It would be a gross abuse of Commission discretion, however, to bar an investment adviser from the industry on the basis of isolated negligent violations.⁴⁴²

Commission sanctions are also subject to judicial challenge if the Commission excludes relevant evidence from its consideration. In *Blinder, Robinson & Co. v. SEC*,⁴⁴³ the District of Columbia Circuit Court of Appeals concluded that the Commission must consider evidence relevant to a party's degree of culpability when the Commission determines the nature and scope of sanctions that are appropriate in the public interest.⁴⁴⁴ The Court's receptiveness to the respondent's argument that the Commission treats smaller newer firms more harshly than it treats older established firms was also of note in *Blinder, Robinson*. The court stated that mere disparities in penalties were not sufficient grounds to set aside a sanction.⁴⁴⁵ Rather, according to the court:

What is alleged here are not mere disparities . . . but rather an asserted systemic pattern of disparate treatment, resulting in predictably, disproportionately harsh sanctions being visited upon firms such as Blinder Robinson. If the Commission believes that the alarms are false, then it should say so and explain why what might appear to be troubling systemic variances are in fact not such variances at all, or alternatively, variances justified by the circumstances of the case.⁴⁴⁶

As discussed above,⁴⁴⁷ the Remedies Act provides that in administrative proceedings, with the exception of section 19(h) proceedings, the Commission may impose a monetary penalty.⁴⁴⁸ Given the wide discretion that the Remedies Act vests in the Commission, it may be difficult for respondents to successfully challenge the imposition or the amount of an administrative fine. Nevertheless,

440. *Id.* at 1140.

441. *Id.* But see *Beck v. SEC*, 439 F.2d 673, 675 (6th Cir. 1970) (refusing to decide whether Commission may issue order solely to deter members of securities industry in general)

442. *Steadman*, 663 F.2d at 1141

443. 837 F.2d 1099 (D.C. Cir.), cert. denied, 109 S. Ct. 177 (1988)

444. *Id.* at 1109.

445. See *id.* at 1112-13; *Butz v. Glover Livestock Comm'n Co.*, 411 U.S. 182, 187 (1973); *SEC v. Hiller*, 429 F.2d 856 (2d Cir. 1970); *Dlugash v. SEC*, 373 F.2d 107 (2d Cir. 1967)

446. *Blinder, Robinson*, 837 F.2d at 1112-13.

447. See *supra* notes 122-30 and accompanying text

448. The one other administrative proceeding in which the Commission may impose a monetary penalty is § 17A of the Exchange Act relating to clearing agencies and transfer agents. See 15 U.S.C.A. § 78q-1 (West 1981 & Supp. 1991)

at least initially, respondents may attempt such action, particularly, if the Commission imposes substantial penalties

Section 15(c)(4) Proceedings

Section 15(c)(4) of the Exchange Act authorizes the Commission to institute administrative proceedings to address violations of certain specified provisions of the Exchange Act. If the Commission finds that any person subject to sections 12, 13, 14 or 15(d) of the Exchange Act fails to comply with those provisions in any material respect, the Commission may publish its findings and issue an order requiring the violator to comply or take steps to effect compliance with the provisions.⁴⁴⁹ Additionally, section 15(c)(4) provides for the entry of such orders against any person who was the cause of a failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply.⁴⁵⁰

The Commission often utilized section 15(c)(4) proceedings when it appeared that the violative conduct was not sufficiently egregious to require an injunction. Virtually all section 15(c)(4) proceedings were settled, and the respondents consented, without admitting or denying the findings, to the entry of an order requiring the respondent to comply with the applicable provision in the future.⁴⁵¹

In 1988, in *In re George C. Kern, Jr.*,⁴⁵² an administrative law judge (ALJ) issued an initial opinion in one of the few litigated cases under section 15(c)(4). *Kern* involved allegations that Allied Stores failed to comply with section 14(d)(4) of the Exchange Act and rule 14d-9 thereunder by failing to promptly amend a Schedule 14D-9 filed with the Commission. The Division of Enforcement (Division) also alleged that *Kern* was a cause of Allied's failure to comply. *Kern*, an attorney, had acted as Allied's principal outside counsel and was also a member of its board of directors.

After determining that Allied had not promptly disclosed material changes on its Schedule 14D-9,⁴⁵³ the ALJ turned to the standard of culpability required under section 15(c)(4). Section 15(c)(4) required a showing that the respondent charged with causing a failure to comply "knew or should have known" that his act or omission would contribute to the violation.⁴⁵⁴ *Kern* contended, *inter alia*, that this required the Division to prove that he knowingly or consciously

449. 15 U.S.C.A. § 78o(C)(4) (West Supp. 1991)

450. *Id.*

451. *In re George C. Kern, Jr.*, Exchange Act Release No. 29,356, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,815, at 82,005 (June 21, 1991)

452. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342 (Nov. 14, 1988), *aff'd*, Exchange Act Release No. 29,356, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991) Prior to the 1984 amendments to § 15(c)(4), only two proceedings had been litigated. See *In re Oppenheimer & Co.*, Exchange Act Release No. 16,817, 1980 SEC. LEXIS 1465 (May 19, 1980), *In re Susquehanna Corp.*, 44 S.E.C. 379 (1970)

453. *Kern*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,586, 89,588

454. *Id.* ¶ 84,342, at 89,590-91

counseled a course of illegality or, at the very least, that the standard as that required for aiding and abetting liability should apply. The ALJ rejected these arguments and ruled that Kern's conduct should be judged by the standard of negligence.⁴⁵⁵

The ALJ then turned to the scope of the Commission's authority under section 15(c)(4). After examining the legislative history, the ALJ ruled that section 15(c)(4) authorized the Commission to issue an order of future compliance requiring Kern to take steps necessary to effect compliance on the part of Allied.⁴⁵⁶ The ALJ determined, however, that section 15(c)(4) did not authorize the Commission to issue an order directing Kern to comply generally, nor did section 15(c)(4) authorize the Commission to order Kern to take steps necessary to effect compliance with sections 12, 13, 14, or 15(d) on the part of his other clients or persons he becomes associated with in the future.⁴⁵⁷

Although the ALJ ruled that section 15(c)(4) authorized the Commission to issue orders directing future compliance limited to Allied, the ALJ declined to enter such an order. Since Kern was no longer affiliated with Allied and could not effect compliance by Allied, the ALJ concluded that the issuance of an order was beyond his authority and discontinued the proceedings.⁴⁵⁸

The Commission decided to review the ALJ's decision.⁴⁵⁹ During the two and one-half years the matter was before the Commission, it appeared that the Commission observed an informal moratorium on section 15(c)(4) proceedings.⁴⁶⁰ One of the reasons for this moratorium may have been the Commission's fear that an order imposing prospective relief in another proceeding would be viewed as prejudgment of the *Kern* case.⁴⁶¹ In any event, it appears that the uncertainty surrounding the scope of the available section 15(c)(4) proceedings was a major factor in the Commission's decision to seek and obtain cease-and-desist authority in the Remedies Act.⁴⁶²

On June 21, 1991, the Commission affirmed the ALJ's determination to discontinue the proceedings.⁴⁶³ The Commission construed section 15(c)(4) as not providing for the issuance of orders directing general future compliance.⁴⁶⁴ Finding the text of section 15(c)(4) ambiguous, the Commission examined the legislative history of section 15(c)(4) and concluded that section 15(c)(4) was primarily intended to create more limited remedies, such as orders requiring

455. *Id.* ¶ 84,342, at 89,591-92.

456. *Id.* ¶ 84,342, at 89,595.

457. *Id.*

458. *Id.*

459. See *Franklin, Kern Case Stands in Limbo, SEC Inaction Said to Make Settlements Difficult*, N.Y.L.J., June 7, 1990, at 5.

460. See Pitt & Johnson, *supra* note 170, at 32.

461. *Id.*

462. *Id.* at 33.

463. See *In re* George C. Kern, Jr., Exchange Act Release No. 29,356, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991).

464. *Id.* ¶ 84,815, at 82,003, 82,008.

corrective filings.⁴⁶⁵ Accordingly, the Commission stated that "the better view of the proper exercise of our authority, in the context of the Commission's performance of its adjudicative function in contested administrative proceedings, is that we are and ought to be constrained from imposing orders of general future compliance under section 15(c)(4)."⁴⁶⁶

As noted above, the Commission's new cease-and-desist authority expressly allows the Commission to issue orders requiring general future compliance or issue orders requiring steps to effect future compliance.⁴⁶⁷ According to the Commission, the inclusion of this express authority in cease-and-desist proceedings:

[C]onclusively answers, in the affirmative, the question of whether the Commission has the power to issue a broad order requiring generalized future compliance in accordance with the terms of any such order. Thus, for the future, the passage of [the Remedies Act] renders moot the issue of the Commission's general power.⁴⁶⁸

Consequently, the enactment of the Remedies Act probably signals an end to section 15(c)(4) proceedings. The Commission's broad new cease-and-desist authority will now likely address activity which once may have warranted section 15(c)(4) treatment.

Rule 2(e) Proceedings

Pursuant to rule 2(e) of the Commission's Rules of Practice, the Commission may institute proceedings against professionals, such as attorneys and accountants, who appear and practice before the Commission.⁴⁶⁹ Courts have upheld the Commission's authority to promulgate this rule and thereby discipline attorneys, accountants and other professionals by denying them the ability to practice before the Commission.⁴⁷⁰

Rule 2(e) provides that the Commission, after notice and an opportunity for a hearing, may deny, temporarily or permanently, the privilege of appearing or practicing before the SEC to any person who the Commission finds: (1) does not possess the requisite qualifications to represent others; (2) lacks in character or integrity or has engaged in unethical or improper professional conduct; or (3) has willfully violated or willfully aided and abetted a violation of the federal securities laws.⁴⁷¹

465. *Id.* ¶ 84,815, at 82,006.

466. *Id.* ¶ 84,815, at 82,008.

467. See *supra* notes 176, 191-94 and accompanying text.

468. *Kern*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,815, at 82,007.

469. 17 C.F.R. § 201.2(e) (1991).

470. *Davy v. SEC*, 792 F.2d 1418 (9th Cir. 1986); *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979).

471. 17 C.F.R. § 201.2(e)(1) (1991).

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Professional misconduct is also covered by rule 2(e). The rule provides that the Commission will suspend from appearing or practicing before the Commission any professional whose license to practice has been revoked or suspended or who has been convicted of a felony or of a misdemeanor involving moral turpitude.⁴⁷²

Finally, rule 2(e) also permits the Commission, without a preliminary hearing, to suspend temporarily any professional or expert who practices before it who has been (1) "enjoined . . . in an action brought by the Commission from violating or aiding and abetting the violation of any provision of the federal securities laws," or (2) found by a court in a Commission action or found by the Commission to have violated or aided or abetted a violation of any provision of the federal securities laws "unless the violation was found not to have been willful."⁴⁷³

A person who has been temporarily suspended has thirty days from the date of service to petition the Commission to lift the suspension.⁴⁷⁴ The temporary suspension order becomes permanent if that person has not filed a petition within thirty days of service.⁴⁷⁵

Rule 2(e) represents the Commission's attempt to protect the integrity of its disclosure and reporting processes.⁴⁷⁶ Because of its relatively small staff and limited resources, the Commission relies heavily on the legal and accounting professions to ensure compliance with the securities laws.⁴⁷⁷ According to the Commission, rule 2(e) was not designed to be an enforcement tool against those who violate the federal securities laws and happen to be lawyers or accountants.⁴⁷⁸ If the professional misconduct impairs the integrity of the Commission's processes, however, the Commission will respond through the application of rule 2(e).⁴⁷⁹

In *In re Carter & Johnson*,⁴⁸⁰ the Commission addressed the standard for aiding and abetting liability under rule 2(e). In determining whether conduct constitutes aiding and abetting, the Commission stated that the crucial inquiry focuses on the awareness or the intent element.⁴⁸¹ The Commission held that a finding of "willful aiding and abetting" within the meaning of rule 2(e) requires that a respondent be aware or know that his role was part of an activity that

472. *Id.* § 201 2(e)(2).

473. *Id.* § 201 2(e)(3)(i).

474. *Id.* § 201 2(e)(3)(ii).

475. *Id.*

476. See *Touche Ross & Co v SEC*, 609 F.2d 570, 581 (2d Cir. 1979).

477. See *id.*, *In re Keating, Muehling & Klerkamp*, 47 S.E.C. 95, 119 (1979) (Williams, Chairman, concurring).

478. *In re Keating, Muehling & Klerkamp*, 47 S.E.C. at 119 (Williams, Chairman, concurring); *In re Carter & Johnson*, 47 S.E.C. 471, 475, 478 (1981). *But see Siedel, Rule 2(e) and Corporate Officers*, 39 Bus. Law 454, 459 (1984) (citing 14 instances in which rule 2(e) proceedings were brought against corporate officers who happened to be attorneys or accountants).

479. See, e.g., *In re Bill R. Thomas*, 48 S.E.C. 1007, 1015 (1988).

480. 47 S.E.C. 471 (1981).

481. *Id.* at 503.

was improper or illegal.⁴⁸² If the conduct in question is inaction or silence, there must be a finding that the respondent either consciously intended to assist the client's violation, or breached a duty to disclose or act, and had some degree of scienter.⁴⁸³

In *Carter & Johnson*, the Commission also adopted a definition for the phrase "unethical or improper professional conduct" as it applies to lawyers.⁴⁸⁴ The Commission stated that, initially, counselling accurate disclosure is sufficient to avoid rule 2(e) sanctions, even if the advice is not accepted.⁴⁸⁵ The Commission added, however, the following:

When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirement of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance.⁴⁸⁶

The affirmative steps required of the lawyer depend upon the facts of the case and may include directly approaching the board of directors or enlisting the aid of other members of the client's management.⁴⁸⁷ Only in rare circumstances would a lawyer have no choice but to resign.⁴⁸⁸ As long as the lawyer is acting in good faith and exerting reasonable efforts to prevent the client from acting unlawfully, the lawyer has met his professional obligations under rule 2(e).⁴⁸⁹

Although the Treadway Commission recommended money penalties in rule 2(e) proceedings, the Remedies Act does not authorize such penalties. The Commission declined to seek this power in its legislative proposal to Congress,⁴⁹⁰ in part, because of a possible concern that money penalties in rule 2(e) proceedings would undermine the rationale that courts have used to uphold the validity of the rule, i.e., that the rule is necessary to protect the integrity of the Commission's procedures.⁴⁹¹ The Commission did not intend rule 2(e) to be utilized "as an additional weapon in the Commission's enforcement arsenal."⁴⁹² Consequently, if the Remedies Act had authorized money penalties in rule 2(e) proceedings, the validity of rule 2(e) may have been called into question.

482. *Id.* at 503-04.

483. *Id.* at 507.

484. *Id.* at 511.

485. *Id.*

486. *Id.*

487. *Id.* at 512.

488. *Id.*

489. *Id.*

490. Memorandum of the Securities and Exchange Commission, *supra* note 29, at 5.

491. See, e.g., *Touche Ross & Co v SEC*, 609 F.2d 570, 579 (2d Cir. 1979).

492. Memorandum of the Securities and Exchange Commission, *supra* note 29, at 6.

CONTEMPT ACTIONS

When district court orders are violated, the court may impose either "civil contempt remedies or criminal contempt sanctions, or both."⁴⁹³ The Commission may utilize contempt actions to enforce the judgments it has obtained in its injunctive actions.⁴⁹⁴ Recently, the United States Supreme Court, in *Hicks v. Feiock*,⁴⁹⁵ restated the distinction between civil and criminal contempt:

[T]he critical features are the substance of the proceeding and the character of the relief that the proceeding will afford. "If it is for civil contempt the punishment is remedial, and for the benefit of the complainant. But if it is for criminal contempt the sentence is punitive, to vindicate the authority of the court."⁴⁹⁶

A court may use a civil contempt proceeding to imprison or fine an individual unless and until he performs the affirmative act required by the court's order.⁴⁹⁷ By contrast, criminal contempt results in imprisonment for a definite period of time or the payment of a fine to the court.⁴⁹⁸ Generally, actions for civil contempt are sought when the defendant has been ordered to comply with the federal securities laws by performing specific acts, but has failed to do so. Criminal contempt is sought when a court has ordered a person to refrain from engaging in specified conduct, but that person has repeated the violative conduct.

A court cannot issue a contempt order unless the order claimed to be violated is specific and definite.⁴⁹⁹ The proof differs depending upon whether the contempt is civil or criminal. Civil contempt requires proof by clear and convincing evidence.⁵⁰⁰ By contrast, criminal contempt requires proof beyond a reasonable doubt.⁵⁰¹

A criminal contempt action may be initiated by a show cause order or by indictment. The defendant is entitled to reasonable notice of the specific charges and an opportunity to respond.⁵⁰² There is no right to indictment with respect to criminal contempt.⁵⁰³ The defendant, however, is entitled to a jury trial in any

493. *SEC v. American Bd. of Trade, Inc.*, 830 F.2d 431, 439 (2d Cir. 1987), *cert. denied*, 485 U.S. 938 (1988).

494. *See, e.g.*, *SEC v. International Swiss Invs. Corp.*, 895 F.2d 1272, 1274 (9th Cir. 1990).

495. 485 U.S. 624 (1988).

496. *Id.* at 631 (quoting *Gompers v. Bucks Stove & Range Co.*, 221 U.S. 418, 441 (1911)); *see also SEC v. Simpson*, 885 F.2d 390, 395 (7th Cir. 1989) (quoting *Hicks*).

497. 485 U.S. at 632.

498. *Id.*

499. *SEC v. American Bd. of Trade, Inc.*, 830 F.2d 431, 439 (2d Cir. 1987), *cert. denied*, 485 U.S. 938 (1988).

500. *Id.* at 441.

501. *Id.*

502. *Taylor v. Hayes*, 418 U.S. 488, 499 (1974).

503. *Green v. United States*, 356 U.S. 165, 187 (1958); *United States ex rel. SEC v. Greenspan*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,747 (S.D.N.Y. Dec. 19, 1978), *aff'd*, 607 F.2d 1000 (2d Cir. 1979).

criminal contempt action in which the sentence sought exceeds six months. Most importantly, in a criminal contempt action, each element of the offense must be proven beyond a reasonable doubt,⁵⁰⁵ including that the contemnor willfully violated the terms of the court's order.⁵⁰⁶

OTHER COMMISSION ACTIONS IN AID OF ENFORCEMENT

The Commission may take a number of actions in addition to or as alternative to enforcement action.

Section 21(a) Reports

Section 21(a) of the Exchange Act, in relevant part, authorizes the Commission to investigate possible or potential violations and to publish reports concerning such violations.⁵⁰⁷ The Commission may also "investigate any fact conditions, practices, or matters which it may deem necessary or proper to aid the enforcement" of the Exchange Act, "in the prescribing of rules and regulations," or in securing information to serve as a basis for recommending further legislation.⁵⁰⁸

The Commission has issued section 21(a) reports with respect to novel and unique matters, or if it is unable to institute an enforcement action and, in the Commission's view, it is important to express its position. The Commission does not view section 21(a) reports as a type of enforcement action. In *In re Sparte, Inc.*,⁵⁰⁹ Commissioner Karmel stated:

Reports under section 21(a) are not, and should not be, a sanction in an administrative proceeding; indeed such reports can be issued where no administrative proceeding has been, or could be, commenced. They can appropriately be issued where a question of public importance is involved and the public, or at least the financial community, should be informed concerning the nature of the situation and the Commission's response to it. . . .⁵¹⁰

504. *Chell v. Schnackenberg*, 384 U.S. 373, 380 (1966).

505. *United States v. Baker*, 641 F.2d 1311, 1317 (9th Cir. 1981).

506. *SEC v. American Bd. of Trade, Inc.*, 830 F.2d 431, 439 (2d Cir. 1987), *cert. denied*, 485 U.S. 938 (1988).

507. 15 U.S.C.A. § 78u(a) (West Supp. 1991).

508. *Id.*

509. *In re Sparte, Inc.*, Exchange Act Release No. 15,567, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,961, at 81,402 (Feb. 14, 1979).

510. *Id.* at 81,402.

Trading Suspensions

Pursuant to section 12(k) of the Exchange Act, the Commission may suspend trading in any security other than exempted securities for a ten day period.⁵¹¹ Section 12(k) provides the Commission with summary authority with respect to trading suspensions. The section requires only that the Commission determine that the trading suspension is in the public interest and necessary for the protection of investors.⁵¹² The Commission is, however, limited to suspending trading for a single ten day period, unless new circumstances develop.⁵¹³

Foreign Restricted List

The Commission may place securities of foreign issuers on a restricted list. These lists are public statements by the Commission of the names of foreign corporations whose stock the Commission has reasonable cause to believe are being or may have been distributed in the United States in violation of the federal securities laws.⁵¹⁴

Referrals to Governmental Authorities

The Commission may refer matters to other governmental authorities both when it has initiated its own enforcement actions and on occasions when it has determined not to initiate an enforcement action. The Commission frequently refers cases to and assists the Department of Justice and the United States Attorneys.

The federal securities laws authorize the Commission to transmit evidence to the Attorney General's office, who, in its discretion, may initiate criminal proceedings against securities law violators.⁵¹⁵ The securities statutes each contain provisions imposing criminal liability.⁵¹⁶ Several other federal statutes, such as the Federal Mail Fraud Statute⁵¹⁷ and the Federal Wire Fraud Statute,⁵¹⁸ also may be implicated by the violator's conduct.

Additionally, the Commission may refer matters to state prosecutors and state securities commissions as well as to the self-regulatory organizations, such as

511. 15 U.S.C.A. § 78l(k) (West Supp. 1991). Section 12(k) also allows for the suspension of all trading on a national exchange for not more than 90 days if the President does not disapprove of the Commission's decision. *Id.*

512. Exchange Act § 12(k), 15 U.S.C.A. § 78l(k)(1) (West Supp. 1991).

513. See SEC v. Sloan, 436 U.S. 103, 106 (1978).

514. See, e.g., Canadian Restricted List, Seventh Supplement, Securities Act Release No. 4781, 1965 SEC LEXIS 13 (May 18, 1965); see also *Kukatash Mining Corp. v. SEC*, 309 F.2d 647, 649 (D.C. Cir. 1962).

515. See, e.g., Securities Act § 20(b), 15 U.S.C.A. § 77t(b) (West Supp. 1991); Exchange Act § 21(d), 15 U.S.C.A. § 78u(d) (West Supp. 1991).

516. See Securities Act § 24, 15 U.S.C.A. § 77x (West 1981); Exchange Act § 32(a), 15 U.S.C.A. § 78ff(a) (West Supp. 1991); Investment Company Act § 49, 15 U.S.C.A. § 80a-48 (West 1981); Investment Advisers Act § 217, 15 U.S.C.A. § 80b-17 (West 1981).

517. 18 U.S.C.A. § 1341 (West Supp. 1991).

518. *Id.* § 1343 (West Supp. 1991).

the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers, Inc.

Warning Releases

On occasion, the Commission has issued releases in order to alert the public to the federal securities law implications of certain activities.⁵¹⁹

CONCLUSION

The Commission has long been regarded as one of the premier law enforcement agencies. The Commission has achieved such stature with what it has termed limited enforcement alternatives. In submitting legislative proposals that provide significant new remedies, the Commission stated that its existing enforcement alternatives do not provide the flexibility necessary to seek a remedy commensurate with the violation and do not provide an adequate deterrent effect.

In enacting the Remedies Act, Congress addressed the deficiencies the Commission perceived in its existing remedies. The Remedies Act provisions authorizing monetary penalties and cease-and-desist proceedings provide the Commission with the flexibility to seek a remedy commensurate with the violative conduct. The provisions authorizing monetary penalties will increase significantly the deterrent effect of a Commission enforcement proceeding.

Congress also granted the Commission considerable discretion with respect to the exercise of the additional enforcement powers. The legislative history does not provide a clear congressional view as to the exercise of these new powers. It is unclear, therefore, how the Commission will exercise the authority to seek or impose civil penalties for violation of any provision of the federal securities laws. The potential penalties that may be imposed for any of the cases that the Commission typically brings may be more than many defendants will be able to bear. Thus, the exercise of the power to seek or impose such penalties may result in significant litigation or, alternatively, the consent to charges that might otherwise be contested in order to avoid a potentially catastrophic penalty. The Commission may be reluctant, however, to pursue monetary penalties against the most egregious violators because such penalties may preclude a subsequent criminal prosecution due to double jeopardy.

The Remedies Act's cease-and-desist provisions also grant the Commission considerable discretion and leverage that may result in changes in the enforcement of the federal securities laws. The Commission now possesses the authority to proceed administratively against any person to address any violation of the federal securities laws. The Commission, therefore, may decide to bring more enforcement proceedings in the administrative forum, especially actions that

519. See, e.g., *Insider Trading by Law Firm Employees*, Exchange Act Release No. 13,437, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,116 (Apr. 8, 1977); *Condominiums*, Exchange Act Release No. 5347, 38 Fed. Reg. 1735 (1973); *Trading in the Securities of Inactive or Shell Corporations*, Exchange Act Release No. 8638, 34 Fed. Reg. 11,541 (1969).

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otherwise might not be pursued if the agency were required to commence an injunctive action heard by an independent judiciary. The Commission may use the cease-and-desist authority for marginal cases where the evidence of violations is not as strong as is generally the case. Alternatively, the Commission may utilize the administrative forum to extend the reach of the federal securities laws or to advance novel or unique theories.

The enforcement authority provided to the Commission by the Remedies Act raises many questions that only time will answer. Many of the questions raised by the Remedies Act will have to await resolution in the courts. The Commission's interpretation of the parameters of its new authority, however, will no doubt play an important role in determining the answers.

NASD

COMPLIANCE CHECK LIST

This booklet provides you with basic guidelines for evaluating your operational and compliance needs. It does not replace the internally developed audit guides or supervisory check lists that you use to supervise the day-to-day operations of your business.

Certain items in the check lists do not relate to a specific rule or regulation. Rather, they represent sound business practices that will help you avoid possible regulatory problems.

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MEMBER COMPLIANCE CHECK LIST

1 FINANCIAL AND OPERATIONAL

Books and Records — General

1. Properly prepare and maintain each of the following books and records that are required pursuant to SEC Rules 17a-3 and 17a-4 for the type of securities business your firm conducts:

- Order tickets.
- Purchase and sales blotters.
- Securities-received-and-delivered blotter.
- Cash receipts-and-disbursements blotter.
- Customer account ledgers.
- Broker-dealer account ledgers.
- Securities position record.
- General ledger.
- Monies borrowed/loaned ledger.
- Fails-to-deliver/fails-to-receive ledger.
- Long/short securities differences ledger.
- Repurchase and reverse repurchase agreements ledger.
- Trial balances and net capital computations.
- Transfer ledger.
- Securities borrowed/loaned ledger.
- Correspondence and other written communications.

2. Post entries to such books and records accurately and on a current basis.

3. Trial balances should be accurate and agree with corresponding balances in your general ledger.

4. Subledger balances should agree with your general ledger balances.

5. Reconcile your bank balances, omnibus accounts, and clearing corporation accounts on a timely basis and post adjustments to the appropriate records.

