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**An Orientation Program on the U.S. Model
for Regulation and Registration of
Retail Capital Market Intermediaries for
Securities and Exchange Board of India**

**Financial Institutions Reform and
Expansion (FIRE) Project**

September 1996

**Financial Institutions Reform and Expansion (FIRE) Project
US Agency for International Development (USAID/India)
Contract #386-0531-C-00-5010-00
Project #386-0531-3-30069**

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on the
U.S. Model for Regulation and Registration of
Retail Capital Market Intermediaries
for
Securities and Exchange Board of India***

***Price Waterhouse LLP
Mumbai
September 1996***

Price Waterhouse LLP



September 1, 1996

Mr. D. R. Mehta
Chairman
Securities and Exchange Board of India
Mittal Court, B Wing
Nariman Point, Mumbai 400 021.

Dear Mr. Mehta,

**Re: Orientation program for SEBI Senior Executive Director on the U.S.
Regulatory and Registration Model for Retail Market Intermediaries.**

At your request and as a part of our contract with the US AID, Mr. Tom Keyes and Mr. Paul Litteau, consultants to Price Waterhouse Capital Markets, developed and conducted an orientation program for Mr. O. P. Gahrotra, Senior Executive Director, SEBI. The program lasted from May 13, 1996 to May 15, 1996.

Purpose of Activity

The purpose of the program which included meetings with various broker dealers and regulators, was to provide information about the U.S. model for regulation and registration of Retail Capital Market Intermediaries, from which a regulatory and registration system for the Indian Brokers and Sub-brokers can be suggested.

Activities Undertaken

Sessions were scheduled with various types of broker dealer firms i.e. "independent contractors", "fully disclosed" or "introducing broker dealers" and clearing broker dealers to help identify the functioning, duties, risk and exposure, and relative power of each type of broker dealer. Sessions were also arranged with the Chicago office of the NASD and the Chicago Stock Exchange.

Findings and Recommendations

a. Broker dealer arrangements

American Investment Services, an *independent contractor*, and one of the many "hat rack" broker dealer firms offering services to financial professionals wishing

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access to the financial markets, were met with. The firm provides the capital, record keeping, trading and settlement while the registered person provides the sales and supports the physical office. Each has a responsibility to supervise, but the "hat rack" broker dealer is required to supervise the activities of the financial professional. The discussion focused on the balance of power between the financial professional and the "hat rack" firm.

John Dawson and Associates were met as an example of an *introducing or fully disclosed firm*. This firm clears through Bear Stearns for their retail clients. The relationship between Dawson and Bear Stearns, the client confirms and client record keeping functions of Bear Stearns and Dawson and the reason Dawson does not fear the pirating of Dawson accounts by Bear Stearns, were discussed.

Representatives of Mesirow Financial discussed various arrangements. Mesirow is a large Midwest provider of services to financial professionals, with their own corporate finance and origination departments, trading departments, and client servicing departments, in addition to providing services to independent contractors, fully disclosed firms and omnibus firms. The discussion included Mesirow's due diligence before entering into arrangements with other financial professionals, the contracts that are required by the NYSE as a result of Mesirow's membership on that exchange, how contacts between various service providers are usually very similar, the duties of an omnibus firm, and how one broker dealer may have different arrangements for different products.

In addition, NASDAQ trading was observed at Mesirow. The contract of Mesirow for fully disclosed broker dealers is enclosed with this document as Attachment A and Mesirow contract for omnibus broker dealers is attached as attachment B.

Robert B. Cihlar, Sr. of Rosenthal Collins Group, L.P. discussed derivatives operations and supervision in anticipation of the Indian entry into the derivatives market with the NSE's index future.

b. Broker dealer regulation

Jim Moran, the Assistant Director of the Chicago NASD District gave Mr. Gahrotra a tour of the Chicago NASD offices and discussed the relationship of the NASD to the SEC, and the supervision of the District's broker dealers. Mr. Moran spoke of the annual planning session of the SEC and NASD that determined the emphasis of the examinations to be conducted in the year to come. He also spoke of the examiner's training, compensation and retention, the time line of firm's examinations, administrative procedures, sanctions and the time line from discovery in an examination to imposition. The NASD notices on supervision are

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enclosed as Attachment C.

The discussions provided information about the designated examining authority status where one broker dealer has a primary examining authority, and the double function of the SEC examinations, their own regulatory functions, like insider trading rules, and the oversight of the SRO examinations. The SIA presentation on the business relationship of introducing and carrying broker is enclosed as attachment D. Mr. Moran showed Mr. Gahrotra two of several examination modules the NASD use a guides in their broker dealer examination. He was able to observe the degree of detail included in examination modules.

Mr. Moran also demonstrated the computer tracking of the monthly and quarterly broker dealer financial filing, discussed the limits on oversight and emphasized the importance of information sharing between SRO's and other regulatory bodies. The NASD rules of fair practice and brochure are enclosed as attachment E.

c. *Securities validity, custody and collateral and broker dealer financing*

To provide information about the securities lending that is necessary to the functioning of the options market, Alden Jordan of Northern Trust guided us through some of Northern Trust's securities lending operation. Information included not only the matching and delivery of collateral and the use of a third party to provide the holding function, but the use of securities lending in financing broker dealer operations.

Applicability to India securities markets

The balance of power between the introducing broker and the independent contractor and their clearing firms is inherent in the way the markets are structured and function. The legitimacy of the introducing broker and the independent contractor, the contracts under which all parties function, and the need to keep business flowing through the system all help to balance the power between the parties.

The resulting balance allows the retail contact (independent contractor or introducing broker or the Indian sub broker), to be of genuine assistance to their clients in resolving the every day problems of securities industry clients. This balance of power is not available if registration and recognition to all sections of intermediaries is not provided, and that also leads to lack of investor protection and also a limited ability of the intermediary to protect his customers.

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Some of the Indian Sub brokers will be able to enter the system through the current regulatory system, while the regulatory structure may require some adapting for most of the Sub brokers to become part of the system.

Next steps

The U.S. model of an independent self regulatory organization for registration and regulation of retail market intermediaries has relevance to India and our suggestions for the Indian markets include the development of a separate self supporting self regulatory organization for current Sub brokers, perhaps with an affiliation with exchanges similar to the NASDAQ or NASD-R structure in the USA.

Each Indian market participant must qualify and register with one of the system's parts. If a Sub broker cannot organize the resources to register as a separate entity, then that Sub broker must register through a registered entity.

The change in the regulatory framework will require a comprehensive understanding of the current design and the risk and exposure to exchanges, brokers, sub brokers, investors and regulators.

For the success of this project the participation and cooperation of your management and staff is essential. We would like to thank you and your colleagues at SEBI for the time, courtesy and cooperation extended to us during the course of this project.

Please get in touch with us at the FIRE project for any clarifications or further information you may require.

Thanking you,

Yours sincerely,

W. Dennis Grubb
Principal Consultant

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Attachment A.

**Mesirow's contract for fully disclosed broker
dealers**

FULLY DISCLOSED CLEARING AGREEMENT

THIS AGREEMENT is made and entered into this ____ day of _____, 19____ by and between MESIROW FINANCIAL, INC., a Delaware corporation ("MFI"), and _____ ("CORRESPONDENT"), a _____

RECITALS

WHEREAS, MFI offers certain clearing, execution and related services for transactions in securities (which term, for purposes of this Agreement, shall include but not be limited to options on securities or stock indices); and

WHEREAS, CORRESPONDENT desires to introduce accounts ("Introduced Accounts") on behalf of its customers ("Customers") to MFI on a fully-disclosed basis and to obtain such services from MFI; and

WHEREAS, MFI is willing to provide such services solely as agent for, and pursuant to instructions given in accordance with this Agreement from, CORRESPONDENT;

NOW, THEREFORE, in consideration of the premises, and the mutual covenants and agreements hereinafter set forth, MFI and CORRESPONDENT agree as follows:

AGREEMENT

1. **Representations and Warranties of CORRESPONDENT.**

(a) **Legal Compliance.** CORRESPONDENT represents and warrants to MFI that:

- (i) CORRESPONDENT is and at all times during the term of this Agreement shall remain duly registered with the Securities and Exchange Commission ("SEC") as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 and is and shall remain licensed and in good standing as a broker-dealer under applicable state securities laws.
- (ii) CORRESPONDENT is and at all times during the term of this Agreement shall remain a member in good standing of the National Association of Securities Dealers, Inc. ("NASD").
- (iii) CORRESPONDENT has and at all times during the term of this Agreement shall continue to have all requisite authority, whether arising under applicable federal or state laws, rules and regulations or the rules and regulations of any securities exchange to which CORRESPONDENT is subject, and has taken and shall continue to take all requisite action to enter into this Agreement and to retain the services of MFI in accordance with the terms hereof.
- (iv) CORRESPONDENT is and at all times during the term of this Agreement shall remain in compliance with the capital, financial reporting and other requirements of every securities exchange and securities clearing agency of which CORRESPONDENT is

a member, and to the extent required, with the capital, financial reporting and other requirements of the SEC and of every state and other regulatory authority to which it is subject.

- (v) CORRESPONDENT is and at all times during the term of this Agreement shall remain familiar with MFI's clearing procedures, and shall abide by such procedures as may be in effect now and in the future in respect of the Introduced Accounts.
 - (vi) CORRESPONDENT acknowledges and agrees that for purposes of the Securities Investor Protection Act ("SIPC") and the SEC's customer protection rules, CORRESPONDENT'S Customers shall be deemed Customers of MFI and not of CORRESPONDENT.
- (b) **Notice of Non-Compliance.** CORRESPONDENT shall promptly notify MFI if any of the foregoing representations and warranties shall no longer be true and correct in all respects.

2. **Representations and Warranties of MFI.** MFI represents and warrants to CORRESPONDENT that:

- (i) MFI is and at all times during the term of this Agreement shall remain duly registered with the SEC as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 and is and shall remain licensed and in good standing as a broker-dealer under applicable state securities laws.
- (ii) MFI is and at all times during the term of this Agreement shall remain a member in good standing of the NASD.
- (iii) MFI has and at all times during the term of this Agreement shall continue to have all requisite authority, whether arising under applicable federal or state laws, rules and regulations or the rules and regulations of any securities exchange to which MFI is subject, and has taken and shall continue to take all requisite action to enter into this Agreement and to perform its services in accordance with the terms hereof.
- (iv) MFI is and at all times during the term of this Agreement shall remain in compliance with the capital and financial reporting requirements of every securities exchange and securities clearing agency of which MFI is a member, and to the extent required, with the capital and financial reporting and other requirements of the SEC and of every state and other regulatory authority to which it is subject.
- (v) MFI acknowledges and agrees that for purposes of the Securities Investor Protection Act and the SEC's customer protection rules, CORRESPONDENT'S Customers shall be deemed Customers of MFI and not of CORRESPONDENT.

3. **Services of MFI.**

- (a) **Services to be Performed by MFI With Respect to Introduced Accounts.** Subject to the provisions of Sections 3(b) and 3(c) below, MFI shall perform the following services, as agent for CORRESPONDENT on a fully-disclosed basis, with respect to the Introduced Accounts:

- (i) Execution of orders for CORRESPONDENT's Customers in accordance with MFI's written execution procedures; provided, however, that execution of orders for OTC securities shall be provided only on a best efforts basis and shall otherwise be subject to the limitations specified in Section 3(e)(i) below.
- (ii) Unless CORRESPONDENT elects and MFI consents to CORRESPONDENT'S election to handle the mailing of confirmations by initialing the space provided below or by delivering written notice of election to MFI at a later date, preparation and mailing of confirmations to CORRESPONDENT's Customers, with a duplicate of each confirmation simultaneously sent to CORRESPONDENT, which confirmations will be on MFI forms with CORRESPONDENT'S name and address on top and bear a statement that the order was "cleared through MFI" (it being understood MFI reserves the right to decline to handle the billing for new issue underwriting in which CORRESPONDENT serves as managing underwriter).

CORRESPONDENT ELECTS TO HANDLE ITS OWN MAILING OF CONFIRMATIONS TO CORRESPONDENT'S CUSTOMERS FROM DATA SUPPLIED BY MFI.

_____ (Please initial)

- (iii) Preparation and mailing of monthly or quarterly statements, as may be appropriate, to CORRESPONDENT's Customers, with a duplicate of each statement simultaneously sent to CORRESPONDENT.
- (iv) Settlement of open contracts and transactions in securities for Introduced Accounts.
- (v) Handling of proxy materials with respect to securities held by MFI for CORRESPONDENT's Customers in compliance with the applicable rules and regulations of every securities exchange or other regulatory organization to which MFI is subject.
- (vi) Performance of all cashiering functions for the Introduced Accounts (other than those functions described in clause (A) and/or (B) below if CORRESPONDENT elects and MFI consents to CORRESPONDENT'S election to perform those functions itself by initialing the space provided below or by delivering written notice of election to MFI at a later date), including but not limited to:
 - (A) receipt and delivery of securities purchased, sold, borrowed and loaned;
 - (B) receipt and transmittal of payments for securities purchased, sold, borrowed or loaned;
 - (C) handling of margin accounts including extension of credit, charging of interest, collection of additional margin, and re-hypothecation and lending of Customer securities, all in conformity with the requirements of Regulation T of the Board of Governors of the Federal Reserve System;
 - (D) collection of, and crediting of Introduced Accounts with, dividends and interest;

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- (E) processing of exchange offers, rights offers and tender offers, and conversion of convertible bonds and convertible stock, but only insofar as instructions for such items are transmitted by CORRESPONDENT to MFI;
 - (F) maintenance of required books and records in accordance with the provisions of SEC Rule 17(A)(3) and (4) and all other applicable laws, rules and regulations; and
 - (G) making the quarterly securities examinations, counts, verifications and comparisons required by SEC Rule 17a-13.
- (vii) With respect to Introduced Accounts that are margin accounts:
- (A) notification of CORRESPONDENT when margin calls are made; and
 - (B) maintenance of daily records of required margin and other information specified by New York Stock Exchange ("NYSE") Rule 432(a) and all other applicable rules and regulations covering margin transactions of the NASD, the SEC, the Board of Governors of the Federal Reserve System and other securities exchanges.

All transactions under this Agreement shall be subject to MFI's house rules and policies applicable to its correspondent broker/dealers generally, including without limitation, credit policies, house margin requirements, margin interest rates, and policies regarding concentration of positions in thinly-traded securities.

- (b) **Right to Decline to Perform Services With Respect to Particular Introduced Accounts.** MFI may, in its sole discretion, after giving reasonable prior notice to CORRESPONDENT, refuse to open an Introduced Account for a specific Customer; close an Introduced Account already opened; refuse to confirm and/or cancel a confirmation; reject a delivery or receipt of securities or money; or refuse to execute any trade for any Introduced Account. The exercise by MFI of any of the foregoing rights with respect to any Customer shall not be deemed to confer upon MFI any of the responsibilities of CORRESPONDENT set forth in Section 4 below, including without limitation the duties set forth in Section 4(c).
- (c) **Use of Service Bureaus.** MFI may in its sole discretion, after giving reasonable prior notice to CORRESPONDENT, retain one or more independent data processing service bureaus to perform any of MFI's services under this Agreement (other than as specified in Section 3(a)(i) and 3(a)(vi) above). MFI shall not be responsible for any losses, damages, liability or expenses incurred by or claims made by CORRESPONDENT or its Customers arising from the failure of any such service bureau to perform such services accurately, in accordance with specifications or within the customary time periods. MFI's only obligation will be to cause any such service bureau to correct any processing errors and to deliver any overdue work as soon as reasonably practicable. In no event shall MFI be responsible for indirect or consequential damages caused by any act or omission of any such service bureau.
- (d) **Access to Information.** MFI will afford access to its books and records pertaining to the Introduced Accounts by:
 - (i) Authorized officers or representatives of CORRESPONDENT.

- (ii) Any governmental agency, exchange or association having regulatory jurisdiction over the affairs of CORRESPONDENT.
- (iii) Any firm of independent public accountants conducting an audit of the financial statements of CORRESPONDENT and its operations and affairs.

MFI will exercise reasonable care to prevent access by unauthorized persons to information relating to CORRESPONDENT, its Customers and the Introduced Accounts and will hold confidential, except as otherwise provided above or as required by valid court or administrative process, any such information not otherwise publicly available.

- (e) **Reporting of Financial Information.** MFI will supply Correspondent unaudited semi-annual and audited annual financial statements.
- (f) **Services Not to be Performed by MFI.** Unless otherwise expressly agreed in writing, MFI shall be responsible only for those services described in Section 3(a) above. Without limiting the foregoing, MFI shall not provide nor be responsible for providing any of the following services:
 - (i) Accounting, bookkeeping or record keeping or any other services with respect to commodity transactions, foreign currency transactions or any transactions other than a transaction in securities for which a recognized public market exists, or monitoring open orders on OTC securities.
 - (ii) Preparation of CORRESPONDENT's payroll records or financial statements or of any analysis thereof.
 - (iii) Preparation or issuance of checks in payment of CORRESPONDENT's expenses, other than expenses incurred by MFI on behalf of CORRESPONDENT pursuant to this Agreement.
 - (iv) Payment of commissions to account executives for CORRESPONDENT.
 - (v) Making of reports to the SEC, any state securities commission, any securities exchange, the NASD or any other self-regulatory organization to which CORRESPONDENT is subject; provided, however, that MFI will, at the request of CORRESPONDENT, furnish CORRESPONDENT any information and data contained in records kept by MFI necessary to enable CORRESPONDENT to make such reports.
 - (vi) Rendering investment advice, suggesting investment products, reviewing investment objectives or providing investment counseling to any of the Customers of CORRESPONDENT, which matters shall be the sole and exclusive responsibility of CORRESPONDENT, and with respect to which matters MFI shall not have any responsibility or liability.
 - (vii) Performing any of the responsibilities of CORRESPONDENT set forth in Section 4 below.

4. **Responsibilities of Correspondent.**

- (a) **Documentation for Introduced Accounts.** CORRESPONDENT shall be responsible for:

- (i) Preparing a new account input form, reasonably acceptable to MFI, for use with each of CORRESPONDENT'S Customers pertaining to the Customer's Introduced Accounts;
 - (ii) Prior to requesting MFI to perform services with respect to any Introduced Account for a Customer:
 - (A) obtaining such financial and other information regarding the Customer, in such form, as MFI may reasonably require; and
 - (B) furnishing to the Customer, in form and substance reasonably satisfactory to MFI, written disclosure of the existence of this Agreement, the agency relationship between MFI and CORRESPONDENT hereunder, and the limitations on MFI's responsibilities and liability hereunder.
 - (iii) For any Introduced Account that is a margin account:
 - (A) obtaining and furnishing to MFI a fully executed customer's margin agreement and consent to loan of securities in form provided by MFI (it being understood that any transaction for a Customer will be considered a cash transaction until such time the agreement has been furnished to MFI); and
 - (B) sending to the Customer, at the time the margin account is opened, a written statement in compliance with Rule 10b-16 under the Securities and Exchange Act of 1934.
 - (iv) So long as MFI is performing services hereunder with respect to any Introduced Account for a Customer:
 - (A) keeping current with respect to any information regarding the Customer obtained pursuant to Section 4(a)(ii) above; and
 - (B) keeping MFI informed of any changes in such information that may affect MFI's performance of services hereunder, including without limitation, Customer address changes.
- (b) **Maintenance of and Access to Information.** CORRESPONDENT shall maintain in its files all documents and information obtained pursuant to Section 4(a)(ii), (iii) and (iv) above and shall, upon request, furnish copies of any such documents and information to, and permit inspection of any such documents or information by, MFI or its designee.
- (c) **Conduct of Customer Accounts.** CORRESPONDENT acknowledges and agrees that it has sole responsibility for "knowing the customer" and determining the "suitability" on all investments and transactions for its Customers in accordance with the requirements of NYSE Rule 405 and any comparable requirements of any other applicable exchange or self-regulatory organization. Without limiting the generality of the foregoing, CORRESPONDENT shall be responsible for:
- (i) Using due diligence to learn the essential facts relative to every Customer, every Introduced Account (whether a cash or margin account), every order for an

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Introduced Account and every person holding a power of attorney over any Introduced Account.

- (ii) Diligently reviewing and supervising the handling of Introduced Accounts, including discretionary accounts, by CORRESPONDENT's registered representatives.
 - (iii) Ascertaining that persons entering orders and issuing instructions to CORRESPONDENT or MFI with respect to Introduced Accounts do so upon proper authority.
 - (iv) Obtaining required approvals for, and handling and supervising, Introduced Accounts for employees or officers of exchange or NASD members, self-regulatory organizations and other financial institutions except employees, agents or officers of MFI.
- (d) **Placing of Orders.** Orders for an Introduced Account shall be placed by CORRESPONDENT only with MFI unless CORRESPONDENT gives MFI prior notice of CORRESPONDENT'S intention to place orders with a third party and MFI consents.
- (e) **Restricted Securities.** CORRESPONDENT shall comply with all rules and regulations relating to the sale of "control" or "restricted" securities under SEC Rules 144 and Rule 144A and any successor rules and regulations.
- (f) **Notification of Discrepancies.** CORRESPONDENT shall, upon receipt of Customers' monthly and quarterly statements, examine the same and promptly notify MFI of any errors or discrepancies which it discovers as a result of such examination and shall promptly bring to the attention of MFI any errors in such confirmations or monthly statements claimed by any Customer.
- (g) **Delivery of Money and Securities.** CORRESPONDENT agrees to cause its Customers to deliver directly to MFI all funds and securities relating to the Introduced Accounts. Concurrently with the delivery of such funds or securities to MFI, CORRESPONDENT will furnish MFI such information as may be relevant or necessary to enable MFI promptly to record receipt of such funds and securities in the proper Introduced Accounts.
- (h) **Financial Responsibility for Customers.** CORRESPONDENT shall be responsible to MFI for unpaid debits in Introduced Accounts not fully covered by collateral and for any loss sustained by MFI if any Customer of CORRESPONDENT fails to make payment for securities purchased or to meet any initial margin call or margin maintenance call (collectively referred to as "Unpaid Customer Obligations").
- (i) **Use of MFI's Name.** CORRESPONDENT shall submit to MFI for written approval in advance of use all advertising, signs, brochures or other sales promotion materials, in whatever form (collectively, "sales materials") that use the name MESIROW FINANCIAL, INC., any variation or abbreviation of MESIROW FINANCIAL, INC., or any other corporate or trade name now or hereinafter used by MFI. MFI reserves the right to change the name under which it conducts its clearing business, and CORRESPONDENT agrees to begin using such changed name in all sales materials within such time period as MFI may reasonably require.

- (j) **Confidentiality.** CORRESPONDENT will hold confidential, except as otherwise required by valid court or administrative process, any information not otherwise publicly available regarding MFI and its business and affairs that CORRESPONDENT may acquire as a result of this Agreement.
- (k) **Reporting of Financial Information.** CORRESPONDENT will promptly supply copies of the following:
 - (i) Concurrently with filing:
 - (A) Any FOCUS or other financial reports required to be filed with the SEC, the NASD or any securities exchange of which it is a member;
 - (B) Any filing with the SEC, the NASD, any securities exchange or any state agency providing notice of non-compliance with applicable capital and/or financial requirements; and
 - (C) Any amendment to its Form BD.
 - (ii) Within 10 days after issuance or receipt:
 - (A) a copy of its audited annual financial statement; and
 - (B) any order or decree issued by the SEC, the NASD, any securities exchange or any state agency imposing a material sanction on CORRESPONDENT or any of its officers or employees (involving a monetary fine equal to or greater than \$15,000, a suspension of or expulsion from membership, and/or a suspension or revocation of any registration or license.
- (l) **Handling of Customer Inquiries and Complaints.** CORRESPONDENT shall be responsible for the receipt and initial review of Customer inquiries and complaints relating to Introduced Accounts. If the inquiry or complaint relates to services rendered by MFI under this Agreement, CORRESPONDENT shall direct the inquiry or complaint to MFI's compliance department for resolution, and MFI shall send a written notice of such resolution to CORRESPONDENT. If the inquiry or complaint relates to responsibilities of CORRESPONDENT under this Agreement, CORRESPONDENT shall resolve the inquiry or complaint and, if such inquiry or complaint also relates to MFI, send written notice of such resolution to MFI.
- (m) **Handling of Other Instructions, Inquiries and Complaints.** Each party shall promptly transmit to the other upon receipt all instructions, orders, requests or complaints from regulatory bodies (including without limitation the SEC, NASD or any applicable securities exchange) which are not solely related to the performance by the receiving party of its services or responsibilities hereunder. The parties shall cooperate with one another in responding to such instructions, orders or requests or in resolving such complaints.

6. **Compensation; Settlement Account; Risk Deposit Account; Reserve for Bad Debt Account.**

- (a) **Compensation to MFI.** To compensate MFI for services performed under this Agreement, CORRESPONDENT shall pay to MFI the fees for maintenance of the

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Introduced Accounts and for transactions in the Introduced Accounts, including the minimum aggregate fee per annum, set forth in Exhibit A hereto. It is understood that MFI may change such fees at any time upon 45 business days prior notice to CORRESPONDENT; provided, however, that changes to the minimum aggregate fee per annum shall be effective only on an anniversary date of this Agreement. Fees shall be paid to MFI as provided in Section 6(b) below.

- (b) **Settlement Account.** MFI shall maintain on its books a settlement account for CORRESPONDENT ("Settlement Account") which shall be:
- (i) credited, promptly upon receipt, with all commissions due CORRESPONDENT from its Customers and any other amounts collected by MFI upon CORRESPONDENT's behalf, less any amounts credited to the Reserve for Bad Debt Account maintained pursuant to Section 6(f) below;
 - (ii) charged with the amount of any distributions to CORRESPONDENT (including advances made pursuant to Section 6(c)); and
 - (iii) charged with all amounts due MFI from CORRESPONDENT hereunder, subject to the following terms:
 - (A) any compensation due pursuant to Section 6(a) above shall be charged against the Settlement Account monthly;
 - (B) any amounts due to reimburse MFI for any costs and expenses incurred pursuant to Section 7(c) below as a result of CORRESPONDENT's failure to provide MFI with indemnification to which MFI is entitled (including without limitation any amounts related to costs and expenses incurred by MFI in legal proceedings to enforce CORRESPONDENT's indemnification obligations) shall be charged against the Settlement Account when incurred by MFI; and
 - (C) any other amounts due MFI under this Agreement shall be charged against the Settlement Account when the payment obligation is incurred.
- (c) **Payment of Net Credit or Debit Balances in Settlement Account.** Any net credit balance in the Settlement Account at the end of any month shall be distributed to CORRESPONDENT as soon as practicable following the close of such month; provided, however, that MFI shall be allowed to retain any such credit balance to cover potential charges against the Settlement Account pursuant to Section 6(b)(iii) above that MFI reasonably believes will mature and be chargeable against the Settlement Account. Any net debit balance in the Settlement Account at the end of any month shall be paid to MFI by CORRESPONDENT immediately upon demand. MFI, in its discretion, based on its experience with the Introduced Accounts, may make on the 15th day (or the immediately preceding business day) of any month an advance payment of CORRESPONDENT'S estimated credit balance for that month.
- (d) **Failure to Pay Net Debit Balances.** In the event that CORRESPONDENT fails to timely pay the amount of any net debit balance in the Settlement Account:

- (i) MFI shall be entitled to offset the amount due against any other account or assets of CORRESPONDENT held by MFI, including without limitation the Risk Deposit Account required to be maintained under Section 6(e) below.
- (ii) Any amount which is not so offset shall bear interest at the Broker Call Rate as announced from time to time by The Wall Street Journal until paid.

Any failure by MFI to charge such accounts or assets or to demand payment of interest shall not act as a waiver of MFI's right to demand payment or to charge CORRESPONDENT'S accounts or assets for, or demand interest on, the full amount due at any time.

- (e) **Risk Deposit Account.** To secure CORRESPONDENT's obligation under Section 6(c) above to pay any net debit balance in the Settlement Account at the end of any month immediately upon demand and to cover any insufficiency in the Reserve for Bad Debt Account, CORRESPONDENT shall, on or prior to the execution of this Agreement, deposit \$ _____ in cash, government securities or a combination of cash and government securities in an account in its name at MFI (the "Risk Deposit Account"). MFI may increase the amount CORRESPONDENT is required to maintain in the Risk Deposit Account by providing written notice of such increase to CORRESPONDENT, and CORRESPONDENT agrees to deposit sufficient additional cash or government securities into the Risk Deposit Account to comply with such increase within five business days after receipt of such notice. In the event of any offset against the Risk Deposit Account pursuant to Paragraph 6(d) above, CORRESPONDENT shall promptly deposit in the Risk Deposit Account cash or government securities sufficient to bring the value of such account back to the level required pursuant to this Section 6(e). For purposes of this Section 6(e), "government securities" shall include only direct obligations issued or guaranteed as to principal and interest by the federal government of the United States.
- (f) **Reserve for Bad Debt Account.** To secure CORRESPONDENT'S payment of Unpaid Customer Obligations under 4(h) above, MFI shall maintain on its books a Reserve for Bad Debt Account. MFI shall credit to the Reserve for Bad Debt Account, from commissions due CORRESPONDENT from CORRESPONDENT'S Customers and any other amounts collected by MFI upon CORRESPONDENT's behalf, an amount equal to any debits of CORRESPONDENT'S customers. The Reserve for Bad Debt Account shall be charged by MFI with the amount of any Unpaid Customer Obligations at such time or times as it may determine appropriate. In the event that amounts credited to the Reserve for Bad Debt Account are insufficient to cover Unpaid Customer Obligations, MFI may charge CORRESPONDENT'S Settlement Account and/or Risk Deposit Account.