6. Securities positions posted to your sub-ledgers should agree with the corresponding positions in your position record.

7. Month-end trial balance proprietary positions should agree with the corresponding positions in your securities position record.

8. Obtain and maintain required customer account information, such as age, address, and the signature of the officer or manager accepting the account. Also make a reasonable effort to obtain relevant additional information, such as the customer's financial status, tax status, and investment objectives.

9. Properly prepare and send customer confirmations in accordance with SEC Rule 10b-10 and maintain a copy of each.

10. Properly prepare and send customer account statements either on a monthly or quarterly basis in accordance with SEC rules.

11. Notify customers of free credit balances in accordance with SEC Rule 15c3-2.

12. Maintain copies of written customer complaints.

13. Notify the NASD in writing of disciplinary actions taken against any person associated with the firm.

14. Designate the Financial and Operations Principal(s) responsible for supervising the preparation and maintenance of your firm's books and records.

15. Report on the appropriate forms currency transactions of \$10,000 or more and foreign transactions in accordance with SEC Rule 17a-8.

16. Comply with due-diligence and certification requirements for taxpayer identification numbers and back-up withholding under the Tax Equity and Fiscal Responsibility Act.

17. Keep your Form BD updated and current.

Books and Records — Municipal Transactions

1. Determine whether you will follow SEC Rules 17a-3 and 17a-4 or MSRB Rules G-8 and G-9 for recordkeeping requirements for municipal securities transactions.

2. Properly prepare and maintain on a current basis each applicable record for your firm's business, as described above and as follows:

- Repurchase agreements and put options.
- Syndicate transaction ledger.
- Uncompleted transaction ledger.

3. Keep a current record of the principal(s) responsible for supervising the firm's municipal securities business.

4. Ensure that your confirmations disclose yield and call information, if appropriate.

Books and Records — Options Transactions

1. Obtain, maintain, and update for suitability determinations and other purposes at least minimal customer account information, such as annual income, net worth, investment experience, and employment status.

2. Ensure the customer's account information is sufficient to determine the suitability of any options recommendation.

3. Obtain and maintain each customer's written agreement for options trading and written acknowledgement of the applicability of the Options Clearing Corporation (OCC) and appropriate options exchange rules.

4. Establish and maintain customer account records reflecting any approval for options trading by a Registered Options Principal.

5. Maintain your work papers and other materials relating to the allocation of exercise assignment notices; keep them for at least three years.

6. Maintain copies of your option customer account statements and retain them for six months at the branch office and the Office of Supervisory Jurisdiction (OSJ).

7. Maintain at your branch office the background and financial information on customers who have been approved for options trading, as well as copies of the financial statements of options customers, for the most recent six-month period.

8. Establish and maintain a *separate* file for all options-related customer complaints and include at least the minimum information required by self-regulatory organizations.

Net Capital (Rule 15c3-1)

1. Compute your net capital in accordance with SEC Rule 15c3-1; make certain that you are in compliance. If you are a government securities broker or dealer registered under Section 15(c) of the Securities and Exchange Act of 1934, compute your net capital in accordance with Part 402 of the Department of the Treasury's rules.

2. Review your secured demand notes; after you apply haircuts, does the collateral value equal or exceed the face value of the relevant secured demand notes?

3. File your subordinated loans and secured demand notes with the self-regulatory organization that is your designated examining authority.

4. In accordance with Appendix D to Rule 15c3-1, send notifications relating to your subordinated loans and secured demand notes to your designated examining authority.

5. Conform your subordinated loans to the applicable requirements of Appendix D to Rule 15c3-1.

6. In computing your net capital, deduct the current market values of unresolved short-count differences from net worth, when appropriate.

7. Whenever you are an underwriter of a firm-commitment offering, make certain that you have adequate capital.

8. If you are a member of OCC, make certain that your net capital satisfies OCC requirements.

9. Verify that your net capital has not fallen below OCC's early-warning limits.

10. Do not make any withdrawals of equity or payments on subordinated loans that would cause your net capital to fall below the early-warning limits or result in a violation of Rule 15c3-1.

11. Treat concessions receivable and related commissions payable according to the SEC staff interpretations that are outlined in *NASD Notices to Members 84-48 and 85-5*.

Firms Operating Under an Exemption From SEC Rule 15c3-3

1. If you claim an exemption from SEC Rule 15c3-3 under subparagraph (k)(2)(i), make certain that:

■ You have established a "special account."

■ You have obtained a written notification from the bank(s) maintaining the special account in accordance with paragraph (f) of SEC Rule 15c3-3.

■ You have processed all customer financial transactions through the special account.

■ If you clear customer transactions through a bank, you have established adequate procedures to ensure that all financial transactions are promptly processed through the (k)(2)(i) special account.

■ You are operating in compliance with the provisions of subparagraph (k)(2)(i).

2. If you claim an exemption from the provisions of SEC Rule 15c3-3 under subparagraph (k)(2)(ii), verify that your method of operation continues to meet the requisites for exemption — for example, you introduce customer transactions on a fully disclosed basis and do not hold customer funds or securities.

3. If you claim an exemption from the provisions of SEC Rule 15c3-3 under subparagraph (k)(3), confirm that you meet the terms and conditions set forth in the SEC's letter of exemption.

Firms Subject to SEC Rule 15c3-3

1. Take required actions to reduce customers' fully paid and excess margin securities to possession and control.
2. Make and maintain a record of your daily determination of the excess and deficiency of customers' fully paid and excess margin securities.
3. Do not make deliveries that increase your deficiencies or create a deficiency.
4. Close out long-sell orders for which the securities have not been received from customers within 10 business days following the settlement date; otherwise, obtain an extension of time.
5. Buy in short security differences or obtain extensions of time whenever you have security differences outstanding 45 calendar days or more from the date of determination.
6. Establish a reserve bank account.
7. Obtain a written notification from the bank maintaining your reserve bank account in accordance with paragraph (f) of SEC Rule 15c3-3.
8. Make your Reserve Formula computations within the specified time frames, maintain them in accordance with SEC Rule 17a-4, and make required deposits within the prescribed time.
9. Use your reserve bank account in conformity with paragraphs (e) and (g) of SEC Rule 15c3-3.
10. If you fail to make the required deposit, send telegrams to the designated agencies.

Safekeeping and Segregation of Securities

1. Hold quarterly securities counts in accordance with SEC Rule 17a-13.
2. Post all unresolved differences resulting from your quarterly box counts to the securities position record and general ledger within seven business days from the date of determinations.
3. Properly segregate customers' securities that you hold in safekeeping.
4. Comply with the provisions of SEC Rule 15c2-1 for the hypothecation of customers' securities.
5. Comply with Article III, Section 19, of the NASD Rules of Fair Practice before lending or pledging customers' securities.
6. Prior to opening an omnibus account with a carrying broker-dealer, follow these procedures:
 1. Execute a written omnibus account agreement.
 2. Establish procedures to properly margin all customer accounts.
 3. Establish procedures to issue and collect margin calls on a timely basis.
 4. Promptly issue possession and control instructions to the carrying broker-dealer in conformity with subparagraph (c)(2) of SEC Rule 15c3-3.
 5. Establish procedures to ensure that firm securities are not commingled with customer securities.
7. Prior to opening and maintaining an omnibus account for any introducing broker-dealer, follow these procedures:

1. Execute a written omnibus account agreement.
2. Establish procedures to properly margin the omnibus account.
3. Issue and collect margin calls on a timely basis.
4. Promptly execute the instructions issued by the introducing broker-dealer.
5. Do not commingle in a single account a customer's transactions with an officer's or partner's transactions.
8. Comply with SEC Rule 17f-1, the Lost and Stolen Securities Program.

Financial Reporting

1. Review FOCUS Reports Parts I and II, or IIA, as appropriate, and confirm that you accurately prepared them and filed them on a timely basis.
2. In compliance with the requirements of paragraph (n) of Rule 17a-5, send your financial statements to the SEC, your customers, and your designated examining authority. Make sure that the statements contain the required information and that you file them on a timely basis.
3. Confirm that your annual certified audit report contains the required supplements, including the Securities Investor Protection Corporation report required by paragraph (e)(4) of Rule 17a-5.
4. Correct any material inadequacies that were noted in the supplemental report to the annual certified audit report.
5. If you are required to file notification under SEC Rule 17a-11, file the reports on a timely basis and correct the problem that prompted the filing of Form X-17A-11.
6. Comply with any financial or operational restrictions.

Clearing

1. Send comparisons required by the Uniform Practice Code, Section 9.
2. Maintain copies of cancelled, un-compared, as-of, and corrected comparisons, as stipulated in SEC Rule 17a-4.
3. Review the number of "don't know," "as-of," and un-compared trades in relation to your overall volume of business.
4. If you are a member of the National Securities Clearing Corporation (NSCC), clear all transactions with other NSCC members in NSCC-traded securities through the clearing corporation.
5. Properly review and verify the net position and accounting reports supplied by the NSCC.
6. Prior to accepting collect-on-delivery and payment-on-delivery orders, obtain the information and assurances that are required by paragraphs (a)(1) through (a)(4) of the Uniform Practice Code, Section 64.
7. Confirm, acknowledge, and settle customers' depository-eligible, collect-on-delivery, and payment-on-delivery transactions in a manner consistent with paragraph (a)(5) of the Uniform Practice Code, Section 64.

Confirmations

1. Properly indicate the capacity in which you are acting.
2. If you make a market in the security being confirmed, disclose this information on the confirmation.

3. If the transaction is of a dual-agency nature, disclose it on the confirmation.

4. If the transaction is executed on a "riskless" principal basis, disclose to the customer the exact amount of your markup.

5. Disclose any additional remuneration you receive in connection with customer transactions.

6. Disclose yield and call information on confirmations of transactions in debt securities, as appropriate.

Fidelity Bonding

1. On the anniversary date of your fidelity bond, review your bonding requirements and ascertain that you have the minimum required coverage under all insuring agreements.

2. If you do not use the NASD Group Fidelity Bond, make certain that your bond contains a cancellation rider that provides for notification to the NASD if the bond is canceled or terminated.

3. Ensure that your bond covers all of the firm's associated persons who engage in the securities business, including independent contractor registered representatives.

NASD and SIPC Assessments

1. Accurately prepare and file NASD assessment forms; pay your assessments on a timely basis.

2. Accurately prepare and file your quarterly and annual SIPC assessment forms; pay the assessments on a timely basis.

3. If you claim an exemption from SIPC membership, confirm that you comply with all exemption requirements.

2 RECOMMENDATIONS TO CUSTOMERS

General Suitability Requirements

1. Prior to the execution of a transaction recommended to a noninstitutional customer, a reasonable effort must be made to obtain information concerning the customer's financial status, tax status, investment objectives, and such other information used or considered to be reasonable and necessary by the firm or salesperson in making recommendations to the customer.

2. At the time of the recommendation, the salesperson must have reasonable grounds to believe that the recommendation is suitable for the particular customer based on the information obtained about the customer, particularly his financial status, investment objectives, and other security holdings.

3. Recommendations should not be made during "cold call" telephone solicitations to customers or prospective customers prior to obtaining the customer information and determining the customer's suitability.

4. Recommendations to customers involving other than equity securities, such as options and municipal securities, are subject to special suitability requirements.

SEC Rule 15c2-6 Suitability and Recordkeeping Requirements

1. Where the securities to be recommended are OTC equity securities priced below \$5 per share and involve an issuer having less than \$2 million in net tangible assets, and an exemption from Rule 15c2-6 is not available, obtain the information about the customer's previous investment experience, investment objectives and financial situation.

2. With that information the firm must reasonably determine whether transactions in such designated securities are suitable for the particular customer.

3. If the securities are determined by the firm to be suitable, the firm's written suitability determination must be delivered to the customer, who is required to manually sign and return the statement, if it is accurate, as a condition for opening the account.

4. The firm must also obtain from the customer a written agreement to enter into each of the first three transactions in such designated securities.

5. In considering whether a security is to be recommended exempt from SEC Rule 15c2-6 because the issuer's financial statement lists \$2 million or more in net tangible assets, the firm must carefully consider and evaluate any questionable assets listed.

Adequate and Reasonable Factual Basis for Recommendation

1. The salesperson must have an adequate and reasonable factual basis for any securities recommendation based on current material and reliable information about the issuer and the marketplace.

2. Issuer and market information conveyed to a customer in support of any recommendation must be accurate, complete, and timely.

3. In making a securities recommendation to a customer, all material information about the issuer or the market that is adverse or unfavorable must be disclosed to the customer so the customer can make an informed decision about the investment risks.

4. Where the firm or the salesperson lacks essential information about the issuer of the security being recommended, such fact must be disclosed to the customer as well as the risks that arise from this lack of information.

3 SALES PRACTICES

General

1. Predictions of price increases (or decreases) involving the securities of seasoned companies with an operational and financial history and with experienced management must have a reasonable factual basis. Unseasoned companies with limited or no operational and financial history do not provide the necessary factual basis for a price prediction.

2. Claims of investment safety for a particular security must have a reasonable factual basis.

3. In situations when a salesperson recommends a securities transaction, he must disclose any material adverse facts of which he is or should be aware.

4. High pressure sales techniques, including concentrated and extensive unsolicited telephone calls to prospective customers to induce hurried and uninformed sales decisions, must not be employed.

5. Plans or efforts to restrict or delay a customer's resale of a recommended security must be disclosed to the customer at the time of the recommendation (for example, in situations when the firm will not execute a resale unless the salesperson has another customer to purchase it).

6. With regard to discretionary accounts:

- Designate a supervisor or compliance person to periodically review activity in the accounts for indications of abusive practices.

- Keep the customer's written discretionary authorization on file for each account.

- Include the age and occupation of each customer on the customer account card.

- A designated person must promptly approve in writing all orders for discretionary accounts.

7. Establish a supervisory procedure to periodically review an adequate number of transactions with customers for:

- Unsuitable recommendations.

- Excessive trading of customer accounts.

- Excessive markups or markdowns.

- Unauthorized transactions.

- Free-riding and withholding.

- Failure to obtain best execution.

- Misrepresentations or misleading statements.

- Guarantees against loss.

Advertising and Sales Literature

1. Maintain files for all advertising and sales literature.
2. Have a principal or designee approve the material prior to use.
3. Satisfy applicable filing requirements pursuant to Article III, Section 35 of the NASD Rules of Fair Practice and Section 8 of the Government Securities Rules.
4. Comply with provisions governing exaggerated statements, contents, and required disclosure under Article III, Section 35; Section 8 of the Government Securities Rules; and the various SEC, MSRB, and SIPC rules governing advertising and sales literature.

Investment Company Shares — Retail Dealers

1. Execute principal sales to customers of open-end investment company shares at the next-quoted public offering price after the order is received and in accordance with your sales agreement with the underwriter.
2. If available, give customers quantity discounts at breakpoint levels on single purchases, letters of intent, and rights of accumulation.
3. Advise prospective investors that no advantage accrues from purchasing investment company shares just prior to an income or capital-gain distribution.
4. Ensure that you do not improperly switch customers from positions in one investment company to another in violation of the suitability rule.

5. Adhere to the provisions of Article III, Section 26(f) of the Rules of Fair Practice, which prohibit withholding customers' orders for firm gain.

6. Ensure you comply with the provisions of the anti-reciprocal rule, Article III, Section 26(k) of the Rules of Fair Practice.

7. Associated persons may not receive anything of material value directly from principal underwriters or their employees.

8. Do not encourage customers to improperly use the contractual plan withdrawal and reinstatement privilege.

9. Promptly make payment to underwriters, mutual funds, or their agents of payments received from customers for the purchase of investment company shares.

10. Comply with the provisions of SEC Rule 11(d)(1) and (2) on the margin requirements governing mutual fund shares.

4 MARKET MAKING AND TRADING

Quotations

1. **"Firm Quotation" Rule** — A market-maker holds itself out as willing to buy or sell at least a normal trading unit and, therefore, must be ready to buy from or sell to other broker-dealers at its quoted prices and/or to customers at a price equal to its quoted price plus or minus a reasonable markup or markdown in at least the amount of a normal trading unit.

2. Allowable Quotation Spreads

(Nasdaq) — A Nasdaq market maker's quotation spread between its bid and ask in a security may not exceed the "average quotation spread" of all market makers by more than a specific amount. [See Schedule D, Part VI, Section 2(d) of the NASD By-Laws for the maximum allowable spreads.]

3. Locked and Crossed Markets

(Nasdaq) — A Nasdaq market maker shall not maintain quotations in the Nasdaq system if:

▫ Its ask quotations are *equal to* (a "locked" market) or *lower than* (a "crossed" market) other market makers' bid quotations; or

▫ Its bid quotations are *equal to* (a "locked" market) or *greater than* (a "crossed" market) other market makers' ask quotations.

4. **Issuer Information** — SEC Rule 15c2-11 (non-Nasdaq) — Before inserting quotations for a non-Nasdaq security in a quotations medium (such as the OTC Bulletin BoardSM or the "Pink Sheets"), a market maker must obtain, maintain, and review specific information about the issuer pursuant to SEC Rule 15c2-11 unless an exemption is available (such as the "piggyback" exemption).

5. **Correspondent's Quotations** — A dealer that enters quotations in a quotations medium as a correspondent for another dealer, or pursuant to some other arrangement, must promptly disclose the relationship.

Fair Prices

1. Best Execution of Customer Orders —

In any transaction for or with a customer, the firm must:

- Use "reasonable diligence" to ascertain the best inter-dealer market for the security, and
- Buy or sell in such market so that the resultant price to the customer is as favorable as possible under the prevailing market conditions.

2. Obtaining Three Quotations for Non-Nasdaq Securities to Determine Best Market —

Prior to executing a transaction for or with a customer in a non-Nasdaq security, the firm must:

- Contact and obtain "quotations" from a minimum of three "dealers," and
- Note on the customer's order ticket the identities of the dealers contacted and the quotations received to determine the best inter-dealer market.

3. Markups/Markdowns — Where a dealer executes principal transactions with its customers, its markups (or markdowns) must be fair and consistent with the NASD Markup Policy. For equity securities, that policy states that markups should not exceed 5 percent of the "prevailing market price for the security."

Where no independent market exists for the stock away from the subject market maker, the most reliable evidence of the prevailing market price is the contemporaneous prices the subject paid other dealers on the "day before or the same day" as its sales to customers (i.e., the subject's contemporaneous costs).

■ Where an independent market exists for the stock away from the subject market maker, the prices paid by other dealers to the subject are considered an accurate reflection of the prevailing market price.

■ When a broker-dealer is not a market maker in a security, its contemporaneous cost should be used as the prevailing market in calculating markups in the absence of countervailing evidence.

Short Sales

1. Execute short sales of listed securities in compliance with SEC Rule 10a-1, which is designed to prevent short selling in a declining market and requires short sales to be effected only on a plus tick or a zero-plus tick.

2. Execute short sales in compliance with SEC Rule 10b-21, which prohibits purchases from a public offering to cover short sales executed after the filing of the registration statement for the offering.

3. Identify any short sale as "short" on the order ticket.

4. Before accepting a short-sale order from a customer, make an affirmative determination that the customer will deliver that security or that the security can be borrowed on behalf of the customer by settlement date.

5. Maintain a record of total "short" positions in Nasdaq securities in all customer and proprietary firm accounts and make monthly reports of such information to the NASD on a timely basis.

Trade Reporting

1. All reports of transactions should be accurate, complete, and timely.

2. Nasdaq/NMS Transactions (Schedule D, Part XII of the NASD By-Laws):

■ Registered market makers must report a Nasdaq/NMS trade within 90 seconds after execution.

■ Report the Nasdaq symbol, price, volume, and a symbol indicating buy, sell, or cross.

■ Special requirements apply to reporting transactions effected before or after trading hours and to the bunching of trade reports.

3. Nasdaq Non-NMS Transactions (Schedule D, Part IV):

■ Registered market makers must report their volume each day by 5 p.m., Eastern Time (ET).

■ Report the Nasdaq symbol and daily volume (purchases and sales).

■ Report "no volume" on days when no volume occurred.

4. Non-Nasdaq Transactions (Schedule H):

■ All dealers must report their purchases and sales (as principal) each day by 5 p.m. ET in accordance with Schedule H.

■ Report the symbol, the daily volume, the highest sales price, and the lowest purchase price.

5. OTC Transactions in Listed Securities (Schedule G):

■ Registered Third Market Makers must report within 90 seconds after execution all eligible securities unless the transaction is exempt.

■ Report the stock symbol, price, and volume.

SOES Requirements

1. Participation in the Small Order Execution System (SOES) is mandatory for registered market makers in any Nasdaq/NMS security.
2. Execution of a "SOES Participant" application agreement with the NASD is required for both market makers and SOES order-entry firms.
3. SOES may be used only for customers' agency orders of limited size for Nasdaq/NMS securities.
4. Order splitting to achieve the requisite size is prohibited.
5. "Professional traders" are prohibited from using SOES.

Special Prohibited Trading Practices

1. **Price Manipulation** — No purchase or sales order should be entered that is designed to raise or lower the price of a security or to give the appearance of trading for purposes of inducing others to buy and sell.

Examples:

■ "Marking the close," where one or more trades are executed or falsely reported at or near the close of trading with the intention of affecting the closing price of the security.

■ "Prearranged trading" or "round robin" trading designed to give the appearance of trading activity.

2. **"Parking" Securities to Conceal Ownership** — No arrangement should be used to conceal the true ownership of securities through a fictitious sale or transfer to an accommodator who agrees to later sell or transfer the securities to the true owner (or his agent) at the agreed upon time at essentially the same terms.

3. Insider Trading —

■ No firm proprietary account or employee account should trade a security while in possession of material nonpublic information about the issuer of that security or its marketplace.

■ All firms must establish, maintain, and enforce written policies and procedures reasonably designed to prevent and detect insider trading by proprietary and employee accounts.

4. **Front Running** — No firm proprietary account or employee account should trade a security while in possession of material information about an imminent block-sized transaction in that security or a derivative security.

5. **Undisclosed Self-Preferencing While Holding Customer's Limit Order** — No firm can trade for its own account at prices more favorable than the customer limit order unless there is an understanding by the customer as to the priorities that will govern the order.

5 UNDERWRITING AND RELATED ACTIVITIES

General

1. If you participate or intend to participate in the distribution of a public offering of securities, whether as an underwriter, a selling group member, or otherwise, you have to act at all times in accordance with high standards of commercial honor and just and equitable principles of trade.

2. You may not participate when the underwriting or other arrangements in connection with or related to a distribution, or the terms or conditions relating thereto, are unfair or unreasonable.

3. In the case of an underwritten public offering, the managing underwriter must file the appropriate documents with the NASD for review pursuant to the provisions of the Interpretation of the Board of Governors — Review of Corporate Financing under Article III, Section 1 of the Rules of Fair Practice.

4. The managing underwriter must file with the NASD for review concurrent with the filing of any such documents with the SEC, state securities commission, or any other regulatory authority documents relating to all proposed public offerings of securities including, but not limited to, the following:

■ Direct participation programs as defined in Article III, Section 34(d)(2) of the Rules of Fair Practice.

■ Mortgage and real estate investment trusts.

■ Rights offerings.

■ Securities exempt from registration with the SEC pursuant to Section 3(a)(11) of the Securities Act of 1933, as amended, which is considered a public offering in the state where offered.

■ Securities exempt from registration with the SEC pursuant to Rule 504 adopted under the Securities Act of 1933, as amended, which is considered a public offering in the states where offered.

Securities offering by a bank, savings and loan association, church or other charitable institution, or common carrier even though such offering may be exempt from registration with the SEC.

Securities offered pursuant to Regulation A or Regulation B adopted under the Securities Act of 1933, as amended.

Any offerings of a similar nature.

5. You need not file documents and information relating to the following public offerings with the NASD for review, unless subject to the provisions of Schedule E to the By-Laws:

... Securities offered by a corporate, foreign government, or foreign government agency issuer which has unsecured nonconvertible debt with a term of issue of at least four years, or unsecured nonconvertible preferred securities, rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories, except that the initial public offering of the equity of an issuer is required to be filed.

.. Nonconvertible debt securities and nonconvertible preferred securities rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.

Securities registered with the SEC on registration statement Form S-3 or F-3 and offered pursuant to Rule 415 adopted under the Securities Act of 1933, as amended.

Securities offered pursuant to a redemption standby "firm commitment" underwriting arrangement registered with the SEC on Form S-3; and

Financing instrument-backed securities that are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.

6. However, it shall be deemed a violation of Article III, Section 1 of the Rules of Fair Practice (Appendix F to Article III, Section 34 of the Rules of Fair Practice if it involves a direct participation program) for a member to participate in any way in these public offerings if the underwriting or other arrangements in connection with the offering are not in compliance with the Corporate Financing Interpretation or Appendix F.

7. The following offerings are exempt from the Corporate Financing Interpretation and you do not need to file documents and information relating to them for review:

.. Securities exempt from registration with the SEC pursuant to the provisions of Sections 4(1), 4(2), and 4(6) of the Securities Act of 1933, as amended and pursuant to Rule 504 (unless considered a public offering in the states where offered), Rule 505, and Rule 506 adopted under the Securities Act of 1933, as amended.

.. Securities that are defined as "exempt securities" in Section 3(a)(12) of the Securities Act of 1934, as amended.

.. Securities of investment companies registered under the Investment Company Act of 1940, as amended, except securities of a management company defined as a "closed-end company" in Section 5(a)(2) of that Act.

.. Variable contracts as defined in Article III, Section 29(b)(1) of the Rules of Fair Practice.

Offerings of municipal securities as defined in Section 3(a)(29) of the Securities Exchange Act of 1934, as amended.

.. Tender offers made pursuant to Regulation 14D adopted under the Securities Exchange Act of 1934, as amended.

.. Securities issued pursuant to a competitively bid underwriting arrangement meeting the requirements of the Public Utility Holding Company Act of 1935, as amended.

Board of Governors' Interpretation On Corporate Financing

1. Comply with the Interpretation's filing requirements on those issues for which you are an underwriter or for which you participate in an advisory, distributive, or other capacity in a nonunderwritten issue of securities.

2. Provide the NASD Corporate Financing Department with all information and documents relating to the offering, including compensation and distribution arrangements, names of participating members, any arrangements between the issuer and any member or any person associated with a member, and any arrangements between the issuer and consultants.

3. Prior to participation in the distribution, make certain that the NASD Corporate Financing Department has no objections to the offering terms and arrangements.

4. If an issuer hires unregistered persons primarily to assist in or distribute a non-underwritten issue of securities, refrain from acting in an advisory, distributive, or other capacity unless in compliance with SEC Rule 3a4-1.

5. When you are acting as managing underwriter, always notify all members of the syndicate and selling group if the NASD renders an opinion that the underwriting compensation is unfair or unreasonable.

6. Ensure that you observe the "lock-up" on securities considered underwriting compensation.

Offerings of Your Own Securities, Parent's Securities, or Securities of an Affiliate

1. If you are offering your own securities, if your parent is offering securities, or if you are participating in the distribution of a public offering of your securities, your parent's securities, or the securities of an affiliate, file the offering for review by the NASD Corporate Financing Department under Schedule E of the NASD's By-Laws.

2. Have a qualified independent underwriter, independent market, or investment-grade rating determine the offering price of the securities.

3. Make certain any qualified independent underwriter meets the definition in Schedule E, provides a fairness opinion of the price, and establishes procedures for adequate review of the registration and other documents relating to the offering.

4. Ensure that the offering document contains appropriate disclosure of Schedule E compliance.

5. Make a suitability determination on each purchaser and retain the appropriate suitability information.

6. Ensure that all participating members refrain from making sales to accounts over which the member holds, directly or indirectly, discretionary power unless the member obtains prior specific written authorization for each purchase from the customer.

7. If you offer your securities in an intrastate offering, ensure that you give the appropriate information.

8. Properly escrow the proceeds of any public offerings of your securities, compute your net capital properly and accurately, make certain that the appropriate ratio is correct, notify the NASD of the termination of the offering, and file the appropriate capital computation (return the proceeds of the offering if the ratio does not meet the standards specified in Schedule E).

9. Send the requisite operational and financial reports to each security holder after offering your own securities.

10. Make certain that you or your parent firm establishes, within the prescribed time frame, an audit committee composed of appropriate members of the board of directors.

Intrastate Offerings

1. Make certain that each intrastate offering made by a single issuer is independent of that issuer's other offerings.

2. If these offerings are not independent, determine that the entire, integrated issue satisfies the provisions of the rule.

3. Determine that the issuer is a resident of the state in which all securities are offered and sold.

4. Confirm that the issuer's principal office and 80 percent of its gross revenues and assets are within the state in which all securities are offered and sold.

5. Make certain that at least 80 percent of the proceeds of the offering will be used within the state.

6. Ascertain that the prohibitions on resale of the securities have been observed.

7. Take all necessary precautions to guard against interstate offers and sales and to ensure that all offers and sales are made to residents of the state.

8. Unless it is exempt under state securities law, file the offering for review by the NASD Corporate Financing Department.

Registered Offerings

1. After filing with the SEC, confirm that only appropriate "red herring" prospectuses are used before the effective date of the registration statement.

2. Observe the appropriate prospectus delivery requirements.

3. Ascertain that a prospectus is sent to each offeree and purchaser within the allotted time.

4. Make certain that no offers or sales of securities are made prior to the effective date of the registration statement.

5. Ensure that all syndicate and selling group agreements reveal the price at which the securities are to be sold to the public or the formula by which the price may be ascertained and the amount of selling concession, if any, that may be allowed.

6. If concessions or discounts are allowed to any party involved with a public offering of securities, make proper disclosure of the concession or discount.

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7. Ensure that selling concessions, discounts, or other allowances given in consideration for services rendered in the distribution process are not granted to anyone other than a broker or dealer actually engaged in the investment banking or securities business.

8. If a portion of an underwriting has been allotted to a foreign nonmember, determine that the nonmember firm has followed steps 6 and 7 above.

9. If a person associated with you acts as a finder, wholesaler, or consultant in a public offering of securities, reflect the activity on your books and records and have a qualified principal supervise this activity.

10. Make sure that advertisements or communications preceding the prospectus comply with SEC Rule 134.

11. Make sure that advertising and sales literature are filed with the NASD in accordance with Article III, Section 35.

Miscellaneous

1. If involved in an offering or sale of new issues of industrial development bonds, determine that the bonds are exempt from registration.

2. If involved in an offering or sale of new issues of commercial paper, determine that the paper is exempt from registration.

3. If involved in an offering or sale of new issues of securities issued by eleemosynary institutions, determine that the institutions and securities qualify for an exemption from SEC registration. Also insure that the offerings are filed for review with the NASD Corporate Financing Department.

4. If involved in an offering or sale of new issues of other securities exempt from registration by definition, determine whether the exemptions are proper or whether they should be reviewed by the NASD Corporate Financing Department.

5. In a contingent offering, check for instances of parking all or part of the issue to satisfy the contingency.

6. Observe the applicable state securities laws.

7. Comply with the provisions of the NASD's Interpretation on Free-Riding and Withholding.

8. If you allot a portion of an offering to a foreign nonmember, ascertain that the foreign nonmember observes the provisions of the NASD's Interpretation on Free-Riding and Withholding.

9. Escrow funds in contingency offerings, whether public or private, to comply with SEC Rule 15c2-4.

10. Ensure that "securities taken in trade" in connection with the sale of an offering of securities are purchased at a bona fide market price.

Rule 144 Transactions

1. Make reasonable inquiry into the propriety of the exemption.

2. Ascertain whether the seller is an affiliate of the issuer.

3. Verify the seller's holding period.

4. When required, file proper notice of the sale.

5. Unless the seller is unaffiliated with the issuer and has held fully paid for securities for longer than three years (a) ascertain that sufficient public information is available relative to the issuer, and (b) verify that the volume limit is observed.

6. Confirm that the manner of sale is proper.

Regulation D Offerings

1. Ensure that the issuer is qualified to use the particular rule under Regulation D of the Securities Act of 1933.

2. Verify that the exemption is used only by the issuer.

3. Confirm that the aggregate sales of the securities fall within the dollar limitations established by the particular rule.

4. Ascertain that the offering made by an issuer is independent of other offerings made by that issuer; if not, make certain that all offerings when integrated meet the provisions of the particular rule.

5. Confirm that the aggregate number of nonaccredited purchasers does not exceed 35.

6. Where a sale is to be made to an "accredited investor," make certain that there is reasonable belief that such investor meets the definition.

7. If there are nonaccredited investors purchasing, determine that a disclosure document containing adequate information is given to all investors prior to sale.

8. If relying on Rule 506, determine that all nonaccredited purchasers: (a) satisfy sophistication standards, or (b) that every nonaccredited purchaser who is not sophisticated has a purchaser representative that meets the tests established by the regulation.

9. Make sure that purchasers provide evidence that they are purchasing for investment and not with an intent to resell.

10. Observe the prohibition against general solicitation or advertising as set forth in Rule 502(c).

11. Provide issuer with such information as is necessary to permit it to file the appropriate notice of sales on Form D with the SEC on a timely basis.

12. Follow established due-diligence procedure to ensure that all material facts have been accurately disclosed to purchasers.

13. File Rule 504 offerings that are public in each state with the NASD Corporate Financing Department.

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OPTIONS

Opening Accounts

1. Have a registered options principal approve in writing the opening of all customers' accounts for options trading before you effect any options transactions.

2. If you maintain discretionary accounts, obtain specific authorizations for options trading, have the senior registered options principal review the acceptance of the accounts, and have the compliance registered options principal conduct frequent supervisory reviews.

3. If you use options programs in discretionary accounts, give customers a written explanation of the nature and risks of the programs.

4. Have a registered options principal approve discretionary account option orders within the prescribed time frame and maintain records of the orders.

5. Before you approve the account for options trading, obtain the minimum background and financial information from each customer who is a natural person.

6. Maintain records of your inquiries to determine the suitability of options trading by customers.

7. Obtain signed account agreements from your customers within the prescribed time frames, and verify background and financial information from your customers who are natural persons.

Exercise Arrangements

1. Be sure that you have an approved assignment procedure and that you follow the procedure. If you make changes to the assignment procedure, make certain that the changes are approved.

2. Establish procedures for the timely submission of exercise notices to the OCC.

3. Inform your customers of the type of assignment procedure, and give them an explanation of that procedure.

4. Notify your customers on a timely basis when you receive an automatic exercise report.

5. When you accept an exercise instruction after a cut-off time but prior to the applicable expiration date, be sure that the circumstances are extraordinary and justify the acceptance.

6. Establish a nondiscriminatory procedure for accepting exercise instructions after the cut-off date.

7. Determine whether deposit requirements for customers who are exercising options are promptly met.

Position and Exercise Limits

1. Make certain you observe option exercise and position limits.

2. When necessary, observe the procedures for liquidating excess option positions.

3. If applicable, observe limits on uncovered short option positions.

4. Observe the prohibitions against "acting in concert" on exercise and position limits.

Disclosure Documents Delivery Requirements

1. Use a current OCC disclosure document and deliver a copy to all new options customers within the allowed time frame.

2. Provide your options customers with a copy of each new or revised OCC disclosure document.

3. Deliver a special risk-disclosure document to any customer approved for uncovered option transactions.

Reporting

1. When required, file an "acting in concert" report.

2. File accurate, daily reports with the NASD on accounts with positions on the same side of the market totaling 200 contracts or more of the same option class.

Sales Practices

1. Establish supervisory procedures to prevent wash sales or matched orders in options and their underlying securities.
2. Review your accounts to determine that no manipulative activity, such as pegging, churning, or mini-manipulation, has occurred.
3. When approval for an underlying security in an option has been withdrawn, give customers appropriate notice before you execute customer options transactions in that security.
4. Review customer accounts to determine that their options transactions appear suitable in light of all relevant information and that customers are able to evaluate and bear the risks of a recommended transaction.

Margin

1. Ascertain that all purchases of options effected by customers have been paid in full.
2. Make certain that your customers meet minimum equity requirements established for margin transactions and that you observe all initial Regulation T margin requirements.
3. Determine that you meet appropriate margin maintenance requirements for uncovered short option positions, option straddle positions, short options covered by exchangeable or convertible securities, and conventional option positions.
4. When covering short option positions or satisfying margin requests and exercise notices, make sure that you refuse securities that are restricted, unregistered, or in any other manner not salable under the registration provisions of the Securities Act of 1933.

Advertising and Sales Literature

1. Establish and maintain files of your options advertising and sales literature.
2. Make certain that your options advertising or sales literature complies with applicable standards.
3. Meet appropriate filing requirements and have a compliance registered options principal or his designee approve the material prior to use.
4. In accordance with requirements of the options exchange, make copies of projections or performance reports easily accessible to the sales office.
5. In accordance with requirements of the options exchanges, have a registered options principal approve performance reports in writing.

OCC Rules

1. Process all customer transactions in OCC options through an OCC customer account.
2. Deposit securities, depository, and escrow receipts held for the accounts of customers only in OCC customer accounts.
3. Make specific deposits in an underlying security held for the account of a customer only for option contracts that are short or that have been exercised by the OCC.
4. Do not use fully paid or excess-margin securities in a bulk deposit with the OCC.

5. Give instructions to the OCC to release from segregation or to retain in an unsegregated status only long positions carried in customer accounts offset by short option positions of the same class.

6. When you close out a customer's short option position, promptly ask the OCC for the return of the deposit or escrow receipt.

7. Prepare and maintain the appropriate records on specific OCC deposits you make in an underlying security held for the account of a customer.

8. Obtain an appropriate agreement for specific and bulk OCC deposits.

9. Promptly reconcile all reports of options activity supplied by the OCC.

10. Do not effect closing transactions in any account at a time when it does not have a corresponding opposite position in the same account for at least the same number of options contracts.

11. Honor exercise restrictions imposed by the OCC or any other regulatory body of which you are a member.

12. When you directly deliver securities or make payment on exercised options to another OCC member, file an accurate and timely report with the OCC.

Miscellaneous

1. Have a registered options principal regularly review all order tickets and accounts relating to options transactions and maintain records of the review.

2. Follow written supervisory procedures for handling customers' options transactions; make certain that the procedures call for a regular review of each customer's options account by the senior registered options principal.

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3. Establish safeguards to prevent an issuer from writing call options on its own securities.

4. Ensure that the compliance registered options principal reports regularly and directly to your compliance officer and other senior management.



MUNICIPAL SECURITIES

Fees and Assessments

1. Pay the annual fee in a timely manner.
2. If you serve as a sole underwriter or manager of a syndicate or similar account for which you keep the records, remit the underwriting assessment for each offering, determine the amount of assessments you must pay, pay the assessments within the prescribed time period, and file the appropriate information.

Reports and Quotations

1. If you make a market, ensure that your quotations are bona fide and reflect the best judgment of the fair market price for the security.
2. If you make quotations for other broker-dealers, make certain you have adequate reason to believe that the quotations are bona fide and that the prices are fair.

3. If you make quotations for a syndicate or joint account, ensure that the quotations do not indicate more than one market for the same security.

4. Make certain that you properly report purchases and sales of municipal securities transactions.

Syndicate Practices

1. When you act as a syndicate manager or in a similar capacity, return good-faith deposits within the appropriate time frame.
2. Make final settlement of syndicate or similar accounts formed for the purchase of municipal securities within the required time.
3. Forward designated credits on time.
4. If you act as a syndicate manager, properly confirm sales of securities held by the syndicate to a related portfolio, municipal securities investment trust, or an accumulation account.
5. Properly disclose group orders to syndicate members on request.
6. If you act as manager, properly make required communications on the priority of orders.
7. If you act as manager, furnish an itemized expense statement to all syndicate members before the final settlement.
8. When you participate in a new-issue underwriting, identify for the syndicate all orders for a related portfolio; on group orders, disclose the identity of the person for whom they are submitted.

Sales Practices

1. Execute principal transactions with customers at prices that are fair and reasonable.

2. Adopt commission rates and service charges that are fair and reasonable.

3. Obtain best execution for agency transactions.

4. Ensure that purchasers are provided the issuer's final official statement by settlement date with respect to any purchase of a new-issue municipal security. (The underwriter must also provide a copy to the MSRB.)

5. Review promptly:

- The opening of each municipal securities account.
- Each transaction in municipal securities.
- The handling of customer complaints.
- All correspondence pertaining to the solicitation or execution of transactions in municipal securities.

6. Examine all customer accounts regularly and frequently to detect irregularities and abuses.

7. Provide written notice for accounts of customers known to be employed by another broker-dealer or municipal securities dealer, and send duplicate confirmations to the employers of these customers.

8. Keep written authorization on file for each discretionary account.

9. Have a municipal securities principal review and approve in writing all discretionary transactions.

10. Make sure that advertising is filed in accordance with Article III, Section 35 of the NASD's Rules of Fair Practice.

11. Maintain a file of all advertisements and sales literature, and have a principal approve them in writing prior to use.

12. In conformance with MSRB Rule G-21, ensure that your advertising is free of false or misleading information and that your advertisements of new issues properly reflect the availability of the securities.

13. Provide the investor complaint brochure required by MSRB Rule G-10.

MSRB Uniform Practice Requirements

1. Accurately prepare confirmations, disclose yield and call information, if applicable, and forward each on a timely basis.

2. Follow comparison and verification procedures.

3. Comply with the procedures for the rejection and reclamation of municipal securities.

4. Follow MSRB close-out procedures, if appropriate.

5. Effect interdealer comparisons and book-entry settlement in conformity with MSRB Rule G-12.

6. Use the facilities of a depository for comparison, acknowledgement, and settlement of transactions effected for institutional customers pursuant to MSRB Rule G-15.

Miscellaneous MSRB Rules

1. Provide customers with required information on a timely basis for all new issues of securities sold.

2. Observe the prohibition on giving gifts and providing services to others.

3. Maintain a copy of MSRB rules in each office in which you conduct municipal securities dealer activities.

4. Observe the prohibition on reciprocal dealings with municipal securities investment companies.

5. Deal with nonmember broker-dealers and municipal dealers consistent with the requirements of Article III, Section 25 of the Rules of Fair Practice.

6. Occasionally inquire about the existence of a "control relationship" and, as necessary, maintain a file documenting all disclosures you make in compliance with MSRB requirements.

7. Establish and follow procedures on financial advisory relationships and make all applicable disclosures to issuers and customers.

8. Establish and follow procedures for using or disseminating information you obtain in a fiduciary or agency capacity.

9. Establish procedures for supervising personnel engaged in municipal securities activities, properly designate all persons responsible for conducting this supervision, and make certain they satisfactorily carry out the function.

10. Establish and enforce written supervisory procedures to assure compliance with all MSRB and other applicable securities regulations.

11. Establish and comply with procedures for opening and handling accounts for employees of other municipal securities professionals. Follow the employer's instructions, if any, and promptly forward notification of account activity.

12. Establish and enforce written procedures to assure compliance with the use of automated comparison, clearance, and settlement systems pursuant to MSRB Rule G-12(f).

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MARGIN

In regard to Article III, Section 30 of the NASD Rules of Fair Practice or other applicable margin rules:

1. Extend credit only on margin securities.

2. Make certain that your customers deposit in their accounts initial margin in an amount consistent with Regulation T within the appropriate time.

3. Maintain minimum margin in each margin account.

4. Promptly issue and collect margin calls.

5. Comply with the truth-in-lending provisions of SEC Rule 10b-16.

6. Comply with SEC Rule 11(d)(1), which prohibits extending credit on new issues.

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REGISTRATION REQUIREMENTS

General Requirements

1. Verify the prior employment of applicants for registrations.

2. If people perform functions requiring NASD registration, properly register them before they carry out those functions.

3. Comply with the provisions in SEC Rule 17f-2 on fingerprinting of registered and non-registered employees.

4. When appropriate, update and file Form U-4 amendments as changes occur.

5. Accurately prepare Form U-5, and submit it to the NASD before 30 days from the date that registered personnel terminate association.

6. Disclose to the NASD terminations for cause of nonregistered associated persons.

7. Properly and fully report all disciplinary actions that require disclosure on Forms BD, U-4, and U-5.

8. Promptly and properly update Form BD when any changes occur.

9. Promptly submit Schedule E of Form BD to register your branch offices with the NASD and designate which are OSJs.

10. Identify on Schedule E the individual who maintains supervisory responsibility for each branch.

11. Promptly report all branch office closings and changes on Schedule E of Form BD.

12. Maintain compliance with the two-principal and chief-financial-and-operations-principal membership requirements that pertain to senior management personnel.

13. Comply with appropriate state registration requirements.

14. Complete and submit annual NASD Assessment Reports on receipt.

15. Submit payment of annual NASD general assessment and Central Registration Depository renewal/assessment invoices on receipt.

16. Complete and submit Form BDW to request membership resignation at the time the firm ceases to conduct securities business and wishes to terminate broker-dealer registration.

Registered Personnel — General Securities

1. For firms conducting a general securities business, ensure that at least two persons are qualified and registered as general securities principals. One of them may qualify and register as the General Financial and Operations Principal.

2. Qualify and register sales persons as general securities representatives unless limited to a specific securities field such as municipals.

Registered Personnel — Municipal Securities

1. For firms conducting a municipal securities business, qualify and register appropriate persons as municipal principals as required by MSRB rules.

2. Prepare and maintain the appropriate records for all principals.

3. Make certain that every principal subject to the 90-day apprenticeship period satisfies the requirement.

4. Qualify and register appropriate persons as municipal representatives.

5. Prepare and maintain the appropriate records for all municipal representatives.

6. Make certain that every representative subject to the 90-day apprenticeship period satisfies the requirement, including general securities representatives in their municipal business.

7. Qualify and register appropriate persons as municipal securities financial and operations principals including general securities representatives in their municipal business.

8. Ensure that persons registered with you as "Limited Principal — Municipal Securities" function within their limited registration.

9. Make certain persons registered with you as "Limited Representative — Municipal Securities" function within their limited registration.

Registered Personnel — Options

1. Properly qualify and register options principals and representatives.

2. Register branch office managers as registered options principals, when required.

3. Designate the Senior Options Principal and the Compliance Registered Options Principal on Form BD and register with the appropriate self-regulatory organizations.

4. Ensure that persons registered with you as "Limited Principal — Options" function within their limited registration.

5. Make certain persons registered with you as "Limited Representative — Options" function within their limited registration.

Registered Personnel — Government Securities

1. Register sales personnel engaged exclusively in government securities as government securities representatives and ensure that they function within their limited registration.

2. Register appropriate management personnel as government securities principals and ensure that they function within their limited registration.

3. Ensure that persons registered with you as "Limited Principal — Government Securities" function within their limited registration.

4. Make certain persons registered with you as "Limited Representative — Government Securities" function within their limited registration.

Registered Personnel — Direct Participation Programs

1. Ensure that persons registered with you as "Limited Principal — Direct Participation Programs" function within their limited registration.

2. Make certain persons registered with you as "Limited Representative — Direct Participation Programs" function within their limited registration.

Registered Personnel — Investment Company Shares and Variable Contracts

1. Ensure that persons registered as "Limited Principal — Investment Company and Variable Contracts Products" function within their limited registration.

2. Ensure that persons registered as "Limited Representative — Investment Company and Variable Contracts Products" function within their limited registration.

Registered Personnel — Corporate Securities

1. Ensure that persons registered as "Limited Representative — Corporate Securities" function within their limited registration.

Registered Personnel — Assistant Representative — Order Processing

1. Ensure that persons registered as "Assistant Representative — Order Processing" function within their limited registration.

10 SUPERVISORY SYSTEM

Supervisory Personnel

1. Designate one or more principals to be responsible for a periodic review of the adequacy of the firm's overall supervisory system.

2. Designate a principal to be responsible for overall supervision of each type of business the firm conducts.

3. Maintain a record of the name of each supervisor responsible for each specific area and the dates they assumed these responsibilities.

4. Verify that all supervisory personnel are properly qualified for their assigned areas.

5. Designate a supervisor for each branch office and OSJ.

6. Assign each employee to a specific supervisor.

7. Designate one or more principals to periodically review all securities transactions in the manner and frequency described in the firm's written supervisory procedures.

8. Designate one or more principals to review sales literature, advertisements, correspondence of registered representatives, and customer complaints and make sure the review is documented.

Written Supervisory Procedures

1. Establish and maintain written supervisory procedures and make certain they adequately cover the scope and nature of your business activities and method of operation (e.g., SOES, options, municipal bonds, low-priced securities, etc.).

2. Such written procedures must describe the principal supervisory steps supervisors are required to take in carrying out their supervisory duties, the frequency of such efforts, and the method of documenting completed supervisory reviews.

3. Such written procedures must also include procedures designed to detect and prevent insider trading.

4. Supervisors must adequately carry out, implement, and enforce the firm's written supervisory procedures.

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Operations Department Supervision

1. Maintain adequate security protection for the operations department and/or "cage" area.
2. Maintain adequate controls of the receipt and disbursement of cash, including filing and maintaining reports of cash receipts, pursuant to SEC Rule 17a-8. Also, maintain procedures to identify cash and other transactions that are subject to the Rule.
3. Maintain proper control of the receipt and delivery of securities.
4. If you are operating under any operational limitations or restrictions, comply with the terms of the agreements.

Special Supervision Concerns

1. Maintain special supervision over any employee who has been statutorily disqualified but permitted by the NASD to continue in employment under prescribed conditions.
2. Exercise the same supervision over "independent contractors" that you do for any other employees.
3. Promptly and completely respond to NASD requests for information.

4. Review sales literature, advertisements, radio and television presentations, seminar presentations, and outgoing correspondence by salespersons to ensure that they are free of statements that are misleading, exaggerated, or based on rumor.

5. Establish and maintain a customer complaint file, including a record of verbal complaints, and adequately investigate such complaints.

6. Establish and maintain a file of internal disciplinary actions taken against associated persons.

7. Conduct an adequate investigation into the past activities of persons you plan to hire.

8. Ensure that all registered representatives attend an annual compliance meeting.

Branch Office/OSJ Inspections

1. Ensure that all OSJs are inspected annually.

2. Establish a frequency schedule for branch office inspections in light of the size, scope, and complexity of the business conducted by each branch.

3. Establish an adequate list of items for review during branch office or OSJ inspections.

4. Maintain a record showing the date and scope of each branch office or OSJ inspection.

5. Ensure that one or more qualified persons conduct each branch office or OSJ inspection.

6. Establish follow-up procedures to effectively remedy deficiencies found during any branch office or OSJ inspection.

7. Ensure that the procedures for supervising branch office or OSJ activities are included in the firm's written supervisory procedures.

8. Ensure that sales made by your branch personnel and their state registrations satisfy relevant state securities laws.

9. Ensure that all branch offices are registered.

10. Off-site salespersons (outside a branch office or OSJ) should be subject to effective supervisory procedures to monitor and review all such persons' activities.

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BRANCH OFFICE COMPLIANCE CHECK LIST

1 BRANCH OFFICE OPERATIONS/ RECORDS

Money and Securities Handling

1. Establish and enforce a policy that only authorized persons approve and sign checks drawn on local bank accounts.
2. Establish a receipt and follow-up verification system if you permit salespersons or others to personally deliver securities or checks to customers.
3. Review and reconcile deposits to local bank accounts to ensure they agree with branch office records.
4. Review canceled checks and other bank records for indications of conversion of customer funds, embezzlement, etc.
5. Promptly notify your financial and operations principal of any large receipts of cash or foreign transactions that require reporting under SEC Rule 17a-8.
6. Maintain adequate safeguards against access to blank checks and drafts by unauthorized persons.
7. Adequately safeguard against unauthorized access to the branch's vault area and other locations where securities are held.
8. Review securities received from customers in accordance with the SEC's Lost and Stolen Securities Program (SEC Rule 17f-1).

Books and Records

1. Properly prepare and maintain any required records based on the operations of the branch office.
2. Properly prepare and maintain order tickets for orders initiated by the branch office.
3. Properly prepare and maintain appropriate records for any receipt or disbursement of monies and securities by the branch office.
4. Establish appropriate safeguards against misuse of confirmations and account statements sent by the branch office.

Correspondence, Advertising, and Sales Literature

1. Establish and maintain branch office files for incoming and outgoing correspondence, advertising, and sales literature.
2. Make sure that an appropriate supervisor reviews and approves all outgoing correspondence, advertising, and sales literature prior to mailing or use.
3. Conduct a periodic review of the branch's outgoing correspondence, advertising, and sales literature for possible employee misconduct, including deceptive or misleading statements.
4. Ensure that you make the required filings of advertisements.

2 BRANCH OFFICE TRADING ACTIVITY

1. For all non-Nasdaq securities in which your branch office makes a market, observe the provisions of SEC Rule 15c2-11 and Schedule H to the NASD By-Laws on the initiation or resumption of quotations.
2. Submit accurate and timely trade reports on relevant Nasdaq and non-Nasdaq transactions executed by the branch order room.
3. Submit accurate and timely third-market trade reports on relevant trades executed by the branch.
4. Ensure that markups/markdowns on principal transactions with customers at the branch office are consistent with the NASD Markup/Markdown Policy.
5. Ensure that transactions with customers at the branch office satisfy best-execution requirements.
6. Review for manipulative practices and other trading abuses any proprietary trading by the branch office.
7. Ensure that customer limit orders are promptly executed and in accordance with any required disclosure concerning any execution preference given to your firm's proprietary trading.
8. If the branch office transmits customer orders to another location for execution, set up a system to ensure that it does so as rapidly as possible.

3 BRANCH OFFICE RETAIL SALES

Sales Practices

1. Ensure that recommendations to customers provide a balanced factual presentation. (As discussed above.)
2. Ensure that salespersons in the branch office have current, complete and accurate information about the companies they recommend, including access to the most current periodic reports of such companies.
3. Periodically review transactions for indications of sales practice misconduct, including:
 - Deceptive or misleading statements.
 - Unsuitable recommendations.
 - Excessive trading.
 - Unauthorized transactions.
 - Improper use of nominee accounts.
 - Unsuitable switching of mutual funds and selling below the break point.
 - Parking shares in customer accounts.
 - Guarantees against loss.
 - Interpositioning.
 - Improper charges.
 - Misuse of customer funds or securities.
4. Review the customer accounts of individual salespersons for an undue concentration of transactions in a single security.
5. Review claimed private placements and interstate offerings of securities for compliance with the Securities Act of 1933 and related SEC rules.
6. Review claimed Rule 144 transactions effected through your branch office for compliance.