7. **Indemnification.**

- (a) **CORRESPONDENT's Indemnification Obligation.** CORRESPONDENT hereby agrees to indemnify, defend and hold harmless MFI from and against all claims, demands, proceedings, suits and actions made or brought against MFI and all of MFI's liabilities, losses, damages, sanctions, judgments, expenses, attorneys' fees and costs (collectively, "claims") arising out of one or more of the following:
 - (i) Failure of CORRESPONDENT or any of CORRESPONDENT'S Customers to make payment when due for securities purchased for an Introduced Account.

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- (ii) Failure of CORRESPONDENT or any of CORRESPONDENT's Customers to deliver when due any securities sold for an Introduced Account.
 - (iii) Failure of CORRESPONDENT or any of CORRESPONDENT's Customers to meet any initial or maintenance margin call.
 - (iv) Failure of CORRESPONDENT or any of CORRESPONDENT's Customers to make delivery of or payment for securities to MFI upon exercise of options in any Introduced Account.
 - (v) Failure of CORRESPONDENT or any of CORRESPONDENT's Customers upon MFI's demand to cover any short call or long put option contract.
 - (vi) Any adverse claims with respect to any Customer securities delivered or cleared by MFI.
 - (vii) MFI's guarantee of any signature with respect to transactions in any Introduced Account.
 - (viii) Default or error by any broker-dealer other than MFI (including without limitation over-the-counter brokers) with whom CORRESPONDENT executes a transaction on behalf of itself or a Customer for any Introduced Account.
 - (ix) Failure of CORRESPONDENT to satisfy or perform properly any of its other responsibilities under this Agreement (including without limitation failure to satisfy or perform properly its responsibilities under Sections 4(a) and 4(c) hereof) or commission by CORRESPONDENT of any error for which CORRESPONDENT is responsible under the terms of this Agreement.
 - (x) Any claim by any of CORRESPONDENT's Customers based on conduct or omissions of CORRESPONDENT or any third-party broker-dealer (including without limitation over-the-counter brokers) or arising from the clearing relationship between CORRESPONDENT and MFI except to the extent such claim has resulted from MFI's gross negligence or willful misconduct.
 - (xi) Any dishonest, fraudulent, negligent or criminal act or omission on the part of any of CORRESPONDENT's officers, partners, employees, agents or Customers.
 - (xii) Breach by CORRESPONDENT of any representation or warranty made by it under this Agreement.
- (b) **MFI's Indemnification Obligation.** MFI hereby agrees to indemnify, defend and hold harmless CORRESPONDENT from and against all claims, demands, proceedings, suits and actions made or brought against CORRESPONDENT and all of CORRESPONDENT's liabilities, losses, damages, sanctions, judgments, expenses, attorneys' fees and costs (collectively, "claims") arising out of any dishonest, fraudulent, grossly negligent or criminal act on the part of any of MFI's officers, employees or agents, including any such act committed in any transaction in which any such officer, employee or agent is acting as agent or attorney-in-fact for CORRESPONDENT pursuant to resolution, powers of attorney or other authorization by CORRESPONDENT.

- (c) **Indemnification Procedure.** Promptly upon receipt of notice of any claim with respect to which either MFI or CORRESPONDENT is entitled to indemnification under Section 7(a) or 7(b) above (the "Indemnified Party") by the other party (the "Indemnifying Party"), the Indemnifying Party shall institute defense of such claim, at its sole expense, using counsel reasonably acceptable to the Indemnified Party. The Indemnifying Party shall keep the Indemnified Party informed of the status of defense of such claim, and the Indemnifying Party shall not agree to any settlement without the consent of the Indemnified Party, which shall not unreasonably be withheld. If within 10 days after receiving notice of such claim the Indemnifying Party shall fail to properly institute the defense of such claim, the Indemnified Party shall have the right to defend against the same at the Indemnifying Party's cost and expense or, in its sole discretion, to settle the same at the Indemnifying Party's cost and expense. In the event that the Indemnified Party is required to institute legal proceedings to enforce the Indemnifying Party's indemnification obligations, the Indemnified Party shall be entitled to recover from the Indemnifying Party its costs and expenses, including attorneys' fees, incurred in such proceedings.

8. **Term and Termination.**

- (a) **Term.** The term of this Agreement shall commence on the later of (i) the date hereof or (ii) if required, the date this Agreement is approved by the New York Stock Exchange. _____ will honor this agreement ___ year(s) from the date hereof.
- (b) **Right to Terminate.** This Agreement may be terminated:
- (i) MFI, upon 30 days written notice, by registered or certified mail, to the other party.
- (ii) Immediately by either party, in its discretion, if any representations, warranties, duties, responsibilities or obligations of the other party shall not be true or duly performed or shall cease to become true or duly performed; provided, however, that the failure of either party to terminate this Agreement shall not be deemed acquiescence in the other party's misrepresentations or failure to perform its duties, responsibilities or obligations and shall not preclude such party from subsequently terminating this Agreement.
- (c) **Obligation to Pay Minimum Annual Fee Upon Termination.** If CORRESPONDENT terminates this Agreement pursuant to Section 8(b)(i) above prior to the end of any year and, as of the effective date of termination, MFI has not yet received the minimum aggregate fee of _____ for such year specified in Section 6(a), the unpaid balance of the minimum aggregate fee shall be due and payable as of the effective date of termination.
- (d) **Survival of Rights.** MFI shall be entitled to retain any credit balances in the Settlement Account, the Risk Deposit Account or the Reserve for Bad Debt Account on the effective date of termination hereof, and MFI's right of setoff against such amounts hereunder shall continue, as long as there remain any unsettled transactions or outstanding obligations from CORRESPONDENT to MFI in respect to any Introduced Account.
- (e) **Transfer of Introduced Accounts.** If MFI terminates this Agreement, MFI, at CORRESPONDENT's request, shall reasonably assist CORRESPONDENT in transferring the Introduced Accounts to another broker-dealer designated by CORRESPONDENT.

CORRESPONDENT agrees to pay MFI the usual and customary fees charged by MFI for the transfer of each Introduced Account.

9. **Employment Restrictions.** During the term of this Agreement, and for a period of one year thereafter, neither party nor any of its affiliates shall, without the written consent of the other party, hire or attempt to hire any person:

- (i) who is employed by the other party or its affiliates on the effective date of termination of this Agreement, or
- (ii) whose employment with such other party or its affiliates terminated within the one year period prior to the termination of this Agreement.

10. **General Provisions.**

- (a) **Exclusivity.** CORRESPONDENT agrees that during the term of this Agreement MFI will be the exclusive clearing broker for CORRESPONDENT except with respect to transactions not covered by the scope of this Agreement or accounts rejected by MFI. MFI reserves the right to enter into similar agreements with other broker-dealers on terms and conditions which may vary from those herein.
- (b) **Governing Law.** This Agreement shall be construed and enforced under and in accordance with the internal laws of the State of Illinois without regard to the provisions thereof relating to the conflict of laws.
- (c) **Headings.** The headings for each Section of this Agreement are for descriptive purposes only and shall not be deemed to modify or qualify any of the provisions of such Section.
- (d) **Relationship of Parties.** Neither this Agreement nor the performance of services hereunder shall be considered to create a joint venture or partnership between MFI and CORRESPONDENT or between CORRESPONDENT and other broker-dealers for whom MFI may perform the same or similar services.
- (e) **Binding Effect.** This Agreement shall be binding upon and inure to the benefit of MFI and CORRESPONDENT and their respective successors, assignees and transferees of every kind; provided, however, that no assignment or transfer shall be binding without the prior written approval of the other party. This Agreement shall not be construed as creating any rights in any third parties who are not parties hereto (including without limitation any Customers of CORRESPONDENT).
- (f) **Entire Agreement; Amendments.** This Agreement represents the entire agreement between the parties with respect to the subject matter contained herein. This Agreement may be amended, and provisions hereof may be waived, only by writing signed by the party against whom enforcement of the amendment or waiver is sought.
- (g) **Modification by Applicable Rule or Law.** All transactions which MFI executes for any Introduced Account shall be subject to the constitution, by-laws, rules, regulations, customs, usages, rulings and interpretations of any relevant marketplace or clearing agency and to all applicable governmental laws and regulations (collectively referred to as any "rule or law"), and MFI shall not be liable to CORRESPONDENT or any of CORRESPONDENT's Customers as a result of any action taken by MFI or its agents to

comply therewith. Whenever any rule or law shall be enacted, prescribed or promulgated which shall affect in any manner or be inconsistent with any of the provisions hereof, the provisions of this Agreement so affected shall be deemed modified or superseded, as the case may be, by such rule or law, and all other provisions of this Agreement and any provisions as modified shall in all respects continue in full force and effect.

- (h) **Partial Invalidity.** If any provision of this Agreement is held invalid or unenforceable, the remainder of the Agreement shall nevertheless remain in full force and effect. If any provision is held invalid or unenforceable with respect to particular circumstances, such provision shall nevertheless remain in full force and effect in all other circumstances.
- (i) **Force Majeure.** MFI shall not be liable for any default resulting from any circumstances beyond its reasonable control, including without limitation computer malfunctions, labor disputes, natural disasters and acts of God.
- (j) **Dispute Resolution.** In the event that any dispute arises under this Agreement, the parties shall in good faith attempt to settle such dispute. If settlement of a dispute relating to a transaction in the Account is not possible, the parties agree to submit the dispute to arbitration through the facilities of the marketplace (NASD or securities exchange) on which the transaction giving rise to the dispute arose. Any other disputes under this Agreement shall be resolved in a court of competent jurisdiction located in Chicago, Illinois and the parties hereby waive any objections to such venue.
- (k) **Notices.** Except as otherwise specifically provided herein, notices hereunder may be given by personal delivery, telecopy, or registered or certified mail and shall be deemed given when actually received. Notices to either party shall be sent to the address set forth opposite its name on the signature page hereof or to such other address as such party shall notify the other in writing.

* * * * *

IN WITNESS WHEREOF, the parties have hereunto affixed their hands as of the day and year first above written.

Address for Notice:

Attention: _____
Telecopier: _____

(Name of CORRESPONDENT)

By: _____

(Printed Name)

(Title)

Address for Notice:
350 North Clark Street
Chicago, Illinois 60610

Attention: _____
Telecopier: (312) 670- _____

MESIROW FINANCIAL, INC.

By: _____

(Printed Name)

(Title)

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Attachment B.

Mesirow's contract for omnibus broker dealers

**OMNIBUS SECURITIES CLEARING AGREEMENT
(U.S. Dealer)**

THIS AGREEMENT is made and entered into this ____ day of _____, 19____
by and between MESIROW FINANCIAL, INC., a Delaware corporation ("MFI"), and
_____ ("Dealer"), a _____.

RECITALS

WHEREAS, MFI offers certain securities clearing and execution services; and

WHEREAS, Dealer desires to establish an Omnibus Securities Clearing Account ("Account") with MFI through which Dealer will avail itself of such services on behalf of its customers;

NOW, THEREFORE, in consideration of the premises, and the mutual covenants and agreements hereinafter set forth, MFI and Dealer agree as follows:

AGREEMENT

1. Representations and Warranties of Dealer.

(a) **Legal Compliance.** Dealer represents and warrants to MFI that:

(i) Dealer is and at all times during the term of this Agreement shall remain duly registered with the Securities and Exchange Commission ("SEC") as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 and is and shall remain licensed and in good standing as a broker-dealer under applicable state securities laws.

(ii) Dealer is and at all times during the term of this Agreement shall remain a member in good standing of the National Association of Securities Dealers, Inc. ("NASD").

(iii) Dealer has and at all times during the term of this Agreement shall continue to have all requisite authority, whether arising under applicable federal or state laws, rules and regulations or the rules and regulations of any securities exchange to which Dealer is subject, and has taken and shall continue to take all requisite action to enter into this Agreement and to retain the services of MFI in accordance with the terms hereof.

(iv) Dealer is and at all times during the term of this Agreement shall remain in compliance with the capital and financial reporting requirements of every securities exchange and securities clearing agency of which Dealer is a member, and to the extent required, with the capital and financial reporting requirements of the SEC and of every state and other regulatory authority to which it is subject.

(v) Dealer is and at all times during the term of this Agreement shall remain familiar with MFI's clearing procedures, and shall abide by such procedures as may be in effect now and in the future in respect of the Account.

(vi) All securities carried in the Account will be carried for the account of Dealer's customers, and any short sales effected in the Account shall be short sales effected on behalf of Dealer's customers.

For purposes of this Agreement, the term "customer" shall not include any general or special partner or any director or officer of Dealer, or any participant in any joint, group or syndicate account with Dealer or with any partner, officer or director of Dealer.

(b) Notice of Non-Compliance. Dealer shall promptly notify MFI and shall forthwith discontinue effecting transactions in the Account if any of the foregoing representations and warranties shall no longer be true and correct in all respects.

2. Representations and Warranties of MFI. MFI represents and warrants to Dealer that:

(a) MFI is and at all times during the term of this Agreement shall remain duly registered with the SEC as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 and is and shall remain licensed and in good standing as a broker-dealer under applicable state securities laws.

(b) MFI is and at all times during the term of this Agreement shall remain a member in good standing of the NASD.

(c) MFI has and at all times during the term of this Agreement shall continue to have all requisite authority, whether arising under applicable federal or state laws, rules and regulations or the rules and regulations of any securities exchange to which MFI is subject, and has taken and shall continue to take all requisite action to enter into this Agreement and to perform its services in accordance with the terms hereof.

(d) MFI is and at all times during the term of this Agreement shall remain in compliance with the capital and financial reporting requirements of every securities exchange and securities clearing agency of which MFI is a member, and to the extent required, with the capital and financial reporting requirements of the SEC and of every state and other regulatory authority to which it is subject.

3. Services of MFI.

(a) Services to be Performed by MFI. MFI shall perform the following services with respect to the Account:

- (i) Execution of orders for the Account pursuant to Dealer's instructions; provided, however, that MFI reserves the right at any time to reject any order for the Account.
- (ii) Settlement of contracts and transactions in securities.
- (iii) Holding in one or more properly established accounts securities under the control of MFI.
- (iv) Preparation and mailing of trade confirmations to the Dealer, which confirmations may be in the form of a summary trade list and shall contain the information required to be furnished on confirmations in accordance with all applicable laws, rules and regulations.

For purposes of this Agreement, the term "securities under the control of MFI" shall mean those securities maintained in the Account where both of the following conditions are satisfied: (A) Dealer has instructed MFI to maintain physical possession or control of such securities free of any charge, lien or claim of any kind in favor of MFI or any persons claiming through MFI, and (B) MFI within 24 hours after receipt of such instruction has informed Dealer in writing or in form acceptable to both parties that it accepts such instruction.

(b) Services Not to be Performed by MFI. Unless otherwise expressly agreed in writing, MFI shall be responsible only for those services described in Section 3(a) above. Without limiting the foregoing, MFI shall not provide nor be responsible for providing any of the following services:

- (i) Accounting, bookkeeping or record keeping, cashiering or other services in respect to commodity transactions or any other transactions not involving securities.
- (ii) Preparation of Dealer's payroll records, financial statements or any analysis thereof.
- (iii) Preparation or issuance of checks in payment of Dealer's expenses, other than expenses incurred by MFI on behalf of Dealer pursuant to this Agreement.
- (iv) Payment of commissions to Dealer's salesmen.
- (v) Preparation or filing of any of Dealer's reports to the SEC, any state securities commission or any securities exchange, securities association or other membership association to which Dealer is subject.
- (vi) Performance of any of the responsibilities of Dealer set forth in Section 4 or 5 below.

4. Non-Financial Responsibilities of Dealer.

(a) Conduct of Customer Accounts. Dealer shall be solely responsible for the conduct of its customer accounts, including, but not limited to, obtaining all papers required for the opening and operation of such accounts; determining the suitability of all transactions therein; establishing the authenticity of all orders and the genuineness of all certificates and papers; obtaining all necessary authorizations and maintaining all required records in respect of discretionary accounts; and furnishing all required confirmations and statements of account to customers.

(b) Notification of Trade Discrepancies. Dealer shall reconcile its internal position records with the confirmations provided by MFI under Section 3(a) above and notify MFI within one day after receipt of the confirmations of any discrepancies.

(c) Margin. Dealer shall comply and assure that its customers comply with all applicable margin requirements.

(d) Consent to Hypothecation. Dealer acknowledges and agrees that MFI may lend, pledge or hypothecate any or all of the securities in the Account (other than securities in the control of MFI), whether separately or in common with other money, securities or other property, as MFI in its sole discretion shall deem appropriate. Dealer shall obtain from each of its customers all necessary authorization to such lending, pledge and hypothecation.

(e) **Reporting.** Dealer shall be responsible for providing MFI with copies of the following:

(i) Concurrently with filing:

(A) Any FOCUS or other financial reports required to be filed with the SEC, the NASD or any securities exchange of which it is a member;

(B) Any filing with the SEC, the NASD, any securities exchange or any state agency providing notice of Dealer's non-compliance with applicable capital and/or financial requirements; and

(C) Any amendment to Dealer's Form BD.

(ii) Within 10 days after issuance or receipt:

(A) a copy of Dealer's audited annual financial statement; and

(B) any examination report issued by SEC, the NASD, any securities exchange or any state agency.

5. **Financial Responsibilities of Dealer.**

(a) **Acknowledgment of Risk.** Dealer acknowledges and agrees that all transactions effected in the Account are at the Dealer's risk.

(b) **Deposit of Margin.** Dealer shall deposit with MFI such initial or maintenance margin with respect to transactions in the Account as MFI in its sole discretion may require, irrespective of whether Dealer shall have received payment from its customers. It is understood that MFI may revise or amend its margin requirements at any time and without prior notice to Dealer.

(c) **Clearing and Settlement Instructions.** Dealer shall provide MFI with written or oral instructions for settling and clearing securities transactions, including but not limited to instructions to accept or deliver securities, make payment for securities or transfer funds out of or into the Account.

(d) **Delivery of and Payment for Securities.** Dealer shall be responsible for acceptable deliveries to MFI of securities sold for the Account and for payment to MFI of securities purchased for the Account, irrespective of whether Dealer shall have received delivery or payment from its customers.

(e) **Payment of Debit Balances.** Dealer shall pay on demand all debit balances in the Account, irrespective of whether Dealer shall have received payment from its customers. It is understood that debit balances shall accrue interest on a daily basis at a rate per annum equal to the broker call rate as quoted from time to time by WSJ (changing concurrently with any change in such rate), plus a percentage determined by MFI. It is understood that MFI may change such percentage at any time and without prior notice to Dealer.

(f) **Compensation to MFI.** To compensate MFI for services performed under this Agreement, Dealer shall pay to MFI the fees for maintenance of the Account and for transactions in the Account, including the minimum aggregate fee per annum, set forth in Exhibit A hereto.

It is understood that MFI may change such fees at any time upon two business days prior notice to Dealer; provided, however, that changes to the minimum aggregate fee per annum shall be effective only on an anniversary date of this Agreement. Fees shall be charged against the Account monthly, with a year-end adjustment, if necessary, to cover the minimum aggregate annual fee.

(g) Timing. Dealer shall deposit any margin required under Section 5(b) above and satisfy any demand for payment of a debit balance under Section 5(e) above (including any debit balance resulting from fees payable under Section 5(f) above) by 12:00 noon Chicago time the next business day or such earlier time as MFI may reasonably require.

(h) Currency Fluctuation. If Dealer directs MFI to enter into any transaction to be effected on any securities exchange or in any market on which transactions are settled in a foreign currency, (i) any profit or loss arising as a result of a fluctuation in the rate of exchange between such currency and the United States dollar shall be entirely for Dealer's account and risk, (ii) all initial and maintenance margin deposits required or requested by MFI shall be in the currency required by the applicable marketplace or clearing agency in such amounts as MFI in its sole discretion may require and (iii) MFI is authorized to convert funds in the Account into and from such foreign currency at rates of exchange prevailing at the banking and other institutions with which MFI normally does business.

6. Failure to Discharge Financial Responsibilities.

(a) Lien. To secure performance of its obligations hereunder, including but not limited to its financial responsibilities under Section 5 above, Dealer hereby grants to MFI a lien on all securities, cash and other property in the Account or any other account carried by MFI for Dealer which Dealer advises MFI is for its own account or for the account of anyone other than its customers ("non-customer accounts"). MFI may, at any time, without prior notice to Dealer, transfer from a non-customer account to the Account such excess securities, cash or other property as in MFI's judgment may be required for margin or to reduce any debit balance in the Account. It is understood and agreed that MFI shall not have any lien on securities, cash or other property in the Account to secure obligations with respect to any non-customer account.

(b) MFI's Remedies. In the event that Dealer fails to timely perform any of its financial responsibilities, or MFI in its sole discretion deems it necessary for its protection, MFI is authorized, without notification to Dealer:

- (i) To sell any or all of the securities or other property which may be in its possession, or which MFI may be carrying for the Account, other than securities which are in the control of MFI, and apply the proceeds of such sale and any cash in the Account to amounts owed to MFI hereunder.
- (ii) To buy in any securities or other property of which the Account may be short.
- (iii) To cancel any outstanding orders.
- (iv) To take such other steps as MFI in its sole discretion determines appropriate under the circumstances.

Any sale or purchase made pursuant to this Section 6(b) shall be made, at MFI's discretion, on the securities exchange or other market where such business is then usually transacted, or at public auction or at private sale, without advertising the same and without notice to Dealer or

upon personal representatives of Dealer, and MFI may purchase the whole or any part thereof free from any right of redemption, with Dealer remaining liable for any deficiency. It is understood that a prior tender, demand or call of any kind from MFI, or prior notice from MFI, of the time and place of such sale or purchase shall not be considered a waiver of MFI's right to sell or buy any securities and/or other property held by MFI or owed MFI by Dealer, at any time. Dealer agrees to reimburse MFI for any expenses incurred by MFI in exercising its remedies under this Section 6(b), including attorneys' fees.

7. **Communication.**

(a) **Methods of Communication.** MFI will have discretion over the type and proper location of communications equipment deemed necessary to render the most efficient service to the Dealer. MFI shall not be responsible for any instructions or orders which it does not receive due to malfunction of communications equipment.

(b) **Recording.** Dealer consents to the recording of conversations between Dealer and MFI (or any of their respective agents), without any obligation by MFI to make or retain such recordings. Dealer agrees to the use of such recordings as evidence by either party in any disputes between Dealer and MFI, subject to proper authentication, or in any other proceeding to which MFI is a party or in which MFI's records are subpoenaed.

(c) **Responsibility for Errors.** MFI and Dealer will be responsible for their respective errors; provided, however, that MFI shall not be responsible for any errors not reported by the time specified in Section 4(b) above.

8. **Indemnification.**

(a) **Indemnification Obligation.** Dealer hereby agrees to indemnify, defend and hold harmless MFI from and against all claims, demands, proceedings, suits and actions made or brought against MFI and all of MFI's liabilities, losses, damages, sanctions, judgments, expenses, attorneys' fees and costs (collectively, "claims") arising out of one or more of the following:

- (i) Failure of Dealer to make payment when due for securities purchased or to deliver when due securities sold for the Account.
- (ii) Failure of Dealer to meet any initial or maintenance margin call.
- (iii) Default or error by any broker-dealer other than MFI with whom Dealer executes a transaction for the Account.
- (iv) Failure of Dealer properly to satisfy or perform any of its other responsibilities under this Agreement or commission by Dealer of any error for which Dealer is responsible under the terms of this Agreement.
- (v) Any claim by any of Dealer's customers based on conduct or omissions of Dealer or any third-party broker-dealer or arising from the clearing relationship between Dealer except to the extent such claim has resulted from MFI's gross negligence or willful misconduct.
- (vi) Any adverse claims with respect to any customer securities delivered or cleared by MFI.

- (vii) Any dishonest, fraudulent, negligent or criminal act or omission on the part of any of Dealer's officers, partners, employees, agents or customers.
- (viii) Breach by Dealer of any representation or warranty made by it under this Agreement.

(b) **Indemnification Procedure.** Promptly upon receipt of notice of any claim with respect to which MFI is entitled to indemnification under Section 8(a) above, Dealer shall institute defense of such claim, at its sole expense, using counsel reasonably acceptable to MFI. Dealer shall keep MFI informed of the status of defense of such claim, and Dealer shall not agree to any settlement without the consent of MFI, which shall not unreasonably be withheld. If within 10 days after receiving notice of such claim Dealer shall fail to properly institute the defense of such claim, MFI will have the right to defend against the same at Dealer's cost and expense or, in its sole discretion, to settle the same at Dealer's cost and expense. In the event that MFI is required to institute legal proceedings to enforce Dealer's indemnification obligations, MFI shall be entitled to recover from Dealer its costs and expenses, including attorneys' fees, incurred in such proceedings.

9. **Term and Termination.**

(a) **Term.** The term of this Agreement shall commence on the later of (i) the date hereof or (ii) if required, the date this Agreement is approved by the New York Stock Exchange.

(b) **Right to Terminate.** This Agreement may be terminated:

- (i) By _____, upon 30 days written notice by registered or certified mail.
- (ii) By MESIROW FINANCIAL, INC., upon 48 hours written notice to the other party.
- (iii) Immediately by MFI, in its discretion, if any representations, warranties, duties, responsibilities or obligations of Dealer shall not be true or duly performed or shall cease to become true or duly performed; provided, however, that the failure of MFI to terminate this Agreement shall not be deemed acquiescence in Dealer's misrepresentations or failure to perform its duties, responsibilities or obligations and shall not preclude MFI from subsequently terminating this Agreement.

(c) **Survival of Rights.** The lien and other rights of MFI hereunder shall continue as long as there remain any unsettled transactions or outstanding obligations from Dealer to MFI in respect to the Account.

(d) **Transfer of Account.** If MFI terminates this Agreement, MFI, at Dealer's request, shall reasonably assist Dealer in transferring the Account to another broker-dealer designated by Dealer.

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10. **General Provisions.**

(a) **Non-Exclusivity.** MFI reserves the right to enter into similar agreements with other broker-dealers on terms and conditions which may vary from those herein.

(b) **Governing Law.** This Agreement shall be construed and enforced under and in accordance with the internal laws of the State of Illinois without regard to the provisions thereof relating to the conflict of laws.

(c) **Headings.** The headings for each Section of this Agreement are for descriptive purposes only and shall not be deemed to modify or qualify any of the provisions of such Section.

(d) **Relationship of Parties.** Neither this Agreement nor the performance of services hereunder shall be considered to create a joint venture or partnership between MFI and Dealer or between Dealer and other broker-dealers for whom MFI may perform the same or similar services, nor shall either party be deemed an agent or representative of the other.

(e) **Binding Effect.** This Agreement shall be binding upon and inure to the benefit of MFI and Dealer and their respective successors, assignees and transferees of every kind; provided, however, that no assignment or transfer shall be binding without the prior written approval of the other party. This Agreement shall not be construed as creating any rights in any third parties who are not parties hereto (including without limitation any customers of Dealer).

(f) **Entire Agreement; Amendments.** This Agreement represents the entire agreement between the parties with respect to the subject matter contained herein. This Agreement may be amended, and provisions hereof may be waived, only by writing signed by the party against whom enforcement of the amendment or waiver is sought.

(g) **Modification by Applicable Rule or Law.** All transactions which MFI executes for the Account shall be subject to the constitution, by-laws, rules, regulations, customs, usages, rulings and interpretations of any relevant marketplace or clearing agency and to all applicable governmental laws and regulations (collectively referred to as any "rule or law"), and MFI shall not be liable to Dealer as a result of any action taken by MFI or its agents to comply therewith. Whenever any rule or law shall be enacted, proscribed or promulgated which shall affect in any manner or be inconsistent with any of the provisions hereof, the provisions of this Agreement so affected shall be deemed modified or superseded, as the case may be, by such rule or law, and all other provisions of this Agreement and any provisions as modified shall in all respects continue in full force and effect.

(h) **Partial Invalidity.** If any provision of this Agreement is held invalid or unenforceable, the remainder of the Agreement shall nevertheless remain in full force and effect. If any provision is held invalid or unenforceable with respect to particular circumstances, such provision shall nevertheless remain in full force and effect in all other circumstances.

(i) **Force Majeure.** MFI shall not be liable for any default resulting from any circumstances beyond its reasonable control, including without limitation computer malfunctions, labor disputes, natural disasters and acts of God.

(j) **Dispute Resolution.** In the event that any dispute arises under this Agreement, the parties shall in good faith attempt to settle such dispute. If settlement of a dispute relating to a transaction in the Account is not possible, the parties agree to submit the dispute to arbitration through the facilities of the marketplace (NASD or securities exchange) on which the transaction giving rise to the dispute arose. Any other disputes under this Agreement shall be resolved in a court of competent jurisdiction located in Chicago, Illinois, and the parties hereby waive any objections to such venue.

(k) **Notices.** Notices hereunder may be given by personal delivery, telecopy, or registered or certified mail and shall be deemed given when actually received. Notices to either party shall be sent to the address set forth opposite its name on the signature page hereof or to such other address as such party shall notify the other in writing.

IN WITNESS WHEREOF, the parties have hereunto affixed their hands as of the day and year first above written.