7. Make certain that your branch office observes prospectus delivery and other requirements, such as the prohibitions on "gun-jumping."

8. Establish a system for recording and maintaining copies of written customer complaints received by your branch office.

9. Conduct a prompt and adequate investigation of customer complaints and record your findings.

10. Ensure that salespersons who are required to be specially qualified and registered before they effect transactions in a special securities product such as the registration for options are so qualified and registered.

11. Enforce the firm's procedures to detect and prevent the use of material nonpublic information by your branch office employees for transactions in their personal accounts or the firm's proprietary accounts.

12. Conduct or arrange for periodic educational sessions for salespersons concerning sales-practice compliance matters, and discuss overall compliance with salespersons at least at the annual compliance meeting.

State Law

1. Ensure that sales made by your branch office and its personnel meet relevant state securities laws, including registration requirements.

Options

1. If your branch office transacts options business and has more than three registered representatives, the branch office manager must be a Registered Options Principal (ROP) or a Limited Principal - General Securities Sales Supervisor.

2. Prior to approval of the opening of any

customer's account for options trading, obtain the relevant background information about the customer.

3. Have a ROP approve the opening of any customer account for options trading *before* any options transactions are effected in the account. (If the branch office manager is not a ROP, submit the account to a ROP for approval or disapproval within 10 business days.)

4. Establish and carry out an adequate system for a ROP's periodic review of options transactions by the branch office.

5. Send the customer account information to the customer for verification, if applicable, within 15 days of the approval for options trading.

6. Send to and obtain from the customer a written option agreement pursuant to Appendix E within 15 days of the approval for options trading.

7. For uncovered short options business with public customers, establish written procedures pursuant to Appendix E to govern such transactions, including special standards for suitability and minimum net equity.

8. Ensure that an opening transaction in any option contract shall not be recommended to a customer unless the sales person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

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9. Ensure that no other options transaction may be recommended to a customer unless the salesperson has reasonable grounds to believe (on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known) that the recommended transaction is not unsuitable for such customer.

10. Establish and carry out a reasonable supervisory system to review an adequate number of options transactions for employee misconduct, including deceptive or misleading statements and excessive charges.

11. Ensure that a ROP has reviewed and approved all options orders by a discretionary account.

12. Ensure that position and exercise limits pursuant to Appendix E are satisfied.

13. When covering short option positions or satisfying margin calls and exercise notices, determine if the securities are restricted, unregistered, or in any other manner not salable under the provisions of the Securities Act of 1933.

14. Maintain at your branch office separate files on all options advertising and sales literature used by your branch office.

15. Make sure the content of options advertising and sales literature complies with applicable requirements.

16. File all options advertising and sales literature with the appropriate self-regulatory organization.

17. Maintain at your branch office a separate file of all options-related customer complaints.

18. Maintain at your branch office the background and financial information on customers who have been approved for options trading, as well as copies of the financial statements of options customers, for the most recent six-month period.

Municipal Securities Transactions

1. Qualify (by examination or otherwise) and register all persons as municipal securities principals as required by MSRB rules.

2. Prepare and maintain the appropriate records on all municipal principals.

3. Make certain every municipal principal who operates at a branch office serves the required apprenticeship before functioning as a municipal principal who operates at a branch office serves the required apprenticeship before functioning as a municipal principal.

4. Ensure that quotations on municipal securities by any branch office are bona fide and reflect a fair-market price for the security.

5. Comply with MSRB rules that limit the giving of gifts or gratuities and the rendering of services.

6. Maintain a copy of MSRB rules in your branch office.

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BRANCH OFFICE SUPERVISION

General

1. Designate a person or persons responsible for supervision of operations, sales activities, and trading at each branch office.

2. Ensure that the firm's written supervisory procedures describe the significant supervisory functions the branch office supervisor must perform and their frequency.

3. Ensure that the firm's written supervisory procedures adequately address the branch office functions.

4. Ensure that the firm's written supervisory procedures are adequately performed, regardless of whether the branch operates under a franchise arrangement.

5. Establish a frequency schedule for branch office inspections.

Supervision of Customer Accounts

1. Ensure that the required information on a customer's background, status, and objectives are obtained and maintained.

2. Ensure that an adequate periodic review is made of customer transactions handled by your branch office.

3. Review and approve discretionary orders before execution.

4. Conduct a special review of transactions by discretionary accounts and employee accounts.

Supervision of Branch Operations

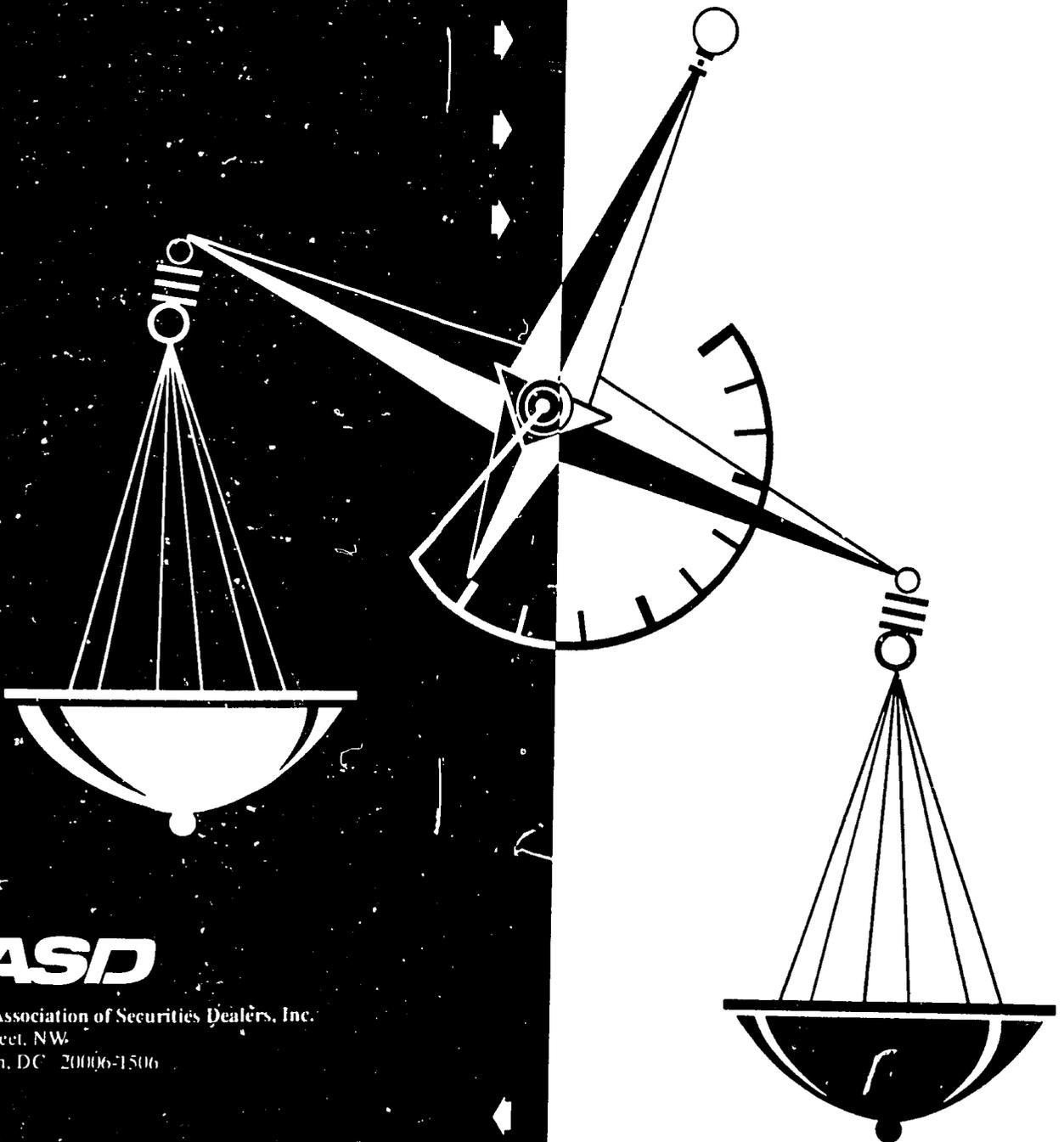
1. Establish and enforce procedures for opening and directing the branch's mail to safeguard funds and securities and to ensure that complaints are directed to supervisory personnel.

2. Ensure that customer's funds and securities are handled properly.

3. Establish a follow-up procedure to ensure that deficiencies noted in supervisory reviews are remedied efficiently and effectively.

4. Have a qualified person periodically review the operations of any subordinate branch.

DISCIPLINARY PROCEDURES



NASD

National Association of Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506

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INTRODUCTION

The NASD is the self-regulatory organization responsible for regulating the NASDAQ and over-the-counter securities markets. Authorized by the 1938 Maloney Act amendments to the Securities Exchange Act of 1934, the NASD is a membership organization with nearly 6,000 member broker-dealers. These include virtually all broker-dealers in the United States doing a securities business with the public. The NASD also operates The NASDAQ Stock Market through a subsidiary company, NASDAQ, Inc.

The NASD exercises statutory authority over its broker-dealer members and over persons associated with them. It performs this function by administering qualification examinations, by conducting compliance inspections, and by taking appropriate disciplinary actions.

NASD disciplinary proceedings are not the same as arbitration proceedings, which serve as an alternative to court resolution of disputes between parties. NASD disciplinary procedures do not recover damages for either party.

Instead, NASD disciplinary proceedings promote member compliance with high standards of commercial honor and just and equitable principles of trade by imposing a range of sanctions on those who fail to comply.

WHAT IS A DISCIPLINARY ACTION?

A disciplinary action is an NASD procedure to confirm apparent violations of NASD rules and regulations by a member firm or a person associated with a member. These disciplinary actions afford respondents an impartial hearing before a body of peers and appropriate rights of appeal. The NASD is a self-regulatory organization in which the disciplinary process is controlled by the members through the Board of Governors and other national and district committees.

The NASD's Board of Governors, composed mostly of persons elected by the general membership, administers the affairs of the NASD, including those involving disciplinary matters.

Various national and district committees, also composed of individuals active in the industry, assist the Board in executing its responsibilities. Except for the President, all members of the Board and its various committees serve without compensation. These volunteers generally come from securities firms or organizations with a direct or indirect interest in the securities markets and the work of the NASD.

A staff of officers and other personnel located in the Executive Office in Washington, D.C., assist the Board and district committees. The Board has direct control of all staff personnel through the President. The NASD divides its operations into five divisions with an Executive Vice President in charge of each. These divisions are Administration, Automation, Compliance, Law and Regulatory Policy, and Marketing and Market Operations.

For administrative purposes, the NASD consists of 13 geographical districts, each of which is governed by a district committee composed of representatives from the local membership. The

* NASD members recently approved changes to its structure that will reduce the Board's size and alter its composition as well as change the number and configuration of the NASD districts.

NASD maintains an office in each of its 13 districts except for District 2, which has offices in both San Francisco and Los Angeles.

Each district committee is composed of members of the securities industry who are elected to their positions by their fellow professionals. These committees spend much of their time enforcing the NASD By-Laws and Rules of Fair Practice, federal securities laws and the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board (MSRB), and other applicable securities regulations. When they function in a disciplinary capacity, these district committees become District Business Conduct Committees (DBCCs).

Each district office functions as a subunit of the Surveillance Department in the Compliance Division. The staff of each district includes a District Director, Deputy Associate/Assistant Director(s), Supervisor(s), and a complement of examiners and support staff. The district staff works to collect information via various examination and surveillance programs to enable a DBCC to determine whether violations have occurred. In cases involving egregious violations, the role of the staff is purely fact finding; the decision on the disposition of such a disciplinary matter rests solely with the DBCC. However, in cases involving minor or technical violations by members, the NASD district directors may take final disciplinary action under delegated authority from the National Business Conduct Committee (NBCC) and DBCC.

In all, 15 NASD committees now address serious disciplinary matters on a regular basis. These committees include: the 13 DBCCs; the Market Surveillance Committee (MSC); and the NBCC.

District Business Conduct Committee (DBCC). Enforcement of the NASD, Securities and Exchange Commission (SEC), and Municipal Securities Rulemaking Board (MSRB) rules and

policy interpretations rests primarily with the DBCCs, which operate under delegated authority from the NASD Board of Governors. In fulfilling their enforcement responsibilities, DBCCs take the following actions:

- ◆ Review examination reports and other investigative summaries submitted by NASD examiners in their respective districts.
- ◆ Initiate or authorize complaints against firms or persons alleged to have violated NASD rules or rules over which the NASD has jurisdiction.
- ◆ Conduct disciplinary proceedings in accordance with the NASD's Code of Procedure.
- ◆ Render decisions and impose sanctions, if appropriate, in complaints filed by or with them.

Market Surveillance Committee (MSC).

The MSC is a Board-appointed, national standing committee. Its members represent NASD firms and NASDAQ issuers. The MSC is the disciplinary committee that oversees the NASD Market Surveillance and Anti-Fraud Departments' investigations. In addition, it handles all market-related violations of NASD and Securities and Exchange Commission (SEC) rules and regulations. These would include, among others, violations of Schedules D, G, and H of the NASD By-Laws; insider trading; specialized options violations; market manipulations; short-sale violations; and violations of the rules of the NASD's Small Order Execution System (SOES) and other automatic execution systems.

Using automated systems, the NASD monitors and analyzes daily activity in the NASDAQ market. These systems generate information and reports that NASD employees use in detecting apparent violations involving NASDAQ. The NASD investigates computer alerts involving unusual price movements and increases

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in volume, as well as other questionable situations. Also, from time to time, NASD members participating in the NASDAQ market and field examiners bring instances of apparent violations to the attention of the staff.

National Business Conduct Committee (NBCC). The NBCC includes all first-year industry members of the Board of Governors. This national committee regularly reviews all decisions rendered by DBCCs and the MSC in disciplinary matters. This review ensures that the hearing record supports the decision and that the decision is consistent with established policy and other similar decisions. The NBCC also reviews DBCC and MSC sanctions for fairness and consistency. The NBCC, or its appointed subcommittee or hearing panel, hears cases that are appealed to the Board. Also, on its own motion, the NBCC may call DBCC or MSC decisions for review. The Board of Governors then reviews and acts on the recommendations of the NBCC.

WHO MAY FILE COMPLAINTS?

Complaints against respondents normally arise from the NASD's regular programs of member examination and surveillance via the DBCC or MSC process. In addition, the Board of Governors and, in some instances, a member or a public investor, may initiate a complaint. An NASD committee hears all complaints and, if appropriate, makes findings of violations and imposes sanctions.

* Members and public investors do not normally file complaints because they cannot recover damages under these procedures. Parties trying to recover damages usually seek relief through NASD arbitration facilities or the courts.

FORMAL DISCIPLINARY PROCEDURES

In keeping with the federally mandated concept of self-regulation, the NASD's Code of Procedure provides a forum for regulating the conduct and activities of its members and persons associated with members through peer review, thus avoiding excessive formality and legalistic procedures. The Code of Procedure clearly establishes fair and orderly procedures for disciplining members or associated persons and contains important protections for persons subject to the disciplinary process.

Initially, at the direction of a DBCC or MSC, a member or associated person receives a statement of the specific charges prompting disciplinary action and the rules alleged to have been violated. This is called a "complaint." A member or associated person can seek to settle the complaint by presenting an Offer of Settlement to the DBCC or have a full and impartial hearing before a body of his or her peers.

If a hearing is requested, the NASD informs respondents that they may review the schedules, documents, and other exhibits supporting the allegations. The NASD procedures permit a member or associated person to be represented by an attorney. Respondents may use the hearing process to question witnesses and to present evidence or other relevant material. The NASD maintains a record of the hearing.

After a hearing, the DBCC or MSC issues a written decision. This decision explains the acts or practices on which the decision is based, the specific rules the respondents violated, and the sanction or sanctions imposed. In the event of a dismissal, the DBCC or MSC issues a written decision to this effect.

The NASD's disciplinary procedures allow for appropriate rights of appeal. Respondents may appeal initial DBCC or MSC decisions to the

NASD's Board of Governors and then to the SEC. In addition, either body may call a decision for review on its own initiative. The NBCC, acting on behalf of the Board of Governors, reviews on a regular basis the decisions of DBCCs and the MSC for consistency and fairness.

In addition, the NASD's procedures provide that no committee member may participate, directly or indirectly, in the determination of any complaint affecting the committee member's interest or the interests of any person with whom the committee member is directly or indirectly associated.

In the exercise of its oversight responsibilities, the SEC receives NASD final decisions in all cases that involve disciplinary action against a member or an associated person. A member or associated person may appeal an SEC decision concerning an NASD action to the appropriate U.S. Court of Appeals.

INFORMAL REMEDIAL ACTIONS

To resolve situations that involve minor rule infractions and do not appear to warrant more formal action, district directors may use one of the following informal actions:

◆ **De Minimis Letter.** This approach applies when the examiner notes minor deficiencies during an examination. Usually, the member corrects them before the examiner leaves the firm. A De Minimis Letter discusses the nature of the deficiencies and the corrective action taken.

◆ **Letter of Caution.** This method covers situations involving infractions that, although somewhat more severe than those covered by a De Minimis Letter, remain relatively minor. A member that receives a Letter of Caution must respond to it promptly and in writing to the district. The

response must describe in detail the corrective action planned or already taken and the preventive steps undertaken or planned to avert recurrence of these infractions.

◆ **Letter of Future Observance and Compliance.** If a member does not dispute the existence of the relatively minor rule infractions, the member may, on its own initiative, submit a Letter of Future Observance and Compliance to the district to resolve the matter quickly. This letter explains the specific violations and advises the district what action will be taken or has already been taken to correct the violations. The district may reject the letter in favor of an alternative action if, after reviewing the circumstances, it feels the letter is inadequate. When a district rejects a Letter of Future Observance and Compliance, it promptly notifies the respondent in writing. However, if a district accepts the letter, it becomes final.

◆ **Staff Interview.** If the violations are repeated or more serious in nature, the district may request a Staff Interview. Either the chairman or the vice chairman of the DBCC must approve such a Staff Interview. However, if they don't agree on the desirability of a Staff Interview, they can order another disposition of the matter.

Usually held in an NASD district office, a Staff Interview includes representatives of the member and district office staff. The staff prepares a report of the interview and places it in the member's record. Promptly after the Staff Interview, the member must detail in writing the remedial action necessary to correct the deficiencies discussed during the interview.

The NASD does not assess sanctions in any of these informal situations. If a member disagrees with these actions, it may request that the matter be presented to the DBCC or MSC for ultimate disposition.

DISCIPLINARY COMMITTEE ACTION

As noted earlier, each DBCC reviews the reports of all examinations uncovering violations that the NASD conducts in its district. The staff gathers all relevant information for DBCC review. Based on this review, the DBCC decides whether to lodge a complaint or to take other action.

Likewise, the MSC considers information gathered by the NASD staff during the Market Surveillance Section's ongoing oversight of NASDAQ trading activity. This committee also considers matters resulting from investigations conducted by the NASD's Anti-Fraud Section; referrals by market makers or members; and referrals by the DBCCs.

The committees review the information gathered by the staff, decide whether the assembled facts indicate a violation of NASD rules, and determine what action to take. Following a review of the facts and a preliminary determination that deficiencies or violations exist, a DBCC or MSC may direct or accept a remedial action.

DISCIPLINARY ACTIONS

For these violations, a DBCC or the MSC relies on one of the following:

◆ **Letter of Acceptance, Waiver and Consent.** When a DBCC or the MSC believes that the facts are not in dispute and violations clearly exist, it may accept a Letter of Acceptance, Waiver and Consent (AWC). An AWC is a disciplinary action submitted by a member to resolve quickly a matter serious enough to warrant disciplinary action. In an AWC, the member accepts the violations cited, outlines a plan for taking corrective action, offers to accept sanctions to which it stipulates, and waives all rights of appeal. The member does not

have to admit the violations.

All DBCC- or MSC-accepted Letters of Acceptance, Waiver and Consent go to the NBCC for approval. If the NBCC concurs with the DBCC or MSC, the DBCC or MSC takes no further action, and the NASD notifies the member in writing. If the DBCC, MSC, or the NBCC rejects the AWC, either the DBCC or the MSC notifies the member and files a complaint against the member. A rejected AWC is neither admissible to, nor considered in the course of, any complaint proceedings or follow-up appeal action.

◆ **Formal Complaint.** A DBCC or the MSC files a Formal Complaint in situations involving serious apparent violations with potentially significant sanctions or in situations involving disputed facts. The Code of Procedure requires that a member receive a written statement of the specific charges and the rules alleged to have been violated. In return, the member must file a written response to the complaint within 20 calendar days. If so desired by a respondent in a complaint, the NASD then schedules a hearing before the DBCC or MSC.

At any point following the issuance of a complaint, a member may submit a written Offer of Settlement to bring the proceedings to an early conclusion. In the Offer of Settlement, the member sets forth the facts involved, details the sanctions proposed, and agrees to waive all rights of appeal.

The member does not have to admit the allegations presented in the complaint. If the DBCC or MSC rejects the Offer of Settlement, the complaint process continues. If a DBCC or MSC accepts the Offer of Settlement, the NBCC must review and approve it before the DBCC or MSC can issue an acceptance of the offer. Acceptance by the NBCC ends the complaint process.

DISCIPLINARY PROCESS

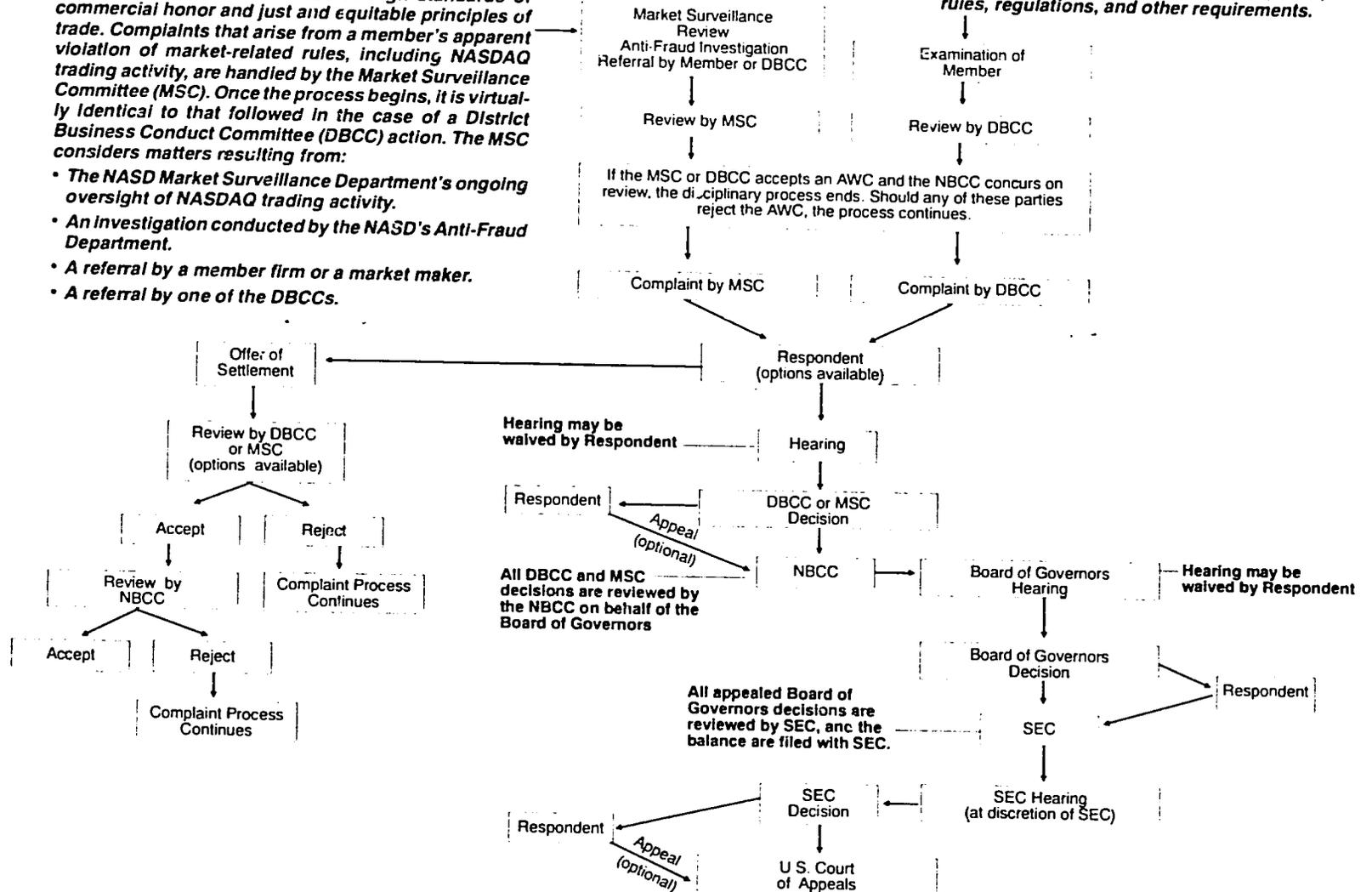
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This schematic traces the flow activity in the NASD formal disciplinary process. It reflects the various options available to respondents, including their avenues of appeal and opportunities to settle a matter within the normal complaint process. Unless appealed or called for review, all DBCC and MSC decisions become final 45 calendar days from the dates of such decisions. If not appealed or called for review, all Board of Governors decisions become final 30 calendar days from the dates of such decisions.

All NASD members are examined by the NASD on a regular cyclical basis. Special examinations are also conducted by the NASD to review customer complaints, to investigate terminations of employees for cause, to follow up on referrals from other organizations and agencies, to evaluate the condition of member firms in financial difficulty, and to educate and thereafter test membership compliance with newly adopted rules, regulations, and other requirements.

All NASD members must observe high standards of commercial honor and just and equitable principles of trade. Complaints that arise from a member's apparent violation of market-related rules, including NASDAQ trading activity, are handled by the Market Surveillance Committee (MSC). Once the process begins, it is virtually identical to that followed in the case of a District Business Conduct Committee (DBCC) action. The MSC considers matters resulting from:

- The NASD Market Surveillance Department's ongoing oversight of NASDAQ trading activity.
- An investigation conducted by the NASD's Anti-Fraud Department.
- A referral by a member firm or a market maker.
- A referral by one of the DBCCs.



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DISCIPLINARY HEARINGS

Respondents in a complaint proceeding can have a hearing. The NASD conducts its hearings as a "businessman's proceeding" since they involve consideration of the issue(s) at hand by impartial businessmen who are knowledgeable professionals in the securities industry. Although not as formal as a court of law, the NASD conducts its disciplinary hearings under the strict guidelines in the NASD Code of Procedure.

A subcommittee of a DBCC or the MSC usually holds the hearings, customarily in the member's NASD district office. In cases involving unusual circumstances, the Code of Procedure provides for scheduling the hearing in another district or locality.