Address for Notice:

Attention: _____
Telecopier: _____

(Name of Dealer)

By: _____

(Printed Name)

(Title)

Address for Notice:
MESIROW FINANCIAL, INC.
350 North Clark Street
Chicago, Illinois 60610
Attention: _____
Telecopier: (312) 670-_____

By: _____

(Printed Name)

(Title)

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EXHIBIT A
COMPENSATION TO MFI

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Attachment C.

NASD notices on supervision

Notice To Members

Number 92-13

Suggested Routing:*

- | | | | |
|---|--|--|------------------------------------|
| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input type="checkbox"/> Systems |
| <input type="checkbox"/> Government Securities | <input type="checkbox"/> Municipal | <input checked="" type="checkbox"/> Registration | <input type="checkbox"/> Trading |
| <input type="checkbox"/> Institutional | <input type="checkbox"/> Mutual Fund | <input type="checkbox"/> Research | <input type="checkbox"/> Training |

*These are suggested departments only. Others may be appropriate for your firm.

Subject: SEC Approval of Amendments to the Definition of the Term "Branch Office" in Article III, Section 27 of the Rules of Fair Practice

EXECUTIVE SUMMARY

On March 24, 1992, the Securities and Exchange Commission (SEC) approved amendments to Article III, Section 27(g) of the Rules of Fair Practice codifying certain interpretations of the term "branch office." The amendments will become effective April 30, 1992. The text of the amendments follows the discussion below.

BACKGROUND AND DESCRIPTION OF AMENDMENTS

On March 24, 1992, the SEC approved amendments to the NASD's supervision rule in Article III, Section 27 of the Rules of Fair Practice regarding the definition of the term "branch office" in Subsection 27(g). The amendments codify interpretations of the term that have been applied to the activities of certain members in the last few years.

In 1989, in response to requests from members, a committee of the Board of Governors ("Board") issued several interpretations under Article III, Section 27(g)(2) of the NASD Rules of Fair Practice to clarify the rule's definition of branch office and the exemptions from branch-office registration available for nonbranch business locations

that meet certain conditions under the rule. These interpretations were reviewed by the Board in November 1989 and were approved for publication in the *NASD Regulatory & Compliance Alert* (February 1990). The interpretations were relied on for more than a year and were found to be workable in practice. Consequently, the NASD decided to codify the terms of the interpretations.

Under the current language of Article III, Section 27(g) of the Rules of Fair Practice, a location could be exempt from registration as a branch office if it was identified to the public only in telephone-book listings, on business cards, or on stationery, that also included the address and telephone number of the branch office or the office of supervisory jurisdiction (OSJ) responsible for supervising the nonbranch business location. Under new Subsection (g)(2)(ii) to Article III, Section 27, a location is also exempt from registration if the member's advertisement includes a local telephone number and/or a local post-office box so long as the advertisement also identifies the location and telephone number of the appropriate supervising branch office or OSJ. The advertisement may not, however, include the address of the nonbranch location. In addition, under new Subsection (g)(2)(iii), a member's sales literature may also include the local address of a nonbranch business location, so long as the location and telephone number of the

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appropriate supervisory branch office or OSJ of the member is identified.

New Subsection (g)(3) allows a member to use the firm's main-office address and telephone number on sales literature, advertisements, business cards, and business stationery instead of the address and telephone number of the supervisory branch office or OSJ so long as the member can demonstrate that it maintains a significant and geographically dispersed supervisory system appropriate to its business. Moreover, any complaints received by the main office must be forwarded to the office or offices with jurisdiction over the non-branch business location.

The new exemptions from the branch-office definition in Article III, Section 27(g)(2) are intended as a reasonable accommodation to member firms with widely dispersed sales personnel selling limited product lines such as variable contracts and mutual funds. Any office location that (i) performs any function of an OSJ, (ii) publicly displays signage, (iii) operates from public areas of buildings, such as bank branches, even when such locations are temporarily staffed, or (iv) advertises an address in any public media would still be required to register as a branch office. Such locations hold themselves out to the public as being places where the member conducts a securities business and, thus, come within the definition of a branch office. The NASD will not, however, regard a listing in a lobby directory or a sign on an interior corridor door as holding the location out to the public in such a way as to require branch-office registration unless other indicia of the location's status as a branch office are present.

Article III, Section 27 and the exclusions in the amendments are designed to avoid requiring the registration of locations as branch offices unless their securities activity would require the continuous direct supervision of a principal (i.e., OSJ-type activity) or the location is being held out to the public as a place where the full range of securities activity is being conducted (requiring supervisory oversight of the initial interactions between customers and the member).

Questions regarding this notice may be directed to R. Clark Hooper, Director, Advertising Department, at (202) 728-8330; P. William Hotchkiss, Director, Surveillance Department, at (202) 728-8221; and Elliott R. Curzon, General Counsel's Office, at (202) 728-8481.

Article III of the NASD Rules of Fair Practice

(Note: New language is underlined, deleted language is in brackets.]

Supervision

Sec. 27.

* * * * *

Definitions

* * * * *

(g)(2) "Branch Office" means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding:

(i) any location identified [solely] in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised[.];

(ii) any location referred to in a member advertisement, as this term is defined in Article III, Section 35 of the NASD Rules of Fair Practice, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised; or

(iii) any location identified by address in a member's sales literature, as this term is defined in Article III, Section 35 of the NASD Rules of Fair Practice provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised.

(g)(3) A member may substitute a central office address and telephone number for the supervisory branch office and OSJ locations referred to in paragraph (g)(2) above provided it can demonstrate to the NASD District Office having jurisdiction over the member that it has in place a significant and geographically dispersed supervisory system appropriate to its business and that any investor complaint received at the central site is provided to and resolved in conjunction with the office or offices with responsibility over the non-branch business location involved in the complaint.

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6-65 Compliance with the NASD Rules of Fair Practice

September 12, 1986

TO: All NASD Members, Associated Persons and Other Interested Persons

RE: Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel

UAAA

EXECUTIVE SUMMARY

NASD rules and policies consider associated persons of a member to be employees of the member, regardless of their locations or compensation arrangements. The notice addresses regulatory issues that relate to off-site employment of registered persons, including supervisory procedures, private securities transactions, fair dealings with customers and communications with the public.

Because of the significance of the issues discussed in this notice, the NASD strongly urges that it be distributed to all associated persons and recommends that it be included in the compliance manual of all firms employing off-site personnel.

AAAU

INTRODUCTION

A significant number of NASD members employ registered persons who engage in securities-related activities, on a full- or part-time basis, at locations away from the offices of the members. These off-site representatives, often classified for compensation purposes as independent contractors, may also be involved in other business enterprises such as insurance, real estate sales, accounting or tax planning. They may also operate as separate business entities under names other than those of the members. The NASD, in the course of its disciplinary proceedings, has observed a pattern of rule violations and other regulatory problems stemming from factors inherent in these arrangements and the manner in which they are effectuated.

Irrespective of an individual's location or compensation arrangements, all associated persons are considered to be employees of the firm with which they are registered for purposes of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the member. The fact that an associated person conducts business at a separate location or is compensated as an independent contractor does not alter the obligations of the individual and the firm to comply fully with all applicable regulatory requirements.

To provide guidance to the membership in meeting these obligations, this notice discusses certain regulatory issues that frequently arise in the context of off-site employment. Because of the importance of these issues, the NASD urges each member to duplicate this notice and distribute it individually to all associated persons. In addition, it is suggested that this notice be included in the compliance manual of firms employing off-site representatives. The NASD, in the course of its member examinations, will make inquiries to ascertain that this notice has been provided to all appropriate personnel.

Article III, Section 27, NASD Rules of Fair Practice:
Supervision

Section 27(a) sets forth the basic duty of a member firm to:

" . . . establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association."

Although the rule does not prescribe specific supervisory procedures to be followed by all firms, it clearly mandates that the adopted procedures enable a firm to supervise properly the activities of each associated person to assure compliance. Thus, firms employing off-site representatives are responsible for establishing and carrying out procedures that will subject these individuals to effective supervision designed to monitor their securities-related activities and to detect and prevent regulatory and compliance problems.

This can include:

1. Educating off-site personnel regarding their obligations as registered persons to the firm and to the public, including prohibited sales practices.

2. Maintaining regular and frequent contact with such individuals.
3. Implementing appropriate supervisory practices, such as records inspections and compliance audits at the representatives' places of employment, to ensure that their methods of business and day-to-day operations comply with applicable rules and requirements.

For greatest effectiveness in preventing and detecting violations, visits should be unannounced and include, for example, a review of on-site customer account documentation and other books and records, meetings with individual representatives to discuss the products they are selling and their sales methods, and an examination of correspondence and sales literature.

To fulfill these obligations, a firm should consider whether the number and location of its registered principals provides the capability to supervise its off-site representatives effectively.

Section 27(c) includes the requirement that a member:

" . . . review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction."

This requirement applies equally in the case of off-site representatives. Firms whose off-site personnel also engage in non-securities businesses should remind these individuals that correspondence pertaining to such businesses, unless submitted for review, may not include material related to securities transactions.

Section 27(d) imposes upon a member the obligation to:

" . . . review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities and abuses and at least an annual inspection of each office of supervisory jurisdiction."

An office of supervisory jurisdiction (OSJ) is defined in Section 27(f) as:

" . . . any office designated as directly responsible for the review of the activities of registered

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representatives or associated persons in such office and/or in other offices of the member."

If a member has designated an individual as responsible for reviewing the activities of other registered persons within the firm, the office of that individual must be inspected annually, regardless of whether such person is compensated as an employee or as an independent contractor.

Article III, Section 40, NASD Rules of Fair Practice:
Private Securities Transactions

Past experience of the NASD in examining members indicates that the conduct of off-site representatives most frequently resulting in violations of NASD rules involves unauthorized private securities transactions, or "selling away." The NASD expects that the promulgation of Section 40 and the clarification of the obligations of members and associated persons in such transactions will reduce the instances of selling away among all associated persons, including off-site representatives.

Several aspects of Section 40, and certain related issues, merit emphasis in the context of off-site personnel. Section 40 cannot accomplish its objectives unless member firms communicate the substance of the rule to their associated persons and take affirmative steps to ensure that these requirements are understood and observed. This is especially true in the case of off-site representatives whose day-to-day access to compliance personnel and individuals experienced in the securities industry may be limited and whose participation in non-private securities transactions may be infrequent and restricted in scope.

Because of their location and other circumstances of their employment, off-site personnel have a greater opportunity than on-site personnel to engage in undetected selling away. Consequently, firms that employ such persons are responsible for monitoring their activities in a manner reasonably intended to detect violations. Further, the obligations imposed upon the firm and the associated person under the rule are neither altered nor lessened in any way by the fact that the individual is compensated as an independent contractor.

The rule requires a member that approves an associated person's involvement in private securities transactions for compensation to record the transactions on its books and records and supervise the individual's participation "as if the transactions were executed on behalf of the member." Although the rule does not specify the manner of recordation,

the firm may wish to maintain records that provide information regarding:

- . The individual and the security involved;
- . The amount and source of compensation;
- . The names of the investors and the amounts and dates of the investments;
- . The issuer, syndicator or any other broker-dealer involved; and
- . The manner in which the firm undertook to supervise the associated person's participation.

These records should be in a form that would permit the NASD to ascertain, upon examination, all relevant information regarding the participation of associated persons in private securities transactions.

Several issues arise in connection with supervising the involvement of off-site representatives in private securities transactions. The NASD has observed that some firms permit such persons to form and sell interests in limited partnerships for which they serve as general partners. While this is not an impermissible activity, members and registered persons are reminded that such transactions are securities transactions, and therefore subject to Section 40 and all other rules and regulations governing such transactions. Thus, the member is responsible for ensuring that the formation of these partnerships and the solicitation and sale of interests therein are conducted in compliance with all applicable requirements, including those pertaining to documentation, due diligence, disclosure, suitability determinations, and the handling of customer funds.

There have been instances in which associated persons have engaged in private securities transactions without notifying the firm, due to the belief or the advice of third parties that the product involved was not a security. Under federal securities laws, the definition of a security includes the commonly understood products, such as stocks and bonds, as well as other investment products, such as an "investment contract" in which one or more individuals invest in a common venture with the expectation of receiving a monetary return on their investment from or through the efforts of a third party.

Because questions frequently arise as to whether a particular investment instrument is a security, a registered person

should not sell any product offered by an entity outside the firm without consulting the member to determine the product's status as a security.

Article III, Section 2, NASD Rules of Fair Practice:
Recommendations to, and Fair Dealings with, Customers

Article III, Section 2 of the NASD Rules of Fair Practice requires that:

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

The policy of the NASD Board of Governors pertaining to Section 2 sets forth specific guidelines in the areas of recommending speculative, low-priced securities, excessive trading activity, trading in mutual fund shares, fraudulent activity, and recommending purchases beyond the customer's capability.

The actions of an associated person in dealing with customers and customer accounts, regardless of whether he or she is compensated as an employee or an independent contractor, are actions on behalf of the firm. The firm is responsible for supervising in a manner designed to detect and prevent violations of Section 2. Members should take affirmative steps to ensure that off-site personnel understand and abide by NASD and firm policies regarding dealings with customers, customer accounts and customer funds.

Article III, Section 10, Rules of Fair Practice:
Influencing or Rewarding Employees of Others

Article III, Section 10 of the NASD Rules of Fair Practice prohibits members and associated persons from giving:

" . . . anything of value, including gratuities, in excess of fifty dollars per individual per year to any person . . . where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity"

unless such payments or gratuities are pursuant to a written agreement between the payor and the recipient to which the recipient's employer has consented.

It is, therefore, a violation of Section 10 for a member to

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compensate an associated person of another member in connection with securities transactions without the employer firm's consent. A member's obligations under Section 10 are not affected by the fact that the recipient is compensated by his or her NASD employer member as an independent contractor.

Article III, Section 35, Rules of Fair Practice:
Communications with the Public

Article III, Section 35(b) of the NASD Rules of Fair Practice requires that every item of advertising and sales literature, as defined in Section 35(a):

" . . . be approved by signature or initial, prior to use, by a registered principal (or his designee) of the member."

Paragraph (2) of Section 35(b) requires further that a separate file of such items be maintained for a period of three years.

This rule applies to all materials originated or distributed by off-site representatives that meet the definition of "advertisement" or "sales literature," including those prepared or used by persons compensated as independent contractors. In particular, firms must approve any materials referencing that securities are sold by the off-site representative through the member, even though such materials may be intended to promote the non-securities businesses of the off-site personnel.

Article III, Section 35(d)(2)(A) further requires that all advertisements and sales literature contain the name of the member, as well as certain other information under specified circumstances. The fact that an associated person may operate under a business name other than that of the member does not alter this requirement. The NASD has received inquiries regarding the need to include the name of the member in promotional materials that do not include references to the associated person's securities-related activities. Particular materials should be considered individually, preferably by the firm's compliance department, to determine whether they fall within the scope of Section 35.

Unregistered Broker-Dealers

The Securities and Exchange Commission has taken the position that an individual who operates as an independent contractor must be registered as a broker-dealer unless he or she is under the control of a registered broker-dealer.[1] The

question of "control" must be evaluated in light of the facts and circumstances of each situation and is not susceptible to a test of general application. There are, however, circumstances inherent in off-site employment and independent contractor compensation arrangements that may give rise to potential liability for operating as unregistered broker-dealers. Thus, registered persons and member firms may want to consider registering of off-site locations as broker-dealers.

[1] Refer to the statement by the SEC Division of Market Regulation, dated June 18, 1982, forwarded to all NASD members on August 25, 1982.

Any questions regarding this notice should be directed to either Dennis C. Hensley, NASD Vice President and Deputy General Counsel, at (202) 728-8245, or Jacqueline D. Whelan, Attorney, NASD Office of the General Counsel, at (202) 728-8270.

Sincerely,

Frank J. Wilson
Executive Vice President
and General Counsel

BEST AVAILABLE COPY

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NASD NOTICE TO MEMBERS 93-50

**Mail Vote — Proposed
New Section to the
Rules of Fair Practice
Relating to the
Respective Obligations
And Supervisory
Responsibilities of
Introducing and Clearing
Firms; Last Voting Date:
September 27, 1993**

Suggested Routing

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

Executive Summary

The NASD invites members to vote on a proposed new section to the Rules of Fair Practice that would require members entering into clearing or carrying agreements to specify the obligations and supervisory responsibilities of both the introducing and clearing firm. The text of the proposed rule follows this Notice.

Background and Description of Proposal

The NASD is proposing to amend the Rules of Fair Practice to require that all clearing or carrying agreements entered into by a member specify the respective functions and responsibilities of each party to the agreement. The proposed rule clarifies the obligations and supervisory responsibilities of clearing and introducing firms. The Board of Governors believes it is important for the NASD to adopt a standard for such agreements that is similar to New York Stock Exchange (NYSE) Rule 382.

Further, when the Securities and Exchange Commission (SEC) considered the NYSE's Rule 382, the NASD commented to the SEC that permitting certain functions to be allocated to the introducing firm may result in compliance failures and violations resulting from the inability of the introducing member to perform those functions adequately. The NASD urged that firms should not be permitted to avoid obligations or responsibilities that would otherwise be theirs under the securities laws. In approving NYSE Rule 382, the SEC recognized the NASD's concerns and stated "no contractual arrangement for the allocation of functions between an introducing and carrying organization can oper-

ate to relieve either organization from their respective responsibilities under federal securities laws and applicable SRO [self-regulatory organization] rules." The Board believes that the rule proposed herein reflects the principles previously asserted by the NASD and noted by the SEC.

Subsection (a) of the rule as originally proposed for member comment required that all clearing or carrying agreements entered into by any member specify, at a minimum, the respective functions and responsibilities of the parties to the agreement with regard to opening and approving customer accounts, extending credit, keeping books and records, receipt and delivery of funds and securities, safeguarding funds and securities, preparing confirmations and statements, and accepting orders and executing transactions.

Subsection (a) of the rule as currently proposed retains these seven requirements and adds two new ones. Proposed Subsection (a)(8) requires the agreement to address whether, for purposes of the Securities Investor Protection Act and the financial responsibility rules adopted under the Securities Exchange Act of 1934, customers are customers of the clearing member. If an introducing member intends to qualify for lower net capital, then the clearing or carrying agreement must clearly state that the customers are customers of the clearing member. Absent such a provision, the SEC net capital rule will treat the introducing member as a firm in possession of customer funds or securities subject to the higher net capital requirements of such a designation. Proposed Subsection (a)(9) requires the agreement to address the customer notification requirement of Subsection (d) of the proposed rule.

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discussed below. Finally, Subsection (a) does not apply to the content of the agreement if either party is also subject to a comparable rule of a national securities exchange.

Subsections (b) and (c) impose filing requirements for new agreements or amendments to agreements. Subsection (b) requires any clearing member designated to the NASD for compliance oversight to file with the NASD for review and approval any new clearing or carrying agreement entered into with an introducing member and any amended clearing or carrying agreement that revises any item enumerated in Subsections (a)(1) through (a)(9).

Subsection (c) requires any introducing member designated to the NASD for compliance oversight to file with the introducing member's local NASD district office for review only any new clearing or carrying agreement entered into with a clearing member and any amended clearing or carrying agreement, entered into with a clearing member designated to another self-regulatory organization (SRO) for oversight, that revises any item enumerated in Subsections (a)(1) through (a)(9). Unlike agreements for approval, agreements submitted for review are effective when executed.

Subsection (d) requires members to notify each customer, whose account is introduced on a fully disclosed basis, of the existence of the clearing agreement when the account is opened.

Member Comments

The NASD published the proposed rule change for comment in *Notice to Members 92-32* (December

NASD Notice to Members 93-50

1991). In response to the comments received, the Board amended the original proposal.

Subsection (d) of the rule change as originally proposed for member comment required more specific disclosure than its analogous subsection in NYSE Rule 382(c). The Board modified Subsection (d) to make its meaning consistent with the text of NYSE Rule 382(c) to respond to commenters who argued that the disparity in disclosure requirements could lead to different disclosure standards and practices among SROs.

Other commenters argued that the proposed rule's informational and filing requirements would create necessarily duplicative filing requirements and add administrative and compliance burdens to member firms. The Board recognized the burden and amended the rule to provide that only new clearing agreements would have to be filed with the NASD by both the introducing and clearing member if the clearing member were not designated to another SRO for oversight. However, if the clearing member is designated to another SRO for oversight, an amended agreement submitted by an introducing member to the NASD will have already been submitted by the clearing firm for review and approval by the SRO, thus obviating the need for the clearing firm to submit the same agreement to the NASD. In addition, an amended agreement that does not change any of the enumerated functions in Subsection (a) of the proposed rule need not be filed. Finally, the filing by the introducing member is a submission for review only and does not require approval by the NASD before becoming effective

Request for Vote

The Board believes that it is appropriate to add a new rule of fair practice that requires members entering into clearing or carrying agreements to specify the obligations and supervisory responsibilities of both the introducing and clearing firm. In addition to creating consistency and uniformity in the regulation of clearing arrangements by all SROs on an industry-wide basis, the proposal would reduce customer confusion regarding the identity of the responsible party when questions or concerns arise. The Board considers the proposed provision necessary and appropriate and recommends that members vote their approval.

The text of the proposed new rule that requires member vote is below. Please mark the attached ballot according to your convictions and mail it in the enclosed, stamped envelope to the Corporation Trust Company. Ballots must be post-marked by no later than **September 27, 1993**. If approved by the members, the amendment will not be effective until it is filed with and approved by the SEC.

Questions regarding this Notice should be directed to Elliott R. Curzon, Senior Attorney, (202) 728-8451, and Robert J. Smith, Attorney, (202) 728-8176, at the Office of General Counsel.

Text of Proposed Rule

(Note: New language is underlined.)

Clearing Agreements

(a) All clearing or carrying agreements entered into by a member.

August 1993

except where any party to the agreement is also subject to a comparable rule of a national securities exchange, shall specify the respective functions and responsibilities of each party to the agreement and shall, at a minimum, specify the responsibility of each party with respect to each of the following matters:

(1) opening, approving and monitoring customer accounts;

(2) extension of credit;

(3) maintenance of books and records;

(4) receipt and delivery of funds and securities;

(5) safeguarding of funds and securities;

(6) confirmations and statements;

(7) acceptance of orders and execution of transactions;

(8) whether, for purposes of the Securities and Exchange Commission's financial responsibility rules adopted under the Securities Exchange Act of 1934, as amended, and the Securities Investor Protection Act, as amended, and regulations adopted thereunder, customers are customers of the clearing member; and

(9) the requirement to provide customer notification under Subsection (d) of this Section.

(b) Whenever a clearing member designated to the NASD for oversight pursuant to Section 17 of the Securities Exchange Act of 1934, as amended, or a rule of the Securities and Exchange Commission adopted thereunder, amends any of its clearing or carrying agreements with respect to any item enumerated in Subsections (a)(1) through (a)(9) of this Section, or enters into a new clearing or carrying agreement with an introducing member, the clearing mem-

ber shall submit the agreement to the NASD for review and approval.

(c) Whenever an introducing member designated to the NASD for oversight pursuant to Section 17 of the Securities Exchange Act of 1934, as amended, or a rule of the Securities and Exchange Commission adopted thereunder, amends its clearing or carrying agreement with a clearing member designated to another self-regulatory organization for oversight with respect to any item enumerated in Subsections (a)(1) through (a)(9) of this Section, or enters into a new clearing agreement with another clearing member, the introducing member shall submit the agreement to its local NASD district office for review.

(d) Each customer whose account is introduced on a fully disclosed basis shall be notified in writing upon the opening of his account of the existence of the clearing or carrying agreement.

Notice To Members

National Association of Securities Dealers, Inc.

June 1992

Number 92-32

Suggested Routing:*

- | | | | |
|---|--|--|------------------------------------|
| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input checked="" type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input type="checkbox"/> Systems |
| <input type="checkbox"/> Government Securities | <input type="checkbox"/> Municipal | <input type="checkbox"/> Registration | <input type="checkbox"/> Trading |
| <input type="checkbox"/> Institutional | <input type="checkbox"/> Mutual Fund | <input type="checkbox"/> Research | <input type="checkbox"/> Training |

*These are suggested departments only. Others may be appropriate for your firm.

Subject: Request for Comments on Proposed Amendment to the Rules of Fair Practice Relating to the Respective Obligations and Supervisory Responsibilities of Introducing and Clearing Firms; Last Date for Comments: July 22, 1992

EXECUTIVE SUMMARY

The NASD requests comments on a proposed amendment to the Rules of Fair Practice to require members entering into clearing or carrying agreements to specify the obligations and supervisory responsibilities of both the introducing and clearing firm. The text of the proposed rule follows this Notice.

BACKGROUND

The NASD is proposing to amend the Rules of Fair Practice to require members entering into a clearing agreement, as either an introducing firm or a clearing firm, to specify the respective functions, obligations, and supervisory responsibilities of each party to the agreement. The proposed rule results from recommendations of the NASD's Advisory Council and the Securities Industry Association (SIA) that the NASD clarify the obligations and supervisory responsibilities of clearing and introducing firms.

In considering whether to adopt the proposed rule, the Board of Governors (Board) has considered that a similar New York Stock Exchange

(NYSE) rule (NYSE Rule 382) was already in place. Accordingly, the Board believes that it is appropriate to propose a rule that would provide consistent treatment for broker/dealers that are not NYSE members.

At the time the Securities and Exchange Commission (SEC) considered the NYSE's proposed rule, the NASD commented to the SEC that permitting certain functions to be allocated to the introducing member may result in compliance failures and violations resulting from the inability of the introducing member to adequately perform those functions. The NASD urged that members should not be permitted to avoid obligations or responsibilities which would otherwise be theirs under the securities laws.

In its order approving the NYSE Rule 382, the SEC recognized the NASD's concerns and stated, "... no contractual arrangement for the allocation of functions between an introducing and carrying organization can operate to relieve either organization from their respective responsibilities under federal securities laws and applicable SRO rules."¹ This rule incorporates this principle as

¹ Securities Exchange Act Release No. 18497

previously asserted by the NASD and noted by the SEC.

Subsection (a) of the proposed rule requires a member's clearing agreement to specify the functions and responsibilities of the respective parties. Subsection (a) further requires that at a minimum the agreement address the seven functions enumerated in subsections (a)(1) through (a)(7), and that the agreement specify the party ordinarily responsible for any other function included in the agreement. Members which are subject to a comparable rule of a national securities exchange, such as NYSE Rule 382, are exempt from the provisions of the proposed rule.

Subsection (b) of the proposed rule requires a clearing member to submit its clearing agreement to the NASD for review and approval in the event there are any amendments relating to the functions specified in subsection (a)(1) through (a)(7), or if the clearing member enters into a new agreement with another introducing firm, unless the clearing member is subject to review and approval pursuant to a comparable rule of a national securities exchange.

Subsection (c) of the proposed rule requires an introducing member to submit its clearing agreement to the NASD in the event of any amendment relating to the functions specified in subsections (a)(1) through (a)(7), or if the introducing member enters into a new clearing agreement with another clearing firm. Subsection (a) does not require the introducing member to seek prior approval of any changes. Subsections (b) and (c) both embody the NASD's view that changes which are of little regulatory concern, such as changes to fees and charges, do not need approval.

Under Subsections (b) and (c), the NASD would review and approve clearing agreements required to be submitted by a clearing firm if the agreement is not subject to the review and approval of a national securities exchange.

Finally, Subsection (d) of the proposed rule requires introducing members to disclose the existence of the agreement to customers on the opening of an account and to disclose the terms of the agreement as it relates to the responsibilities specified in subsections (a)(1) through (a)(7).

The Board believes that this provision will reduce customer confusion regarding the identity of the responsible party when questions or complaints arise.

REQUEST FOR COMMENTS

The Board asks members and other interested persons to comment on the proposed rule to the NASD Rules of Fair Practice. Comments should be directed to:

Stephen Hickman
Office of the Secretary
National Association of Securities
Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506.

Comments must be received no later than **July 22, 1992**. Comments received by this date will be considered by the Board. Prior to becoming effective, the rule must be adopted by the Board and the membership and then filed with the SEC for its approval.

Questions concerning this Notice should be directed to Elliott R. Curzon, Office of General Counsel, at (202) 728-8451.

TEXT OF PROPOSED RULE

Rules of Fair Practice

(Note: All language is new.)

Clearing Agreements

(a) Any clearing or carrying agreement entered into between a member firm and any other firm, except where the member is also subject to a comparable rule of a national securities exchange, shall specify the respective functions and responsibilities of each party to the agreement and shall, at a minimum, specify the responsibility of each party with respect to each of the following functions:

- (1) opening, approving and monitoring customer accounts;
- (2) extension of credit;
- (3) maintenance of books and records;
- (4) receipt and delivery of funds and securities;
- (5) safeguarding of funds and securities;
- (6) confirmations and statements; and
- (7) acceptance of orders and execution of transactions.

(b) Whenever a clearing member amends its clearing or carrying agreement with an introducing firm with respect to any item enumerated in Subsections (a)(1) through (a)(7) of this Section, or enters into a new clearing or carrying agreement with an introducing firm, the clearing member shall sub-

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mit the agreement to the NASD for review and approval unless the clearing member is subject to comparable review and approval requirements of a national securities exchange.

(c) Whenever an introducing member designated to the NASD under Securities and Exchange Commission Rule 17d-1 amends its clearing or carrying agreement with a clearing firm with respect to any item enumerated in Subsections (a)(1) through (a)(7) of this Section, or enters into a new

clearing agreement with another clearing firm, the introducing member shall submit the agreement to the NASD.

(d) Each customer whose account is introduced on a fully disclosed basis shall be notified in writing upon the opening of his account of the existence of the clearing or carrying agreement and of the terms of the agreement as it relates to the responsibilities specified in subsections (a)(1) through (a)(7).

BEST AVAILABLE COPY

Attachment D.

SIA presentation on the business relationship of introducing and carrying brokers

An Analysis of the Business
and Legal Relationship Between
Introducing and Carrying Brokers

by: William J. Fitzpatrick
General Counsel SIA

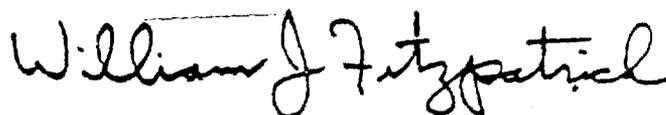
and

Ronald E. Carman
Associate General Counsel SIA

Securities Industry Association
120 Broadway, New York, NY

INTRODUCTION

With this monograph on the relationship between introducing and carrying brokers, the SIA legal staff is continuing its series of white papers on various legal issues facing our broker-dealer members. It is our thought in adding these monographs to the field of legal literature on securities laws that we wish to encourage examinations of the various issues raised to stimulate discussion and research in various areas of the law in which we feel there is uncertainty and, in some instances, confusion. These monographs will explore the existing decisions involving the underlying issue and will also expound an SIA point of view concerning the issue. We hope that by doing this we will at least bring the underlying issues into focus to assist our membership and perhaps to even suggest solutions for the problems they face. It is recognized that not all will agree with our conclusions, but it is our hope that at least the focus of these broker-dealer legal problems will be sharpened so that, when resolutions are made by the courts, it will be on the basis of clearly defined questions.



William J. Fitzpatrick
Senior Vice President
and General Counsel

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Securities Industry Association
120 Broadway
New York, NY 10271

A considerable amount of confusion and uncertainty exists concerning the legal implications emanating from the contractual relationship between introducing and carrying brokers.^{1/} There is also a paucity of literature analyzing this subject. This article posits that many courts have failed to comprehend the business relationship which exists between the two parties to the contract. After providing a background of the subject, the article will discuss the business context of carrying arrangements. It will review the regulatory environment of such agreements, and then analyze the relationship in terms of agency

¹ See, e.g., S. Goldberg, Fraudulent Broker-Dealer Practices (1978), "Broker-dealers are notorious for attempting, at one and the same time, to: 1) lure an investor into a false sense of confidence and security by inducing the investor's reliance upon the prestige and reputation of an old-line New York Stock Exchange firm, while 2) disclaiming any possible liability for fraudulent activities that may have been practiced upon an investor by the trading brokerage firm or its registered representative. One way in which this rather reprehensible practice occurs is when the New York Stock Exchange broker-dealer claims to be a mere 'clearing broker-dealer' for a 'trading broker-dealer,' the later being the direct employer of the errant registered representative." Id. at p. 7-32, 33. See also, text at notes 40-59, infra.

the introducing firm maintains a single account with the carrying firm in its own name and does not identify its individual customers whose purchases and sales of securities are cleared through the carrying firm. In accordance with Regulation T,^{3/} the introducing firm, in an omnibus arrangement, must provide the carrying firm with notice that all securities transactions will be for the account of its customers and that short sales effected through the account will be for customers of the broker or dealer other than partners.^{4/} The customer, in both fully disclosed and omnibus arrangements, deals only with the introducing firm. The introducing firm is responsible for compliance with applicable SRO rules regulating the registered representatives' conduct with the customer.^{5/}

B. The Business Environment of Introducing/Carrying Firms Agreements

An introducing/carrying agreement is the product of arms-length negotiation between the parties. The carrying firm

³ Regulation T, 17 C.F.R. 220, provides rules relating to the extension of credit by broker-dealers. It is promulgated by the Board of Governors of the Federal Reserve and enforced by the Commission and the self-regulatory organizations ("SROs").

⁴ 17 C.F.R. 220.10. Creditors may only effect and finance transactions for broker-dealers registered with the Commission. Id.

⁵ See, e.g., National Association of Securities Dealers ("NASD") Rules of Fair Practice, Article III reprinted in NASD Manual (CCH) ¶s 2151-2197; American Stock Exchange ("Amex") Rules 410-422, reprinted in Amex Guide (CCH) ¶s 9430-9942; NYSE Rules 341-353 and 401-408, reprinted in NYSE Guide (CCH) ¶s 2341-2353, 2401-2408.

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law.^{2/} Next, it will summarize several cases wherein courts failed to comprehend the relationship between introducing and carrying firms and thereby rendered unsound and incorrect decisions. Finally, the article will analyze the cases and suggest a preferred analysis.

I

OVERVIEW OF RELATIONSHIP BETWEEN CARRYING AND INTRODUCING FIRMS

A. Background

Clearing agreements are simply contracts between two entities, usually registered broker-dealers, wherein one party, the carrying firm, agrees to perform certain services for the other party, the introducing firm. There are two types of carrying agreements, fully disclosed and omnibus arrangements. In a fully disclosed carrying agreement, the introducing firm discloses to the carrying firm, among other things, the names, addresses, securities positions, and other relevant data concerning its customers. In contrast, in an omnibus agreement,

² The terms "introducing firm" and "carrying (or clearing) firm" are not defined in the federal securities laws or the rules promulgated thereunder. Section IA contains a detailed discussion of the terms. The terms "carrying firm" and "clearing firm" are often used interchangeably. In its filing pursuant to Securities and Exchange Act of 1934 ("Exchange Act") Rule 19b-4 on this subject, the New York Stock Exchange ("NYSE") stated that "clearing firm" is often construed to be limited to a firm which processes transactions, while "carrying firm" describes a firm providing the capital required by industry rules to maintain a customer's account. See Securities and Exchange Commission ("SEC" or the "Commission") File No. SR-NYSE-81-19, Proposed Rule Change by New York Stock Exchange, Inc., footnote at p. 2 ("Rule 19b-4 Submission").

expects an income stream from the services it provides to the introducing firm. The introducing firm avoids substantial start-up and maintenance costs associated with the initiation and maintenance of back office operations.^{6/} Such costs include computer costs necessary to generate confirmations, stock records and various back office records, staffing a cashiering section, and other back office functions.

The financial capital required to operate as a broker-dealer is another important factor for a firm to consider in deciding whether or not to do its own clearing. The Commission's net capital rule^{7/} establishes regulatory capital requirements for registered broker-dealers which depend, among other things, upon the magnitude of customer margin debits^{8/} and a firm's ability to deliver and receive promptly securities.^{9/} The typical carrying agreement permits the carrying firm's capital to be utilized for these purposes thereby permitting the introducing firm to deploy its capital for trading, underwriting, and other

⁶ Absent the ability to contract with a carrying firm to perform various back office functions, many introducing firms would be unable to enter the brokerage business.

⁷ Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1.

⁸ See, e.g., Exchange Act Rule 15c3-1(a), 17 C.F.R. § 240.15c3-1(a). Broker-dealers computing their capital under the "alternative" method are required to maintain capital in excess of 2% of Rule 15c3-3's Reserve Formula debits.

Exchange Act Rule 15c3-1(c)(2)(v), 17 C.F.R. § 240.15c3-1(c)(2)(v) provides for deductions from capital based on short securities differences.

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proprietary endeavors.^{10/}

Because introducing firms enter into carrying agreements for many different business reasons, a carrying firm will offer a variety of services to the introducing firm. The carrying firm's compensation is subject to negotiation and will vary substantially between agreements and will depend upon the services performed by the carrying firm. Pursuant to some agreements, the introducing firm merely submits its customer's orders to the carrying firm for execution and the carrying firm does everything else. In other agreements, the introducing firm may execute its own trades and report them to the carrying firm for completion of back office and cashiering tasks. In contrast, some arrangements require the carrying firm to perform only recordkeeping and confirmation functions while the introducing firm maintains its own cashiering operation. In still other types of agreements, broker-dealers may contract with data processing firms for the production of confirmations, customer statements, and other books and records required to be made and maintained by registered

¹⁰ The net capital rule affords certain introducing firms with favorable capital requirements. See text at note 18, infra.

broker-dealers.^{11/} The introducing firm makes a decision as to what back office functions it wishes to complete on its own, and then contracts with another entity to perform all other necessary operations.

Depending on the nature and extent of its particular responsibilities as enumerated in the carrying arrangement, the carrying firm is particularly concerned with the credit worthiness of the introducing firm and their customers and will monitor closely potential credit exposure for its own protection. In most carrying arrangements, the introducing firm guarantees its customers' ability to complete cash transactions. If the customer fails to pay for a purchase or deliver securities against a sale, the introducing firm will absorb the loss, if any, resulting from either the sell-out or buy-in. With respect to margin transactions, the introducing firm usually^{12/} assumes financial responsibility for its customers' ability to meet the

¹¹ See Exchange Act Rules 17a-3, 17 C.F.R. § 240.17a-3 and 17a-4 17 C.F.R. § 240.17a-4. In such cases, entities providing such services may not be broker-dealers registered with the Commission. They must file with the Commission a written undertaking to the effect that the records are the property of the broker-dealer otherwise required to make and maintain such records, and that it will furnish them, when requested, to the Commission. See Exchange Act Rule 17a-4(i), 17 C.F.R. § 240.17a-4(i).

¹² Because of the lack of homogeneity among carrying agreements, only generalizations can be made as to how responsibilities are allocated between the parties. A sample agreement for securities clearance services is attached as Exhibit A.

initial margin requirements of Regulation T^{13/} while the carrying firm assumes responsibility for maintenance margin required by rules of the self-regulatory organizations.^{14/} In some arrangements, the introducing firm assumes responsibility for both initial and maintenance margin. Therefore, sound business practice dictates that the clearing firm monitor closely potential financial exposure arising from transactions emanating

13 Section 220.18(a), 17 C.F.R. § 220.18(a), of Regulation T provides that for most margin securities, initial margin is 50% of the security's current market value. Generally speaking, the carrying firm extends credit and is responsible for compliance with Regulation T. See, Board Interpretation of Regulation T, 5-620 (September 25, 1979).

14 See, e.g., NYSE Rule 431. While Section 7 of the Exchange Act, 15 U.S.C. § 78g (1981), authorizes the Federal Reserve Board to establish maintenance margin requirements, this function has traditionally been left to the exchanges. See Board Interpretation of Regulation T, 5-650.11 (July 20, 1981). Maintenance margin requirements established by SROs are, generally, lower than initial requirements under Regulation T.

at the introducing firm.^{15/}

It is clear, therefore, that business, and not legal, considerations determine the terms of a clearing agreement. A carrying firm's compensation will vary based upon the services it provides to the introducing firm. An introducing firm may contract with a carrying firm to perform virtually all the functions of a broker-dealer except direct, individual communications with its customers concerning their investment decisions, and pay accordingly for such services. The method of payment can also vary. In some agreements, the carrying firm receives a flat percentage of commissions generated by the introducing firm; in

15 In imposing sanctions on an introducing firm for failing to disclose to its carrying firm material facts as to the credit worthiness of one of its customers, the Commission recognized the potential credit exposure of carrying firms and stated:

It is true that [the introducing firm] had a contractual obligation to indemnify [its clearing brokers] for losses. However, considering [the introducing firm's] small net capital...there was a substantial likelihood that the clearing brokers would themselves have to bear all or part of any potential losses.

In Re Boylan, Exchange Act Rel. No. 18378, 24 SEC Docket 449, 455 n. 33 (January 14, 1982). In its appellate brief in this case, the Commission's brief stated:

The failure of an introducing broker to fulfill its disclosure obligations to a clearing broker can subject the latter to losses...[T]he clearing broker has a right to expect [the introducing broker to] comply...with 'rules of conduct basic to the securities industry--full and fair disclosure of all known, material information.'

Brief of the Securities and Exchange Commission, Boylan v. Securities Exchange Commission 82-7111 (9th Cir. 1982).

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others, the carrying firm receives a flat fee on a per share or per transaction basis. Some agreements call for the carrying firm to receive a monthly fee unrelated to the introducing firm's business volume. Regardless of the method used for computing the carrying firm's remuneration, it is important to remember that the fee structure is a means by which one business entity (the introducing firm) compensates another business entity (the carrying firm) for services rendered according to contract.

C. The Regulatory Environment of Carrying Arrangements

1. Commission Rules

Depending on the allocation of certain responsibilities under the Exchange Act in the carrying agreement, introducing firms receive favorable regulatory treatment under various rules promulgated under the Exchange Act. Broker-dealers are exempt from the possession and control requirements of Exchange Act rule 15c3-3¹⁶/ if they "promptly transmit all customer funds and securities to the clearing broker or dealer...."¹⁷/ Introducing broker-dealers have reduced capital requirements under the Commission's net capital rule if, among other things, it "introduces and forwards as a broker all transactions and accounts of

¹⁶ Rule 15c3-3, 17 C.F.R. § 240.15c3-3, requires, inter alia, broker-dealers to obtain and thereafter maintain possession and control of its customers' fully paid and excess margin securities.

¹⁷ Exchange Act Rule 15c3-3(k)(2)(b), 17 C.F.R. § 240.15c3-3(k)(2)(b).

customers to another broker or dealer [carrying] such accounts on a fully disclosed basis....^{18/} Firms introducing customer accounts on a fully disclosed basis are exempt from certain of the recordkeeping requirements of rule 17a-3 if such records are kept and maintained by their carrying firm.^{19/} In summary, various rules promulgated by the Commission permit certain back office responsibilities to be discharged by carrying firms and afford favorable regulatory treatment to introducing firms.

2. SRO Rules

Any uncertainty concerning the legal implications of the introducing-carrying relationship in which at least one of the parties was a member of the NYSE should have been resolved by the recent amendments to New York Stock Exchange rule 382.^{20/}

In February 1982, the Commission approved amendments to NYSE rules 382 and 405 designed to "clarify the responsibilities of organizations relative to the handling of customer accounts that are introduced by one organization (introducer) to another (carrier) pursuant to a [fully disclosed] carrying agreement."^{21/} Rule 382, as amended, provides that fully disclosed

18 Exchange Act Rule 15c3-1(a)(2)(i), 17 C.F.R. § 240.15c3-1(a)(2)(i).

19 Exchange Act Rule 17a-3(b)(1), 17 C.F.R. § 240.17a-3(b)(1). Exchange Act Rule 17a-5(c)(i), 17 C.F.R. § 240.17a-5(c)(i), exempts certain introducing firms from the requirement to furnish customers with various financial statements.

20 Exchange Act Release No. 34-18497, 24 SEC Docket 964 (March 9, 1982).

21 Id.

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clearing agreements (in which one or both parties is a member of the NYSE) must allocate seven functional areas related to the obligations of the introducing and carrying firms: (1) opening, approving and monitoring of accounts; (2) extension of credit; (3) maintaining of books and records; (4) receipt and delivery of funds and securities; (5) safeguarding of funds and securities; (6) confirmations and statements; and (7) acceptance of orders and execution of transactions.^{22/} Rule 382 does not suggest how the parties allocate these functions.

While the amendments to rule 382 dealt with the relationship between introducing and carrying firms, it has no effect on a broker-dealer's responsibility to supervise its own employees or the activities conducted in its branch offices.^{23/} NYSE rule 342 requires, inter alia, that each office of a broker-dealer be under the supervision and control of such organization. Similarly, Article III, Section 27 of the NASD's Rules of Fair Practice requires member firms to supervise the activities of all of its registered representatives and associated persons, wherever located. Every broker-dealer, therefore, has a duty to supervise its employees, and SROs have rules specifically addressed to this

²² If an NYSE firm enters into a clearing arrangement, the contract must be approved by the NYSE.

²³ Exchange Act Section 15(b)(4)(E), 15 U.S.C. § 78o(b)(4)(E) (1981), authorizes the Commission to sanction a broker-dealer if it "fail[s] reasonably to supervise" a person subject to its supervision if such person violates the federal securities laws.

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obligation. Employees of an introducing firm are subject to the supervision and control of their employer and their firm's principals, but not to the control of the carrying firm.^{24/}

The amendments to NYSE rules 382 and 405 should have resolved any question as to the ability of firms to allocate contractually enumerated responsibilities.

When the Commission approved the amendments to NYSE rule 382, it also approved amendments to NYSE rule 405. Rule 405, entitled "Diligence as to Accounts," requires NYSE members, through certain persons: (1) to use due diligence as to the essential facts of its customers; (2) to supervise diligently all accounts handled by its registered representatives; and (3) to approve specifically the opening of accounts. The 1982 amendments rescinded, among other things, supplementary materials to rule 405 which dealt with the relationship between introducing and clearing firms.^{25/} The amendments to rule 382, which clarified the ability of organizations subject to a fully disclosed clearing agreement to allocate certain regulatory responsibilities, rendered this interpretation nugatory. Despite

²⁴ In *In Re D.H. Blair & Co., et.al.* 44 S.E.C. 320 (May 21, 1970), the Commission, while censuring a carrying firm, stated that there is no general responsibility for a carrying firm to supervise the activities of an introducing firm. *Id.* at 328.

²⁵ See NYSE Information Memo 82-18 (March 5, 1982). A copy of this memo is attached as Exhibit B.

these amendments, courts continue to confuse and misinterpret the applicability of rule 405.^{26/}

D. Carrying and Introducing Firms - An Agency Analysis

The relationships between a customer, his broker-dealer (the introducing firm) and a carrying firm can best be analyzed in agency terms. After discussing briefly certain key definitions, we will review the relationship in such terms.

Agency is the "fiduciary relationship which results from the manifestation of consent by one person to authorize that the other shall act on his behalf and subject to his control, and consent by the other so to act."^{27/} A principal is the party for whom action is to be taken while an agent is the party acting for the principal.^{28/} A subagent is a party appointed by an agent to perform functions undertaken by the agent, but the agent is responsible to the principal for the actions of the subagent.^{29/} Agents generally are permitted to delegate to a subagent the responsibility to perform mechanical and ministerial acts if, among other things, it is customary to employ other

26 See text at notes 97-107, infra.

27 Restatement (Second) of Agency § 1 (1957). (Hereinafter, "Restatement.")

28 Id.

29 Id. at § 5.

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agents to perform the tasks assigned to the subagent.^{30/}

In a fully disclosed clearing arrangement, a customer (the principal) places an order to purchase or sell securities with a registered representative, a person associated with the introducing firm (the customer's agent).^{31/} The introducing firm effects this transaction either on its own or via the carrying firm. The carrying firm is the introducing firm's subagent, that is, a party appointed by an agent (the introducing firm) to perform specific functions on its behalf.^{32/} The customer of the introducing firm receives, among other things, confirmations of purchases and sales directly from the carrying firm. As noted previously, an agent (the introducing firm) is responsible to its principal (the customer) for the actions of its agent (the carrying firm, the subagent in this relationship).

As a subagent, a carrying firm owes the introducing firm the duties of an agent to its principal.^{33/} In unusual cases, such as if it misuses the principal's property (i.e., the customer's

³⁰ Id. at § 78-79.

³¹ See, e.g., Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc. 337 F. Supp. 107 (N.D. Ala. 1971) where the court stated, "[a] broker's office, without special circumstances...is simply to buy and sell. The office commences when the order is placed and ends when the transaction is complete." Id. at 111.

³² See note 29, supra.

³³ Restatement at § 428.

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securities or money), a subagent (the carrying firm) is liable directly to the principal.^{34/} Generally, however, a subagent's duties and responsibilities inure to the benefit of the agent.^{35/} While this agency analysis is straightforward, some courts have failed to understand the relationship between the parties and therein rendered unsound legal analysis.^{36/}

E. The Customer's Perspective

The existence of the agency relationship between the introducing and carrying firm also can be understood by reviewing a customer's legitimate expectations upon opening an account with an introducing firm. The customer opens an account with a registered representative employed by the introducing firm. All his orders to buy and sell securities and the day-to-day servicing of his account are given to the registered representative of the introducing firm.

The registered representative's employer, however, has made

34 Id. at Comment a.

35 Id. at § 5.

36 See text at notes 60-107, infra. Limiting the analysis to the relationship between the introducing and carrying firms, the carrying firm could, alternatively, be viewed as a non-agent independent contractor engaged by the introducing firm to perform certain tasks. See Restatement at § 14N, comment b. With respect to the principal-agent relationship between a customer and his broker, however, the carrying firm is, as discussed above, the introducing firm's subagent. See text at notes 29-35, supra.

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a business decision to contract with another entity (usually a registered broker-dealer) to perform certain back office functions. The customer, therefore, does not receive his confirmations and monthly statements from his registered representative's firm, but rather from the carrying firm. The receipt of a confirmation could be the first time the customer becomes cognizant of the carrying firm's existence. But for the introducing firm's decision to contract with a carrying firm to perform certain services, the investor would have no relationship with the carrying firm.^{37/}

In addition, customers generally are fully aware of the relationship between introducing and carrying firms. NYSE Rule 382 requires that customers whose accounts are introduced on a fully disclosed basis be notified upon the opening of their account of the existence of the carrying agreement and the relationship between the introducing and carrying firms.^{38/}

Such notification typically states clearly that the key individual as to the customer's relationship with his or her broker is their registered representative, a person associated

⁷ Some customers, however, have been successful in asserting that the carrying firm was their broker. See text at notes 57-59, infra.

³⁸ NYSE Rule 382(c). Amex Rule 400(c) contains a similar requirement. A sample of such a letter is attached as Exhibit C.

with the introducing firm.^{39/}

Having examined the business and regulatory background of introducing/carrying agreements, this essay will now review some relevant cases.

II

BRIEF HISTORY OF THE PROBLEM

Given this relatively simple contractual arrangement between the introducing and carrying firm, why do courts fail to comprehend this relationship? The seminal case dealing with the relationship between introducing and clearing firms, Hawkins v. Merrill Lynch, Pierce, Fenner & Beane ("Merrill Lynch")^{40/} illustrates this lack of comprehension and frequently forms the basis for opinions misinterpreting the relationship.

A. Hawkins

In Hawkins, Merrill Lynch, the defendant, was the clearing broker for D.S. Waddy and Company ("Waddy"), a small brokerage firm located in Arkansas. While the decision is unclear, it appears that Merrill Lynch cleared all but one of Waddy's accounts on a fully disclosed basis. The remaining account was

³⁹ If neither the introducing nor the carrying firm were members of the NYSE, rule 382(c) would not apply. Assuming the customers were informed as to the existence of a fully disclosed carrying arrangement, the analysis discussed above should apply.

⁴⁰ 85 F. Supp. 104 (W.D. Ark. 1949).

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an omnibus account and the source of defendant's problems.^{41/} Evidently, several customers of the introducing firm (whose trading purportedly was effected through Waddy's omnibus account) ordered securities (through Waddy) which were not purchased, and they suffered losses.

The court found that although the introducing firm was not the agent of the carrying firm, the plaintiff "did have the right...to expect the [carrying firm] to control [the introducing firm's actions] and that such control would be in accordance with the law and their orders would be executed in the manner provided by the law."^{42/} In analyzing the defendant carrying firm's liability for the introducing firm's violation of section 10(b), the court stated:

Defendants permitted, and...encouraged [the introducing firm] to [effect the transactions in question]. As the result of their experience in the brokerage field they knew the inherent dangers to the investing public [of such transactions].... The loss suffered by all of the plaintiffs is the proximate result of the maintenance [of the relevant account] and the conduct of defendants in permitting the use of the account and in failing to properly supervise it paved the way [for plaintiffs losses]....^{43/}

The court found, among other things, that by "permitt[ing], approv[ing], and [failing to supervise]" the introducing firm's

⁴¹ Id. at 109.

⁴² Id. at 121. The court cited no authority for this responsibility to control or from whence came the carrying firm's duty to supervise. The carrying firm does not "control" the actions of the introducing firm. See text at notes 83-88, infra.

⁴³ Id. at 122. (Emphasis supplied.)

actions, the defendant violated Exchange Act section 10(b)^{44/} and rule 10b-5 promulgated thereunder.^{45/} It also found the carrying firm liable as a controlling person under section 20(a) of the Exchange Act.^{46/}

B. Recent Cases

Two recent district court cases illustrate that the confusion emanating from the Hawkins decision still exists in the courts. In both Cothren v. Donaldson Lufkin & Jenrette Securities Corporation ("DLJ"),^{47/} and Margaret Hall Foundation, Inc. v. Atlantic Financial Management, Inc. ^{48/}, the district court judges, denied defendant carrying broker's motion to

⁴⁴ Exchange Act section 10(b) makes it unlawful to use or employ manipulative or deceptive devices or contrivances in connection with the purchase or sale of securities.

⁴⁵ Hawkins at 122. Concerning liability "for failing to supervise," Exchange Act section 15(b)(4)(E) empowers the Commission to sanction a registered broker-dealer if it "fail[s] to reasonably supervise a person subject to its supervision." An introducing firm is not, however, subject to the supervision of a carrying firm and there is no civil analogue to section 15(b)(4)(E) imposing civil liability on a broker-dealer for failure to supervise.

⁴⁶ But see text at notes 83-88, infra. Section 20(a) imposes liability on "control" persons under certain circumstances, based upon the actions of persons subject to their control.

⁴⁷ 82 Civ. 363 (E.D. Tex. 1982). Hereinafter cited as Cothren or "Slip Opinion."

⁴⁸ Current Fed. Sec. L. Rep. (CCH) ¶ 99,514, (October 26, 1983.)

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dismiss for failure to state a claim upon which relief could be granted based on an incorrect analysis of the relationship between the introducing and carrying firm.

In Cothren, plaintiff alleged that DLJ, the carrying firm, violated Exchange Act section 10(b) and rule 10b-5 and aided and abetted violations of the same provisions committed by plaintiff's broker, Affiliated Securities Brokers ("Affiliated") and its principals.^{49/} Plaintiffs alleged, among other things, that DLJ "aided and abetted Affiliated's misrepresentations...by failing to exercise due diligence to learn the essential facts...of the Plaintiffs' financial situations and investment experience as required by NYSE Option Rule 721...[and] by failing to observe...[various self regulatory organization's] suitability rules...."^{50/}

The most important section of the opinion for the purposes of this article discussed DLJ's liability for the acts of Affiliated and its principals. The court found that Affiliated and its principals were agents of DLJ. Relying extensively on the fact that plaintiff thought one of Affiliated's principals

⁴⁹ DLJ cleared transactions for Affiliated on a fully disclosed basis through one of its subsidiaries, Pershing. Pershing acts as a clearing broker for many introducing firms.

⁵⁰ Slip Opinion at 5-6. NYSE rule 721 requires NYSE members to take certain actions before accepting options orders from their customers.

was an agent of DLJ,^{51/} the court found that DLJ had "delegat[ed] to Affiliated the responsibility for fulfilling all of DLJ's responsibilities to its customers."^{52/} It also found that "[w]hile clearing brokers are free to attempt to delegate various statutory and regulatory duties] to others, ultimate responsibility must remain their own."^{53/} Citing Hawkins with approval, the court concluded that plaintiffs had stated a claim against DLJ on the basis of fraudulent misrepresentations of its "agents," Affiliated and its two principals.^{54/}

In Margaret Hall Foundation v. Atlantic Financial Management, Inc. ^{55/} ("MHF v. AFM"), plaintiffs alleged that a broker-dealer (Tuton, DiIanni, & Draizin, Inc. "TDD") and an affiliated investment adviser (AFM) engaged in a fraudulent scheme in violation of Exchange Act section 10(b) and rule 10b-5. A.G. Becker, Inc. ("Becker") carried TDD's customer

⁵¹ The mere fact that an individual "thinks" that one party is the agent of a third party does not suffice to create an agency relationship. See text at notes 92-94, infra.

⁵² Slip Opinion at 13. Of course, plaintiffs were Affiliated's customers and Affiliated had, in accordance with rules of DLJ's self-regulatory organization approved by the Commission, delegated some of its responsibilities under the federal securities laws to DLJ. See text at notes 97-107, infra.

⁵³ Id. The court failed to define the statutory source or precise nature of this "ultimate responsibility."

⁵⁴ Id. at 14.

⁵⁵ Current, Fed. Sec. L. Rep. (CCH) ¶ 99,514 (D. Ct. Mass. October 26, 1983).

accounts on a fully disclosed basis. Plaintiffs alleged, in summary, that they had given AFM full discretionary authority pursuant to an investment advisory contract and, contrary to their instructions, defendants invested in speculative ventures.^{56/}

Plaintiffs alleged that Becker was liable under section 10(b) and rule 10b-5 for three reasons: (1) it knew that the other defendants (AFM and TDD) were selling the same security for their own account that AFM and TDD were purchasing for plaintiff's account, and that Becker "did nothing about this conflict of interest"; (2) it had a "close working relationship" with the other defendants; and (3) it "was their broker and...[it] recklessly disregarded the unsuitability of (the stock in question) for their investment purposes."^{57/}

Becker asserted that it was simply a clearing broker whose responsibilities were limited to executing plaintiffs' orders. It argued that it had no knowledge of any fraud and that it had no duty to monitor or police the accounts of the introducing firm. The court disagreed, because of factors such as Becker's renting space to the other defendants and the fact that

⁵⁶ Id. at 96,969. The court placed a great deal of emphasis on the delegation of "full," in contrast to "sole," discretionary authority. A critique of such analysis is beyond the scope of this article.