Although the hearing does not have the formality of a courtroom proceeding, it resembles one in many important respects. For instance, a respondent may question witnesses (including members of the staff), present evidence or other relevant material, and have an attorney present. The emphasis during the proceedings, however, is on an orderly presentation and discussion of the facts and circumstances without the technical or legalistic procedures frequently followed in a court proceeding. Moreover, the hearing panel may consider as a relevant and important aspect of the proceeding any evidence concerning the respondent's past record in the securities business, as well as any mitigating circumstances presented by the respondent. The NASD keeps a full and complete record of the hearing.

In the hearing process, the staff (generally an NASD regional attorney) presents the information that is relevant to the allegations in the complaint. The staff ensures that the record is as complete as possible to help the full DBCC or MSC, NBCC, and the SEC reach an informed decision. If applicable, this will necessarily include information of a mitigative nature. Thus, the staff and the hearing subcommittee try to ensure there is

a complete record of the proceedings through their line of questioning.

The NASD is very sensitive to the need to provide a fair procedure for disciplining firms and associated persons. Accordingly, it has procedures in place to ensure the hearing process is fair. The NASD staff will not discuss the merits of the case with the hearing panel or any of its members during deliberations unless the respondent, or its representative, is also present. When the hearing panel finishes its deliberations, the staff transcribes and confidentially transmits the hearing panel's recommendation to the full committee for its review.

DBCC/MSC DECISIONS

Thereafter, the full committee discusses the record and makes its decision. While members of the staff may be present at full committee meetings, they do not participate in the committee's discussion of a complaint's merits or in discussions leading to the committee's conclusions or findings. The staff's role at this step is to record the committee's decision in writing. Thus, the members of the committee make their decision in light of their collective experience in the securities industry.

After a DBCC or the MSC renders its decision and determines the sanctions to be imposed, if any, the NASD staff prepares a written decision on behalf of the DBCC or the MSC and forwards it to the respondent. This procedure also applies when the DBCC or MSC dismisses some or all of the alleged violations.

In determining whether a violation has occurred and in assessing an appropriate sanction, the members of the DBCC or the MSC rely to a large extent on their own knowledge of trade practices and experience in the securities business and of applicable securities regulations as well as guidelines established by the NBCC.

The aim of a DBCC or the MSC is to render a "businessman's" judgment as to whether a member has engaged in conduct inconsistent with NASD rules or other applicable securities regulations. To this end, a DBCC or the MSC considers past cases and previous decisions when evaluating the seriousness of particular violations and in rendering a final disposition.

All written decisions contain the following information:

- ◆ The basis for the complaint and a discussion of the facts and circumstances that led to the complaint.
- ◆ An analysis of the facts and evidence presented.
- ◆ A statement of the specific rule(s) alleged to have been violated.
- ◆ The committee's decision on each alleged rule violation.
- ◆ Any sanctions imposed.

SANCTIONS VARY DEPENDING ON THE VIOLATIONS

After the hearing, if the DBCC or MSC finds the respondent has violated one or more rules, it determines the appropriate sanction. The NASD By-Laws authorize the imposition of any suitable sanction. Depending on the nature of the violations that have occurred and other extenuating circumstances, the DBCC or MSC may sanction a member or an associated person by imposing any one or more of the following sanctions:

- ◆ **Censure.** The basic sanction for the

commission of certain acts or practices, censure is a serious sanction considering the importance placed in the securities industry on one's business reputation. The DBCC or MSC may impose censure on both a member and an associated person of a member.

- ◆ **Fines and Costs.** A DBCC or the MSC can also fine a member or an associated person any amount it judges appropriate. In arriving at a dollar amount of a fine, the committee may consider the profit from the violations, the seriousness of the violations, and any previous warning given to the respondent regarding violations of the same nature or comparable to those alleged in the complaint. A DBCC or the MSC may assess costs in cases in which it finds that the member has violated any one or more of the NASD's rules. These costs may include expenses involved with preparing transcripts and other hearing-related expenses.

- ◆ **Suspension.** The suspension of a member or an associated person in any capacity means that the member or person may not conduct any securities business for the period of time specified in the decision. The suspension of a member, or associated person, may also cover a particular activity in the business, e.g., as financial and operations principal. A suspension may range from one day to a year or more.

At the end of the suspension, however, the NASD will reinstate the member or person in good standing, provided the respondents have paid any fines and costs assessed in the decision.

- ◆ **Expulsion, Revocation, or Bar.** The most severe sanctions, invoked in only the most serious situations, are the expulsion of a firm from membership in the NASD, the revocation of an associated person's registration, and the bar of an individual from future association with a member in any capacity or in some specified capacity. Under these sanctions, the NASD excludes a firm

from the securities business or bars an associated person from employment with a member.

Persons subject to any form of statutory disqualification cannot become members of the NASD, continue in membership, or be associated with a member in good standing. The sanctions of expulsion, revocation, and bar constitute statutory disqualifications under federal securities laws.

After a sufficient period of time, a firm or associated person subject to such disqualification can seek relief from the disqualification. In order to engage in the securities business despite a statutory disqualification, a firm may apply on its own behalf or on behalf of an individual under the NASD's "Eligibility Proceedings."

Since the sanctions that give rise to a statutory disqualification are never imposed without good reason, an Eligibility Proceeding does not assure reinstatement. The NASD General Counsel's Office located at the national headquarters can answer specific questions about Eligibility Proceedings.

APPEAL PROCESS

While the NBCC reviews all decisions of DBCCs and the MSC for consistency and fairness, the NASD's Code of Procedure provides appeal procedures for members disciplined by these committees.

◆ **Review by the Board of Governors.** A member has 15 calendar days from the date of the initial decision by a DBCC or the MSC to appeal the decision to the Board of Governors. The Board also has the authority to review decisions or actions of either committee on its own initiative. The Board of Governors has 45 calendar days from the date of the initial decision to decide whether to review a DBCC or MSC decision.

A disciplinary subcommittee of the NBCC reviews every decision called for review or

appealed to the Board of Governors. These disciplinary subcommittees meet at scheduled times in all NASD district offices. This hearing cycle allows maximum flexibility for respondents and committee members, as well as expeditious disposition of the cases. In addition, on occasion, hearings are held at a location other than in a district office. In case of a hearing postponement, the subcommittee reviews the decision at the next meeting in the hearing cycle. However, a rescheduled hearing may occur at a location less convenient for the respondents than was the original hearing.

The NBCC acts for the Board of Governors in reviewing decisions of the DBCCs or MSC on a regular basis, deciding on its own motion which decisions should be reviewed by the Board, and designating a subcommittee to hear decisions on review or on appeal to the Board. The full Board of Governors considers the recommendations of the NBCC and decides on the matters involved.

The Board of Governors has the authority to affirm or deny the decision of a DBCC or the MSC, and to increase, reduce, modify, remand, or cancel any disciplinary action taken by such committees. The sanctions imposed in a disciplinary action on appeal to the Board of Governors are stayed pending the outcome of the appeal. A member or person associated with a member receives prompt written notification of the results of its appeal.

◆ **Review by the SEC.** Any member or associated person may appeal a decision of the NASD's Board of Governors to the SEC within 30 calendar days of the Board's decision. Filing an appeal with the SEC does not automatically stay sanctions. According to federal statute, such sanctions are effective unless the SEC orders a stay. Upon formal application to do so, the SEC can order a stay of the NASD-imposed sanctions pending review of the disciplinary action.

As a matter of policy, however, the NASD

NASD EXECUTIVE OFFICE

National Association
of Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506
(202) 728-8000

NASD District Offices

District 1

One Union Square
600 University, Suite 1911
Seattle, WA 98101-3132
(206) 624-0790
Bradford M. Patterson, Director
Alaska, Idaho, Montana, Oregon, Washington

District 2N

425 California Street
Room 1400
San Francisco, CA 94104
(415) 781-3434
Theodore F. Schmidt, Director
California, Nevada

District 2S

300 South Grand Avenue
16th Floor
Los Angeles, CA 90071
(213) 627-2122
Kye Hellmers, Director
California, Nevada, Hawaii

District 3

1401 17th Street, Suite 700
Denver, CO 80202
(303) 298-7234
Frank J. Birgfeld, Director
Arizona, Colorado, New Mexico, Utah, Wyoming

District 4

12 Wyandotte Plaza
120 West 12th Street, Suite 900
Kansas City, MO 64105
(816) 421-5700
Jack Rosenfield, Director
Kansas, Missouri, Nebraska, Oklahoma

District 5

Energy Centre, Suite 850
1100 Poydras Street
New Orleans, LA 70163-0850
(504) 522-6527
Warren A. Butler, Jr., Director
*Alabama, Arkansas, Louisiana, Mississippi,
Western Tennessee*

District 6

1999 Bryan Street, Suite 1450
Olympia & York Tower
Dallas, TX 75201
(214) 969-7050
Peter M. Walker, Director
Texas

District 7

One Securities Centre
3490 Piedmont Road, N.E.
Atlanta, GA 30305
(404) 239-6100
Bennett Whipple, Vice President, Director
*Florida, Georgia, South Carolina, Eastern
Tennessee, Puerto Rico, Canal Zone, Virgin Islands*

District 8

1680 Three First National Plaza
70 West Madison
Chicago, IL 60602
(312) 899-4400
E. Craig Dearborn, Director
*Illinois, Indiana, Iowa, Michigan, Minnesota,
North Dakota, South Dakota, Wisconsin*

District 9

1940 East 6th Street
Fifth Floor
Cleveland, OH 44114
(216) 694-4545
William H. Jackson, Jr.
Director
Kentucky, Ohio

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District 10

1735 K Street, NW
Washington, DC 20006-1506
(202) 728-8400
Thomas P. Forde, Director
*District of Columbia, Maryland, North Carolina,
Virginia*

District 11

1818 Market Street, 14th Floor
Philadelphia, PA 19103
(215) 665-1180
John P. Nocella, Director
*Delaware, Pennsylvania, West Virginia, New
Jersey (with the exception of counties adjacent to
New York City)*

District 12

NASD Financial Center
33 Whitehall Street
New York, NY 10004
(212) 858-4000
William S. Clendenin
Senior Vice President, Director
*New York City (including adjacent New York and
New Jersey counties)*

District 13

260 Franklin Street, 16th Floor
Boston, MA 02110
(617) 261-0800
Willis H. Riccio
Vice President, Director
*Connecticut, Maine, Massachusetts, New
Hampshire, Rhode Island, Vermont, New York
(with the exception of New York City and adjacent
counties)*

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NASD

COMPLIANCE CHECKLIST

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An Introduction To The
NASD



— NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. —



NASD Offices

Executive Office
National Association
of Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506
(202) 728-8000

London Office
NASDAQ International, Ltd.
43 London Wall
London EC2M 5TB, United
Kingdom
011-44-1 374-6969

Gordon S. Macklin Building
9513 Key West Avenue
Rockville, MD 20850-3389
(301) 590-6500

NASDAQ Data Center
80 Merritt Boulevard
Trumbull, CT 06611
(203) 385-4500

NASD District Offices

District 1
One Union Square
600 University
Suite 1911
Seattle, WA 98101-3132
(206) 624-0790
Bradford M. Patterson, Director

District 2N
425 California Street
Room 1400
San Francisco, CA 94104
(415) 781-3434
Theodore F. Schmidt, Director

District 2S
300 South Grand Avenue
16th Floor
Los Angeles, CA 90071
(213) 627-2122
Kye Hellmers, Director

District 3
1401 17th Street, Suite 700
Denver, CO 80202
(303) 298-7234
Frank J. Birgfeld, Director

District 4
12 Wyandotte Plaza
120 West 12th Street, Suite 900
Kansas City, MO 64105
(816) 421-5700
Jack Rosenfield, Director

District 5
Energy Centre
1100 Poydras Street
Suite 850
New Orleans, LA 70163
(504) 522-6527
Warren A. Butler, Jr., Director

District 6
1999 Bryan Street, Suite 1450
Olympia & York Tower
Dallas, TX 75201
(214) 969-7050
Peter M. Walker, Director

District 7
One Securities Centre,
Suite 500
3490 Piedmont Road, NE
Atlanta, GA 30305
(404) 239-6100
S. Bennett Whipple,
Vice President, Director

District 8
1680 Three First National Plaza
70 West Madison
Chicago, IL 60602
(312) 899-4400
E. Craig Dearborn, Director

District 9
1940 East 6th Street, Fifth Floor
Cleveland, OH 44114
(216) 694-4545
William H. Jackson, Jr., Director

District 10
1735 K Street, NW
Washington, DC 20006-1506
(202) 728-8400
Thomas P. Forde, Director

District 11
1818 Market Street, 14th Floor
Philadelphia, PA 19103
(215) 665-1180
John P. Nocella, Director

District 12
NASD Financial Center
33 Whitehall Street
New York, NY 10004
(212) 858-4000
William S. Clendenin,
Vice President, Director

District 13
260 Franklin Street, 20th Floor
Boston, MA 02110
(617) 439-4404
Willis H. Riccio,
Vice President, Director

An Introduction to the NASD



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Origin of the NASD

The National Association of Securities Dealers, Inc., is the self-regulatory organization of the securities industry responsible for the regulation of NASDAQ and the over-the-counter securities markets. The NASD was established under the authority granted by the 1938 Maloney Act amendments to the Securities Exchange Act of 1934.

For one-half century, the NASD has fulfilled its statutory responsibilities and has protected investors through the enforcement of federal securities laws as well as the broader ethical requirements of its own rules, which obligate members to observe high standards of commercial honor.

It was organized in cooperation with Congress and the Securities and Exchange Commission (SEC) to promote the investment banking and securities business, to standardize its principles and practices, and to promote high standards of commercial honor and observance by its members of federal and state securities laws.

The principle behind the 1938 legislation is that of cooperative regulation by which voluntary associations of broker-dealers regulate themselves under the oversight of the SEC. The NASD is the only securities association to have been established under the Maloney Act amendments.

Today, its members comprise virtually all of the broker-dealers in the nation doing a securities business with the public. This includes the large and the small, the diversified

and the specialized, and those that are members of the exchanges and those that are not.

Although the NASD devotes considerable time and resources to regulatory matters, its overall programs are much more encompassing and reflect a commitment to use the self-regulatory process to facilitate efficient financial markets for the benefit of investors, issuers, and members.

The NASD has three subsidiaries. *NASDAQ, Inc.*, operates the nationwide electronic NASDAQ System that collects price quotations from nearly 500 dealers in more than 4,900 NASDAQ securities and disseminates the data to NASDAQ subscribers and information vendors worldwide.

NASD Market Services, Inc., provides a variety of market-related services. Its principal services include systems for the automatic execution of orders and computerized facilities for comparison of trades, reconciliation of uncompleted trades, and last-sale information reports.

NASDAQ International, Ltd., located in London, assists companies in listing on NASDAQ either through an American Depositary Receipt or a direct listing. This office helps companies evaluate having their shares traded in the U.S. and provides assistance in administration and regulatory matters.

For companies already on NASDAQ, the London office serves as an information source and as a communications channel to the U.S. It also supports a growing number of NASD members in London and on the European continent.

Purposes of the NASD

As described more fully in the NASD By-Laws, the purposes of the NASD are:

- To promote the investment banking and securities businesses.
- To standardize their principles and practices.
- To promote high standards of commercial honor and to promote among members observance of federal and state securities laws.
- To provide a medium through which the membership may consult with governmental and other agencies.
- To cooperate with governmental and other agencies in the solution of problems affecting the securities business and investors.
- To adopt and enforce rules of fair practice.
- To encourage self-discipline among members.
- To promote just and equitable principles of trade for the protection of investors.
- To investigate and adjust grievances between the public and NASD members.

Organizational Structure

In keeping with the true spirit of self-regulation, the NASD is governed by a member-controlled Board and uses a nationwide committee system to conduct peer reviews of members' actions, to develop rules and regulations, and to design marketplace services and facilities.

Board of Governors

The Board of Governors is the controlling body of the NASD and determines policy on a national scale.

The Board of Governors consists of 31 members, 21 of whom are elected by the membership. For administrative purposes, the membership is divided into 13 regional districts. Board representation is based on the number of members in each district.

The Board includes five Governors from District 12 (New York area); three Governors from District 2 (California, Hawaii, and Nevada); two Governors from District 8 (mid-western states); two Governors from District 13 (New England states); and one Governor from each of the remaining districts.

Nine additional Governors-at-Large are elected by the Board from among NASDAQ companies, investors, insurance company members, principal underwriters of investment company shares, and professions related to the securities industry, such as accounting, business education, and law.

The President of the NASD serves as a continuing member of the Board. With the exception of the President, all Board members serve without compensation for three-year terms. The Chairman of the Board is elected annually.

Committees of the Board

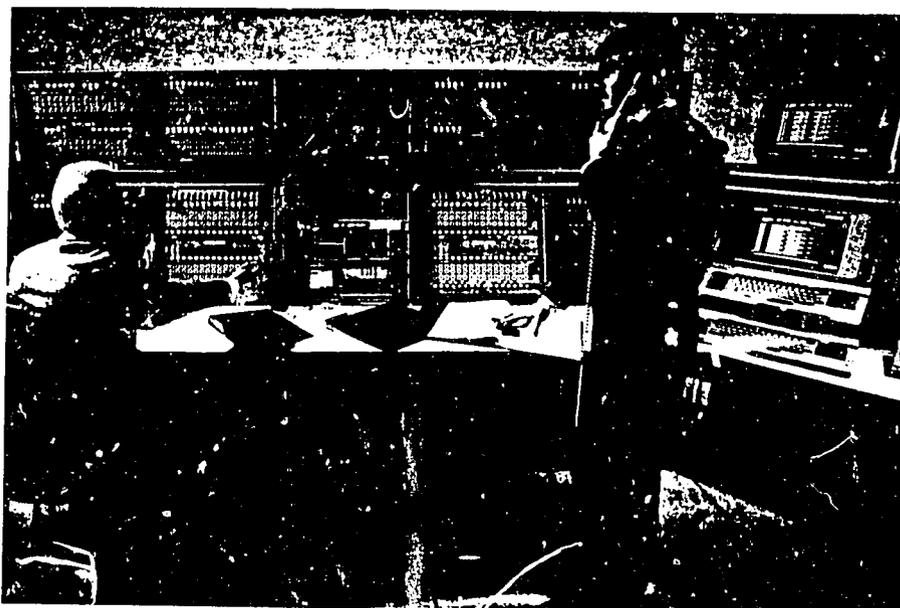
Working directly with the Board are various standing committees, special committees, and task

forces. Members of these committees, which advise the Board on specific areas of NASD activity, are appointed by the Board.

Currently, the NASD has the following standing committees:

- Arbitration
- Board Surveillance
- Congressional/State Liaison

- Corporate Advisory Board
- Corporate Financing
- Direct Participation Programs/
Real Estate
- Executive
- Finance & Audit
- Fixed Income Securities
- Institutional Investors
- International



State-of-the-art computers drive the NASDAQ stock market and monitor members' trading activities on a real-time, on-line basis.

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Investment Companies
 Legal Advisory Board
 Long-Range Planning
 Market Surveillance
 Marketing
 Membership
 NASDAQ Hearing Review
 NASDAQ/NMS Qualifications
 National Business Conduct
 National Nominating
 Operations
 Strategic Planning
 Trading
 Variable Contracts

In addition, special committees or task forces are appointed to study current problems as the need arises. In the past, special committees have been appointed to study areas such as investment advisor and financial planner regulation; government securities regulation; the handling of limit orders; the NASD's regulatory policies, practices, and procedures; NASDAQ structural and quality-of-market issues; and NASD rule and By-Law amendments.

District Committees

Each NASD district has a district committee that functions as an agent of the Board in executing NASD policy. District committees operate pursuant to delegated authority from the NASD Board of Governors.

Each district committee is composed of people from the securities business who are elected to their positions by their peers.

The chairmen of the district committees comprise the Advisory Council. This council is available to

advise the Board at all times, and it meets with the Board each year to discuss problems, policies, and actions to be taken.

NASD Staff

The President of the NASD serves as the official spokesman for the NASD and is charged with the administration of NASD affairs. All staff personnel are under the direct control of the Board through the President.

The NASD maintains a single office in each of its 13 districts (with the exception of District 2, which has offices in both Los Angeles and San Francisco); extensive support facilities in New York; a major computer facility in Rockville, Maryland; an Executive Office headquarters in Washington, D.C.; and an office in London.

The principal NASDAQ System facilities are situated in a data center complex in Trumbull, Connecticut. Various NASD service departments as well as auxiliary NASDAQ System facilities are located in the operations center in Rockville, Maryland.

The NASD's operations are divided into five divisions, each of which is headed by an Executive Vice President. The five divisions of the NASD engage in various regulatory and regulatory-support activities, perform administrative functions, and provide membership and NASDAQ companies with various service-oriented programs and facilities to ensure efficient markets.

The Office of the Secretary reports directly to the President and is responsible for the NASD's corporate long-range planning and handling administrative duties.

A brief description of the five divisions of the NASD follows.

Administration Division

The Administration Division includes Membership and Administration, the Treasurer's Office, Human Resources, Member and Market Data Services, Qualifications, and Administrative Services.

Member and Market Data Services handles contract administration, operates an Information Services unit that responds to inquiries on all facets of the NASD, and takes care of the housekeeping needs of the organization. Human Resources performs many functions, including recruitment, employment, salary administration, employee counseling, and staff training and development.

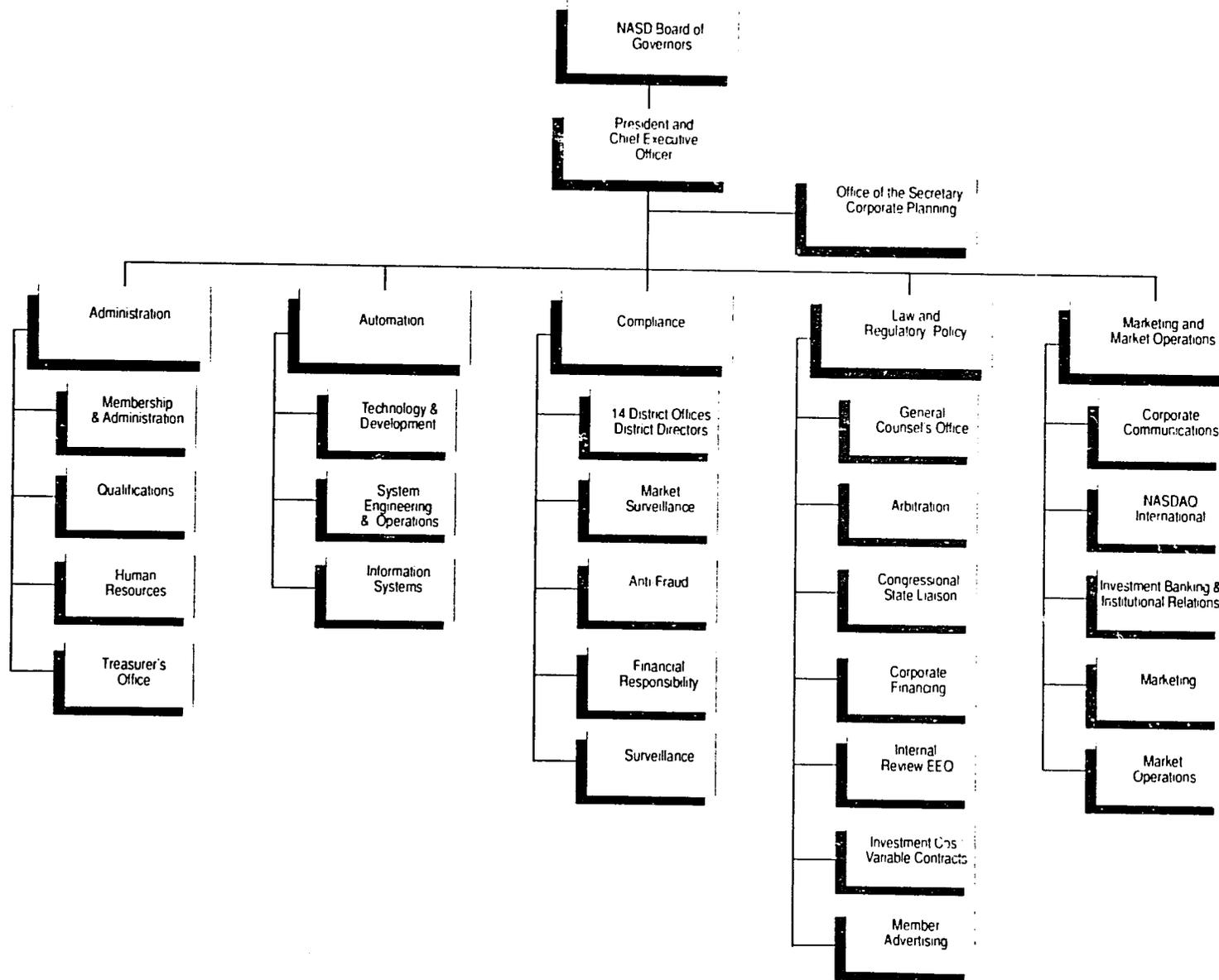
The Treasurer's Office handles the NASD's finances, including collecting and disbursing NASD funds and billing and accounting.

The Membership and Administration Department maintains records of NASD members and registered representatives via the operation of the Central Registration Depository, a computerized on-line system that facilitates same-day registration of associated personnel of member firms.

Qualifications is responsible for developing and maintaining the NASD's qualification examinations.

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Organization Chart National Association of Securities Dealers, Inc.



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Automation Division

The Automation Division consists of Technology and Development, Systems Engineering and Operations, and Information Systems. Together, these groups plan, develop, and operate computerized services for the NASD and its subsidiary organizations.

Technology and Development, the planning arm of the Division, originates product concepts and designs. Systems Engineering translates the designs into actual applications and enhancements, and Systems Operations runs both the NASDAQ System and NASD market services.

The Information Systems Department supports the regulatory functions of the NASD. It provides automation support for the Central Registration Depository; the automated systems used by NASDAQ Market Surveillance; and the Automated

Regulatory Reporting System, through which member firms file various reports and information.

Compliance Division

The Compliance Division consists of the NASD's 14 district offices located in major cities throughout the country and four Washington-based departments: Market Surveillance, Anti-Fraud, Financial Responsibility, and Surveillance.

The NASD's district offices conduct on-site examinations of member firms to determine their compliance with NASD rules, federal securities laws, and other applicable rules and regulations.

Market Surveillance's primary responsibility is to oversee the trading of NASDAQ issues and listed securities traded over the counter. The NASD uses sophisticated Market

Surveillance operations to maintain a vigilant watch over issuers' quotations and trading. Anti-Fraud conducts investigations of serious sales practice abuses, as well as fraudulent and manipulative activities.

Financial Responsibility monitors the financial and operational viability of members and processes financial reports, short-interest information, and other regulatory reports required of members. Surveillance oversees the work of the district staffs and coordinates the investigative activities of the NASD with other regulatory agencies.