⁵⁷ Id. at 96,971.

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plaintiff's received confirmations on Becker's stationery.^{58/}
It also cited Becker's "failure to warn" plaintiffs about the
apparent conflict of interest in certain of the other defendants'
trading strategies. Becker's motion to dismiss was denied
because the court found that sufficient issues of fact were
present with respect to whether or not it had aided and abetted
the allegedly fraudulent conduct of the introducing firm and its
affiliated investment adviser.^{59/}

III

ANALYSIS OF THE CASES

This article maintains that there are three major reasons
why the reasoning in the cases discussed in the previous section
and of various commentators is incorrect: (1) it evidences a
misunderstanding of the elements of a cause of action under
section 10(b) either on a primary, or an aiding and abetting,
basis; (2) it fails to comprehend the agency relationship between
introducing and clearing firms; (3) it nullifies the impact of
NYSE rule 382 and inappropriately applies other SRO rules, par-
ticularly NYSE rule 405, to the facts. The following discusses
each of these reasons.

⁵⁸ Id.

⁵⁹ See also, Faturik v. Woodmere Securities, Inc. 431 F. Supp.
894 (S.D.N.Y. 1977). (Court denied carrying firm's motion to
dismiss in an action based upon alleged fraudulent activities
conducted by an introducing firm (plaintiff's broker)
because, in appropriate cases, a carrying broker "may be
liable for manipulative or deceptive schemes of trading
brokers"). Id. at 897.

A. Elements of a Violation of Section 10(b)

As noted previously, some courts have held clearing firms liable for violations of section 10(b) either on a primary or an aiding and abetting basis, or as a controlling person. All of these theories do not withstand careful analysis.

1. Primary Liability

Section 10(b) prohibits "the use in connection with the purchase or sale of any security...[of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."^{60/} A necessary element of a violation of section 10(b) is the use of a manipulative or deceptive device or contrivance employed in connection with the purchase or sale of securities. While this formulation merely restates the statute, it poses it in a way important for this analysis.

Carrying firms do not employ manipulative acts or practices in connection with the purchase or sale of securities. In fact, the carrying firm has no role in an investor's decision to buy or sell a particular security.^{61/} Its only nexus to the purchase or sale comes after the introducing firm's customer, either alone

⁶⁰ Exchange Act Section 10(b), 15 U.S.C. § 78j(b)(1976).

⁶¹ See, e.g., Livingston v. Weis, Voisin, Cannon, Inc., 294 F. Supp. 676 (D.N.J. 1968). (Court dismissed action against a clearing firm because it "had nothing to do with the actual purchasing and selling decisions [in question] and...served only as a bookkeeper." Id. at 683.

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or on the basis of his broker's advice, makes a decision to purchase or sell a security. As the Supreme Court has stated, "to constitute a violation of rule 10b-5, there must be fraud."^{62/} Absent a carrying firm's making, with scienter,^{63/} a material misrepresentation or omission in connection with the purchase or sale of a security, the carrying firm cannot, by definition, be a primary violator of section 10(b) or rule 10b-5.^{64/}

2. Aiding and Abetting Liability

Plaintiffs also sue clearing firms on an aiding and abetting theory of liability.^{65/} The theory, in summary, is that the clearing firm knowingly and substantially assists the fraudulent

⁶² Dirks v. SEC, U.S., 1982-1983 Decisions, Fed. Sec. L. Rep. (CCH) ¶ 99,255 at 96,130, n. 27.

⁶³ In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court held that scienter is a necessary element of a civil action brought under section 10(b) and rule 10b-5. It defined scienter as "embracing a mental state to deceive, manipulate, or defraud." Id. at 201, n. 12.

⁶⁴ In Schenck v. Bear, Stearns & Co., 484 F. Supp. 937 (S.D.N.Y. 1979), in an action based upon, inter alia, the manner in which plaintiff's account was liquidated because of margin calls, the court stated "[a]t no time did [the carrying firm] make any representations to plaintiff which might give rise to a violation of section 10(b) or rule 10b-5." Id. at 945. (Emphasis supplied.)

⁶⁵ As noted by Dean Ruder, an aider and abettor will, in many cases, "merely be engaging in customary business activities, such as...completing brokerage transactions." Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution, 120 U. Penn. L. Rev. 597, 632 (1972).

activities of a carrying firm. For example, in MHF v. AFM, plaintiff asserted that Becker, the carrying firm, had a very close relationship to the introducing firm,^{66/} "len[t] credibility to [defendant's] enterprise,...actively promoted the [sales in question]...and sent confirmation slips [to the defendants]."^{67/}

The elements of aiding and abetting liability are well established: (1) the existence of a securities law violation by the primary violator; (2) knowledge of the violation by the alleged aider and abettor; and (3) substantial assistance by the aider and abettor in the primary violation.^{68/} These elements can be analyzed using the facts of the MHF case. For purposes of this analysis, it is assumed that the introducing firm violated section 10(b) by misrepresenting material facts in connection

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AAA.

⁶⁶ All carrying firms have contractual relationships with introducing firms; whether or not the relationship is "close" and the legal implications of such "closeness" were not adequately explained by the court.

⁶⁷ Id. at p. 96,971. Any large, publicly identifiable broker-dealer which acts as a carrying firm will be the target of claims that it lent credibility to the operations of the introducing firm by having its name on, among other things, confirmations and customer statements sent to the introducing firm's customers. Such conduct, however, hardly "substantially assists" the alleged fraudulent activities of the introducing firm.

⁶⁸ See, e.g., IIT v. Cornfeld 619 F.2d 909, 922-23 (2nd Cir. 1980).

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with the purchase of securities.^{69/}

With respect to the carrying firm, the second two elements of aiding and abetting liability are generally not present. A carrying firm is not cognizant of specific representations made by a representative of the introducing firm and, therefore, the second element (knowledge of the violative actions) is not present.^{70/} In MHF, plaintiffs asserted, in essence, that Becker should have known^{71/} about the conflict of interest which

⁶⁹ It is not clear that the introducing broker in MHF violated section 10(b) because an investment adviser (albeit an affiliate of the introducing firm) had full discretionary authority as to the relevant investment decisions, and, in a discretionary account, the adviser generally makes purchases and sales without discussing them with the client. Some courts, however, have found that a broker's conduct in managing such an account "operated as a fraud." See, e.g., Rolf v. Blyth Eastman Dillon 570 F.2d 38 (2nd Cir.) cert. denied 439 U.S. 1078 (1978).

⁷⁰ In Investors Research Corporation v. Securities and Exchange Commission, 628 F.2d 168 (D.C. Cir.) cert. denied 449 U.S. 919 (1980), the court stated that the awareness of wrongdoing requirement of aiding and abetting liability "is designed to insure that innocent, incidental participants in transactions later found to be illegal are not subjected to harsh, civil, criminal, or administrative penalties." Id. at 177 (citations omitted).

⁷¹ This negligence formulation is inconsistent with the scienter requirement of section 10(b), which requires an intent to deceive or defraud. Under a "should have known" standard, plaintiff need not prove that defendant intended to defraud anyone; it must only show that, given hindsight, the defendant should have acted differently. Such an allegation is insufficient to sustain either a primary violation of section 10(b) or an allegation of aiding and abetting because the party does not act with an intent to deceive or defraud.

allegedly existed because the introducing broker or its affiliated investment adviser was recommending the purchase of a certain security when it was simultaneously selling it for its principal account. This argument suggests that a carrying firm is required--indeed has a duty--to investigate actively trades effected for customers of the introducing firm^{72/} in order to escape civil liability based on the actions of the introducing firm. Neither the federal securities laws nor the rules of a self-regulatory organization impose such a duty upon broker-dealers, the violation of which will constitute providing substantial assistance to a primary violator's fraudulent

72 In *Investors Research Corp. v. SEC*, supra note 70, Judge Bazelon rejected the Commission's "should have known" analysis when the Commission attempted to impose aiding and abetting liability against an individual based on violations of Section 17(e)(1) of the Investment Company Act of 1940 15 U.S.C. § 80a-17(e)(1) 1976, he stated that the Commission's attempt to impose liability on such a theory: creates a duty to investigate potential violations of law which, in essence, would amount to eliminating [any awareness of wrongdoing] as a necessary element in imposing aiding and abetting liability. Id. at 1978. Accord, *Ruder*, supra note 65, "[t]he essential point is that, imposition of a duty to investigate under the guise of a 'should have known' standard in essence would amount to eliminating scienter as a necessary element in imposing aiding and abetting liability." Id. at 633.

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activities.^{73/}

Why is the absence of such a duty important? Courts have held that the requisite assistance and the level of culpability of an alleged aider or abettor scales upward if it has a fiduciary duty to the plaintiff. The First Circuit recently stated:

Courts generally have held that in the absence of a duty or disclosure, a defendant should be held liable as an aider and abettor only if the plaintiff proves that the defendant had actual knowledge [of the primary violation].... Where the defendant has a duty to disclose the primary violations, however, courts have been willing to impose liability on the basis of a recklessness

73 In *Faturik v. Bear Stearns*, supra note 59, the court, in denying the carrying firm's motion to dismiss, held that the carrying firm could be liable under an aiding and abetting theory if it aided and abetted the introducing firm's violation of NYSE Rule 405 by failing to detect irregularities or suspicious circumstances present in the trading activities conducted by the introducing firm.

Commenting on *Faturik*, one commentator noted, Apparently the court believed that the clearing broker had an imperative duty to investigate the trading account and was willing to imply liability solely on the broker's notice of irregularities in [the introducing firm's] activities. While this rationale may be desirable from a plaintiff's point of view, it imposes an additional burden on brokers which is inconsistent with [section 10b's] scienter standards.

Note, Implied Liability for Violation of Stock Exchange and NASD Rules - After Rolf and Faturik, 9 *Loyola L.J.* 685, 705 (1978).

standard.^{74/}

There is no basis in the federal securities to sustain the theory that a carrying firm has a statutory duty to investigate and, if appropriate, disclose to the customer of the introducing firm actions of the introducing firm which might violate the law.^{75/}

Therefore, a plaintiff should have to demonstrate actual knowledge of the wrongdoing to satisfy the second element of the aiding and abetting liability test.^{76/}

In the rare case when a plaintiff can demonstrate actual knowledge of the introducing firm's fraud, the carrying firm should still not be liable on an aiding and abetting theory

⁷⁴ Cleary v. Perfectune, Inc. 1982-1983 Transfer Binder, Fed. Sec. L. Rep (CCH) ¶ 99111 p. 95,319 (1st Cir. 1983). See also, Edwards & Hanly v. Wells Fargo Securities Clearance Corp., 602 F.2d 478 (2nd Cir. 1979) where the court stated, "[f]inding a person liable for aiding and abetting a violation of [rule] 10b-5...requires something closer to an actual intent to aid in a fraud, at least in the absence of some special relationship with the plaintiff that is fiduciary in nature." Id. at 485. Accord L. Loss, Fundamentals of Securities Regulation (1983). "[with respect to the civil liability of an aider and abettor], the required degree of fault is greater, if anything, than it is with respect to the person primarily liable." Id. at p. 1182.

⁷⁵ See, e.g., In Re D.H. Blair & Co., supra note 24.

⁷⁶ Judge Skelly Wright, in Dirks v. SEC 681 F.2d 824 (D.C. Cir. 1982) rev'd on other grounds ___ U.S. ___, 1982-1983 Decisions, Fed. Sec. L. Rep. (CCH) ¶ 99,255 (July 14, 1983) found that the federal securities laws, taken as a whole, support the proposition that a broker-dealer has a "duty to the SEC and the public created by the ethical standard that applies to broker-dealers....to report [possible violations of law] to the SEC...." 681 F.2d at 841. The Commission opted not to address this liability theory before the Supreme Court and the Court did not address this theory of broker-dealer liability in its decision. Id. at p. 96,130 n. 26.

unless plaintiff can demonstrate it provided substantial assistance to the primary violator--the third element of aiding and abetting liability--in a manner which evidences an intent to defraud.

Some courts have found "substantial assistance" present as a result of an incorrect analysis of the relationship between the parties. For example, the Cothren court found that the carrying firm provided substantial assistance to the introducing firm's alleged fraud by failing "to exercise due diligence...to supervise its customer accounts."^{77/} In a similar case, the Seventh Circuit has held that a carrying firm aided and abetted an introducing firm's fraud by "permit[ting] the financially irresponsible president of the [introducing firm] to use [the carrying firm's] facilities for the purpose of speculating [with the introducing firm's customer's funds.]"^{78/}

This analysis is seriously flawed. The "substantial assistance" referred to in the Cothren case is conduct consisting of the carrying firm's failure to supervise certain trading activities conducted through the introducing firm. No provision of the federal securities laws imposes a duty upon carrying firms

⁷⁷ Cothren, Slip Opinion at 9.

⁷⁸ Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, 410 F.2d 135, 143 (7th Cir.) cert. denied, 396 U.S. 838 (1969). In Buttrey, the court found that the carrying firm's activities were "tantamount to fraud." Id. at 143.

to supervise the activities of the introducing firms.^{79/} Mechanical executions of an order upon the instructions of the introducing firm do not, or should not, constitute substantial assistance, the third prerequisite to imposition of aiding and abetting liability.^{80/}

Given that mere execution of an order by a carrying firm does not constitute substantial assistance, plaintiffs attempt to allege that inaction by the carrying firm--a failure to act when it allegedly should have--caused their losses. For example, in MHF, plaintiffs alleged, among other things, that Becker (the carrying firm) "failed to warn them of [the unsuitability of certain investments]....[and] failed to warn plaintiffs about the apparent conflict of interest involved in the other defendants' trading practices."^{81/} Carrying firms, however, have no such independent duty to police the activities of introducing firms.

79 See In Re D.H. Blair, supra. note 24 at 328.

80 According to this theory, a carrying firm substantially assists an introducing firm's fraudulent activities when it fails to detect, and, presumably, stop executing, certain questionable orders. This theory assumes that a carrying firm has a duty to take such actions and the failure to do so results in a breach of a duty owed to the customers of the introducing firm. In Chiarella v. United States, 445 U.S. 222 (1980), the Court noted, "when an allegation of fraud is based upon [a failure to act], there can be no fraud absent a duty to speak." Id. at 235. Because a carrying firm owes no duty to disclose allegedly unusual trading activities to the introducing firm's customers, the carrying firm's failure to act cannot violate section 10(b).

81 MHF v. AFM at p. 96,971.

Absent such a duty, "inaction can not constitute the assistance necessary to support the imposition of aiding and abetting liability."^{82/}

3. Controlling Person Liability - Section 20(a) of the Exchange Act

Some courts have held carrying firms liable for the actions of introducing firms as a controlling person under Section 20(a).^{83/} For example, in Cothren, the court found that Affiliated was DLJ's agent for the narrow purpose of complying with the NYSE's and the NASD's "due diligence" and "suitability" rules.^{84/} Because the "agent" (the introducing firm) allegedly failed to comply with such rules, the court found that a section 10(b) claim was stated against the carrying firm.^{85/}

Such an interpretation evidences a complete misunderstanding

⁸² See, e.g., Woodward v. Metro National Bank, 522 F.2d, 85, 96-97 (5th Cir. 1975).

⁸³ Exchange Act Section 20(a), 15 U.S.C. § 78t(a)(1976), reads as follows:

Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

⁸⁴ Cothren, Slip Opinion at 14.

⁸⁵ Id.

of the contractual and business relationship between the introducing and carrying firm. Neither party "controls" the other; rather, the introducing firm initiates the relationship and the various obligations under federal law and the rules of the parties' SROs are allocated by contract. Indeed, the only relevant control relationship for purposes of liability under section 20(a) is the control the introducing firm exercises over its registered representative. Although, as discussed earlier,^{86/} the carrying firm may be viewed, for some purposes, as a subagent appointed by the introducing firm to perform certain duties, neither party to a clearing agreement controls the other for purposes of control person liability under section 20(a). Section 20(a) was intended, among other things, to impose liability on persons such as employers who control the acts of their employees and are unable to demonstrate the good faith defense of section 20(a). A "controlling person" is a person having the power to control the direction, management, and activities of the controlled person.^{87/} A carrying firm simply

⁸⁶ See text at notes 27-35, supra.

⁸⁷ The legislative history of section 20 states that "control" means "actual control as well as what has been called legal control.... A few examples of [such control] are stock ownership, lease, contract, and agency." 78 Cong. Rec. 7709 (1934). Nothing remotely equivalent to these relationships exists in the introducing-carrying firm relationship.

does not control the actions of the introducing firm.^{88/}

B. Misapplication of Agency Analysis and Customer Relationship

This article previously has argued that imposing liability upon the carrying firm in certain cases ignores the scienter requirement of section 10(b). Perhaps the clearest mistake made by courts in analyzing the relationship between introducing and carrying firms, however, is their conclusion that the carrying firm is a principal which has delegated specific responsibilities to its agent, the introducing firm.^{89/} For example, the Cothren court stated:

it is clear that DLJ delegated to Affiliated the responsibility for fulfilling all of DLJ's responsibilities to its customers.... While clearing brokers are free to attempt to delegate such duties to others, ultimate responsibility must remain their own.^{90/}

The implication of such an analysis is that the carrying firm is liable for the actions of its "agents" (introducing firms). This analysis fails to comprehend the relationship between the parties, misapplies agency law, and generally reverses the actual role of the introducing and clearing firm.^{91/}

⁸⁸ Once a court understands that a carrying firm is not a principal of the introducing firm, it should be clear that section 20(a) does not apply.

⁸⁹ See text at notes 41-59, supra.

⁹⁰ Slip Opinion at 13. (Citations omitted.)

⁹¹ See text at notes 27-36, supra.

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1. Definition of Agency

As discussed previously, agency is a fiduciary relationship resulting from the manifestation of consent by one person authorizing that the other shall act on his behalf and subject to his control, and consent by the other so to act.^{92/} First of all, it is the introducing firm which requests the carrying firm to act on its behalf in performing selected, if not all, of its back office functions. With respect to the relationship between the two entities, therefore, the introducing firm is the principal and the carrying firm is the agent.^{93/} The introducing firm is also the agent of the customer (the investor) for the purpose of carrying out the customer's instructions as to the purchase or sale of a security. The carrying firm acts on behalf of the introducing firm and its relationship to the customer is that of a subagent (i.e., an agent of the customer's agent, the introducing firm).^{94/} It has no direct contact with the customer and only acts in accordance with directions received from the introducing firm. In addition, the carrying firm does not--and cannot--control the actions of the introducing firm vis

92 See text at notes 27-36, supra.

93 See note 36, supra for an alternative analysis.

94 See text at note 31-35, supra. The principal's agent (the introducing firm) is, generally, liable to both the principal and third parties for its agent's (the subagent, the carrying firm) misconduct. See Restatement, § 5, comment b.

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a vis the introducing firm's customer; fraudulent statements made by the customer's registered representative simply are not subject to the carrying firm's control. The starting point, therefore, is to remember that the carrying firm is the introducing firm's agent (or subagent vis a vis the customer); the introducing firm is the carrying firm's principal and the customer's agent. There is no direct relationship between the customer and the carrying firm.

2. The Customer-Broker Relationship

The Cothren court also misconstrued the customer-broker relationship. The allegedly defrauded individuals in Cothren were the customers of the introducing firm (Affiliated) and not the carrying firm. The customer's limited nexus with the carrying firm began after the allegedly fraudulent statements made by the introducing firm's agent (the registered representative) supposedly induced the customers to purchase the securities in question. The carrying firm, therefore, has no responsibility to the customer other than duties assigned to it by the introducing firm in the clearing agreement.

Notwithstanding the fact that its dealings are with the introducing firm, customers of an introducing firm's registered representative often claim that the clearing firm was their broker. For example, the plaintiffs in MHF asserted that Becker,

the clearing firm, was their broker.^{95/} A customer's incorrect belief, asserted for the purpose of seeking recovery from the party with the "deep pocket," is--or should be--irrelevant. The carrying firm's participation in the transactions in question begins after the alleged fraud has taken place. The mere existence of the carrying firm's name on a confirmation is insufficient to create a brokerage relationship between the introducing firm's customer and the carrying firm. No agency agreement--express or implied--exists between the allegedly defrauded customer and the carrying firm. The customer has not requested the carrying firm to be his broker and the carrying firm has not agreed to be his broker. None of the elements of an agency relationship exists between the customer and carrying firm.^{96/}

C. NYSE Rule 382

As noted previously, the NYSE proposed, in 1981, important amendments to rules 382 and 405 designed to clarify the responsibilities of broker-dealers related to the handling of customer accounts which are introduced by one firm and carried by another. The raison d'etre for the NYSE recommending such

⁹⁵ Plaintiffs stated that the basis for this belief was the presence of Becker's name on their confirmation. MHF v. AFM supra note 48 at 96,969, n. 3.

⁹⁶ See text at note 27, supra.

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amendments was the "uncertainty and confusion"^{97/} which existed as to the responsibilities attendant to the handling of customer accounts under a fully disclosed carrying agreement. By approving the New York Stock Exchange's proposal, the Commission implicitly found that the rule was in the public interest.^{98/}

Shortly after the Commission approved the NYSE's amendments, the NYSE issued an Information Memo on rule 382.^{99/} It stated:

Rule 382...concerns itself with the relationship between firms arising from a business determination on the part of the "introducer" to contractually allot certain functions to another organization. Thus, depending upon the specifics of the arrangement, its effect would be to relieve a party to the contract from duties and responsibilities which...otherwise would be imposed upon the party.^{100/}

Decisions such as the Cothren decision evidence a complete misunderstanding of the relationship between clearing and introducing firms and nullify the impact of rule 382. The Cothren court evidently believed that the clearing broker was the focal point in the relationship between the customer and the two

97 Rule 19b-4 Submission at p. 2

98 Section 6(b)(5) of the Exchange Act, 15 U.S.C. § 78f(b)(5) (1976), requires, inter alia, that rules of a national securities exchange be "in general,...[in] the public interest."

99 NYSE Information Memo No. 82-18 (March 5, 1982).

100 Id. at p. 2. (Emphasis supplied.)

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broker-dealers (the introducing and clearing firm).^{101/} This is simply not the case; as the NYSE noted in its Information Memo, the entry of the carrying and introducing firms into a contractual relationship is the result of a business decision made by the introducing firm to engage a third party (the carrying firm) to perform certain functions. Generally speaking, the carrying firm delegates nothing; it is the introducing firm which allocates, in accordance with SRO rules, some of its responsibilities under the federal securities laws as to the servicing of its customers' accounts to the carrying firm. By concluding that DLJ could not relieve itself of its "ultimate responsibilities,"^{102/} the court simply evidenced a complete misunderstanding of the relationships between the parties. Plaintiffs were not DLJ's customers, they were customers of the introducing firm. DLJ was simply an agent of the introducing firm. The introducing firm has the "ultimate responsibilities" (whatever this term means); it contracted with DLJ for the performance of specific regulatory responsibilities. Because of this fundamental error, the court's application of rule 382 is misguided.

When the Commission approved the amendments to NYSE rule 382, it also approved amendments to NYSE rule 405. Rule 405,

¹⁰¹ See text at note 51-54, supra.

¹⁰² The court failed to define with precision or cite any statutory provision as the source of such "ultimate responsibilities."

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entitled "Diligence as to Accounts," requires NYSE members, through certain persons. (1) to use due diligence as to the essential facts of its customers, (2) to supervise diligently all accounts handled by its registered representatives; and (3) to approve specifically the opening of accounts.^{103/} The 1982 amendments rescinded, among other things, supplementary materials to rule 405 dealing with carrying and introducing firms and substituted the amended version of rule 382. Despite these amendments, courts continue to confuse and misinterpret the applicability of rule 405, which, as amended, has nothing to do with carrying arrangements.

In Cothren, for example, the court found that aiding and abetting liability could be imposed on DLJ, the carrying firm, because it failed to comply with NYSE rule 405 and 721.^{104/} Such a holding ignores the intent of NYSE rule 382 and renders nugatory the ability of introducing and carrying firms to enter into a carrying agreement which, by its terms, allocates

¹⁰³ Although some courts have stated that rule 405's purpose is to protect a broker-dealer's customers, Buttery, supra 73 at 141, it was, as noted by Professor Loss, "designed to protect the member firm [and not] the customer." L. Loss, supra note 74 at 971. Accord, Nelson v. Hensch, 428 F. Supp. 411, 419 (D. Minn., 1977).

¹⁰⁴ Rule 721 establishes procedures to be followed when member firms open option accounts. Rule 721(b) requires firms to "exercise due diligence to learn the essential facts as to the customer" when he opens an options account. Other SROs have rules similar to rule 721. See, e.g., Amex Rule 921, 923; NASD Rules of Fair Practice, Appendix E.

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responsibilities to the parties.

Rule 405's requirement to supervise diligently all accounts handled by a member's registered representatives, was, or should have been, irrelevant in the Cothren case because none of DLJ's registered representatives had anything to do with the plaintiffs. Affiliated, in accordance with the provisions of the carrying agreement, had responsibility to supervise the activities of its registered representatives. It had agreed to do so within the four corners of the contract. The Cothren court's position on this issue effectively voided, ab initio, that particular provision in the carrying agreement and thereby nullified the impact of Rule 382. Second, Affiliated, a member of the NASD, had an independent obligation to "establish, maintain, and enforce written procedures which will enable it to supervise properly the activities of each [of its] registered representatives."^{105/} The representatives of Affiliated, not DLJ, allegedly made the statements and recommendations in question. The registered representative was employed by Affiliated, not DLJ. Affiliated, in accordance with NASD rules, had the responsibility to supervise the activities of its registered representatives and DLJ had no obligation in this case under Rule 405. Finally, a private right of action does not exist for stock exchange rule violations.^{106/} The alleged

¹⁰⁵ Art. III, Section 27 of the NASD's Rules of Fair Practice.

¹⁰⁶ See, e.g., Jablon v. Dean Witter & Co., 614 F.2d 677, 680 (9th Cir. 1980), Jester v. Rothschild Unterberg Towbin, Gruntal & Co., 1982-1983 Transfer Binder Fed. Sec. L. Rep. (CCH) ¶ 99,084 at p. 95,177 (S.D.N.Y. 1983).

violation of rules 405 and 721 does not give rise to a private right of action and should not support an aiding and abetting allegation. For all of the above reasons the court should have dismissed claims asserted against DLJ for violations of Rules 405 and 721.^{107/}

CONCLUSION

Analysis of the relationship between introducing and carrying firms, as well as relevant Commission and NYSE rules, leads to the conclusion that some courts have failed to examine closely and understand the business and contractual relationship between introducing and carrying firms. The same courts have failed to appreciate the implications of the scienter requirement in actions brought under section 10(b) against carrying firms. Introducing firms are liable for their own actions, and plaintiffs' attempts to embroil carrying firms into disputes involving the acts of the agents of the introducing firm should fail.

¹⁰⁷ Perhaps the Cothren court was influenced by the fact that because Affiliated was not a member of the NYSE, only DLJ had a colorable duty to comply with Exchange rules specifically addressed to options trading. Affiliated was, however, subject to the rules of its self-regulatory organization, the NASD. Appendix E, section 16 of the NASD's Rules of Fair Practice, requires NASD members, in approving a customer's account for options trading, to "exercise due diligence to ascertain the essential facts relative to the customer...." Section 20 of Appendix E requires NASD members to develop and implement a program "providing for the diligent supervision of all of its customer [options] accounts" and section 19 imposes a suitability standard. Therefore, the fact that a customer's firm is not subject to NYSE rules pertaining to options trading does not mean that the customer's firm has no rules relating to options trading; rather, such a firm is subject to relevant rules of the NASD. It is clear that the customer's registered representative is in a far better position than the carrying firm to fulfill such responsibilities.

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In addition to the legal reasons, plaintiff's attempts to sue carrying firms on the basis of the introducing firm's actions should be rejected for sound policy reasons. Increasing the risk to carrying firms of frivolous, vexatious litigation under rule 10b-5¹⁰⁸ will inevitably lead carrying firms to negotiate for increased compensation for the services they provide. This, in turn, could make it increasingly difficult for small, start-up broker-dealers to negotiate with a carrying firm for clearing services. Such a result is not in the public interest because it could result in barriers to entry into the brokerage industry and stifle competition.

Courts should ignore the fact that carrying firms are typically large, well capitalized, firms that are easy targets for plaintiffs' counsel. Rather, courts should use the analysis suggested in this article that a fully disclosed clearing agreement relationship is the result of arms length negotiation between the parties. For legal and policy reasons, courts should reject attempts by customers of introducing firms to involve carrying firms in the embryo of a simple rule 10b-5 claim based on the actions of an introducing firm or its agents.

¹⁰⁸ The Supreme Court, in *Blue Chip Stamp v. Manor Drug Stores*, 421 U.S. 723 (1975) discussed the onerous problems associated with litigation under rule 10b-5:

"[such litigation] is different in degree and kind from that which accompanies litigation in general.... [E]ven a complaint which by objective standards may have little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pending of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the law suit

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EXHIBIT A

Following is a sample contract for securities clearance services. As discussed in depth in the Monograph, introducing/carrying agreements vary substantially depending upon the extent of services performed by the carrying firm.

EXHIBIT A

Gentlemen:

AGREEMENT FOR SECURITIES CLEARANCE SERVICES

This Agreement sets forth the terms and conditions under which XX will act as your clearing broker to carry and clear on a fully disclosed basis, your customer margin and cash accounts, and you will become a correspondent of XX.