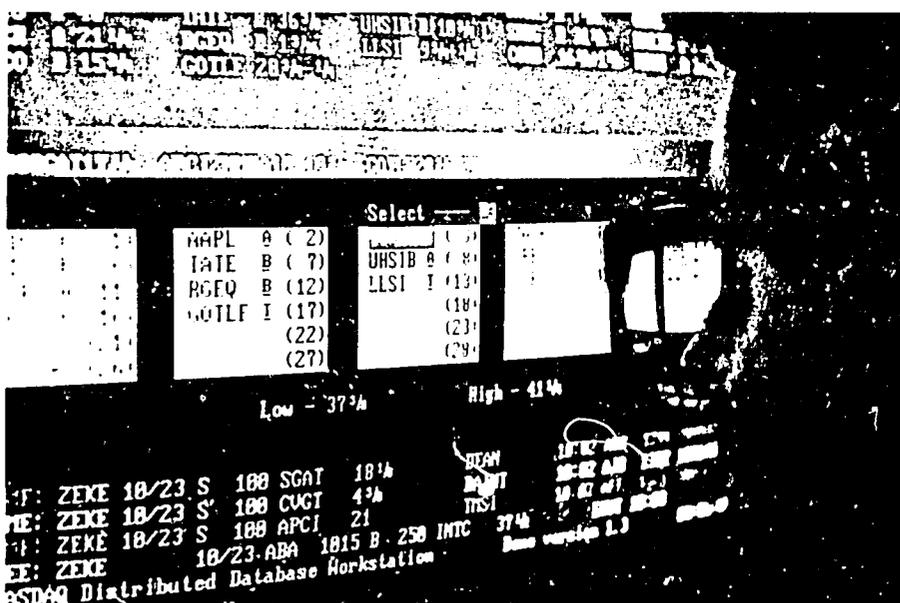
Law and Regulatory Policy Division

The Law and Regulatory Policy Division is composed of the Office of the General Counsel, Arbitration, Congressional and State Liaison, Corporate Financing, Internal Review, Investment Companies/Variable Contracts, as well as Member Advertising.

The Office of the General Counsel handles the legal affairs of the NASD. In addition to coordinating disciplinary matters at the national level, this office provides a continuing source of legal advice for the Board of Governors, its standing committees, and the NASD staff.

Arbitration administers the NASD's arbitration facilities, the largest in the industry. NASD arbitration offices are located in New York, Chicago, San Francisco, and Fort Lauderdale.

The Office of Congressional and State Liaison maintains contacts



The NASDAQ WorkstationSM service provides members and their customers with a wealth of information on the stocks they trade.

with legislators and other officials at both the federal and state levels. This office monitors legislative developments affecting the NASD, its members, and the investing public.

Corporate Financing reviews the underwriting and compensation arrangements of public offerings of securities in which members participate to determine whether the terms and conditions of these offerings are fair and reasonable.

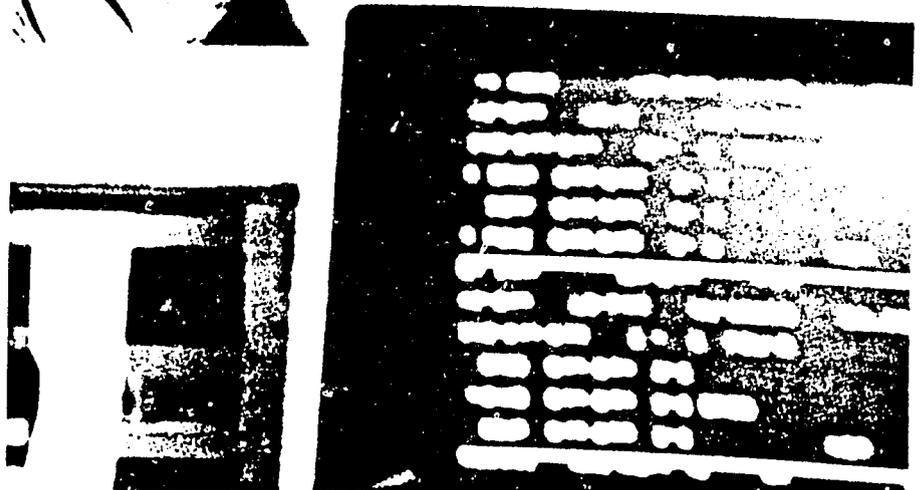
The Office of Internal Review is responsible for evaluating the effectiveness of various NASD activities, operations, and programs. The Director of Internal Review also manages the NASD's equal employment opportunity program.

Investment Companies and Variable Contracts develops and administers the regulations concerning the distribution of mutual funds and variable insurance products. Member Advertising reviews sales literature, advertisements, and market letters of NASD members to ensure they comply with applicable rules and guidelines.

Marketing and Market Operations Division

The Marketing and Market Operations Division includes Corporate Communications, Marketing, Market Operations, NASDAQ International, and Investment Banking and Institutional Relations.

Corporate Communications performs three separate functions. The News Bureau disseminates NASDAQ market information and maintains day-to-day liaison with the



In the 1980s, NASDAQ led other major U.S. markets in terms of the number of companies listed and the percent of increase in both share and dollar volume.

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print and broadcast media. Economic Research conducts analyses of various kinds and serves as the NASD's liaison to the academic community. Communication Services produces print and audiovisual materials about the NASD and NASDAQ.

The Marketing Group develops various product and service programs. Marketing Research and Planning researches issuer and member-firm needs, as well as competitive market forces, to identify new product opportunities. It also develops comprehensive marketing plans for the development, delivery, advertising, and sale of products and services.

Business Development recruits companies eligible for listing on NASDAQ and markets new and existing services to members and other users.

Company Services provides a variety of consulting and counseling services to NASDAQ companies. It also offers orientations for new companies and sponsors meetings and seminars on a wide range of subjects.

The Market Listing Qualifications Department administers the various qualifications standards governing participation in the NASDAQ stock market.

Investment Banking and Institutional Relations, located in New York City, maintains close liaison with the corporate finance and syndicate departments of NASD member firms as well as institutional investors who have become increasingly more active in the NASDAQ market.

Market Operations is respon-

sible for day-to-day operation of the NASDAQ market. It authorizes subscribers for new NASDAQ services and assists NASDAQ subscribers with operation of existing and new services. Its Uniform Practices Department simplifies the processing of members' business by administering various transaction-related computerized services and a code of procedure for facilitating clearance and settlement of securities transactions.

NASDAQ International, Ltd., located in London, assists companies in listing on NASDAQ either through an American Depository Receipt or a direct listing.

Regulatory Programs

The NASD is responsible for regulating NASDAQ and the over-the-counter securities markets. About 6,100 securities firms are members of the NASD, and approximately 440,000 individuals are registered with the NASD as sales representatives and principals of those firms.

The NASD fulfills its self-regulatory responsibilities through an integrated regulatory plan involving a nationwide field-inspection program and centralized computer surveillance.

Field Examinations

All NASD members are subject to examination by the NASD. For firms that are solely members of the NASD and no other self-

regulatory organization, the NASD is the exclusive examining authority.

If a firm belongs to more than one self-regulatory organization, the SEC designates one as the principal examining authority for determining the firm's compliance with the financial responsibility requirements under federal securities laws. The NASD is the designated examining authority for many members that maintain affiliations with other self-regulatory organizations.

Many of the NASD's responsibilities go beyond the purview of any other self-regulatory organization. For example, the NASD is singularly responsible for regulating members' market-making activities and trading practices; their municipal securities activities; their underwriting arrangements in connection with the public distributions of securities; their new-issue distribution practices; and a wide range of products, including NASDAQ issues, over-the-counter securities, exchange-listed securities traded over the counter, direct participation programs, mutual funds, and variable contracts.

Determining member compliance with the rules of the Municipal Securities Rulemaking Board (MSRB) is an important part of the NASD's examination program. The NASD conducts annual examinations of all municipal securities departments of large firms, even if they are designated to another self-regulatory organization for financial-responsibility reviews.

The NASD also has regulatory responsibilities for government securities under the Government Securities Act of 1986.

NASD members that are designated to the NASD for examination and are engaged in a general securities business are subject to a minimum of one on-site inspection per year. NASD members that are not designated to the NASD for financial responsibility and who do a general securities business are subject to intensive sales and trade practice reviews by the NASD every other year.

Certain members that do not hold customers' funds and securities and that observe certain limitations on the scope of their business activities are examined by the NASD on either a two- or three-year basis. Virtually all NASD examinations are unannounced.

During a routine examination, a member's books and records are examined for currency and accuracy. Sales practices are examined to determine whether the firm has dealt fairly with customers when making recommendations, executing orders, and charging commissions or markups and mark-downs. NASD district examiners utilize computers in the field to facilitate these reviews.

Routine examinations also seek to determine member compliance with the anti-fraud provisions of the Securities Exchange Act of 1934, the registration and disclosure requirements under the Securities Act of 1933, the NASD's advertising rules, and Regulation T of the Federal Reserve Board, which governs the extension of credit (margin) by brokers and dealers.

A financial and operational review is another part of a routine examination. This review determines

whether a member's financial and operational condition is sufficiently sound to continue transacting business. Computers also assist in conducting this review.

In addition to routine field examinations, the NASD districts also conduct thousands of investigations each year involving matters such as customer complaints, terminations of registered persons for cause, financial problems, and questionable sales practices or fraud.

Market Surveillance

While the NASD's broker-dealer regulatory programs are carried out in 14 district offices throughout the country, surveillance of the NASDAQ market is centralized in the Market Surveillance Department.

The Market Surveillance staff is aided by a variety of automated systems that analyze trading activity on a monthly, weekly, and daily basis.

Among these is the Stock-Watch Automatic Tracking (SWAT) system, which employs a number of sophisticated statistical models and parameters to alert Market Surveillance analysts to any unusual price or volume movements in any NASDAQ security.

The SWAT system also captures news on-line, allowing Stock-Watch calculations to include news as a criterion for unusual price or volume movement. An Incident Tracking Function links the Stock-Watch parameter breaks with the related news stories, captures information on the analysis performed for each alert, and provides an historical reference on all alerts.



The PORTALSM Market, which compliments SEC Rule 144A, facilitates global trading by qualified investors of certain unregistered securities.

The NASDAQ Equity Audit Trail provides a fully integrated data base of second-by-second quotation, transaction, and clearing detail for all NASDAQ securities on a firm-by-firm basis. This historical record of trading in NASDAQ securities is used in a broad range of NASD surveillance systems and provides an efficient and effective means of overseeing trading activity in the NASDAQ market.

NASD analysts can instantly reconstruct unusual trading patterns and create a complete audit trail of quotation activity for all market makers. This tool facilitates the efforts to investigate insider-trading cases and document other instances of questionable activity.

Market Surveillance will often impose trading halts to permit the dissemination by an issuer of material

news to market participants. Once the news is widely distributed over a major wire service to investors, trading is resumed.

Enforcement Procedures

Each district committee spends a significant amount of time enforcing the NASD's By-Laws and Rules of Fair Practice, federal securities laws, MSRB rules, and other securities regulations. When it functions in a disciplinary capacity, a district committee is called a District Business Conduct Committee (DBCC).

Enforcing the NASD's By-Laws, Rules of Fair Practice, and policy interpretations rests primarily with DBCCs and the Market Surveillance Committee, which acts as the central review body for cases

developed by Market Surveillance that involve possible violations of market-related NASD and SEC rules. As a disciplinary committee, the Market Surveillance Committee's authority is identical to that of the DBCC.

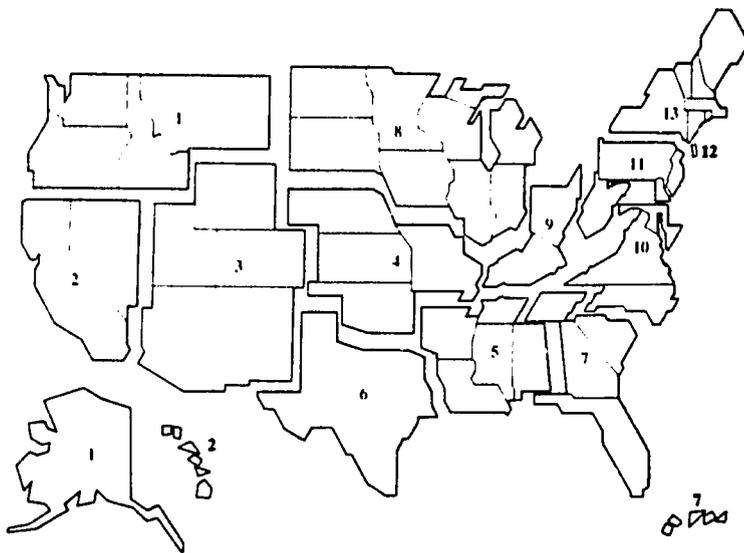
In fulfilling their enforcement responsibilities, these committees:

- Review all examination reports submitted by NASD examiners/market surveillance analysts.

- Investigate all complaints against members and persons associated with members who appear to have violated provisions of the NASD's By-Laws, Rules of Fair Practice, or any other applicable securities rules or regulations over which the NASD has jurisdiction.

- Conduct disciplinary proceedings in accordance with the NASD's Code of Procedure.

- Render decisions and impose penalties, if appropriate, in complaint cases filed by or with it.



The NASD carries out its regulatory responsibilities through a nationwide network of districts.

Disciplinary Procedures

NASD disciplinary procedures are not designed to recover damages or to obtain relief for any party. Instead, they are used to promote membership compliance with high standards of commercial honor and just and equitable principles of trade by appropriately penalizing those who fail to comply.

Following the review of an examination report and a preliminary determination that deficiencies or violations exist, a DBCC or the Market Surveillance Committee may direct informal remedial action or for-

mal disciplinary action by the NASD. Hearings are usually held for complaint proceedings.

When a complaint has been heard, the committee renders its written decision, which may specify certain sanctions. Depending on the nature of the violations that have occurred and other extenuating circumstances, a DBCC or the Market Surveillance Committee may sanction a member or an associated person by imposing any one or more of the following penalties — censure, fine, suspension or expulsion of a firm, or the suspension or revocation of a person's license to sell securities.

Appeal Process

The NASD's disciplinary procedures provide appropriate rights of appeal. Initial decisions made by a DBCC or the Market Surveillance Committee can be appealed to the NASD Board of Governors.

The Board of Governors has delegated to the National Business Conduct Committee (NBCC) the authority to review, on a regular basis, the decisions of the DBCCs and the Market Surveillance Committee for consistency and fairness.

The NBCC will determine if the DBCCs' and the Market Surveillance Committee's actions, decisions, and sanctions are consistent with established policy, previous actions, and decisions involving similar matters. The NBCC, its appointed subcommittee, or its panel hears appeals on behalf of the Board of Governors.

Also, on its own motion, the NBCC may call a committee's

decision for review. The recommendations of the NBCC are then reviewed and acted upon by the NASD Board of Governors.

The SEC also receives and reviews NASD final decisions if disciplinary action has been taken against a member or an associated person.

Any member or associated person may appeal a decision of the NASD's Board of Governors to the SEC within 30 calendar days of the Board's decision.

The SEC may also institute proceedings on its own initiative. If a member or associated person chooses, the party may appeal the SEC decision to a U.S. Court of Appeals and thereafter petition the U.S. Supreme Court to hear the case.

The self-regulatory framework established by the NASD gives brokers and dealers direct participation in the formulation and enforcement of rules, regulations, practices, and procedures that govern their daily operations and their relationships with other brokers, dealers, and the public.

This system of disciplinary proceedings effectively administers the NASD's rules in a consistent and uniform manner while safeguarding the interests of members and the investing public.

Market Services

In addition to its regulatory function, the NASD operates the NASDAQ stock market. Two NASD subsidiaries — NASDAQ,

Inc., and NASD Market Services, Inc. — provide a variety of services in support of that market.

The NASDAQ System

The NASDAQ (National Association of Securities Dealers Automated Quotations) System, operated by NASDAQ, Inc., is the electronic quotation display system for the NASDAQ market. Unlike the exchanges, there is no centralized trading floor. The System receives, stores, and transmits price and volume data and market statistics for more than 4,900 domestic and foreign equity securities to the financial services industry in the U.S. and 48 other countries, to individual and institutional investors, and to the print and broadcast media.

The NASDAQ market is the second-largest equity market in the United States and one of the largest in the world. It regularly trades more than 33 billion shares a year.

It is also the fastest growing of the U.S. markets. In the last decade, NASDAQ share of the aggregate volume among the major U.S. markets has grown from 26 percent to 42 percent. NASDAQ share volume is more than 80 percent of the volume of the New York Stock Exchange (NYSE) and nine times the volume of the American Stock Exchange (Amex).

More than 4,200 companies list their securities on NASDAQ — more companies than the NYSE and the Amex combined.

NASDAQ continues to be the market of individual investors, who

hold about two-thirds of the market value of its securities. The balance is held by institutions, which have increased their NASDAQ holdings in the last decade twice as rapidly as they have increased their NYSE holdings.

The upper tier of the market consists of almost 2,700 NASDAQ National Market securities. These securities are traded under real-time

price and volume reporting and account for more than 90 percent of total NASDAQ dollar volume and market value. The other 2,200 securities are traded on the basis of bid and ask quotations continuously disseminated by the NASDAQ System, with volume reported at the end of the trading day.

About 900 NASDAQ securities meet the financial requirements for listing on the NYSE, and 2,400 could list on the Amex. These companies have made NASDAQ their market of choice because they prefer its electronic efficiency and its competitive multiple market-maker system over the single specialist system of the exchanges.

Nearly 500 securities firms compete for order flow in NASDAQ securities, which they buy for and sell from their own inventories. Very active securities have upward of 50 market makers; the average security in the NASDAQ National Market has 11.

The advantages to investors and issuers of the multiple market-maker system over the single specialist system are: competition; greater capital support of trading; superior liquidity; continuity of trading, without halts for "order imbalances"; and sponsorship of securities.

NASDAQ has become the model for a growing number of overseas markets. The International Stock Exchange in London and the Stock Exchange of Singapore now operate screen-based, floorless trading facilities using multiple market-maker systems, and NASDAQ-type markets are being developed in Japan and elsewhere in Europe.

Member Services

The NASD and its subsidiaries provide a variety of market-related services to the industry. Some of these services include:

- **The Advanced Computerized Execution System (ACES)**, an order-routing and execution system that gives NASD members with NASDAQ service the ability to participate in an automated execution system.

Through ACES, market makers execute orders of their broker-dealer customers (who may be acting for their customers or their own account) automatically in certain securities up to specified amounts (pursuant to established arrangements) at the best prices available in NASDAQ at the time such orders are entered into ACES.

- **The Small Order Execution System (SOES)** provides for the automatic execution of customer agency orders of up to 1,000 shares. By locking in the trade the system automatically reports trades to NASDAQ and sends transaction details to the clearing corporation for comparison and settlement, saving securities firms considerable time and paperwork.

A limit-order service, which operates as part of SOES, accepts and holds customer day orders and good-till-cancelled orders for 1,000 shares or less, executing these orders when the best bid or ask price in an issue is equal to or better than the limit-order price.

- **Automated Confirmation Transaction (ACT)** enables parties on either side of a telephone-



The Small Order Execution System provides investors with automatic execution of their orders up to 1,000 shares.

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negotiated trade to use the same locked-in trade features of the NASDAQ market execution services.

ACT allows for the comparison of about 90 percent of NASDAQ trades within minutes after they take place, and 95 percent will be compared by the end of the trade day, with the balance being compared on the following day.

■ **The Order Confirmation Transaction (OCT)** service permits firms to send orders of any size and for any account to a specific market maker via computer. The market making firm responds electronically by accepting, rejecting, or countering the order with new terms.

■ **The Trade Acceptance and Reconciliation Service (TARS)** is a mandatory on-line data base of trade information that assists members in resolving uncompleted trades processed through participating clearing corporations.

■ **The Municipal Bond Acceptance and Reconciliation Service (MBARS)** provides an on-line data service to expedite the settlement of trades in municipal securities. MBARS also enables firm users to electronically submit trade records to the clearing corporations.

■ **The OTC Bulletin Board** is a new service that will provide price quotations and indications of interest by market makers in non-NASDAQ OTC securities. It will display firm and nonfirm price quotations and unpriced indications of interest, all retrievable on a real-time basis. The service will bring new visibility and order to this large and heterogeneous market.

■ **The PORTAL™ Market** facilitates global trading by qualified investors of certain unregistered securities of major companies.

The new, competitive, screen-based market for the large and rapidly growing private placement market complements SEC Rule 144A. This rule provides safe harbor protections by exempting the private placements of certain issuers from the SEC's registration and disclosure requirements and by allowing eligible institutions to freely trade these securities among themselves. PORTAL provides U.S. companies with increased flexibility in raising capital by creating a new method to access a significant source of funds.

Central Registration Depository

The NASD maintains the qualification, employment, and disciplinary histories of more than 435,000 registered securities employees of member firms through the automated Central Registration Depository (CRD).

Developed jointly by the North American Securities Administrators Association (NASAA) and the NASD, CRD is an on-line registration data bank and application-processing facility to which each of its regulatory participants are linked by a nationwide network of on-line computer terminals.

In addition to NASD representative and principal registrations, the CRD system processes applications for agent registration in all states, the

District of Columbia, and Puerto Rico. Via agreements between the NASD and six securities exchanges, CRD also processes registrations for the Boston, Midwest, New York, Pacific, and Philadelphia stock exchanges, as well as the Chicago Board Options Exchange.

CRD has eliminated the separate licensing and registration requirements of the various state and national securities industry authorities. CRD streamlines personnel-related registrations for broker-dealers by allowing them to submit a single form and a combined payment of fees for multiple registrations.

In addition to individual registration, CRD now processes the registration and withdrawal forms for broker-dealers.

Clearing Transactions

Transactions in NASDAQ stocks are cleared through the National Stock Clearing Corporation (NSCC) with custody and book-entry arrangements through the Depository Trust Company (DTC) in a manner identical to those of exchange-listed securities. The NASD, NYSE, and Amex are each one-third owners of NSCC. NSCC clears and settles trades through a Continuous Net Settlement (CNS) accounting system.

The CNS system accumulates a net long or short securities position in each eligible issue that a participant has traded and then receives or delivers the net quantities (versus a net payment) each day within DTC book-entry accounts.

Coordinated Regulatory Programs

The NASD works cooperatively with other self-regulatory organizations and government agencies in the areas of examination, qualification testing, and arbitration of disputes.

1. Regulatory Allocation

Plans. By virtue of agreements among the NASD and the Boston, Cincinnati, Midwest, Pacific, and Philadelphia stock exchanges, the NASD performs on-sight inspections of approximately 180 members of the NASD and these exchanges. This program is designed to eliminate regulatory duplication and overlap.

Also the NASD and the NYSE coordinate their efforts by examining dual members of both organizations on a joint basis. An agreement among the NASD and the options exchanges to allocate regulatory responsibility for the options activity of dual members also serves to lessen regulatory duplication.

2. Qualification Examinations. In addition to administering its own qualification exams, the NASD administers a variety of examinations on behalf of other self-regulatory organizations, the states, the commodities industry, and other certifying organizations.

3. Arbitration. As noted, the NASD operates a nationwide arbitration system to facilitate the resolution of disputes between two or more parties by impartial arbitrators who are knowledgeable in the areas of controversy. This facility is used by customers to resolve disputes with their broker-dealers and by broker-dealers to settle disagreements between themselves.

The NASD is an active participant in the Securities Industry Conference on Arbitration. The conference, which developed the industry's uniform arbitration code, has continued to refine and improve over the years.

Education and Communication

By means of communications and educational programs of various kinds, the NASD alerts members to new and changing requirements to prevent inadvertent or unintentional violations. More specifically, the NASD regularly provides its members with educational notices and informational bulletins describing industry developments.

The NASD "family of publications" includes *Notices to Members*, *Executive Digest*, *Regulatory & Compliance Alert*, *NASD Guide to Rule Interpretations*, special reports, and how-to brochures, such as the *Compliance Check List*.

To inform members of current issues and solicit their views and comments on matters affecting them, the NASD conducts a variety of membership meetings, seminars, and conferences. Formats range from one-on-one discussions between a member and an NASD representative to general membership meetings and seminars.

Each year, the NASD also conducts meetings and seminars for NASDAQ companies. The formats vary from hands-on investor relations workshops to get-acquainted meetings for representatives of new

companies to personal visits by NASDAQ representatives.

Corporate Communications also publishes *NASDAQ Notes* and the *Investor Relations Report*. *Notes* is a monthly newsletter mailed to NASDAQ companies with news about their securities and markets.

The *Investor Relations Report* is a quarterly newsletter designed to help NASDAQ companies improve their investor relations programs by providing helpful hints and practical advice to company CEOs and investor relations managers.

In addition, the NASD provides computer-generated reports to NASDAQ companies that summarize trading activity in their stocks.

Relationships of The NASD

Two of the purposes of the NASD are to encourage and promote among members observance of federal and state securities laws and to provide a medium through which the membership can confer, consult, and cooperate with governmental and other agencies in solving problems affecting the investing public, investment banking, and the securities business.

To those ends, the NASD maintains working relationships with many securities industry and governmental organizations. The results of this cooperation benefit NASD members, NASDAQ companies, and investors.

■ **Securities and Exchange Commission.** Section 15A of the Se-

curities Exchange Act of 1934 gives the SEC authority to review any disciplinary action imposed by the NASD, abrogate any rule of the NASD, disapprove any proposed change in the rules of the NASD, and suspend or revoke its registration should it fail to enforce compliance with its own rules.

The SEC holds certain other residual powers over NASD activities. For example, the SEC receives NASD disciplinary decisions and may review any disciplinary action taken by the NASD. It also annually reviews the NASD's assessment schedule to determine if it is fair and equitable.

The NASD Board of Governors maintains an independent position on all proposed changes to SEC regulations and regularly presents comments and suggestions on them. The NASD's comments on SEC proposals frequently result in adjustments being made before the proposals are finalized.

■ **Congressional Committees.** The NASD also maintains working relationships with a number of congressional committees. At the request of various House and Senate committees, the NASD frequently presents reports, analyses, and statements of its views on a variety of issues.

■ **State Governments.** The NASD coordinates many activities with the states and provides information to reduce regulatory duplication. The NASD also works with the states on matters affecting the membership and NASDAQ companies.

■ **SIPC, MSRB, Exchanges, Industry Organizations, and**



NASD employees around the country enforce high standards of commercial honor and equitable principles of trade among members to facilitate efficient financial markets for investors, issuers, and members.

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Others. The NASD maintains a close liaison with the Securities Investor Protection Corporation and the Municipal Securities Rulemaking Board.

The NASD also cooperates with the securities exchanges, industry trade associations, and various service organizations in developing industry facilities and in expressing industry positions on proposed rules, regulations, and legislation.

Member Participation

Congress and the SEC did not impose the NASD on the investment banking and securities business. The industry actively sought the privilege of self-regulation.

The NASD is the only securities industry organization founded primarily to enable business people to regulate their own affairs and to discipline themselves in accordance with their own ethical code of conduct and the federal securities laws. It is also the only securities self-regulatory organization that operates a nationwide network of district offices to facilitate member access and local participation.

The NASD is designed to be representative of all segments of the industry and all regions of the country. Today, more than 350 industry volunteers from virtually every state in the nation dedicate their skills and talents to promote and preserve the NASD's concepts of self-regulation. Their service on the Board and its committees is the key to the NASD's long history of serving issuers and members.



Competition among NASDAQ market makers gives broker-dealers a clear choice among competing quotations. This affords investors the best price available.

Building Investor Confidence Through NASDAQ Market Surveillance

By Anthony V. Ricotta

One of the forces that could bring the individual investor back is his conviction that the markets are scrupulously and efficiently regulated and will therefore treat him fairly. The NASDAQ Market Surveillance Department, which defends the integrity and the credibility of the market against insider trading, manipulation and assorted other abuses, is working hard to create this essential component of investor confidence.

Revamped Department

The NASDAQ Market Surveillance Department occupies the fourth floor of the NASD Operations Center in Rockville, Md., 20 miles from NASD headquarters in Washington, D.C. Its centerpiece is the long, glassed-in, on-line Stockwatch Section, where a dozen analysts scan their Sun workstations. The quarters are new; the workstations are new; the resources behind them are new. On one side of Stockwatch is the CORE Section, which conducts detailed historical reviews of cases of unusual activity in NASDAQ stocks. On the other side are the NASDAQ National Market System, SOES, non-NASDAQ OTC, and Market Maker Compliance sections, which check for special improprieties in those areas. There are 81 people in all, keeping an eye on the stock trading that comes under the NASD's regulatory jurisdiction.

Until a year ago, the NASDAQ Market Surveillance Department was located in the NASD's downtown Washington offices, with smaller space and staff. It moved out as Rockville's computer facilities were built up and as the recommendations of a Peat Marwick/

Nolan Norton & Co. study of the former surveillance program were implemented.

Stock Alert Mechanisms

Peat Marwick's most important recommendations were:

- To develop a new automated stock alert process, employing statistical models which take into consideration security-specific parameters, breaking news, and general market trends. Previously, the parameters for testing unusual behavior in stock were generic, and not combined with news and market trends. The statistical models for the new Stockwatch were developed by two professors from Pennsylvania State University, with the counsel of two Nobel laureate economists/statisticians from MIT, and further refined by NASD staff during the system development cycle. Stockwatch, as implemented, has an off-line and on-line capability, both computing the probability that an incident (a quote change, a volume report, a last-sale price, etc.) is the result of legitimate market forces or possibly the result of improprieties. The off-line reports analyze stock price and volume activity over various periods of time, to identify statistically significant events; the on-line Stockwatch examines intraday market activity, to provide immediate warnings of unusual activity, which may require trading halts or lead to reviews and, possibly, full-dress investigations. The new Stockwatch systems have refined parameter break alerts, to focus on the more significant ones, pinpointing real potential trouble. They

have strengthened Market Surveillance in accuracy and depth.

- To develop an automated system to identify and store news stories by stock symbol. NASDAQ Market Surveillance had a news collection and storage system, but it was largely manual. The automated news capability accepts and processes stories about NASDAQ companies from Business Wire, Dow Jones, PR Newswire, and Reuters, and also allows for the manual entry of news received by Market Surveillance over the phone, before the companies release it to the wires. The automated system makes it much easier to relate news to stock price and volume movements.
- To develop an Incident Tracking System, to track parameter breaks on securities and how they are being pursued. This facility was completed at the same time as the on-line and off-line Stockwatch. It is currently being enhanced to help in collecting additional data for investigations and also in monitoring the progress of investigations.

Workstations and Other Resources

To provide a split-screen workstation through which all the information that Market Surveillance analysts need can be obtained in one place. In the past, Market Surveillance analysts had to collect the information they required from several screens and hard-copy sources. Now the Department has 40 Sun workstations, which support simultaneous access to multiple applications—Stockwatch, NEWS, Incident

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Tracking, and other regulatory systems, such as the Equity Audit Trail, the Retail Account Name Search, Automated Blue Sheets, and CRD. The workstations are also equipped with word processing and database capabilities to assist the analysts in the preparation of cases.

Among the other regulatory systems, the Equity Audit Trail reconstructs each step in a stock transaction. The Retail Account Name Search is a compendium of accounts which have been involved in insider trading and market manipulation, and may be prone to recidivism. The Blue Sheets are forms required to be filled out by NASD member firms, detailing their activities in certain securities at certain times, which are under Market Surveillance scrutiny. CRD is the Central Registration Depository, with its voluminous files on securities industry personnel.

Break and Review

With this formidable battalion of automated weapons, the Market Surveillance analysts pursue a rigorous pattern of scrutiny of possible violations. The search-and-detect sequence in Stockwatch goes approximately like this:

- When the computer detects improbable quotes or transaction reports—ones that break the parameters of NASDAQ security, adjusted for news and market trends—it rings a bell in the Stockwatch Section, and prints out the details.
- In the absence of news that explains the break, an analyst profiles the stock. He or she retrieves all recent bids, with the identity of the market makers who entered them—the previous day's and the previous week's closing prices—the previous day's and week-to-date volume—the week's high and low prices—month-to-date, year-to-date, and average weekly volume—15-month high and low prices—the total shares outstanding—and the status of the market makers in the stock, whether they are active or inactive.
- Next come phone calls to the market makers who are doing significant volume in the stock:
 - What kind of buyers and sellers are you seeing, at your firm and others?
 - Confidentially, in what sizes are they dealing?



James M. Cangiano, VP,
Market Surveillance

— Who is coming back repeatedly to buy or sell?

- Then a phone call to the issuer:
 - Are there undisclosed corporate developments that would account for the unusual activity?
 - If not, are you aware of any other possible reasons for the parameter break in your stock?
 - If the initial review discloses no legitimate reason for the unusual activity, the case is referred to the CORE Section for investigation.

The CORE Investigation

Between 80 and 90% of the investigations that the CORE Section conducts grow out of the release of material news by a NASDAQ company. The question arises: has anybody tried to profit from advance, insider information about the news?

A CORE investigation could start with the published news of the acquisition of a company.

The CORE analyst learns, from the acquired company and the acquirer, the chronology of meetings related to the acquisition, before it was actually approved. This chronology helps to point to possible insider trading volume. Some insiders trade before corporate meetings, if they feel reasonably sure of their outcome. Others trade soon after such meetings.

The chronology requested by the CORE analyst includes the names

and addresses of all participants in the meetings, the addresses of their secretaries, right down to the duplicators and printers of documents developed at the meetings.

The CORE analysts are so practiced at their craft that they can often look at a pattern of unusual trading volume and tell from it when important company meetings took place, even before companies relate their chronologies.

On the basis of the company chronology, the CORE analyst sends questionnaires to the NASDAQ market makers in the stock under investigation, and asks who did significant buying and selling in the stock at critical times. The activities of investors with the market-making firms and others are reported electronically through the NASD's "blue sheet" system. If any investor with no history of interest in the stock has suddenly become very active in it, there is reason to look at that investor closely. Or if, for example, a young person has just opened a brokerage account to trade the stock, that can be one of many red flags.

Next, the CORE analyst goes back to the company which provided the chronology, and asks whether it can identify any of the investors in the stock during the period under investigation. This can become very interesting.

A Sample Case

In one case, preliminary discussions between the acquirer and the company which would be acquired took place in mid-September. From January through August, the stock in question traded an average of 15,400 shares a day. There were pockets of greater trading, on Sept. 7 and 8, before the preliminary discussions, and on Sept. 14, 19 and 20 after the discussions. The stock price in 10 days rose from 3 to 3 6/8.

Further discussions of the acquisition were held on Sept. 21. There was a surge in trading volume on that day, on the 22nd and on four days following. In this 10-day period, the stock price went up from 3 6/8 to 4 5/8.

On Oct. 6, a confidentiality agreement was signed between the acquirer and the acquiree. Further discussions were held on Oct. 18, and volume was up sharply the day before that. The stock price fell back to 3 1/8.

Volume continued strong for three days after Oct. 18. Then it really took

off again on Oct. 27, which happened to be the day on which the board of directors of the acquirer definitively authorized the acquisition.

The acquisition was publicly announced on Oct. 31, at \$6 a share, and trading volume went through the roof—1.7 million shares. Whoever bought in September and earlier in October made a handsome profit.

The CORE Section is fast. It generally wraps up an investigation in 90 days. This particular case has been referred to the SEC for action.

Other Market Surveillance Functions

The NASDAQ Market Surveillance Department has other functions in addition to those performed by the Stockwatch and CORE sections.

The National Market System Section looks at transaction reporting on the 2,600 NMS securities, for the accuracy of the price and volume reports. Where inaccuracies may exist, staff examiners from the NASD Compliance Division go into the reporting firms, to compare their order tickets with what they reported to the NASDAQ computers.

The SOES Section checks for improper use of the Small Order Execution System. This System automatically executes orders from individual investors of up to 1,000 shares at the best price available in the NASDAQ market. Securities firms are forbidden to use SOES for proprietary trades or for trades in the accounts of employees, relatives and friends. Violations of this rule are infrequent, but firms

still call in to say, "I just got SOESed by a dealer who I don't think has a real buyer for the stock". All such complaints are investigated, and the NASDAQ computer daily prints out possible exceptions.

The NASD is also responsible for the regulation of the over-the-counter, or "pink sheet" market, and has 47,000 "pink sheet" stocks on its computer data base. All principal transactions in these stocks must be reported to Market Surveillance, by electronic means, if during a day they amount to more than 50,000 shares or \$10,000. The OTC Section receives on an average day 700 transaction reports on 500 different "pink sheet" securities, aggregating 40 million shares and \$25 million dollars. These reports can lead Market Surveillance to investigations of market manipulation and excessive mark-ups.

The Compliance Section reviews for possible violations of the NASD's Rules relating to market maker performance in the NASDAQ market. Such practices as excess spreads, locked/cross markets, "backing away" allegations and price and volume reporting are closely monitored by the Compliance group.

The Market Surveillance Committee

All investigations and reviews by the CORE, NMS, SOES, and Compliance sections are presented to the NASD's Market Surveillance Committee, which consists of 12 securities industry executives from across the country. The Committee will issue "traffic tickets" of \$250 to \$1,000 for minor infractions,

such as inaccurate price and volume reporting.

In apparently more serious violations, the Market Surveillance Committee issues formal complaints against firms and individuals or both. Hearings are held by a panel of the Committee, at which the respondents are entitled to be represented by counsel. The results of a hearing can be:

- The dismissal of the complaint;
- An Offer of Settlement; or
- A disciplinary decision.

NASD-imposed sanctions for violations may include the expulsion of firms from the Association, the barring of individuals from association with any member firm, suspensions of firms and individuals, and monetary fines.

In 1989, the Market Surveillance Committee issued 50 summary actions for minor violations, with fines totaling \$29,000. It issued 20 Formal Complaint, including three letters of Admission, Waiver and Consent, which resulted in 14 suspensions and fines totaling \$858,500. In May, 1990, the Committee imposed fines in excess of \$2 million on a firm and three individuals whose activities were also restricted, for excessive markups in low priced securities.

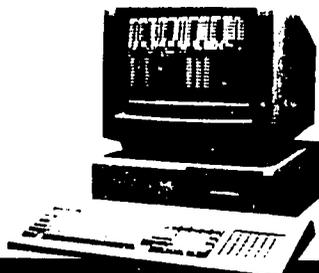
The jurisdiction of the NASD is limited to its 6,000 member firms and to the 440,000 professionals associated with them. When a Market Surveillance investigation indicates that private investors, employees of a NASDAQ company and others may have been involved in insider trading or other violations, the case is referred to the SEC, with its broader enforcement powers. In 1989, Market Surveillance referred 49 cases, and its assistance has on occasion been publicly acknowledged by the SEC.

Enhancing Credibility

NASD members, NASDAQ issuers and people in securities-related professions are kept abreast of the Market Surveillance Department's capabilities. Technology publications have begun to report on them. Investors learn of them as they read in their newspapers about disciplinary actions taken by the Market Surveillance Committee. Thus, the NASD's major investment of professionals and computer power in the integrity of the NASDAQ market is enhancing its credibility among the investing public.

TM





N A S D A Q

By utilizing SOES to execute agency orders at the best available price, you'll have more time to negotiate large trades.

SOES Works to Save You Time and Money

It takes only seconds from receipt of a customer order to transmit it to the trading desk, input it to an in-house computer, execute it in turn against a participating market maker at the inside price, confirm the trade, automatically report the trade to the NASDAQ[®] system, and submit it to clearing as a locked-in trade for comparison and hassle-free settlement.

No fees are charged to order-entry firms, and market makers pay a minimum of 50 cents to a maximum of \$1 per execution.

Order-entry firms can execute internalized trades and even preferenced orders to a specific market maker. Market makers can set size limits, which only they see,

Only NASDAQ Offers The SOES (Small Order Execution System) Advantage

for each stock and set preferencing on individual stocks.

Tiered maximum order-size limits exist for various securities categories to allow for differing trading characteristics. SOES also stores and processes limit orders. With a good-till-date feature, SOES executes limit-order entries before new market orders once the bid/ask price is reached. SOES also offers other options such as "good till cancelled," "good till filled," and "fill or kill."

Get the SOES Advantage

Be part of the growth of SOES; your trading volume can grow with it. Since SOES began in December 1984:

- NASDAQ's approximately 5,000 stocks were authorized for the automated features of SOES.

- The number of order-entry firms grew to 450, and participation in SOES became mandatory for market makers in NASDAQ National Market issues — drawing NASDAQ's

458 market makers into the service. Limited excused withdrawals reinforced market makers' commitment to NASDAQ issues.

- Executions increased almost 40 percent in just two years. Volume is currently 1.6 million shares a day.

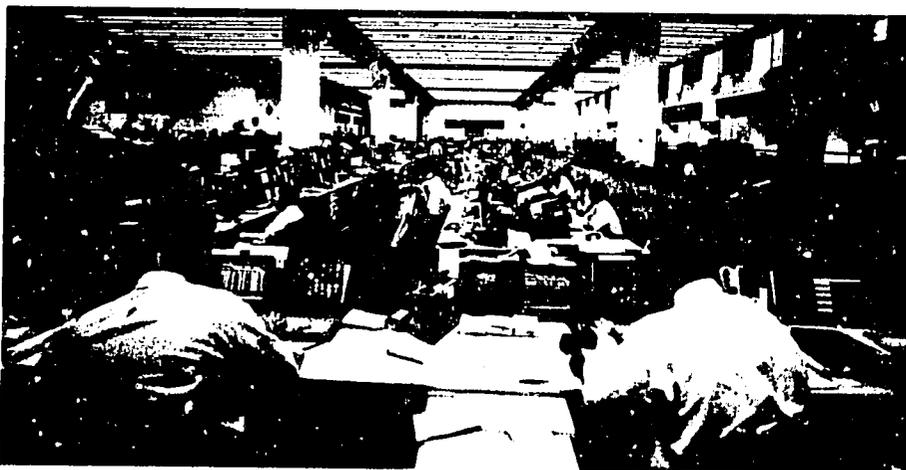
- Operations have been continuous, regardless of market volatility or "locked or crossed" market situations.

To find out more about the SOES advantage, write or call:

NASDAQ Subscriber Services
9513 Key West Avenue
Rockville, MD 20850-3389
(301) 948-6162

NASD Market Services, Inc.

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Participation in SOES is mandatory for every market maker registered in a NASDAQ/NMS security.

Attachment 13 Is To Large To Insert In Binder

Please See Attached

Fee Structure and Financial Requirements

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Nasdaq National Market[®] Fee Structure

There is a separate fee structure for listing securities, including ADRs and foreign securities, for Nasdaq[®] and Nasdaq National Market[®] issues.

A. Entry Fees

- \$5,000 one time company initial listing fee
- Variable fee schedule per each class of security:

Tier	Total Shares	Fee Per Share
1	1 to 5,000,000	\$0.005
2	5,000,001 to 15,000,000	\$0.0025
3	15,000,001+	\$0.001

- The maximum entry fees to be paid per issuer cannot exceed \$50,000, inclusive of the \$5,000 original company listing.

B. Annual Fees¹

Each Nasdaq National Market issuer's annual fee is comprised of a base and variable charge, but may not exceed certain limits.

I. Base Annual Fee

The base fee is calculated using the aggregate total shares outstanding for each class of security listed on the Nasdaq National Market as follows:

Up to 1 million shares	\$5,250	8+ to 9 million shares	\$9,250
1+ to 2 million shares	\$5,750	9+ to 10 million shares	\$9,750
2+ to 3 million shares	\$6,250	10+ to 11 million shares	\$10,250
3+ to 4 million shares	\$6,750	11+ to 12 million shares	\$10,750
4+ to 5 million shares	\$7,250	12+ to 13 million shares	\$11,250
5+ to 6 million shares	\$7,750	13+ to 14 million shares	\$11,750
6+ to 7 million shares	\$8,250	14+ to 15 million shares	\$12,250
7+ to 8 million shares	\$8,750	15+ to 16 million shares	\$12,750
		Over 16 million shares	\$13,250

II. Variable Annual Fee

The variable fee is assessed only for issuers with total market capitalization greater than \$100 million, as follows:
\$.025 per \$1,000 of market capitalization above \$100 million.

III. Annual Fee Limits

	Max. Fee
For companies with 10 million shares or less	\$10,000
For companies with 10+ to 20 million shares	\$15,000
For companies with more than 20 million shares	\$20,000

C. General Notes

- All entry fees are due at the time of application.
- The total shares outstanding (TSO) to be used as a basis for billing will be based on those reported in the issuer's most recent periodic report that is required to be filed with the issuer's appropriate regulatory authority and is received by The Nasdaq Stock Market.SM In cases of *reverse* issues, the TSO will be derived from the offering circular, as received by The Nasdaq Stock Market.SM
- The term "shares" shall include common and preferred stock, American Depositary Receipts (ADRs), warrants, partnership interests, or any other security, but will exclude convertible debentures.
- In the case of units, each component but not the unit itself shall be considered separately as an "equity security" for fee purposes.

¹ Phase-In Credit

The current annual fee structure will be phased in over a two-year period commencing in 1992. Accordingly, in 1992, companies will be afforded an annual fee credit equal to 50% of the difference between the calculated 1992 annual fees and those calculated under the old annual fee schedule.

Old Annual Fee Structure:

Participation Fee – \$2,000 flat fee assessed per issuer.

Variable Fee – A variable fee is assessed per each security listed, based on a rate of \$.0005 per share. The minimum variable fee charged per issue is \$500. The maximum variable fee charged per issuer is \$6,000. The maximum annual fee charged may not exceed \$8,000, inclusive of the participation fee.

Nasdaq Market Fee Structure

A. Entry Fees

- \$5,000 one time company listing fee
- Variable fee schedule per each class of security:
 - a. All Equity Securities — The greater of \$1,000 or \$0.001/share, not to exceed \$5,000.
 - b. Convertible Debentures — The greater of \$1,000 or \$50 per million dollars face amount of debentures, not to exceed \$5,000.
 - c. Maximum entry fees to be paid per issuer cannot exceed \$10,000, inclusive of the \$5,000 original company listing fee.

B. Annual Fees¹

- Nasdaq issuers will be assessed a flat fee per issuer listed as follows:
 - a. \$4,000 for the first class of securities.
 - b. \$1,000 for each subsequent class of securities.
 - c. No maximum will apply.

C. General Notes

- All entry fees are due at the time of application.
- \$1,000 Application Processing Fee per application, which is non-refundable, will be charged and credited to the initial listing fees.
- The total shares outstanding (TSO) to be used as a basis for billing will be based on those reported in the issuer's most recent periodic report that is required to be filed with the issuer's appropriate regulatory authority and is received by The Nasdaq Stock Market. In cases of new issues, the TSO will be derived from the offering circular, as received by The Nasdaq Stock Market.
- The term "shares" shall include common and preferred stock, American Depositary Receipts (ADRs), warrants, partnership interests, or any other security, but will exclude convertible debentures.
- In the case of units, each component but not the unit itself shall be considered separately as an "equity security" for entry fee purposes.

¹Phase-In Credit

The current annual fee structure will be phased-in over a two-year period commencing in 1992. Accordingly, in 1992, companies will be afforded an annual fee credit equal to 50% of the difference between the calculated 1992 annual fees and those calculated under the old annual fee schedule.

Old Annual Fee Structure

Nasdaq issuers will be assessed a variable fee per issue listed, based on the total shares outstanding for each issue at year end as follows:

Rate Schedule -

- Equity Securities \$0.0005 per shares outstanding.
- Convertible Debt: \$25 per million dollars face amount.

Annual Fee Limits -

- The minimum fee charged per issue is \$500.
- The maximum fee charged per issue is \$6,000.

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Summary of Financial Requirements for Initial Listing

Nasdaq Market

Total Assets	\$4 million
Total Stockholders Equity	\$2 million
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent ¹	Yes
Public Float (Shares) ²	100,000
Market Value of Public Float	\$1 million
Shareholders	300
Minimum Bid Price	\$3
Number of Market Makers	2

¹A temporary, automatic exemption exists for initial public offerings.

²Public float is defined as shares that are not "held directly or indirectly by any officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding . . ."

Nasdaq National Market

	Alternative 1	Alternative 2
Registration under Section 12(g) of the Securities Exchange Act of 1934 or equivalent	Yes	Yes
Net Tangible Assets ¹	\$4 million	\$12 million
Net income (in latest fiscal year or 2 of last 3 fiscal years)	\$400,000	N/A
Pretax Income (in latest fiscal year or 2 of last 3 fiscal years)	\$750,000	N/A
Public Float (Shares) ²	500,000	1 million
Operating History	N/A	3 years
Market Value of Float	\$3 million	\$15 million
Minimum Bid	\$5	\$3
Shareholders		
— if between 0.5 and 1 million shares publicly held	800	N/A
— if more than 1 million shares publicly held	400	N/A
— if more than 0.5 million shares held and average daily volume in excess of 2,000 shares	400	N/A
Number of Market Makers	2	2

¹Net Tangible Assets means total assets (excluding goodwill) minus total liabilities.

²Public float is defined as shares that are not "held directly or indirectly by any officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding . . ."

OVERVIEW OF NASDAQ MARKET SURVEILLANCE

The Market Surveillance Section operates as an arm of the Surveillance Department and as such is charged with the responsibility to monitor and investigate potential violations of rules governing trading in the NASDAQ marketplace and the OTC market in listed securities. In order to accomplish this task, Market Surveillance employs a staff of 50 individuals utilizing a vast amount of automated detection systems.

The Section is divided into four basic functional areas: On-Line Surveillance, Core Surveillance, SOES/NMS Surveillance, and Off-Board/Options Surveillance, each addressing the activities unique to each group. The following will briefly discuss the activities of each of the foregoing areas.

On-Line Surveillance

The basic function of the On-Line Section is to respond to real-time alerts of price movements and to implement quotations halts. In monitoring price volatility in NASDAQ issues, Market Surveillance relies heavily upon on-line computerized analysis of all price changes as they occur in the NASDAQ System. Throughout the trading day, the computer analyzes individual market maker trade reports and/or quotation changes and provides Market Surveillance with instantaneous notification of all unusual price and volume movements. In many cases the first indication of the presence of insider trading comes from these on-line alerts when price fluctuation is detected prior to a material news release. In 1986, Market Surveillance analysts responded to 17,275 on-line alerts.

Quotations Halts

In 1986 Market Surveillance implemented 1,065 quotations halts. The purpose of a quotations halt, which normally lasts from one to two hours, is to alert the marketplace that important corporate news, which could affect the value of a security, is about to be released or has been released. A halt makes it more likely that all segments of the marketplace -- especially investors and potential investors -- will have the opportunity to evaluate the news and make their investment judgments on it before entering into a transaction.

Core Surveillance

The basic purpose of the Core unit is to conduct detailed reviews and analyses of unusual market activity taking into account price and volume anomalies. Following the market's close each day, the NASDAQ computer analyzes individual market makers' quotations, as well as total purchases and sales, and provides Market Surveillance with key regulatory reports from the NASDAQ System's Central Processing Complex in Connecticut. Market Surveillance analysts rely on these regulatory reports during major investigations as well as routine inquiries.

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Routine Trading Reviews

In many instances (1,464 in 1986) routine trading reviews are conducted. Depending on the situation, these include:

- o Studying reports from the NASDAQ computer, which
 - recorded each change of market makers' quotations in the stock during the time under review,
 - identified the market makers most active stock, and
 - recapitulated other securities' price and volume activity during the day, and thus provided a context for the parameter break under study;
- o Analyzing detailed transaction data and statements secured from NASD member firms; and
- o Evaluating information from NASDAQ issuers on how they released news and on the timing of pertinent corporate activities.

Formal Investigations

As a result of the routine reviews of unusual activity in NASDAQ securities, during 1986 over 260 formal investigations were conducted into possible violations of NASD and SEC rules regarding trading practices and fraud. These investigations, which are normally triggered by exceptional volume and/or price activity, include inquiries into possible insider trading, price manipulations, fictitious quotations, volume reporting errors, propping the price immediately prior to the close of the market (marking-the-close) as well as various underwriting reviews. Formal investigations involve in-depth trading analysis by the analyst together with inquiries to registered persons, the issuer and his affiliates, i.e. attorneys and accountants, and occasionally visits are made to member firms to obtain additional information and/or depose registered persons. Many of these investigations are forwarded to the SEC for further review into the activities of non-member persons who are not within the NASD's jurisdiction. These referrals may encompass insider trading, improper disclosure by the issuer, price manipulations and other violations of the Federal Securities Laws.

All alleged securities violations by member firms and their associates will be presented to the Market Surveillance Committee for final disposition.

Off-Board/Options Surveillance

The Off-Board/Options group is concerned with the surveillance of securities in the trade reporting environment, that is, transactions in listed securities traded over-the-counter. The unit monitors for compliance with the various provisions to which trade reported securities are subject, namely Schedule G of the Association's By-Laws and the ITS/CAES Rules in the case of transactions in listed securities. The group also monitors for compliance with Article III, Section 33 and Appendix E of the Rules of Fair Practice with respect to members' activities in conventional options and listed option activity by NASD members who are not also members of a particular options exchange.

SOES/NMS

The SOES/NMS area monitors member compliance with the Rules of the Small Order Execution System as well as compliance with the various provisions of Schedule D of the By-Laws and SEC Rule 11Ac1-1. Of particular interest in the SOES area is monitoring automated exception reports to insure that orders are not broken up to circumvent the SOES execution limits and to insure that principal trades are not entered into the system. Trade reporting focuses primarily on the 90-second reporting requirement and insures that prints are reasonably related to the current market.