1. XX will carry such of your customer accounts as will be mutually agreed by the parties hereto. These accounts are hereinafter called the "Accounts" and the legal and beneficial owners thereof are hereinafter called the "Customers".

2. (a) You shall have sole discretion to determine the amount of commission charged to your Customers' accounts cleared by XX. You agree to pay XX for its services pursuant to this agreement, on each order executed on your behalf on a national stock exchange or over-the-counter, such amounts as set forth in Schedule A hereto.

(b) XX agrees to pay to you monthly such commissions received by XX less any amounts due to XX under this agreement or otherwise and any expenses or other sums to third parties paid on your behalf by XX.

3. XX agrees to notify your Customers in writing concerning the respective obligations of the parties hereto pursuant to paragraphs 4-11 of this agreement and any other Customer related responsibilities of the parties to this Agreement.

4. You agree to supply XX with copies of all financial information and reports filed by you with the New York Stock Exchange, Inc. (if a member), the National Association of Securities Dealers, Inc., the Securities and Exchange Commission, and any other National Securities Exchange (where a member) (including but not otherwise limited to monthly and quarterly Financial and Operational Combined Uniform Single Reports i.e., "FOCUS" Reports) simultaneous with the filing therewith. You shall submit to XX on a monthly basis or, if so requested by XX, at more frequent

intervals, information and reports relating to your financial integrity, including but not otherwise limited to information regarding your aggregate indebtedness ratio and net capital.

5. You will be responsible to XX for: (a) all payments required so that all Accounts, cash and margin, shall be at all times in compliance with Regulation T, as amended, promulgated by the Board of Governors of the Federal Reserve Board, (b) maintaining margin in each margin Account to the satisfaction of XX, (c) the payment of any unsecured debit balance in an Account, (d) until funds are credited to XX, all payment to XX on checks received by it in connection with your Accounts (e) payment and delivery of "when issued" transactions in the Accounts; and (f) the delivery by Customers of securities in good deliverable form under all applicable rules and practices. XX has sole discretion to execute buy-ins or sell-outs in any cash or margin Account whenever it determines such action appropriate regardless whether the Account complies with applicable margin maintenance requirements or has requested extension of time in which to make payment. Any request by you that XX should waive either buying-in or selling-out an Account must be in writing signed by an officer, partner or principal of your firm and you agree that if XX accedes to your request that you will indemnify and hold XX harmless against any loss, liability, damage, claim, cost or expense (including but not limited to fees and expenses of legal counsel) arising therefrom. XX shall have sole discretion as to any application for an extension of time for any Account to make any payment required by Regulation T.

6. (a) XX may, at its discretion, either buy back in the "cash" market or borrow the day you are notified of option assignments affecting shares which have been tendered and cause short positions in your Accounts as of either the proration or withdrawal date. Shares purchased for cash or borrowed will not be considered part of an Account's tendered position until such shares are in XX's actual possession. XX will reduce the tender for your firm accounts and the Accounts by the size of the short or unreceived shares.

(b) During a tender period in which there are competing and counter tender offers for a security XX will tender only on a trade date basis the number of the shares net long in your firm account and the Accounts as of either the proration or withdrawal date.

7. In the event you execute orders away from XX, XX will on a best efforts basis attempt to clear the transaction within reasonable period and utilize the same procedures it clears transactions on its own behalf and on behalf of other firms clearing

through XX; but if either you or the other broker for any reason whatsoever fail to settle the transaction you will be solely liable to XX for any and all loss, including expenses, caused thereby.

8. For each account you agree to supply to XX a new account report on such forms as XX will supply you and to supply any other documentation and information which XX may in its sole discretion, request you to obtain from the Customer. XX agrees to provide you with copies of its Customer Agreement and such other forms necessary to enable you to document each Account. In the event requested documentation or information is not promptly received by XX, XX has the right to refuse to accept orders for such Account, to close the Account and to withhold your commissions and assess upon you any other penalties it sees fit.

9. Unless otherwise agreed to in writing by XX, XX shall issue confirmations, statements and notices directly to your Customers on XX's forms for such purpose which shall state in front of your name "Through the Courtesy of" and will send you duplicate confirmations, statements and notices.

10. You agree that before you commence any trading in options for any Account you will have a Senior Registered Options Principal registered with either the American Stock Exchange, Inc. or the National Association of Securities Dealers, Inc.

11. (a) This Agreement and all transactions in the Accounts, will be subject to the applicable Constitution, Rules, By-Laws, Regulations and customs of any securities market, association, exchange or clearing house where such transactions are effected or of which XX is a member, and also to all applicable U.S. Federal and state laws and regulations. All of the foregoing are hereinafter called the "Applicable Rules".

(b) Except as otherwise specified in this Agreement you are solely responsible for the conduct of the Accounts, and ensuring that the transactions conducted therein are in compliance with the Applicable Rules. Such responsibility includes, but is not limited to: (i) using due diligence to learn and on a continuing basis to know the essential facts of each Customer, including verifying the address changes of each Customer, knowing all persons holding power of attorney over any Account, being familiar with each order in any Account and at all times to fully comply with Rule 405 of the New York Stock Exchange, Inc., and any interpretations thereof, and all similar Applicable Rules; (ii) selecting, investigating, training, and supervising all personnel who open, approve or authorize transactions in the Accounts; (iii) establishing written procedures for the conduct of the Accounts and ongoing review of all transactions in Accounts,

and maintaining compliance and supervisory personnel adequate to implement such procedures; (iv) determining the suitability of all transactions, including option transactions; (v) ensuring that there is a reasonable basis for all recommendations made to Customers; (vi) determining the appropriateness of the frequency of trading in Accounts; (vii) determining the authorization and legality of each transaction in the Account; and (viii) obtaining and maintaining all documents necessary for the performance of your responsibilities under this Agreement and retaining such documents in accordance with all the Applicable Rules.

(c) You will be responsible to all your Customer inquiries and complaints and you agree to promptly notify XX in writing of complaints concerning XX.

(d) You hereby agree to indemnify and hold XX harmless against any loss, liability, damage, claim, cost or expense (including but not limited to fees and expenses of legal counsel) caused by you directly or indirectly as a result of your breach of any of the terms hereof. You hereby agree and warrant that you will maintain appropriate brokers blanket bond insurance policies covering any and all acts of your employees, agents and partners adequate to fully protect and indemnify XX against any loss, liability, damage, claim, cost or expense (including but not limited to fees and expenses of legal counsel) which XX may suffer or incur, directly or indirectly, as a result of any act of your employees, agents or partners.

12. XX, unless otherwise agreed, will supply you on each business day with copies of customer confirmations, margin status reports, money line and a daily commission detail report. Unless you notify XX within a reasonable time (and for the purposes hereof a period of 24 hours after your receipt of such information shall be a reasonable time) of all mistakes or discrepancies in the above described reports and information, XX shall be entitled to consider all the information supplied to you as correct.

13. (a) XX agrees to: monitor and require your Customers to (i) make prompt payment for purchases of securities, interest and other charges, (ii) deliver securities sold, (iii) maintain money and securities in each Account as required by the Applicable Rules, and to comply with any additional requirements as XX may as clearing broker, in its sole discretion require, upon reasonable notice to you and your Customers; advise you of the necessity for buying in or selling out positions in Accounts for failure to comply with payment or delivery requirements and XX shall have the right at its discretion to execute buy-ins or sell-outs if you decline or fail to act; arrange the extension of credit for margin purchases in Accounts in accordance with the Applicable Rules, and with XX's own additional requirements; transfer securities to and from accounts; provide custody, safekeeping and segregation of money and securities of Customers carried by XX; and arrange for the receipt and delivery of securities in exchange and tender offers, rights and warrants offerings, redemptions and other similar type transactions.

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(b) XX agrees to maintain all books and records as are required by the Applicable Rules governing brokers having custody of money and securities in the Accounts.

(c) XX agrees to promptly notify you in writing of complaints concerning you, your employees or your agents.

14. Errors, misunderstandings or controversies, except those specifically otherwise covered in this Agreement, between the Accounts and you or any of your employees, which shall arise out of your acts or omissions (including, without limiting the foregoing, your failure to deliver promptly to XX any instructions received by you from an Account with respect to the voting, tender or exchange of shares held in such Account) shall be your sole and exclusive responsibility. In the event, that by reason of such error, misunderstanding or controversy, you in your discretion deem it advisable to commence an action or proceeding against an Account, you shall indemnify and hold XX harmless from any loss, liability, damage, claim, cost or expense (including but not limited to fees and expenses of legal counsel) which XX may incur or sustain directly or indirectly in connection therewith or under any settlement thereof. If such error, misunderstanding or controversy shall result in the bringing of any action or proceeding against XX, you shall indemnify and hold harmless from any loss, liability, damage, claim, cost or expense (including but not limited to fees and expenses of legal counsel) which XX may incur or sustain directly or indirectly in connection therewith or under any settlement thereof.

15. Each party hereto agrees to indemnify the other and hold the other harmless from and against any loss, liability, damage, claim, cost or expense (including but not limited to fees and expenses of legal counsel) arising out of or resulting from any failure by the indemnifying party or any of its employees to carry out fully the duties and responsibilities assigned to such herein or any breach of any representation, warranty or covenant herein by such party under this Agreement. You hereby agree to indemnify and hold XX harmless from and against any loss, liability, damage, claim, cost or expense (including but not limited to fees and expenses of legal counsel) sustained or incurred in connection herewith in the event any Account fails to meet any initial margin call or maintenance call.

16. You represent, warrant and covenant to XX as follows:

(i) You will immediately notify XX when (1) your Aggregate Indebtedness Ratio reaches or exceeds 10 to 1 or (2) if you have elected to operate under paragraph (f) of Rule 15c3-1 of the Securities Exchange Act of 1934, as amended, when your net capital is less than the greater of \$100,000 or 5% of aggregate

debit items computed in accordance with Rule 15c3-3.

(ii) You are a member in good standing of the National Association of Securities Dealers, Inc., or if you have applied for membership of the National Association of Securities Dealers, Inc. you agree to furnish XX upon your receipt thereof, with the National Association of Securities Dealers, Inc.'s notification to you concerning the result of your membership application and if your membership application is refused for any reason whatsoever, XX has the right to forthwith terminate this agreement. You are a member in good standing of every national securities exchange or other securities association of which you are a member and you agree to promptly notify XX of any additional exchange memberships or affiliations. You shall also comply with whatever non-member access rules have been promulgated by any national securities exchange or any other securities exchange of which you are not a member.

(iii) You are and during the term of this Agreement will remain duly registered or licensed and in good standing as a broker/dealer under the Applicable Rules.

(iv) You have all the requisite authority in conformity with all Applicable Rules to enter into this Agreement and to retain the services of XX in accordance with the terms hereof and you have taken all necessary action to authorize the execution of this Agreement and the performance of the obligations hereunder.

(v) You are in compliance, and during the term of this Agreement will remain in compliance with (1) the capital and financial reporting requirements of every national securities exchange or other securities exchange and/or securities association of which you are a member, (2) the capital requirements of the Securities and Exchange Commission, and (3) the capital requirements of every state in which you are licensed as a broker/dealer.

(vi) Unless otherwise agreed to in writing by XX, you shall not generate any statements, billings or confirmations representing any Account.

(vii) You shall keep confidential any information you may acquire as a result of this Agreement regarding the business and affairs of XX, which requirements shall survive the life of this Agreement.

17. XX represents, warrants and covenants to you as follows:

(i) XX is a member in good standing of the National Association of Securities Dealers, Inc., the New York Stock Exchange,

Inc., the American Stock Exchange, Inc., the Boston Stock, Incorporated, the Midwest Stock Exchange, Incorporated, the Philadelphia Stock Exchange, Inc., the Pacific Stock Exchange Incorporated and the Chicago Board Options Exchange, Inc.

(ii) XX is and during the term of this Agreement will remain duly licensed and in good standing as a broker/dealer under the Applicable Rules.

(iii) XX has all the requisite authority, in conformity with all Applicable Rules to enter into and perform this Agreement and has taken all necessary action to authorize the execution of this Agreement and the performance of the obligations hereunder.

(iv) XX is in compliance, and during the term of this Agreement will remain in compliance with (1) the capital and financial reporting requirements of every national securities exchange and/or other securities exchange or association of which it is a member, (2) the capital requirements of the Securities and Exchange Commission, and (3) the capital requirement of every state in which it is licensed as a broker/dealer.

(v) XX represents and warrants that the names and addresses of your customers which have or which may come to its attention in connection with the clearing and related functions it has assumed under this Agreement are confidential and shall not be utilized by XX except in connection with the functions performed by XX pursuant to this Agreement. Notwithstanding the foregoing, should an Account request, ~~on an~~ unsolicited basis, that XX become its broker, acceptance of such Account by XX shall in no way violate this representation and warranty, nor result in a breach of this Agreement.

(vi) XX shall keep confidential any information it may acquire as a result of this Agreement regarding your business and affairs, which requirement shall survive the life of this Agreement.

18. Notwithstanding any provision in this Agreement, the following events or occurrences shall constitute an Event of Default under this Agreement:

(i) either party hereto shall fail to perform or observe any term, covenant or condition to be performed hereunder and such failure shall continue to be unremedied for a period of 30 days after written notice from the non-defaulting party to the defaulting party specifying the failure and demanding that the same be remedied; or

(ii) any representation or warranty made by either party shall prove to be incorrect at any time in any material respect; or

(iii) a receiver, liquidator or trustee of either party hereto of any property held by either party, is appointed by court order and such order remains in effect for more than 30 days; or either party is adjudicated bankrupt or insolvent; or any property of either party is sequestered by court order and such order remains in effect for more than 30 days; or a petition is filed against either party under any bankruptcy, reorganization, arrangement, insolvency, readjustment of debt, dissolution or liquidation law of any jurisdiction, whether now or hereafter in effect, and is not dismissed within 30 days after such filing; or

(iv) either party hereto files a petition in voluntary bankruptcy or seeks relief under any provision of any bankruptcy, reorganization, arrangement, insolvency, readjustment of debt, dissolution or liquidation law of any jurisdiction, whether now or hereafter in effect, or consents to the filing of any petition against it under any such law; or

(v) either party hereto makes an assignment for the benefit of its creditors, or admits in writing its inability to pay its debts generally as they become due, or consents to the appointment of a receiver, trustee or liquidator of either party, or of any property held by either party.

Upon the occurrence of any such Event of Default, the nondefaulting party may, at its option, by notice to the defaulting party declare that this Agreement shall be thereby terminated and such termination shall be effective as of the date such notice has been communicated to the defaulting party. Upon the occurrence by you of an Event of Default pursuant to paragraphs (iii), (iv), or (v) above, XX shall be entitled to, upon the consent of the Customer, to accept instructions directly from the Customer and to transfer the Account directly to XX.

19. In the event that you execute your own orders and give XX's name to the other broker for clearance and settlement, you agree that you will only execute bona fide orders where you have reasonable grounds to believe that the account and the other broker have the financial capability to complete the transaction. XX reserves the right at any time to place a limit (of either dollars or number of securities) on the size of transactions that XX in these circumstances will accept for clearance. If after you have received notice of such limitation you execute an order in excess of the limit established by XX, XX shall have the right to notify the other party and other broker that it will not accept the transaction for clearance and settlement. In the event any claim is asserted against XX by the other broker because of such

action by XX, you agree to indemnify and hold XX harmless from any loss, liability, damage, cost or expense (including but not limited to fees and expenses of legal counsel) arising directly or indirectly therefrom.

20. (a) XX shall limit its services pursuant to the terms of this Agreement to that of clearing functions and the related services expressly set forth herein and you shall not hold yourself out as an agent of XX or of any subsidiary or company controlled directly or indirectly by or affiliated with XX. Neither this Agreement nor any operation hereunder shall create a general or limited partnership, association or joint venture or agency relationship between you and XX.

(b) You shall not, without the prior written approval of XX, place any advertisement in any newspaper, publication, periodical or any other media if such advertisement in any manner makes reference to XX or to the clearing arrangements and the services embodied in this Agreement.

(c) Should you in any way hold yourself out as, advertise or represent that you are the agent of XX, XX shall have the power, at its option, to terminate this Agreement and you shall be liable for any loss, liability, damage, claim, cost or expense (including but not limited to fees and expenses of legal counsel) sustained or incurred by XX as a result of such a representation of agency or apparent authority to act as an agent of XX or agency by estoppel. Notwithstanding the provisions of paragraph 24 below that any dispute or controversy between the parties relating to or arising out of this Agreement shall be referred to and settled by arbitration, in connection with any breach by you of this paragraph 20, XX may, at any time prior to the initial arbitration hearing pertaining to such dispute or controversy, seek by application to the United States District Court for the Southern District of New York or the Supreme Court of the State of New York for the County of New York any such temporary or provisional relief or remedy ("provisional remedy") provided for by the laws of the United States of America or the laws of the State of New York as would be available in an action based upon such dispute or controversy in the absence of an agreement to arbitrate. The parties acknowledge and agree that it is their intention to have any such application for a provisional remedy decided by the Court to which it is made and that such application shall not be referred to or settled by arbitration. No such application to either said Court for a provisional remedy, nor any act or conduct by either party in furtherance of or in opposition to such application, shall constitute a relinquishment or waiver of any right to have the underlying dispute or controversy with respect to which such application is made settled by arbitration in accordance with paragraph 24 below.

21. The enumeration herein of specific remedies shall not be exclusive of any other remedies. Any delay or failure by any party to this Agreement to exercise any right herein contained, now or hereafter existing under the Applicable Rules shall not be construed to be a waiver of such right, or to limit the exercise of such right. No single, partial or other exercise of any such right shall preclude the further exercise thereof or the exercise of any other right.

22. This Agreement shall be submitted to and approved by the New York Stock Exchange, Inc., or other regulatory and self-regulatory bodies vested with the authority to review and approve this Agreement or any amendment or modifications hereto. In the event of disapproval, the parties hereto agree to bargain in good faith to achieve the requisite approval.

23. (a) This Agreement supersedes all other agreements between the parties with respect to the transactions contemplated herein. This Agreement may not be amended except by a writing signed by both parties hereto and may be terminated upon thirty (30) days written notice to the other party. XX agrees that it will send to you copies of all written notices sent to Customers. Notices to you shall be sent to:

(carrying firm's address) Termination shall not affect any of the rights and liabilities of the parties hereto incurred before the date of receipt of such notice of termination.

(b) This Agreement shall be binding upon and inure to the benefit of the respective successors of the parties. Neither party may assign any of its rights or obligations hereunder without the prior written consent of the other party.

24. (a) This Agreement shall be governed by and construed in accordance with the laws of the State of New York.

(b) All disputes and controversies relating to or any way arising out of this Agreement shall be settled by arbitration before and under the rules of the Arbitration Committee of the New York Stock Exchange, Inc., unless the transaction which gives rise to such dispute or controversy is effected in another United States market which provides arbitration facilities, in which case it shall be settled by arbitration under such facilities.

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Attachment E.

NASD rules and brochure

If the member purchases securities taken in trade at a price which is no higher than the lowest independent offer as determined according to this Section, it will have kept adequate records if it records the time and date quotations were received, the identity of the security to which the quotations pertain, the identity of the dealer from whom, or the exchange or quotation system from which, the quotations were obtained, and the quotations furnished. If a member uses the services of an independent agent to obtain the quotations and the agent does not disclose the identity of the dealers from whom quotations were obtained, the member will have kept adequate records if it otherwise complies with subsection (e) of Section 8 hereof and it records the time and date it received the quotations from the agent, the identity of the agent, and the quotations transmitted by the agent.

If a member takes a security in trade and pays more than the lowest independent offer, it will have kept adequate records if, in addition to the foregoing records, it keeps records of all relevant factors it considered important in concluding that the price paid for the securities was fair market price.

Fair Market Price at the Time of Purchase

Swap transactions that are arranged before the effectiveness of a fixed price offering are not generally viewed as being legally consummated until effectiveness of the fixed price offering. Nonetheless, the fair market price of securities taken in trade in such situations is normally determined at the time of the pricing of the fixed price offering, which occurs on the day before effectiveness usually in the afternoon, and the swap is arranged on the basis of that price. In such cases, for purposes of Section 8(a), the determination of the "fair market price at the time of purchase" of the securities to be taken in trade may be made as of the time of pricing of the fixed price offering. As to swaps agreed upon at a time after effectiveness of the offering, fair market price of the swapped securities must be determined as of the time the transaction is legally consummated.

2159 Use of Information Obtained in Fiduciary Capacity

Sec. 9. A member who in the capacity of paying agent, transfer agent, trustee, or any other similar capacity, has received information as to the ownership of securities shall under no circumstances make use of such information for the purpose of effecting purchases, sales or exchanges except at the request and on behalf of the issuer.

2160 Influencing or Rewarding Employees of Others

Sec. 10. (a) No member or person associated with a member shall, directly or indirectly, give or permit to be given anything of value, including gratuities, in excess of one hundred dollars per individual per year to any person, principal, proprietor, employee, agent or representative of another person where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity. Any gift of any kind is considered a gratuity.

(b) This section shall not apply to contracts of employment with or to compensation for services rendered by persons enumerated in subsection (a) provided that there was no existence prior to the time of employment or before the services are rendered, a written agreement between the member and the person who is to be employed to perform such services. Such agreement shall include the nature of the proposed

2159 Art. III, Sec. 9

such person's employer or principal.

(c) A separate record of all payments or gratuities in any amount known to the member, the employment agreement referred to in subsection (b) and any employment compensation paid as a result thereof shall be retained by the member for the period specified by Rule 17a-4 of the General Rules and Regulations under the Securities Exchange Act of 1934.

[Section 10 amended effective September 1, 1969; June 20, 1984; December 28, 1992.]

Annotations of selected SEC decisions

.10 Duty to Investigate Nature of Payment.—A member firm violated Section 10 of Article III when it paid an employee of another member for referring business to it, without the knowledge or consent of the other firm. The member's president testified that he was told the payments were for advisory services, but concluded that whether or not the member was misled, it should have made further inquiry as to the nature of the payments.

Hibbard & O'Connor Securities, Inc., SEC SEC Release No. 34-13996 (1977).

.11 Payments to Employees of Another Firm.—A member firm and one of its registered representatives violated Section 10 of Article III when it made payments to the senior order clerk of another firm without the knowledge of such other firm for the purpose of inducing the employee to channel his employer's customer orders to the member firm.

In the Matter of H.C. Keister & Company, SEC SEC Release No. 34-7988 (1966).

.12 Payments to Employees of Another Dealer.—A member which made payments to employees of another dealer as compensation for effecting the purchase by the latter's employer of securities which the member was distributing violated Section 10 of Article III. The payments were made without the knowledge and consent of the

principal stockholder of the employer nor did the corporation receive any part of it.

Rosenbloom, d/b/a The James Co., and Rosenbloom, SEC Release No. 34-7762 (1965).

.13 Issuance of Shares of Stock and Check to Employees of Other Members.—The issuance of shares of stock to two representatives of other members and a check to a third representative in return for business referred by them to the issuing member violated Section 10 of Article III. The fact that the arrangement to compensate the representatives were made before the firm became a member of the NASD would not justify the payment made during its membership.

Madison Management Corp., and Harry Friedman, SEC Release No. 34-7453 (1964).

.14 Gift to Salesman of Another Firm for Referring Securities Business.—A member violated Section 10 of Article III when he gave a gift valued at approximately \$300 to a representative of another member firm after the representative had referred an individual who later purchased units in a "best efforts" offering. The SEC set aside the NASD's finding with respect to a cash payment to another representative, stating that it could not conclude that the gift was made in relation to the business the representative's employer.

Albert P. Fosha, SEC Release No. 22815 (1986).

2161 Payment Designed to Influence Market Prices, Other than Paid Advertising

Sec. 11. No member shall, directly or indirectly, give, permit to be given, or offer to give, anything of value to any person for the purpose of influencing or rewarding the action of such person in connection with the publication or circulation in any newspaper, investment service, or similar publication, of any matter which has, or is intended to have, an effect upon the market price of any security, provided that this rule shall not be construed to apply to matter which is clearly distinguishable as paid advertising.

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¶ 2172 Disclosure of Financial Condition

Sec. 22. (a) A member shall make available to inspection by any bona fide regular customer, upon request, the information relative to such member's financial condition as disclosed in its most recent balance sheet prepared either in accordance with such member's usual practice or as required by any State or Federal securities laws, or any rule or regulation thereunder.

(b) As used in paragraph (a) of this rule, the term "customer" means any person who, in the regular course of such member's business, has cash or securities in the possession of such member.

● ● ● Resolution of the Board of Governors

Requirement of Members to Furnish Recent Financial Statement to Other Members

Any member of the Association who is a party to an open transaction or who has on deposit cash or securities of another member shall furnish upon written request of the other member a statement of its financial condition as disclosed in its most recently prepared balance sheet. The refusal of any member to furnish a copy of its most recently prepared balance sheet may be deemed to be conduct inconsistent with just and equitable principles of trade and may be cause for appropriate disciplinary action.

¶ 2173 Net Prices to Persons Not in Investment Banking or Securities Business

Sec. 23. No member shall offer any security or confirm any purchase or sale of any security, from or to any person not actually engaged in the investment banking or securities business at any price which shows a concession, discount, or other allowance, but shall offer such security and confirm such purchase or sale at a net dollar or basis price.

● ● ● Cross Reference

Interpretation: "Transactions Between Members and Non-Members" ¶ 2175

¶ 2174 Selling Concessions

Sec. 24. In connection with the sale of securities which are part of a fixed price offering:

(a) A member may not grant or receive selling concessions, discounts, or other allowances except as consideration for services rendered in distribution and may not grant such concessions, discounts or other allowances to anyone other than a broker or dealer actually engaged in the investment banking or securities business; provided, however, that nothing in this Section shall prevent any member from (1) selling any such securities to any person, or account managed by any person, to whom it has provided or will provide bona fide research, if the stated public offering price for such securities is paid by the purchaser; or (2) selling any such securities owned by him to any person at any net price which may be fixed by him unless prevented therefrom by agreement.

(b) The term "bona fide research," when used in this Section, means advice, rendered either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities, or analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and

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Transactions Between Members and Non-Members*

1. NON-MEMBERS OF THE ASSOCIATION UNDER THE RULES OF FAIR PRACTICE

"Member"*

Section 1(c) of Article II of the Rules defines a "member" as any individual, partnership, corporation or other legal entity admitted to membership in the Association. All other persons, firms or corporations, whether or not they are brokers or dealers, are therefore to be regarded as non-members of the Association.

Expelled Dealer

A dealer who has been expelled from the Association by order either of the Securities and Exchange Commission or the Association becomes a non-member of the Association from the effective date of such order.

Suspended Dealer

A dealer who has been suspended from membership in the Association by order either of the Securities and Exchange Commission or of the Association is to be treated as a non-member of the Association from the effective date of such order and during the period of such suspension. At the termination of the suspension period, such dealer is automatically reinstated to membership in the Association.

Broker or Dealer Whose Registration Revoked by SEC

Revocation by the Securities and Exchange Commission of an Association member's registration as a broker or dealer automatically terminates the membership of such broker or dealer in the Association as of the effective date of such order. Under Section 2 of Article I of the By-Laws of the Association, a firm whose registration as a broker or dealer is revoked is thereby disqualified for membership in the Association and from the effective date of such order, the membership of such broker or dealer in the Association is discontinued. Thereafter such broker or dealer is a non-member of the Association.

Membership Resigned or Cancelled

The membership of a broker or dealer in the Association is automatically terminated when the Association accepts the resignation of such member or cancels its membership in the Association under the provisions of Sections 7

abrogated " to the extent that it permits or has been construed to permit the Association to bar a member's receipt of commissions, concessions, discounts, or other allowances from nonmember brokers or dealers. "

There presently are discussions in progress with the staff of the Commission concerning the scope of Section 25 following these two decisions. It is anticipated that this Interpretation will be revised shortly to include clarifying examples.

Interpretation of the Board of Governors.
or 13 of Article I or Section 3 of Article III of the By-Laws. After the date of acceptance by the Association of the resignation of such member or the date of cancellation of membership by the Association, such broker or dealer is a nonmember of the Association.

2. TRANSACTIONS IN "EXEMPTED SECURITIES"

Section 4 of Article I of the Rules of Fair Practice provides that the Rules shall not apply to transactions, whether between members or between members and non-members, in "exempted securities," which are defined by Section 3(a)(12) of the Securities Exchange Act of 1934 as follows:

Text of § 3(a) (12) of '34 Act

"The term 'exempted security' or 'exempted securities' shall include securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors; securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof or any agency or instrumentality of a State or any political subdivision thereof or any municipal corporate instrumentality of one or more States; and such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do not apply to an 'exempted security' or to 'exempted securities'."

The rules therefore do not apply to transactions in government or municipal securities if within the definition of "exempted securities." Members may join with non-members or with banks in a joint account, syndicate or group to purchase and distribute an issue of "exempted securities" and may trade such securities with non-members or with banks at different prices or on different terms and conditions than are accorded to members of the general public.

3. TRANSACTIONS ON AN EXCHANGE

Rule Not Applicable

An Association member may pay a commission to a member of a national securities exchange for executing an order upon an exchange even though the exchange member is not a member of the Association. Rule 25 does not apply to transactions upon an exchange and, therefore, does not prohibit such transactions.

Where an Association member is also a member of an exchange, an order of the Securities and Exchange Commission or of the Association expelling or suspending the firm from membership in the Association will not directly affect the business of the firm as a member of an exchange because Associa-

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tion Rule 25 does not apply to transactions on the floor of an exchange. While an order of suspension or expulsion is in effect, the firm may continue to conduct its normal business on an exchange and participate in special offerings on an exchange without involving any violation by an Association member of Rule 25.

4. OVER-THE-COUNTER TRANSACTIONS IN SECURITIES OTHER THAN "EXEMPTED SECURITIES"

Participation in Underwriting or Selling Groups. An Association member may not enter into a joint account, underwriting or selling group, or join a syndicate or group, with any non-member broker or dealer or with a member of a national securities exchange, who is not also a member of the Association, for the purpose of acquiring and distributing an issue of securities. Rules 25(a) and 25(b) would be applicable and such exchange member would be a "non-member broker or dealer" within the definition of Rule 25(d).

Sale to Bank or Trust Company

An Association member, participating in the distribution of an issue of securities as an underwriter or in a selling group, may not allow any selling concession, discount or other allowance in connection with the sale of such securities to any bank or trust company. Under Section 3 of Article I of the By-Laws a bank or trust company is excluded from the definition of a broker or dealer and therefore may not receive selling concessions, discounts or other allowances from an Association member under Rule 24.

Suspended or Expelled Dealer—Group Contemplating Distribution

An Association member may not join any underwriting or selling group with a dealer who has been and is suspended from membership in the Association by order of the Securities and Exchange Commission or of the Association if at the time such group was organized, it was contemplating the distribution of an issue of securities to the public. A dealer who has been suspended from membership in the Association is to be treated as a non-member during the suspension period and Rule 25(b) (2) prohibits members from joining with non-members in a group "contemplating the distribution to the public of any issue of securities." Even though the suspension period had terminated before the time when the securities were to be distributed, the rule prohibits a member from joining with a non-member in a group which is contemplating the distribution of an issue of securities at a future time.

Dealer Suspended or Expelled After Underwriting Group Formed

Where a dealer is suspended or expelled from membership in the Association by an order of the Securities and Exchange Commission or of the Association which became effective after such dealer had joined an underwriting group under which each underwriter had severally purchased securities from the issuer, such dealer could thereafter during the period of suspension or expulsion accept delivery from the issuer of the securities which it had underwritten prior to the effective date of such order and pay to the issuer its commitment therefor without involving any violation of the rules by members. After the effective date of such order and during the period of suspen-

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sion or expulsion, Association members could only buy the securities from or sell the securities to the dealer, who was suspended or expelled, at the public offering price, regardless of whether the Association members were also members of the underwriting or selling group for the particular issue. Rule 25 prohibits an Association member from dealing with any non-member broker or dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as the member would deal with a member of the general public at the same time. Delivery of the securities by the issuer to the particular dealer suspended or expelled and payment therefor by such dealer would not involve a violation of Rule 25 in this situation.

Dealer Suspended or Expelled After Selling Group Formed

Where a dealer is suspended or expelled from the Association by an order of the Securities and Exchange Commission or of the Association which became effective after such dealer had joined a selling group, members of the Association, including the underwriters and other selling group members, would be prohibited by Rule 25 from selling the securities to, or buying the securities from, such dealer at any price different from the public offering price. Members would not violate Rule 25 by accepting from such dealer, during the period such order of suspension or expulsion was in effect, payment of the full public offering price for the securities allotted to such dealer. After the effective date of such order Rule 25 prohibits Association members from granting or allowing to the dealer suspended or expelled any selling concession, discount or other allowance for the securities distributed by such dealer. While such order is in effect, Association members could only deal with such dealer at the same prices, for the same commissions, fees, concessions, discounts or other allowances as the Association members would deal at the time of the transaction with a member of the general public.

Commissions in Transactions with Non-Members

Over-the-Counter Trading. An Association member may not pay a commission to any non-member broker or dealer for executing a brokerage order for the Association member in the over-the-counter market. Rule 25 requires an Association member to deal with non-members only on the same terms and conditions as are accorded by such Association member to members of the general public. On the other hand, Rule 25 does not prohibit an Association member from executing over-the-counter an order for a non-member and charging such non-member a commission therefor. Rule 25 merely requires that in transactions with a non-member, such non-member must be dealt with at the same prices, for the same commissions or fees and on the same terms and conditions as are by such member accorded to the general public.

Members of a National Securities Exchange

In over-the-counter transactions in either listed or unlisted securities an Association member may not buy from or sell to a member of a national securities exchange who is not also a member of the Association at different prices or on different terms or conditions than are accorded by such Association member or members of the general public. Such exchange member, with respect to such over-the-counter transactions, comes within the definition of a "non-member broker or dealer" in Rule 25(d), and Rule 25 is therefore

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● ● ● *Interpretation of the Board of Governors*

applicable. For the same reason an Association member may not pay a commission to an exchange member, who is not also a member of the Association, for executing a brokerage order over-the-counter.

When a dealer has been and is suspended or expelled from membership in the Association by order of the Securities and Exchange Commission or of the Association, under Rule 25, during the period of such suspension or expulsion, an Association member may only deal with such dealer at the same prices, for the same commissions, fees, concessions, discounts or other allowances as the Association member would deal at the time of the transaction with a member of the general public.

Investment Advisory Fee

When an Association member has rendered an investment advisory service for a fee to other members and thereafter is suspended or expelled from membership in the Association by order of the Securities and Exchange Commission or of the Association, another Association member may continue to pay the fee to such investment adviser provided that over-the-counter transactions in securities with such investment adviser are made only at the same price and on the same terms as the member would deal with the public and the fee for acting as investment adviser is not used as a method of avoiding the provisions of Rule 25.

Annotations of selected SEC decisions

.10 Joining with Nonmember in Distribution of an Issue of Securities.—An NASD member does not violate Section 25 merely by "joining" with a nonmember in the distribution of an issue, even when the member receives a concession or a discount from the nonmember and the member has registered representatives who are duly registered with the nonmember. The SEC rejected the NASD's argument that the member might, by virtue of the affiliation between it and the nonmember, indirectly through that nonmember grant prohibited discounts or concessions to nonmembers, since there was no showing that such practice was taking place. Furthermore, the SEC stated that the NASD has no authority to prohibit the mere joining in a parallel underwriting by an NASD member and a nonmember since any concession received by the nonmember would come from the issuer and not from the member. There is no violation of the NASD Rules if a nonmember gives a concession to a member.

Plaza Securities Corp., et al., 45 S.E.C. 449 (1974).

.20 Abrogation Proceedings; Sales at Concession to Nonmembers.—Aetna Life and Casualty Company and two subsidiaries petitioned the SEC to institute abrogation proceedings pursuant to Section 15A(k)(1). Aetna argued that the

NASD had no authority under Section 15A(i)(1) to restrict its members from receiving concessions in their dealings with nonmember broker-dealers. The SEC agreed, noting that the "joining" provision in Section 25(b)(2) of the NASD's Rules of Fair Practice should not be interpreted as a flat prohibition against the member joining with a nonmember in a securities distribution, but should be viewed as a restriction on the ability of members to give underwriting concessions and discounts to nonmembers not accorded to the public. The SEC therefore held it appropriate to abrogate NASD's Rule 25(b)(2) to the extent that it permitted or was interpreted to permit such a bar.

NASD, Inc., 44 S.E.C. 896 (1972).

.30 Sales at Concession to Non-Member Firm.—The sale by a member as principal underwriter of two blocks of stocks to another securities firm at concessions of 10 cents per share and 22½ cents per share respectively without verifying the membership status of the purchasing firm violated Section 25(b) of Article III. The member firm acted on the assumption that the purchaser was a member at the time of the transactions involved.

Rosenbloom, d/b/a The James Co., and Rosenbloom, SEC Release No. 34-7762 (1965).

Sec. 27.

Supervisory System

(a) Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the rules of this Association. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) The establishment and maintenance of written procedures as required by paragraphs (b) and (c) of this Section.

(2) The designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker-dealer is required.

(3) The designation as an office of supervisory jurisdiction (OSJ) of each location that meets the definition contained in paragraph (g) of this Section. Each member shall also designate such other OSJs as it determines to be necessary in order to supervise its registered representatives and associated persons in accordance with the standards set forth in this Section 27, taking into consideration the following factors:

- (i) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;
- (ii) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;
- (iii) whether the location is geographically distant from another OSJ of the firm;
- (iv) whether the member's registered persons are geographically dispersed; and
- (v) whether the securities activities at such location are diverse and/or complex.

(4) The designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.

(5) The assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities.

(6) Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

(7) The participation of each registered representative, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the member at which compliance matters relevant to the activities of the representative(s) are discussed. Such interview or meeting may occur in conjunction with the discussion of other matters and may be conducted at a central or regional location or at the representative's(') place of business.

(8) Each member shall designate and specifically identify to the Association one or more principals who shall review the supervisory system, procedures, and inspections implemented by the member as required by this Section and take or

recommend to senior management appropriate action reasonably designed to achieve the member's compliance with applicable securities laws and regulations and with the rules of this Association.

Written Procedures

(b)(1) Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of this Association.

(b)(2) The member's written supervisory procedures shall set forth the supervisory system established by the member pursuant to Section 27(a) above, and shall include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the rules of this Association. The member shall maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective. Such record shall be preserved by the member for a period of not less than three years, the first two years in an easily accessible place.

(b)(3) A copy of a member's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the member. Each member shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws and regulations, including the rules of this Association, and as changes occur in its supervisory system, and each member shall be responsible for communicating amendments through its organization.

Internal Inspections

(c) Each member shall conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations, and with the rules of this Association. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses and at least an annual inspection of each office of supervisory jurisdiction. Each branch office of the member shall be inspected according to a cycle which shall be set forth in the firm's written supervisory and inspection procedures. In establishing such cycle, the firm shall give consideration to the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location. Each member shall retain a written record of the dates upon which each review and inspection is conducted.

Written Approval

(d) Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

Qualifications Investigated

(e) Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association. Where an applicant for registration has previously been regis-

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tered with the Association, the member shall obtain from the Firm Access Query System (FAQS) or from the applicant a copy of the Uniform Termination Notice of Securities Industry Registration ("Form U-5") filed with the Association by such person's most recent previous NASD member employer, together with any amendments thereto that may have been filed pursuant to Article IV, Section 3 of the Association's By-Laws. The member shall obtain the Form U-5 as required by this section no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. A member receiving a Form U-5 pursuant to this section shall review the Form U-5 and any amendments thereto and shall take such action as may be deemed appropriate.

Applicant's Responsibility

(f) Any applicant for registration who receives a request for a copy of his or her Form U-5 from a member pursuant to this section shall provide such copy to the member within two (2) business days of the request if the Form U-5 has been provided to such person by his or her former employer. If a former employer has failed to provide the Form U-5 to the applicant for registration, such person shall promptly request the Form U-5, and shall provide it to the requesting member within two (2) business days of receipt thereof. The applicant shall promptly provide any subsequent amendments to a Form U-5 he or she receives to the requesting member.

Definitions

(g)(1) "Office of Supervisory Jurisdiction" means any office of a member at which any one or more of the following functions take place:

- (i) order execution and/or market making;
- (ii) structuring of public offerings or private placements;
- (iii) maintaining custody of customers' funds and/or securities;
- (iv) final acceptance (approval) of new accounts on behalf of the member;
- (v) review and endorsement of customer orders, pursuant to paragraph (d) above;
- (vi) final approval of advertising or sales literature for use by persons associated with the member, pursuant to Article III, Section 35(b)(1) of the Rules of Fair Practice; or
- (vii) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

(g)(2) "Branch Office" means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding:

- (i) any location identified in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised;
- (ii) any location referred to in a member advertisement, as this term is defined in Article III, Section 35 of the NASD Rules of Fair Practice, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised; or

(iii) any location identified by address in a member's sales literature, as this term is defined in Article III, Section 35 of the NASD Rules of Fair Practice provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised.

(g)(3) A member may substitute a central office address and telephone number for the supervisory branch office and OSJ locations referred to in paragraph (g)(2) above provided it can demonstrate to the NASD District Office having jurisdiction over the member that it has in place a significant and geographically dispersed supervisory system appropriate to its business and that any investor complaint received at the central site is provided to and resolved in conjunction with the office or offices with responsibility over the non-branch business location involved in the complaint.

[Sec. 27 amended effective June 12, 1989; April 30, 1992.]

● ● ● **Cross References**

Explanation: "Appointment of Executive Representative" ¶ 1791

Interpretation: "Private Securities Transactions" replaced by Article III, Section 40. ¶ 2200

● ● ● **Selected NASD Notices to Members**

86-20 Solicitation of Comments on Proposed Rule Requiring Supervisory Procedures on Limit Orders

(March 11, 1986)

86-65 Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel

(September 12, 1986)

87-41 Proposed Amendments to Definitions of "Branch Office" and "Office of Supervisory Jurisdiction" Under the By-Laws, Schedule C to the By-Laws and the Rules of Fair Practice

(June 29, 1987)

88-11 Proposed Amendments to Article III, Section 27 of the NASD Rules of Fair Practice Regarding Supervision and the Definitions of "Office of Supervisory Jurisdiction" and "Branch Office"

(February 8, 1988)

88-44 Proposed Rule Amendments: Supervision and the Definition of "Office of Supervisory Jurisdiction" and "Branch Office"; Conforming Amendment to By-Laws

(July 1988)

88-68 Request for Comments on Proposed Amendments to Article IV, Section 3 of the By-Laws and Article III, Section 27 of the Rules of Fair Practice

(September 1988)

88-84 SEC Approves Amendment to Article III, Section 27 of the Rules of Fair Practice Regarding Supervisory Practices and Definitions of Branch Office and Office Supervisory Jurisdiction

(November 1988)

● ● ● **Selected NASD Notices to Members**

89-34 Guidelines for Compliance with Article III, Section 27 of Rules of Fair Practice Re: Supervisory Practices and Procedures

(April 1989)

89-57 SEC Approves Amendments to By-Laws and Rules of Fair Practice Re: Providing Terminated Employees with Form U-5

(August 1989)

92-18 SEC Approval of Amendments to the Definition of the Term "Branch Office" in Article III, Section 27 of the Rules of Fair Practice

(April 1992)

Annotations of selected SEC decisions

.10 Margin Rules, Inadequate Supervision, Special Omnibus Account.—A member firm violated Article III, Section 30 and Regulation T, Section 4(b) when it improperly purchased call options on credit for a special omnibus account which was supposed to be carried solely for accounts of the firm's customers but which was, in fact, beneficially owned by the firm's officers.

It violated Article III, Section 27 in failing to provide adequate supervision over treasurer when it improperly allowed him to use CBOE margin rules even though the firm was no longer a CBOE member.

Prince, Langheinrich & Greer, Inc., SEC Release No. 34-16898 (1980).

.15 Transactions Not Approved by Written Endorsement.—A member that did not evidence his approval of transactions made by his salesmen by written endorsement violated Section 27 of Article III.

Norman J. Adams, SEC Release No. 34-7327 (1964)

.20 Improper Certification of Character and Business Reputation—Failure to Exercise Reasonable Care in Investigation.—The Commission sustained the action of the NASD finding violations against a member who failed to make adequate investigation before certifying to the good character and reputation of employees registered with the association, as required by Section 27(e) of Article III. Casual interviews and a perfunctory telephone call to a former employer did not constitute sufficient compliance with the requirement of "reasonable care" called for by the Rules, notwithstanding the fact that the application form furnished by NASD would make such inquiries sufficient.

Vickers, Christy & Co., Inc., SEC Release No. 34-6872 (1962).

.25 Failure to Endorse Record of Salesmen's Transactions.—An NASD member that failed to endorse the records of salesmen's transactions was found guilty of violating Section 27 of Article III. The member's contention that the

records of salesmen's transactions were checked daily for pertinent data was of no avail.

Graham & Co., 38 SEC 314 (1958).

Failure to Properly Supervise

.30 The SEC set aside the NASD's finding of a violation of Section 27 where it was found that the firm's salesmen had made "a successful effort to hide their transactions" from the president of the firm. The SEC set aside additional findings of violations since the firm was not given adequate notice or a proper opportunity to defend itself.

Paulson Investment Company, Inc., SEC Release No. 34-19603 (1983).

.31 A Senior Registered Options Principal (SROP) failed to supervise properly a registered representative who was churning discretionary options accounts in violation of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The SEC held that not only was it the SROP's responsibility to devise the member firm's system for options compliance and to oversee its operations, as the SROP contended, but that the SROP must also, along with the firm's branch managers and managing partners, exercise supervisory authority over the registered representative.

The SEC stated that once the SROP had given the registered representative his approval to handle discretionary options accounts, he (the SROP) assumed responsibility for ensuring that this grant of authority was not abused. This is especially true where the SROP was put on notice that the registered representative's accounts were heavily traded, and where there was no Registered Options Principal in the local branch office.

Michael E. Tennenbaum, SEC Release No. 34-18429 (1982).

.32 The SEC affirmed the NASD's finding of a failure to supervise, holding that in the "highly unusual" situation where a branch office manager was permitted to make a market in a stock, stringent home office supervision was required.

Additionally, since the executive vice president was explicitly warned by the firm's trade about

¶ 2177.10 Art. III, Sec. 27

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the firm's "exaggerated trading practices", "over-zealous sales practices," and "large markups", there was sufficient evidence to establish more than a "remote indication of irregularity" with respect to the activities in the branch office, and thus was sufficient to find a failure to exercise reasonable supervision on the part of the firm and its executive vice president.

Universal Heritage Investments Corporation, Inc., et al., SEC Release No. 34-19308 (1982).

.33 A member firm and its president were charged with failure to supervise when they allowed one of their branch manager to have printed on the broker stationery "Cohig and Co., Inc." That name was printed just beneath "Wall Street West" and appeared in bold print. President of Wall Street West, saw the letterhead but raised no objection. The NASD contended that the conduct could mislead customers into believing that Cohig was the broker-dealer and Wall Street West simply an advertising slogan. The president argued that there was no evidence to show that any customers had been misled; that there was no intent to mislead; and that the NASD rules were too vague to provide adequate notice that their conduct constituted a violation. On review the SEC determined that the letterhead was misleading; that proceedings instituted by NASD, like those of the SEC, are to protect the public interest as opposed to redressing private wrongs. Consequently, evidence proving that customers were actually misled or that there was intent to mislead was unnecessary. NASD finding of violation affirmed.

Wall Street West, Inc., et al., SEC Release No. 34-18320 (1981).

.34 Failure to Supervise Disclosure of Commission Charges.—A member firm and a principal violated Sections 1 and 27 of Article III when they failed to exercise reasonable supervision over registered representatives in that the representatives failed to advise customers that direct redemption of mutual funds could be handled at no charge through the funds and that the firm charged a fee for redemption.

Financial Estate Planning, et al., SEC Release No. 34-14984 (1978).

.35 A member firm and its president failed to supervise the vice president who engaged in a wide variety of fraudulent practices for more than a year and a half. The SEC stated that the president of a broker-dealer firm necessarily assumes the duties of keeping himself informed of the firm's activities, of providing adequate supervision, and of taking whatever steps are necessary to secure compliance with the law. Thus, while the president may reasonably delegate a particular function to another person in the firm, he cannot relieve himself of his overall supervisory responsibilities by relying on someone else to perform in his stead.

G. Frederic Helbig & Co., Inc., 45 S.E.C. 773 (1975).

.36 Supervision of Officer's Outside Activities.—Where an officer of a NASD member firm

engaged for his own profit through other NASD members in purchases of "hot issue" securities from broker/dealer distribution participants and in sales of such securities above offering price in the aftermarket, the SEC set aside the NASD's finding that the member failed to exercise proper supervision over such outside activities of the officer. The "investment club" in which the officer participated had no connection with the member firm's business, nor was the member a party to any of the club's activities.

Safeco Securities, Inc. 45 S.E.C. 303 (1973).

.37 Failure to Supervise Salesman—Inadequate Investigation of Salesman's Character.—The employment by a member of a salesman without making any investigation of his character or background other than an inquiry by telephone to a former employer who did not give a wholehearted endorsement, coupled with the firm's failure to supervise his activities, violated Section 27 of Article III. The firm was not excused for its failure to supervise by the fact that the market for the securities involved was hectic and disorderly. It was incumbent upon the firm to provide adequate supervisory controls for the business being conducted. In this situation, it hired a salesman of doubtful recommendation to engage in selling activities, directed to customers who were not known to the firm, in a highly speculative security that was declining in price.

L.B. Securities Corp., and Marx, SEC Release No. 34-7806 (1966).

.38 Employees Improperly Supervised.—The failure of an officer of a member to properly supervise its employees so that its books and records were not maintained as required by the Securities and Exchange Commission and credit was extended to customers in violation of the Federal Reserve Board's Regulation T constituted conduct inconsistent with just and equitable principles of trade.

Albert E. Voelkel, SEC Release No. 34-7652 (1965).

.39 Inadequate Supervision—No Spot-Checking.—A member firm which failed to indicate, upon hearing, that any appropriate supervision procedures were in effect and admitted that no spot-checking was carried out with respect to the extent of activity in particular accounts, was suspended for violating Section 27 of Article III. Derivation of a good income by the customer was immaterial in determining whether or not her account was excessively traded.

First Securities Corporation, 40 SEC 589 (1961).

.40 Failure to Maintain Records—Duty of Principal Officer to Use Reasonable Care in Supervision of Firm's Business.—Violations of Section 27 of Article III was found to have been committed by a member firm when it failed to keep its general ledger regularly posted, to record collateral deposited for bank loans, to consistently keep and post its securities position books and to reflect in the customers' ledgers all receipts and deliveries of securities. The principal officer had a duty to use reasonable care to see that every-day

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operations of the firm's business were properly performed. It was no excuse for him to assert that the bookkeeping functions were delegated to a firm of accountants and to the member's vice-president and its bookkeeper.

Madison Management Corp., and Harry Friedman, SEC Release No. 34-7453 (1964).

.41 Inadequate Supervision of Officers-Salesmen—Person Responsible.—The chief executive officer of a member firm who was daily active in business had the responsibility of supervising the sales activity of the firm's salesmen. He was, therefore, liable for transactions effected by the salesmen at excessive mark-ups or mark-downs from the current market price. The fact that the salesmen also held official titles would not relieve the member firm of its duty under Section 27 of Article III with respect to transactions effected by those persons as salesmen.

Earl L. Combest, 35 SEC 623 (1954).

.42 Failure to Supervise with Respect to the Association's Free-Riding and Withholding Interpretation.—A member, its president, compliance officer, and branch manager violated Article III, Sections 1 and 27, in that the respondents failed to adequately supervise its salesmen with respect to the Association's Free-Riding and Withholding Interpretation. The SEC affirmed the Association's findings that two salesmen of the firm acted in contravention of the Association's Free-Riding and Withholding Interpretation. The SEC noted that the firm's supervisory procedures which did not refer to the Free-Riding Interpretation were grossly inadequate, particularly in light of the large number of underwritings in which the firm engaged. The Commission also concluded that the findings against the individual respondents were proper in that they shared responsibility for instituting supervisory procedures which should have prevented the salesmen's violations.

Blinder, Robinson & Co., SEC Release No. 19057 (1984).

.43 Failure to Supervise.—The SEC set aside the NASD's findings against the president of a

firm for failing to exercise proper supervision in connection with securities registration and record-keeping provisions. The SEC found that a firm's president is not automatically at fault when other individuals in the firm engage in misconduct of which he has no reason to be aware.

Juan Carlos Schidlowski, SEC Release No. 23347 (1986).

.44 Failure to Supervise.—A member firm violated Article III, Section 27 when it failed to exercise proper supervision over the activities of two salesmen with a view to preventing unauthorized transactions and unsuitable recommendations. One registered representative effected unauthorized transactions in the accounts of two public customers, falsified their addresses and sent them false account statements. The SEC stated that the firm's top management had substantial indications of irregularity with respect to the salesmen's activities, yet continually ignored warning signals or took inadequate action when confronted with information indicating that customers of the branch office were being defrauded. A second salesman recommended and sold municipal bonds on margin to a public customer, which was contrary to the customer's objectives and needs. The SEC sustained sanctions against the firm of censure, fine and the requirement to file a statement setting forth supervisory procedures designed to prevent any recurrences.

Wedbush Securities, Inc.(f/k/a Wedbush Noble, Cooke, Inc.), SEC Release No. 25504 (1988).

.45 Failure to Supervise Branch Office.—A member firm and its president failed to exercise proper supervision over a branch office with respect to private securities transactions. The SEC affirmed findings that respondents failed to review and adequately monitor the branch office activities, but reduced sanctions, noting that the branch office salesmen deliberately concealed the improper activities from the firm and main office personnel.

Seco Securities, Inc. and Stanley Richards, SEC Release No. 34-26054 (1988).

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Transactions for or by Associated Persons

Sec. 28

Determine Adverse Interest

(a) A member ("executing member") who knowingly executes a transaction for the purchase or sale of a security for the account of a person associated with another member ("employer member"), or for any account over which such associated person has discretionary authority, shall use reasonable diligence to determine that the execution of such transaction will not adversely affect the interests of the employer member.

Obligations of Executing Member

(b) Where an executing member knows that a person associated with an employer member has or will have a financial interest in, or discretionary authority over, any

¶ 2177.41 Art. III, Sec. 28

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existing or proposed account carried by the executing member, the executing member shall:

(1) notify the employer member in writing, prior to the execution of a transaction for such account, of the executing member's intention to open or maintain such an account;

(2) upon written request by the employer member, transmit duplicate copies of confirmations, statements, or other information with respect to such account; and

(3) notify the person associated with the employer member of the executing member's intention to provide the notice and information required by paragraphs (1) and (2) of this subsection (b).

Obligations of Associated Persons Concerning an Account with a Member.

(c) A person associated with a member, prior to opening an account or placing an initial order for the purchase or sale of securities with another member, shall notify both the employer member and the executing member, in writing, of his or her association with the other member; provided, however, that if the account was established prior to the association of the person with the employer member, the associated person shall notify both members in writing promptly after becoming so associated.

Obligations of Associated Persons Concerning an Account with an Investment Adviser, Bank, or Other Financial Institution

(d) A person associated with a member who opens a securities account or places an order for the purchase or sale of securities with a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall:

(1) notify his or her employer member in writing, prior to the execution of any initial transactions, of the intention to open the account or place the order; and

(2) upon written request by the employer member, request in writing and assure that the investment adviser, bank, or other financial institution provides the employer member with duplicate copies of confirmations, statements, or other information concerning the account or order;

provided, however, that if an account subject to this subsection (d) was established prior to a person's association with a member, the person shall comply with this subsection promptly after becoming so associated.

(e) Subsections (c) and (d) of this section shall apply only to an account or order in which an associated person has a financial interest or with respect to which such person has discretionary authority.

Exemption for Transactions in Investment Company Shares and Unit Investment Trusts

(f) The provisions of this section shall not be applicable to transactions in unit investment trusts and variable contracts or redeemable securities of companies registered under the Investment Company Act of 1940, as amended, or to accounts which are limited to transactions in such securities.

[Amended effective February 28, 1983; December 15, 1986; March 6, 1991; March 14, 1991.]

[The next page is 2123-3.]

• • • **Selected NASD Notices to Members**

83-17 SEC Approval of Amendments to Rules of Fair Practice Article III, Section 28 Governing Transactions Executed for Persons Associated with Another Member

(April 14, 1983)

85-41 Solicitation of Comments on Amendment Concerning Associated Persons' Accounts with Investment Advisors, Banks and Other Financial Institutions

(June 10, 1985)

86-38 Solicitation of Membership Vote on Proposed Amendments to Article III, Section 28 of the Rules of Fair Practice and Article VII, Section 8 of the By-Laws

(May 21, 1986)

87-2 Adoption of Amendments to Article III, Section 28 of the Rules of Fair Practice Regarding Securities Accounts of Associated Persons of Non-NASD Members

(January 7, 1987)

89-20 Request for Membership Vote on Proposed Amendments to Article III, Sections 1-28

(February 1989)

90-50 Request for Comments on Proposed Amendment to Article III, Section 28 of the Rules of Fair Practice Re: Associated Person Notifying and Obtaining Approval of Employer Prior to Opening Securities Account with Another Member

(August 1990)

90-73 Request for Membership Vote on Amendment to Article III, Section 28 of the Rules of Fair Practice Re: Associated Person Notifying Employer Prior to Opening Account with Another Member

(November 1990)

91-27 SEC Approves Amendment to Article III, Section 28 of the Rules of Fair Practice Re: Associated Person Notifying Employer Prior to Opening Securities Account with Another Member

(May 1991)

Annotations of selected SEC decisions

10 Failure to Inform Employer of Private Securities Transaction.—Perkins, a registered principal of an NASD member firm (Piper) placed a purchase order on behalf of Quest (in which Perkins was a 40% partner) with another member firm, Bullock. Neither Perkins nor Bullock notified Piper of the purchase, in violation of NASD rules requiring written notification of such transaction.

Perkins contended that because Bullock knew of Perkins' association with Piper and Quest that the transaction was indistinguishable from a personal transaction and, therefore, that it was Bul-

lock's responsibility, not Perkins', to notify Piper pursuant to Section 28 of the Rules of Fair Practice. The SEC rejected this contention stating that the exception to the interpretation of Section 28 "is limited to those transactions that an associated person, effects for an account in his own name, for his sole benefit," the limitation does not extend to transactions of accounts in which he has a partial or beneficial interest.