PRICE PARAMETER TABLE
FOR OFF-LINE STOCKWATCH AND THE IES QUERY

<u>Issue Selected if Inter- or Intra-Weekly Price Movement Exceeds:</u>	<u>Greater than or equal to:</u>	<u>but Less than:</u>	<u>Issue Selected if Inter- or Intra-Day Price Movement Exceeds:</u>
16/32	0		
20/32	1	1	8/32
28/32	2	2	12/32
1 - 4/32	3	3	20/32
1 - 16/32	4	4	24/32
1 - 24/32	5	5	28/32
		7	1
2	7		
2 - 8/32	9	9	1 - 4/32
2 - 16/32	11	11	1 - 8/32
2 - 24/32	13	13	1 - 12/32
		15	1 - 16/32
3	15		
3 - 8/32	17	17	1 - 20/32
3 - 16/32	19	19	1 - 24/32
3 - 24/32	22	22	2
		25	2 - 8/32
4	25		
4 - 8/32	30	30	2 - 12/32
4 - 16/32	36	36	2 - 16/32
4 - 24/32	42	42	2 - 20/32
		48	2 - 24/32
5	48		
5 - 8/32	54	54	3
5 - 16/32	60	60	3 - 8/32
5 - 24/32	66	66	3 - 12/32
		72	3 - 16/32
6	72		
6 - 8/32	79	79	3 - 24/32
6 - 16/32	86	86	4
6 - 24/32	93	93	4 - 8/32
		100	4 - 16/32
7	100		
8	115	115	4 - 28/32
10	135	135	5 - 16/32
14	160	160	6 - 24/32
16	200	200	8
			9

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REAL-TIME STOCKWATCH PRICE PARAMETER TABLE

<u>SALE PRICE RANGE OF STOCK/OPTION</u>		<u>FLAG EXCEPTION IF INTER-DAY OR INTRA-DAY PRICE MOVEMENT EXCEEDS:</u>	
<u>Greater than or Equal to:</u>	<u>But Less Than</u>		
0	1	+	1/8
1	2	+	1/2
2	3	+	7/8
3	4	+	1 1/8
4	5	+	1 1/4
5	7	+	1 1/2
7	9	+	1 5/8
9	11	+	1 7/8
11	13	2	
13	15	2	1/4
15	17	2	3/8
17	19	2	5/8
19	22	3	
22	25	3	3/8
25	30	3	1/2
30	36	3	3/4
36	42	3	7/8
42	48	4	1/8
48	54	4	1/2
54	60	4	7/8
60	66	5	
66	72	5	1/4
72	79	5	5/8
79	86	6	
86	93	6	3/8
93	100	6	3/4
100	115	7	7/8
115	135	8	3/4
135	160	10	5/4
160	200	12	1/2
200		14	

Notes:

In order to have a High Price Break, the inter-day price movement must be positive. In order to have a Low Price Break, the inter-day price movement must be negative.

REAL-TIME STOCKWATCH REPORT (STKWCH)

This is a real-time exception report which flags those stocks and NASDAQ options where price activity exceed gross limits established by Market Surveillance. NASDAQ stocks are monitored via quote updates affecting the inside bid price while trade activity is used to monitor NASDAQ/NMS and CQS equity, as well as NASDAQ option price movement. Prices are monitored for three trends:

- o High price trend
- o Low price trend
- o Intra-day price range movement

The report is operable during regular trading hours and exception conditions are immediately transmitted to two "receive only" printers in Washington for subsequent review by a Market Surveillance analyst. The parameters used for these tests are in Appendix A.

REPORT CONTENTS

Report Type - Stockwatch reports are identified by the mnemonic STKWCH.

Report Time - The time when the trade was reported as an exception. The time will be shown in standard clock-time notation.

Date - Trade day's date.

Type of Issue - One of the following codes identifying the type of security.

- C - CQS Security
- N - NASDAQ/NMS Security
- O - Option
- Q - NASDAQ Security

Security/Option ID - The identifier of the issue in the NASDAQ system. CQS securities are identified by their five character identifier in NASDAQ instead of their ticker symbol. Listed securities designated as 19c-3 securities should have an asterisk (*) shown in the column immediately before the security identifier.

Type of Break - The exception condition(s) codes as follows:

H = High Test exception

L = Low Test exception

R = Price Range Test exception

H-R = High Test and Price Range Test exceptions

L-R = Low Test and Price Range exceptions

For NASDAQ/NMS and CQS securities, a pound sign (#) should be shown on the column immediately preceding this field if the exception trade was reported with a trade modifier or price override.

Previous Day's Closing Sale Price - The security or option's previous day's adjusted closing sale price. This field will contain the notation "NONE" if this price is not available. For NASDAQ securities, this field will continue to show the stock/option's previous day's adjusted closing inside bid price.

High Sale Price (H) - The intra-day high sale price reported in the stock/option as of the report time. This price will be the same as the Low Sale Price if trading on the current day has not resulted in a High/Low spread. For NASDAQ securities this field will continue to show the stock/option's intra-day high inside bid.

Low Sale Price (L) - The stock/option's intra-day low sale price as of the report time. This price will be the same as the High Sale Price if trading on the current day has not resulted in a High/Low spread. For NASDAQ securities, this field will continue to show the stock/option's intra-day low inside bid.

STKMH	11:30	06/19/86	Q	QBIIU	R	C: 2 1/4	H: 2 1/4	L: 1 5/8
STKMH	11:57	06/19/86	H	RFBC	H-R	C: 18 1/4	H: 022	L: 018.1.4
STKMH	11:58	06/19/86	H	RFBC	H-R	C: 18 1/4	H: 022.1.2	L: 018.1.4
STKMH	12:01	06/19/86	H	BKHT	H-R	C: 770	H: 830	L: 770
STKMH	12:07	06/19/86	Q	EVIAU	L-R	C: 1680	H: 1680	L: 1660
STKMH	12:08	06/19/86	H	TCBY	R	C: 42 3/4	H: 045	L: 041
STKMH	12:11	06/19/86	H	TCBY	R	C: 42 3/4	H: 045	L: 040.1.2
STKMH	12:14	06/19/86	H	TCBY	R	C: 42 3/4	H: 045	L: 040
STKMH	12:28	06/19/86	H	QDPA	H-R	C: 1/2	H: 000.3.4	L: 000.1.2
STKMH	12:33	06/19/86	Q	SOIX	L-R	C: 15 1/2	H: 15 1/2	L: 12 3/4
STKMH	12:35	06/19/86	H	CRFT	L	C: 3/4	H: 000.1.2	L: 000.1.2
STKMH	12:38	06/19/86	Q	SOIX	L-R	C: 15 1/2	H: 15 1/2	L: 12 1/2
STKMH	12:58	06/19/86	Q	HOFX	L-R	C: 3/8	H: 3/8	L: 13/16
STKMH	01:04	06/19/86	H	QDPA	H-R	C: 1/2	H: 000.7.8	L: 000.1.2
STKMH	01:09	06/19/86	H	CCST	L-R	C: 85	H: 085	L: 077.3.4
STKMH	01:09	06/19/86	Q	INDFD	H	C: 3/8	H: 000.3.4	L: 000.3.4
STKMH	01:19	06/19/86	Q	GEEN	H-R	C: 115/16	H: 1 1/8	L: 15/16
STKMH	01:20	06/19/86	Q	INDFD	H-R	C: 3/8	H: 001.1.2	L: 000.3.4
STKMH	01:23	06/19/86	Q	MILA	H-R	C: 5/8	H: 13/16	L: 5/8
STKMH	01:33	06/19/86	Q	INDFD	L	C: 5 7/8	H: 003	L: 003
STKMH	01:39	06/19/86	Q	UMBEZ	L-R	C: 113/16	H: 113/16	L: 5/8
STKMH	01:43	06/19/86	H	CASC	H	C: 21	H: 025	L: 025
STKMH	01:53	06/19/86	Q	GEEN	H-R	C: 115/16	H: 13/16	L: 115/16
STKMH	01:59	06/19/86	Q	EVIAU	L-R	C: 1680	H: 1680	L: 1650
STKMH	02:00	06/19/86	H	CASC	H-R	C: 21	H: 025	L: 021
STKMH	02:05	06/19/86	H	CHMP	R	C: 3/4	H: 000.13.16	L: 000.5.8
STKMH	02:10	06/19/86	Q	BIIU	H-R	C: 19/16	H: 3/4	L: 19/16
STKMH	02:12	06/19/86	Q	MILA	H-R	C: 5/8	H: 7/8	L: 5/8
STKMH	02:20	06/19/86	Q	BURN	R	C: 113/16	H: 113/16	L: 7/8
STKMH	02:27	06/19/86	Q	EVIAU	L-R	C: 1680	H: 1680	L: 1640
STKMH	02:33	06/19/86	Q	INDFD	L-R	C: 5 7/8	H: 003	L: 002
STKMH	02:35	06/19/86	Q	OTFEZ	H-R	C: 1/2	H: 3/4	L: 1/2
STKMH	02:40	06/19/86	Q	HANN	H-R	C: 113/16	H: 131/32	L: 113/16
STKMH	02:43	06/19/86	Q	QBIIU	R	C: 2 1/4	H: 2 1/4	L: 1 1/2
STKMH	02:45	06/19/86	Q	INDFD	L-R	C: 5 7/8	H: 003	L: 001.3.4
STKMH	02:52	06/19/86	Q	OTFEZ	H-R	C: 1/2	H: 7/8	L: 1/2
STKMH	03:02	06/19/86	Q	HANN	H-R	C: 113/16	H: 1	L: 113/16
STKMH	03:09	06/19/86	Q	HANN	H-R	C: 113/16	H: 111/32	L: 113/16
STKMH	03:10	06/19/86	Q	INDFD	H	C: 2	H: 005.1.8	L: 005.1.8
STKMH	03:11	06/19/86	Q	HANN	H-R	C: 113/16	H: 111/16	L: 113/16
STKMH	03:14	06/19/86	Q	HANN	H-R	C: 113/16	H: 113/32	L: 113/16
STKMH	03:15	06/19/86	Q	OTFEZ	R	C: 1/2	H: 5/8	L: 3/8
STKMH	03:25	06/19/86	Q	INDCU	L-R	C: 113/32	H: 113/32	L: 1/4
STKMH	03:35	06/19/86	Q	CCRS	H-R	C: 113/16	H: 1	L: 113/16
STKMH	03:43	06/19/86	Q	IRISZ	L-R	C: 1000	H: 1000	L: 950
STKMH	03:46	06/19/86	Q	AGITU	L-R	C: 1360	H: 1360	L: 1340
STKMH	03:47	06/19/86	Q	CCRS	H-R	C: 113/16	H: 111/16	L: 113/16
STKMH	03:52	06/19/86	Q	CCRS	H-R	C: 113/16	H: 1 1/8	L: 113/16
STKMH	03:58	06/19/86	H	VIRA	H-R	C: 65	H: 071	L: 065.1.2
STKMH	03:59	06/19/86	H	TCBY	R	C: 42 3/4	H: 045.1.4	L: 040
STKMH	04:00	06/19/86	H	TCBY	R	C: 42 3/4	H: 045.1.2	L: 040
STKMH	04:03	06/19/86	Q	INDFD	H-R	C: 3/8	H: 001.1.2	L: 000.5.6

REAL-TIME VOLUME WATCH REPORT (VOLWCH)

This real-time exception report is designated to detect unusual volume in NASDAQ/NMS and listed stocks, as well as in NASDAQ options. As trades are reported during regular reporting hours, the cumulative volume for the stock/option is compared to its normal volume limits during the previous weeks. An unusually high volume will cause a volume watch report to be made to Market Surveillance. A routine review will be conducted upon receipt of the message.

The parameters used for this report are in Appendix A.

REPORT CONTENTS

Report Type - Volume Watch Reports are identified by the mnemonic VOLWCH.

Report Time - The time when the exception trade was reported to Market Surveillance. The time is a few seconds after the trade report and is shown in standard HH:MM clock-time notation.

Date - The current day's date in MM/DD/YY format.

Type of Issue - A code which denotes:
 N = a NASDAQ/NMS security, or
 C = a CQS security.

Security/Option ID - The one to five character identifier of the issue. An asterisk (*) is shown before the identifier of a 19c-3 security.

Type of Break - The code "VOL" denotes a Volume parameter break. A pound sign (#) shown before this code identifies trades which were reported with a trade modifier, price override or in a NO/WAS report.

Trade Size (V) - The number of shares/contracts reported by the exception trade report.

Total Volume (T) - The day's total shares/contracts reported for the security/option as of the report time. For CQS securities, this total is the third market total shares which is adjusted for cancel, error and NO/WAS trade reports.

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Previous Day's Total Volume (Y) - The total volume used in determining the current day's critical volume for the security/option.

VOLHCH	10:12	06/19/86	N	UNISB	VOL	V: 50000	T: 620500	Y: 1712300
VOLHCH	09:56	06/19/86	N	CFNC	RVOL	V: 65000	T: 134600	Y: 9200
VOLHCH	11:04	06/19/86	N	RSTO	VOL	V: 42000	T: 84000	Y: 6900
VOLHCH	10:10	06/19/86	N	TSIC	RVOL	V: 10000	T: 32000	Y: 1100
VOLHCH	11:46	06/19/86	N	RVCC	VOL	V: 1500	T: 277500	Y: 473500
VOLHCH	12:17	06/19/86	N	FDLMB	VOL	V: 27000	T: 211500	Y: 73200
VOLHCH	12:19	06/19/86	N	CYPN	VOL	V: 100000	T: 420300	Y: 315400
VOLHCH	12:19	06/19/86	N	ENLX	RVOL	V: 120000	T: 358600	Y: 941500
VOLHCH	12:50	06/19/86	N	TWIT	VOL	V: 35500	T: 175700	Y: 9900
VOLHCH	12:53	06/19/86	N	STOR	VOL	V: 5000	T: 91300	Y: 190300
VOLHCH	12:53	06/19/86	N	FLOW	RVOL	V: 180300	T: 353200	Y: 93400
VOLHCH	01:02	06/19/86	N	HTEK	VOL	V: 10000	T: 63000	Y: 300
VOLHCH	01:11	06/19/86	N	UESS	VOL	V: 96300	T: 152300	Y: 700
VOLHCH	01:16	06/19/86	N	FDLMB	VOL	V: 10000	T: 296500	Y: 80900
VOLHCH	01:32	06/19/86	N	HOVI	VOL	V: 13000	T: 268800	Y: 202400
VOLHCH	01:38	06/19/86	N	ISLI	VOL	V: 3000	T: 27300	Y: 14300
VOLHCH	01:40	06/19/86	N	GAEO	VOL	V: 900	T: 70100	Y: 6300
VOLHCH	01:46	06/19/86	N	VFED	VOL	V: 500	T: 106500	Y: 11500
VOLHCH	01:57	06/19/86	N	MCCRK	VOL	V: 15000	T: 212400	Y: 74900
VOLHCH	01:57	06/19/86	N	BQDR	VOL	V: 60000	T: 131800	Y: 217000
VOLHCH	01:58	06/19/86	N	PAKTA	VOL	V: 15500	T: 32400	Y: 1000
VOLHCH	02:09	06/19/86	O	NDQSD	RVOL	V: 7	T: 22	Y: 4
VOLHCH	02:36	06/19/86	N	PBEI	VOL	V: 50000	T: 109200	Y: 10600
VOLHCH	02:37	06/19/86	N	CFSB	VOL	V: 60200	T: 63900	Y: 1500
VOLHCH	02:38	06/19/86	N	BSET	VOL	V: 4000	T: 83300	Y: 7200
VOLHCH	02:47	06/19/86	N	FSTRA	VOL	V: 1000	T: 206500	Y: 272500
VOLHCH	02:48	06/19/86	N	DASH	VOL	V: 2500	T: 219300	Y: 23900
VOLHCH	02:57	06/19/86	N	HAVTA	VOL	V: 53500	T: 54000	Y: 33000
VOLHCH	02:53	06/19/86	N	CFOI	RVOL	V: 5000	T: 136400	Y: 253800
VOLHCH	03:10	06/19/86	N	ESCC	VOL	V: 70000	T: 157600	Y: 1900
VOLHCH	03:21	06/19/86	N	CHOT	VOL	V: 5000	T: 60100	Y: 000
VOLHCH	03:22	06/19/86	N	QFCC	VOL	V: 9500	T: 120200	Y: 50500
VOLHCH	03:47	06/19/86	N	KHNS	VOL	V: 3000	T: 49700	Y: 1600
VOLHCH	03:49	06/19/86	N	PTEK	VOL	V: 15000	T: 78100	Y: 5900
VOLHCH	03:54	06/19/86	N	SEED	VOL	V: 1000	T: 558000	Y: 353500
VOLHCH	04:00	06/19/86	N	ACVFA	RVOL	V: 4000	T: 59800	Y: 12600
VOLHCH	10:49	06/19/86	N	THNI	RVOL	V: 65000	T: 130500	Y: 8100

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EQUITY VOLUME FACTOR TABLE

<u>Volume Level</u>	<u>Total Share Volume (Variable)</u>	<u>Volume Factor (Variable) *</u>
Low	1 - 25,000	2.3
Medium	25,001 - 50,000	2.2
High	50,001 - 100,000	2.1
Very High	100,001 - Over	2.0

* The values of these parameters were changed in January 1985 from 1.9, 1.8, 1.7 and 1.6 respectively.

OPTIONS VOLUME FACTOR TABLE

<u>Volume Contract Level</u>	<u>Current Day Contract Volume (Variable)</u>	<u>Options Volume Factor (Variable)</u>
Low	251 - 500	3.2
Medium	501 - 1000	3.1
High	1001 - Over	3.0

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NASD BOARD OF GOVERNORS POLICY STATEMENT ON
MARKET CLOSINGS

September 20, 1988

The Board of Governors of the National Association of Securities Dealers, Inc. has carefully considered the numerous proposals resulting from the October 1987 market break including the Report of the NASD Committee on the Quality of Markets and the "circuit breaker" proposal recommended by the President's Working Group on Financial Markets. The Working Group proposal recommends that all U.S. markets for equity and equity-related products, i.e., stocks, individual stock options, and stock index options and futures, halt trading for one hour if the Dow Jones Industrial Average ("DJIA") declines 250 points from its previous day's closing level and for two hours if the DJIA declines 400 points. The proposal also recommends specific reopening procedures and consistent index futures price limit requirements. Having reviewed these numerous proposals, the Board of Governors has adopted this Statement of Policy.

The Board notes that while progress has been made by the markets in areas involving systems capacity, margin requirements and information sharing, a number of recommendations from the various proposals unfortunately have not yet been either fully considered or actively pursued. The Board believes that market closings are not the answer to the potential danger of precipitous declines in market prices and that it is more important to aggressively pursue other initiatives. Among these are:

1. Congress should vest regulatory authority for all equity derivative instruments in the Securities and Exchange Commission.

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2. Congress should give the Securities and Exchange Commission authority to oversee the establishment of initial or maintenance margin requirements by self-regulatory organizations for all equity instruments. Relative margin levels for equities and equity derivative instruments should be consistent across all market places.
3. The activities of clearing and settlement systems should be coordinated across market places to reduce financial risk for all participants. Clearing and settlement facilities for all equity derivative instruments should be unified or linked as in the options and securities markets.
4. An intermarket self-regulatory coordinating policy group (with subgroups) composed of persons at the senior management level of all self-regulatory organizations should be established to plan, communicate and coordinate with each other in the surveillance, financial, operational and technology areas and, acting with federal regulators, to formulate contingency plans for market emergencies.
5. To the extent that legislation is needed to accomplish any of these objectives, Congress should be urged by all securities industry organizations to act promptly.

We believe implementation of these recommendations would provide a more permanent and appropriate response to the events of October 1987 than would market closings based upon arbitrary formulae. They should be adopted expeditiously. Because sufficient progress on all of these matters has not yet occurred, the Board recognizes the need to consider the Working Group's proposal on "circuit breakers" as an interim step.

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The Board strongly believes that the nation's securities markets should remain open and operating during normal market hours whenever possible. The Board is opposed in principle to the implementation of "circuit breakers" that mandate market closings on the basis of arbitrary formulae. The Board supports the current practice whereby individual markets determine, after coordination with other markets and federal regulators, whether to close based on the character of a particular emergency situation.

The Board of Governors acknowledges that the risks imposed on any single market remaining open while all other U.S. markets have halted trading because of extraordinary price movements could be unacceptable. The Board therefore has determined that, at times when other major securities markets initiate market-wide trading halts in response to extraordinary market conditions, the NASD will, upon request from the Securities and Exchange Commission, act to halt domestic trading in all securities quoted in the NASDAQ system and domestic trading in equity or equity-related securities in the over-the-counter market.

This Policy Statement on Market Closings shall be effective until December 31, 1993 unless modified or extended prior thereto by the Board of Governors.

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CIVIL INSIDER TRADING PENALTIES**The Insider Trading Sanctions Act of 1984**

In 1984, the Exchange Act was amended to authorize the Commission to seek civil penalties for violations involving insider trading through the enactment of the Insider Trading Sanctions Act of 1984 (ITSA).³³⁰ ITSA authorizes the Commission to seek, and a court to impose, a civil penalty upon any person who violates the Exchange Act by purchasing or selling a security while in possession of material non-public information.³³¹ Persons who aid and abet insider trading violations by tipping material non-public information, even though they did not trade in the securities, are also subject to penalties pursuant to ITSA.³³²

Through ITSA, Congress authorized the Commission to seek civil penalties of up to three times the profit gained or loss avoided.³³³ ITSA defines profit gained or loss avoided as the difference between the purchase or sale price of the security and the value of that security as measured by its trading price a reasonable period after public dissemination of the non-public information.³³⁴ The district court is to determine the amount of this penalty in light of the facts and circumstances of the case.³³⁵ The Commission must bring actions for civil penalties within five years of the date of the purchase or sale and the moneys realized from such actions are to be paid into the United States Treasury.³³⁶

The legislation explicitly provides that Commission authorization to seek civil penalties is in addition to existing remedies.³³⁷ Thus, a person who engages in insider trading in violation of the Exchange Act and the rules thereunder is subject to a civil penalty as well as an injunction and disgorgement.³³⁸

As originally enacted, ITSA contained several limitations on liability. First, ITSA provided that no person would be subject to civil penalties solely because he aided and abetted a violation in a manner other than by tipping.³³⁹ Thus, a broker-dealer who executed a trade was not subject to liability under ITSA.³⁴⁰ Second, ITSA provided that the Commission was precluded from utilizing section 20(a) of the Exchange Act, which provides for liability of controlling

330. Pub. L. No. 98-376, 98 Stat. 1264 [hereinafter ITSA]. The legislation also increased the maximum criminal fine established under § 32(a) of the Exchange Act, 15 U.S.C.A. § 78ff (West Supp. 1991), from \$10,000 to \$100,000. *Id.* § 3.

331. *Id.* § 2.

332. *Id.*

333. *Id.*

334. *Id.*

335. *Id.*

336. *Id.*

337. *Id.*

338. See H.R. Rep. No. 355, 98th Cong., 2d Sess. 8, reprinted in 1984 U.S. Code Cong. & Admin. News 2274, 2281.

339. ITSA § 2.

340. See H.R. Rep. No. 355, *supra* note 338, at 2283. The broker-dealer could still be subject to existing administrative and equitable remedies as well as injunctive actions if he was on notice of the violation. *Id.*

persons.³⁴¹ Finally, ITSA expressly rejected a *respondeat superior* theory of liability by providing that no person would be liable for a civil penalty solely by reason of employing another person who was liable for a civil penalty.³⁴²

The Insider Trading and Securities Fraud Enforcement Act of 1988

In the wake of "serious episodes of abusive and illegal practices" on Wall Street,³⁴³ Congress determined to strengthen ITSA by enacting the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).³⁴⁴ Recognizing the lack of resources available to the Commission, Congress designed ITSFEA to provide for an institutional response to the problem of insider trading.³⁴⁵ Specifically, the legislation provides for: (1) increased criminal penalties;³⁴⁶ (2) the initiation of a bounty program to aid the Commission in detecting violations;³⁴⁷ (3) the enactment of section 15(f) of the Exchange Act and section 204A of the Advisers Act to require broker-dealers and investment advisers to establish and enforce policies reasonably designed to prevent misuse of inside information;³⁴⁸ (4) the enactment of section 20A of the Exchange Act to codify a private right of action for contemporaneous traders;³⁴⁹ (5) enhanced Commission authority to cooperate with foreign governmental authorities in the investigation of international securities law violations;³⁵⁰ (6) authorization for the Commission to undertake a study of the adequacy of the present securities laws;³⁵¹ and, perhaps most significantly, (7) expansion of the scope of civil penalties under ITSA to include controlling persons who fail to take adequate steps to prevent insider trading.³⁵²

Under ITSFEA, the Commission may now seek civil penalties against persons who, at the time of a violation, directly or indirectly controlled the person who committed the violation.³⁵³ In order for the Commission to impose such liability, however, it must establish that the controlling person: (1) knew or recklessly disregarded the fact that the controlled person was likely to engage in the violative acts and failed to take appropriate steps to prevent the acts; or (2) knowingly or recklessly failed to establish, maintain, or enforce policies required

341. ITSA § 2.

342. *Id.*; see H.R. Rep. No. 355, *supra* note 338, at 2282.

343. See H.R. Rep. No. 910, 100th Cong., 2d Sess. 7, reprinted in 1988 U.S. Code Cong. & Admin. News 6043, 6044.

344. Pub. L. No. 100-704, 102 Stat. 4677 [hereinafter ITSFEA].

345. H.R. Rep. No. 910, *supra* note 343, at 6051-52.

346. ITSFEA § 4.

347. *Id.* § 3(e); see Exchange Act § 21A(e), 15 U.S.C.A. § 78u-1(e) (West Supp. 1991).

348. ITSFEA § 3(b); see 15 U.S.C.A. § 78u(f) (West Supp. 1991); 15 U.S.C.A. § 80b-4a (West Supp. 1991).

349. ITSFEA § 5; see 15 U.S.C.A. § 78t-1 (West Supp. 1991).

350. ITSFEA § 6.

351. *Id.* § 7.

352. *Id.* § 3; see Exchange Act § 21A(b), 15 U.S.C.A. § 78u-1(b) (West Supp. 1991).

353. *Id.* § 3; see Exchange Act § 21A(a), 15 U.S.C.A. § 78u-1(a)(1)(B) (West Supp. 1991).

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under section 15(l) of the Exchange Act or section 204A of the Advisers Act and this failure substantially contributed to or permitted the occurrence of the violative acts.³⁵⁴

ITSFEA provides that a person will not be subject to a civil penalty solely by reason of employing a person who is subject to a penalty.³⁵⁵ Similarly, ITSFEA's civil penalty provisions do not apply to violations of section 20(a) of the Exchange Act concerning controlling person liability.³⁵⁶ A person who, at the time of the violation, directly or indirectly controls a person who engages in an insider trading violation is subject to a penalty that may not exceed the greater of three times the profit gained or loss avoided or \$1,000,000.³⁵⁷ The legislation further provides that, if the controlled person's violation involved the communication of material non-public information (*i.e.* tipping), the profit gained or loss avoided for purposes of calculating the penalty is limited to the profit gained or loss avoided by the person or persons to whom the controlled person directed such communication.³⁵⁸

Other Civil Money Penalties

The Exchange Act contains two additional civil penalty provisions. First, the Commission may seek civil money penalties of up to \$10,000 against an issuer, and certain persons acting on behalf of an issuer, who violate section 30A(a) of the Exchange Act, the foreign payments provisions of the Foreign Corrupt Practices Act.³⁵⁹

Second, section 32(b) of the Exchange Act authorizes penalties of \$100 per day for each day an issuer fails to file certain required periodic or supplemental reports.³⁶⁰ It appears, however, that Section 32(b) has been used to impose a penalty in only one case.³⁶¹

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