Richard W. Perkins, SEC Release No. 34-19345 (1982).

20 Failure to Comply with Interpretation Respecting Transactions for Employee of An-

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other Broker-Dealer.—An NASD member firm executed securities transactions in accounts for an employee of another firm and failed to send the other firm a written notice of such accounts and was censured by the NASD. The SEC affirmed, noting the mitigating circumstances that the other member was aware of and apparently authorized the employee's actions.

Rothschild Securities Corp., 45 S.E.C. 444 (1974).

.21 Transactions for Employees of Other Members.—The NASD found a member firm to have violated Section 28 of Article III by effecting transactions for employees of other NASD members without properly notifying the members concerned in writing.

Naftalin & Co., Inc., SEC Release No. 34-7220 (1964).

.22 Transactions for Employees of Other Members.—The sale by a member firm of securi-

ties belonging to a representative of another member firm violated Section 28 of Article III. The selling-member firm failed to notify the employer-member firm that an account would be opened for its representative.

Madison Management Corp., and Harry Friedman, SEC Release No. 34-7453 (1964).

.23 Failure to Inform Employers of Employee Securities Transactions.—A member who permitted two individuals, who he knew were registered with other member firms, to purchase units of a private offering without informing their employers of the transactions or taking other steps to ensure that the sales would not adversely affect the interests of those firms was found to have violated Section 28 of Article III.

Albert P. Fosha, SEC Release No. 22815 (1986).

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Private Securities Transactions

Sec. 40. (a) Applicability—No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this section.

(b) **Written Notice**—Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

(c) **Transactions for Compensation**—

(1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to Subsection (b) shall advise the associated person in writing stating whether the member:

(A) approves the person's participation in the proposed transaction; or

(B) disapproves the person's participation in the proposed transaction.

(2) If the member approves a person's participation in a transaction pursuant to Subsection (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.

(3) If the member disapproves a person's participation pursuant to Subsection (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.

(d) **Transactions Not For Compensation**—In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to Subsection (b) shall provide the associated person prompt written acknowledgement of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.

(e) **Definitions**—For purposes of this section, the following terms shall have the stated meanings:

(1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Article III, Section 28 of the Rules of Fair Practice, transactions among immediate family members (as defined in the Interpretation of the Board of Governors on Free-Riding and Withholding) for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.

(2) "Selling compensation" shall mean any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

[Adopted effective November 12, 1985.]

¶ 2200 Art. III, Sec. 40

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• • • Cross References

Article III, Section 1, Business Conduct of Members	¶ 2151
Article III, Section 28, Transactions for Personnel of Another Member	¶ 2178

• • • Selected NASD Notices to Members

85-21 Solicitation of Comments on Proposed Rule on Private Securities Transactions (March 29, 1985)
85-54 Proposed New Rule of Fair Practice Relating to Private Securities Transactions (August 13, 1985)
85-84 New Rule of Fair Practice Relating to Private Securities Transactions (December 18, 1985)
94-44 Board Approves Clarification on Applicability of Article III, Section 40 of the Rules of Fair Practice to Investment Advisory Activities of Registered Representatives (May 1994)

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Private Securities Transactions

.50 Failure to Inform Employer of Private Securities Transaction.—The NASD found that a securities salesman violated the NASD's Interpretation which prohibits any person associated with a member from engaging in any securities transaction "outside the regular course or scope of his association . . . without prior written notification to the member." (NASD Manual ¶ 2177, p. 2109-3).

The SEC affirmed, rejecting the registered representative's contention that he gave oral notice to the firm's secretary and satisfied the written notification requirement when the secretary assertedly wrote down the information that was given to her.

Paulson Investment Company, Inc., SEC Release No. 34-19603 (1983).

.51 Failure to Inform Employer of Private Securities Transaction.—Perkins, a registered principal of an NASD member firm (Piper) placed a purchase order on behalf of Quest (in which Perkins was a 40% partner) with another member firm, Bullock. Neither Perkins nor Bullock notified Piper of the purchase, in violation of NASD rules requiring written notification of such a transaction.

Perkins contended that because Bullock knew of Perkins' association with Piper and Quest that the transaction was indistinguishable from a personal transaction and, therefore, that it was Bullock's responsibility, not Perkins', to notify Piper pursuant to Section 28 of the Rules of Fair Practice. The SEC rejected this contention stating

that the exception to the interpretation of Section 28 "is limited to those transactions that an associated person effects for an account in his own name, for his sole benefit", the limitation does not extend to transactions for accounts in which he has a partial or beneficial interest.

Richard W. Perkins, SEC Release No. 34-19345 (1982).

.52 Failure to Inform Employer of Private Securities Transactions.—The NASD found that Chios, while employed as a registered representative for Hornblower, Weeks, Noyes and Trask, Inc., engaged in securities transactions without informing Hornblower. The SEC disagreed with the NASD finding. Chios' testimony revealed that:

1. He advised his supervisor at Hornblower that he wanted to leave the firm to work for Cal-Am. This notification was given prior to assuming any duties involving Cal-Am.
2. His supervisor advised him to take a leave of absence instead.
3. He did not notify Hornblower in writing of his Cal-Am activities.
4. He was unaware that his NASD registration remained effective during the period in question.

The SEC, referring to the Board's Interpretation on Private Securities Transactions, determined that Chios did not engage in prohibited securities transactions.

Steven Chios, SEC Release No. 34-18024 (1981).

.53 Indemnification Agreement as Private Securities Transaction.—An officer of a mem-

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Art. III, Sec. 40 ¶ 2200.53

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ber firm violated Article III, Section 27 when, without prior written notice to his firm, he executed a personal indemnification agreement in favor of a customer in order to induce that customer to pledge securities to a bank to serve as collateral for a loan. Since the indemnity agreement was inextricably linked to the pledge of stock, this agreement constituted a private securities transaction.

William D. George, SEC Release No. 34-17136 (1980).

.54 Failure to Inform Employer of Private Securities Transactions.—Oral notification to an employer of private securities transactions was insufficient and the lack of knowledge claim as to the NASD interpretation was rebutted by evidence of its availability in August 1976, which was prior to the time of the challenged conduct.

Eugene T. Ichinose, Jr., SEC Release No. 17381 (1980).

.55 Failure to Inform Employer of Private Securities Transactions.—A registered representative engaged in a private securities transaction without prior written notification to his employer/member when he received a "finder's fee" for introducing two individuals who wanted to acquire control of a business to the president of a company that needed additional management personnel and capital. The SEC based its decision upon the rejection of the so-called "sale of business" doctrine by the United States Supreme Court and the Court's conclusion that transactions resulting in a change of corporate control do not fall outside the scope of the federal securities laws. The SEC affirmed the finding of violation and the sanctions of censure and fine, but reduced the period of suspension from three years to six months.

Terry Don Wamsganz, SEC Release No. 22411 (1985)

.56 Failure to Inform Employers of Private Securities Transactions.—A registered representative, who was associated with two member firms, engaged in private securities transactions

when he sold securities of a corporation of which he was the sole owner and interests in a limited partnership in which he and his wife were the general partners without giving prior written notice of his transactions. The SEC rejected the salesman's argument that the purpose of the private securities interpretation is merely to prevent customers from being misled as to the firm's sponsorship, and, since he never used the names of his employer-members, he did not engage in private securities transactions. The SEC held that the Interpretation also serves the very important function of protecting employers against investor claims and protects customers by ensuring proper supervision of a broker's sales efforts. The SEC affirmed findings of violation, but reduced the sanctions to those originally imposed by the District Committee.

Zester Herbert Hatfield, SEC Release No. 25488 (1988).

.57 Failure to Inform Employer of Private Securities Transactions.—The NASD found that two individuals engaged in private securities transactions when they sold limited partnership interests without prior written notification to their employers. The SEC rejected Prosen's contention that his involvement was limited to referring customers to the unregistered broker-dealer handling the limited partnership. The SEC determined that by purchasing a partnership interest for his own account as well as recommending the investment to his clients, Prosen played a substantial role in the sale of limited partnership interests. In addition, the SEC rejected Prosen's argument that the transactions could not have resulted in liability to his employer-member. The SEC stated that, based on Prosen's activities, Prosen's customers could have reasonably assumed that the recommendations were authorized by his employer-member.

Allen S. Klosowski and Jack D. Prosen, SEC Release No. 25467 (1988).

¶ 2200A

Sec. 41. Each member shall maintain a record of total "short" positions in all customer and proprietary firm accounts in securities included in the NASDAQ System and shall regularly report such information to the Corporation in such a manner as may be prescribed by the Corporation. Reports shall be made as of the close on the settlement date falling on the 15th of each month, or, where the 15th is a non-settlement date, on the preceding settlement date. Reports shall be received by the Corporation no later than the second business day after the reporting settlement date.

[Adopted effective January 20, 1986; amended effective August 31, 1987.]

● ● ● Selected NASD Notices to Members

86-4 Interim NASD Rule of Fair Practice Relating to Monthly Reporting of Aggregate "Short" Positions
(January 20, 1986)

¶ 2200.54 Art. III, Sec. 40

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● ● ● *Selected NASD Notices to Members*

86-15 Monthly Reports of Aggregate "Short" Positions

(February 28, 1986)

86-61 Proposed New Rule of Fair Practice Relating to Monthly Reporting of Aggregate "Short" Positions

(September 3, 1986)

86-83 Proposed New Rule of Fair Practice Prohibiting Members From Effecting Securities Transactions During Trading Halts

(December 1, 1986)

87-15 Proposed Amendments to Article III, Sections 21(b) and 41 of the Rules of Fair Practice and the Interpretation of the Board of Governors Concerning Short Sales

(March 6, 1987)

¶ 2200B

Sec. 42. No member or person associated with a member shall, directly or indirectly, effect any transaction in a security as to which a trading halt is currently in effect.

[Adopted effective May 5, 1988.]

● ● ● *Selected NASD Notices to Members*

88-45 Proposed New Rules: Outside Business Activities

(July 1988)

88-46 Adoption of Rule Amendment to Authorize Trading Halts in NASDAQ Securities

(July 1988)

88-86 SEC Approves Article III, Section 43 of the Rules of Fair Practice Regarding Outside Business Activities

(November 1988)

89-2 Request for Membership Vote on Proposed New Rule Regarding Business Conduct by Members

(January 1989)

¶ 2200C

Outside Business Activities

Sec. 43. No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. Activities subject to the requirements of Article III, Section 40 of the Rules of Fair Practice shall be exempted from this requirement.

[Adopted effective October 13, 1988.]

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● ● ● Selected NASD Notices to Members

89-39 Proposed New Rule Re: Handling Customer Limit Orders

(May 1989)

90-37 Request for Membership Vote on Proposed New Section 45 to Article III of the Rules of Fair Practice Re: Customer Limit Orders

(June 1990)

¶ 2200D

THE CORPORATE FINANCING RULE

Underwriting Terms and Arrangements

Sec. 44. (a) Definitions

For purposes of this Section, the following terms shall have the meanings stated below. The definitions in Schedule E to the By-Laws are incorporated herein by reference.

(1) gross dollar amount of the offering—public offering price of all securities offered to the public and securities included in any overallotment option, the registration price of securities to be paid to the underwriter and related persons, and the registration price of any securities underlying other securities;

(2) issuer—the issuer of the securities offered to the public, any selling security holders offering securities to the public, any affiliate of the issuer or selling security holder, and the officers or general partners, directors, employees and security holders thereof;

(3) net offering proceeds—offering proceeds less all expenses of issuance and distribution;

(4) offering proceeds—public offering price of all securities offered to the public, not including securities subject to any overallotment option, securities to be received by the underwriter and related persons, or securities underlying other securities;

(5) participation or participating in a public offering—participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to Rule 13e-3; and

(6) underwriter and related persons—includes underwriters, underwriter's counsel, financial consultants and advisors, finders, members of the selling or distribution group, any member participating in the public offering, and any and all other persons associated with or related to and members of the immediate family of any of the aforementioned persons.

(b) Filing Requirements

(1) General

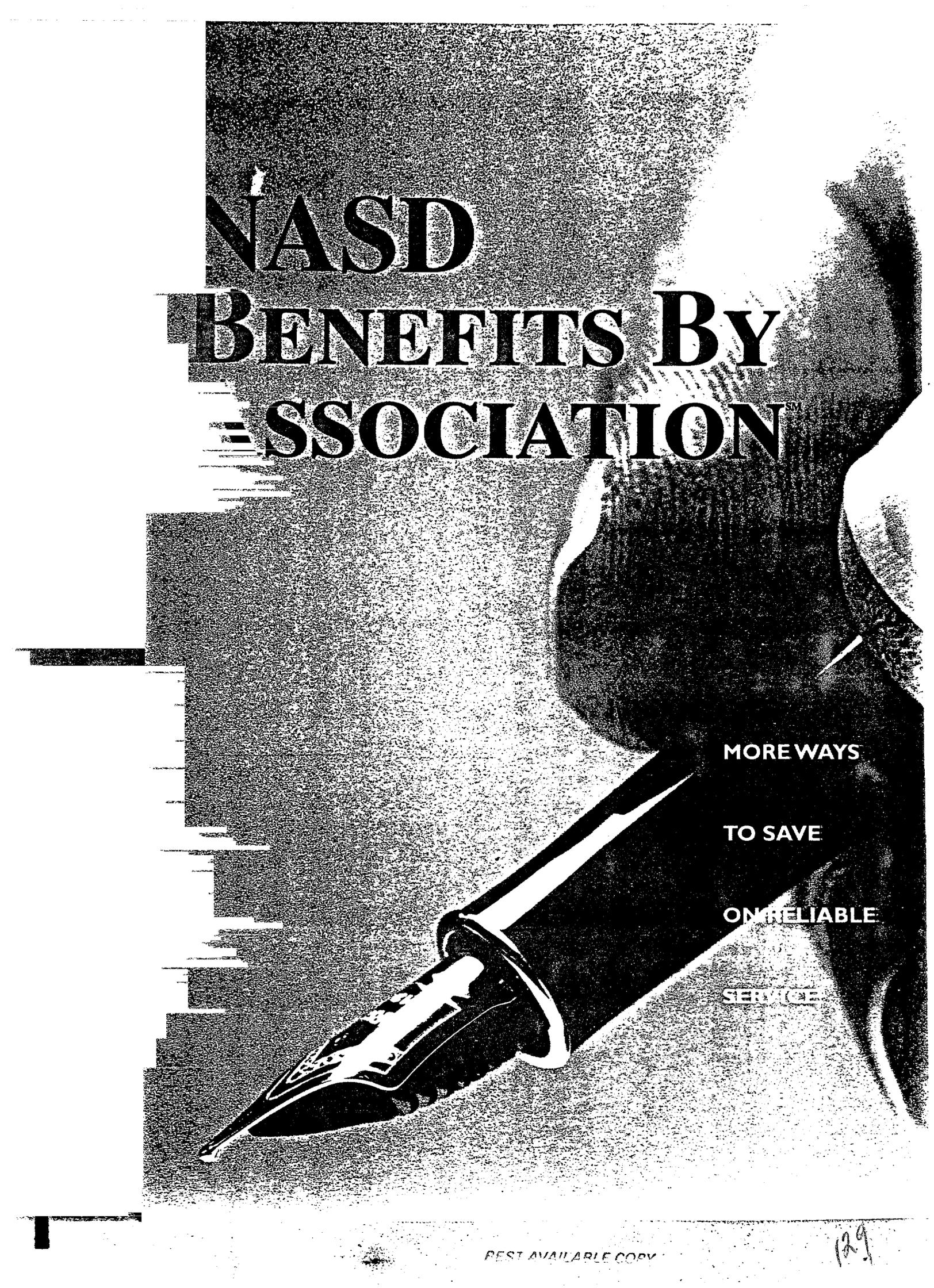
No member or person associated with a member shall participate in any manner in any public offering of securities subject to this Section, Schedule E to the By-Laws, or Article III, Section 34 of the Rules of Fair Practice unless documents and information as specified herein relating to the offering have been filed with and reviewed by the NASD.

(2) Means of Filing

Documents or information required by this rule to be filed with the NASD shall be considered to be filed only upon receipt by its Corporate Financing

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NASD BENEFITS BY ASSOCIATION

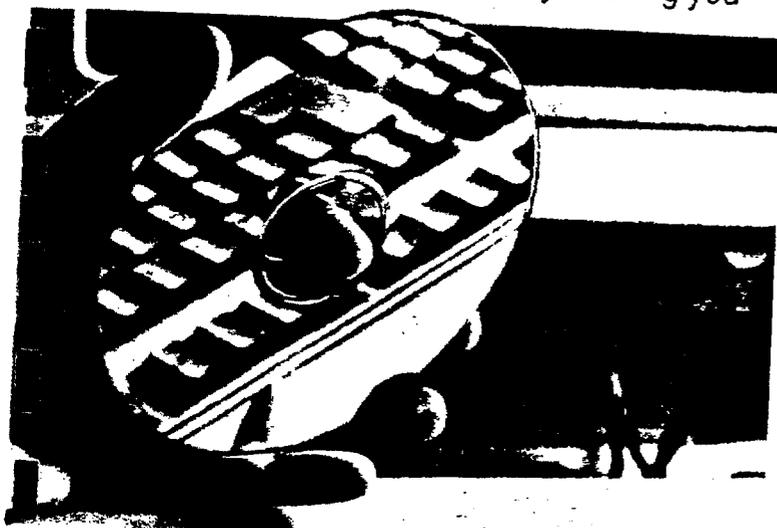
MORE WAYS

TO SAVE

ON RELIABLE

SERVICE

The National Association of Securities Dealers, Inc., (NASD®) has negotiated with many companies that supply services to our industry to bring you—our member firms, branch offices, and individual



registered representatives—quality programs at reasonable prices, just because you are an NASD member.

The nationally known and respected suppliers of **BENEFITS BY ASSOCIATION** programs share the NASD's commitment to providing quality products and services at reasonable rates to the membership and to continuously review and reassess existing programs for additional developments. Please watch for additional information as we continue to introduce new and revised products.



ERRORS AND OMISSIONS INSURANCE

Professional liability insurance for the securities industry at affordable group rates

Until now, the vast majority of NASD members were not eligible for or could not afford to pay the premiums associated with securities dealers' errors & omissions (E&O) insurance. Taking these facts into consideration, representatives from the securities industry, NASD Membership Committee, and staff have developed a program to fulfill the needs of over 80 percent of the membership. The Securities Dealers Errors & Omissions Insurance Program* offers several things that, until now, could not

be associated with E&O insurance:

- ❖ an easy-to-complete application designed specifically for the NASD membership based on reasonable underwriting criteria for members of all sizes;
- ❖ flexible, comprehensive options to allow a firm to develop a plan to suit its needs with choices of two policy packages, both with limits ranging from \$50,000 to over \$2 million per year; and
- ❖ reasonable group rates that start at \$1,500 per year based on desired package, level of coverage, and number of

registered representatives. Members may also be eligible for an additional 10 percent savings on their E&O premium simply through their participation in the NASD Fidelity Bond Program.

The Securities Dealers Errors & Omissions Insurance Program is made possible through the Securities Dealers Risk Purchasing Group, Inc., an NASD subsidiary specifically created to offer all members, large and small, comprehensive, affordable E&O coverage. The Risk

Purchasing Group has been filed with the various state insurance commissioners and will be announced to members in each state as it is approved by their state.

In the meantime, to obtain additional information on your newest benefit program and see how it can help your firm enhance its level of risk protection or

lower its E&O premiums, please contact the NASD Program Administrator at (800) 922-9242 or (202) 296-9640.

NASD GROUP FIDELITY BOND PROGRAM

The securities industry leader in providing fidelity bond coverage

The NASD Group Fidelity Bond Program*, which has serviced the securities industry for over 10 years, offers participating members fidelity bond coverage up to

\$7,500,000 (for members with minimum net capital of \$4,166,000). For 1996, coverage is enhanced while the premium rates are reduced by 20 percent. By

using the Securities Dealers Blanket Bond (SDBB), participating members receive these additional benefits, which are not available with the standard Form 14:

- ❖ full limit of liability coverage for each and every loss, unlike the Form 14 Financial Institutional Bond that carries an aggregate limit of liability;
- ❖ automatic \$25,000 for Audit Expense coverage;
- ❖ computer systems coverage, including voice-

initiated transfer coverage;

- ❖ telefacsimile transmission coverage that protects members from loss resulting from fraudulently transmitted or altered facsimiles;
- ❖ unauthorized check signature coverage to protect members from loss resulting from unauthorized check signature or endorsement; and
- ❖ extended coverage with an optional one-year discovery period to protect against losses later discovered that happened during the bond period.

New coverage incorporated into the 1995-96 bond renewal at no additional cost to you includes:

- ❖ computer virus coverage to protect against financial loss sustained by the insured as a direct result of the destruction, or attempted destruction, of the insider's electronic data due to a computer virus; and
- ❖ uncollectible items of deposit coverage to provide protection against loss resulting from payments of dividends or fund shares, or withdrawals from a customer's account as a result of items of deposit, drawn on a financial institution within the 50 states, which are not paid for any reason (including, but not limited to, forgery or any other fraud, except when caused by an employee).

To obtain additional information on the NASD Group Fidelity Bond Program, call the NASD Program Administrator at (800) 922-9242 or (202) 296-9640.

NASD STATE SURETY BOND PROGRAM

Affordable protection for our valued members

For over a decade, the NASD State Surety Bond Program* has been the proven industry leader, providing ease of compliance with mandated state surety bond requirements. The program satisfies the 22 applicable state statutes, affording protection to the public if a broker/dealer fails to comply with the prescribed state code.

This Program is competitive in the marketplace; the NASD recently negotiated a 40 percent rate reduction for this Program and subsequent refund of over \$500,000 of premiums back to members during the 1995 policy year. Operating on a guaranteed-issue basis, this bond automatically renews annually upon premium payment, saving participating members the time and expense of filing separate financial statements with the underwriter each year.

To obtain an application or additional information on this NASD member benefit, call the NASD Program Administrator at (800) 922-9242 or (202) 296-9640.

NASD MAIL INSURANCE PROGRAM

A mail insurance program specifically designed for the securities industry

The NASD Mail Insurance Program* offers member firms greater savings at one low cost. Most mail insurance programs provide coverage only for first-class or registered U.S. mail, with additional coverage options doubling or tripling your costs. The NASD Program automatically extends coverage for members to include U.S. Postal Service Express Mail and carriers for hire, such as Airborne Express. It even extends coverage to your independent contractors and to you when acting as a transfer agent.

This NASD Program is offered on a self-rated basis, which omits reporting and auditing normally associated with mail insurance, and thus eliminates the possibility of back billing by the carrier. The initial fee submitted with your application is your only payment for the policy term.

To obtain additional information on this NASD member benefit, call the NASD Program Administrator at (800) 922-9242 or (202) 296-9640.

NASD MEMBER FIRM INSURANCE PROGRAM

Flexible employee benefit coverage for members with up to 200 employees

The NASD negotiated with MetLife to bring members the NASD Member Firm Insurance Program*. NASD members with 2 to 200 employees can create a program to meet almost any budget by selecting from:

- ◆ three comprehensive medical options;
- ◆ two term life plans (with or without death and dismemberment);
- ◆ two dental plans;
- ◆ one disability plan.

The Plan Administrator will help interested members assess their insurance requirements, determine program eligibility, and provide quotes for comparison to existing insurance plans and features.

For additional information on the NASD Member Firm Insurance Program, contact the Plan Administrator at (800) 321-1988 or (202) 457-6820.

NASD INSURANCE PROGRAM FOR REGISTERED REPRESENTATIVES

Four types of insurance that are appropriate for all members

The NASD Insurance Program for Registered Representatives* is available to all NASD members' employees who want to supplement existing insurance coverage from other sources or need a stand-alone policy when not covered by their employer. Employees of members that receive a Form W-2 or 1099 are eligible to participate.

Participants can choose from these insurance plans:

- ◆ disability income insurance to protect you should you become totally disabled;
- ◆ major medical insurance for you and your family, with flexible deductible levels that allow you to design a plan that meets your needs and budget; and
- ◆ term-life and high-limit insurance that provide up to \$250,000 coverage.

To find out more about the availability of coverage, options, and rates in your area, contact the Plan Administrator at (800) 424-9883 for a free estimate.

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INVESTMENT ADVISOR PROGRAMS

For 1996, *Benefits By Association* is proud to offer three options for investment advisors.

Investment Advisor Surety Bond*

Over 20 states currently require that investment advisors maintain surety

bonds, providing third-party protection to the public in case an investment advisor fails to comply with provisions outlined in the applicable state statutes.

The Program is competitively priced, providing guaranteed-bond issuance with one of the lowest rates available in the market place. As these bonds are automatically renewed we eliminate the financial statement requirement, thus saving investment advisors the time and expense of annual filings.

To obtain information on this additional member benefit, call the NASD Program Administrator at (800) 922-9242 or (202) 296-9640.

Investment Advisor Third-Party Fidelity Bond Coverage*

For many investment advisors, this bond is a must to remain in compliance with federal ERISA laws pertaining to individuals and firms that handle funds in certain employee pension (and other plans) benefits.

Investment advisors who direct or control the assets of qualified pension and profit-sharing plans are considered fiduciaries under the ERISA Act. As such, the same fidelity bond requirement imposed on the plans' trustee also applies to the investment advisor.

Your legal counsel can tell you if you must have fidelity coverage.

This Program schedules all qualified plans, thereby making the plans the actual insureds under this third-party fidelity coverage. Coverage is available up to \$500,000 per plan, which is the maximum amount required by ERISA, and on an aggregated basis of \$30,000,000.

Investment Advisor Fidelity Coverage*

If you operate as an investment advisor, generally your activities are not covered under the NASD Fidelity Bond that is carried to comply with Rule 32 in the NASD Rules of Fair Practice.

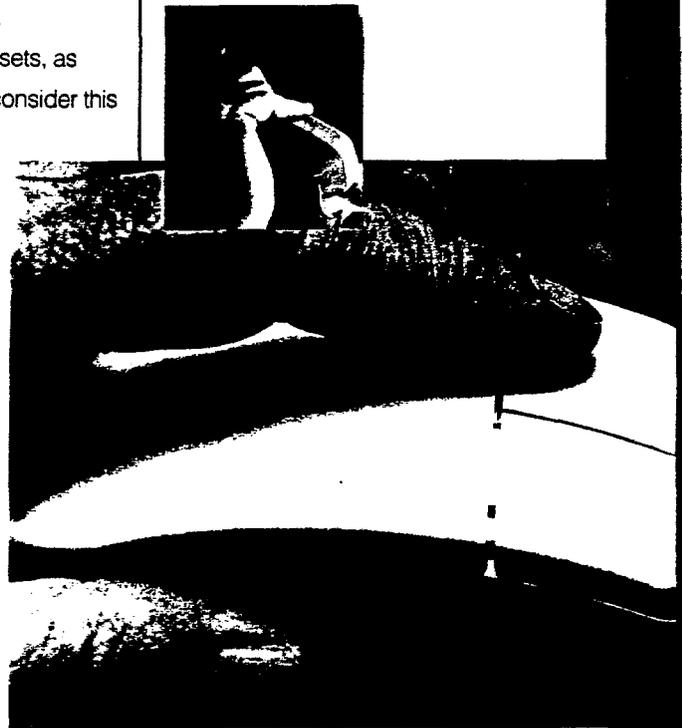
To safeguard your client's assets, as well as your own business, consider this Investment Advisor Fidelity Bond. It protects against losses sustained in your investment advisory business due to employee theft and dishonesty. Your coverage can be extended to provide Fidelity Bond protection to your own ERISA plans as required by law, at no additional cost.

In today's competitive marketplace, the investing public often requests evidence that their assets under management are protected by a fidelity bond. This Program will provide such coverage, and can often be used as a

sales tool against other investment advisors that do not carry this necessary protection.

This coverage is available in limits up to \$1,000,000 on a self-rating basis, with extremely competitive prices, and for higher limits with specific underwriting requirements. For more information on this product, please contact the NASD bond administrator at (800) 922-9242 or (202) 296-9640.

* The above descriptions are only summaries of certain terms and conditions for bonds and insurance. Terms and conditions may vary based on individual state requirements and bonds and insurance may not be available in all states. Please refer to the actual issued bond or certificate of insurance for full details of coverage.



NASD TELECOMMUNICATIONS PROGRAM

Two ways to save on reliable telecommunications service

The NASD Long Distance Program makes available to all participating members and their branch offices, regardless of size, discounted rates on long distance services. This partnership program with MCI Telecommunications, Inc., makes available MCI's services covering voice, data, and 800 services.

Participating members receive rates lower than those available in the general marketplace and an additional 7 percent or 10 percent rebate directly from the NASD. Since the program was created in 1991, it has saved participating members millions of dollars on their telecommunications costs.

To find out what the NASD Long Distance Program can do for you, contact your local MCI representative or call (800) 264-8112.

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NASD AIR EXPRESS PROGRAM

Cost-saving overnight package delivery

NASD member firms can now reduce the cost of overnight delivery service by up to 44 percent

over Airborne's list price with the NASD Express Courier Program.

NASD members pay only \$8.75 for an Airborne Express eight-ounce overnight letter. If your company ships more than 20 packages per month, your savings can be even greater!

Similar discounts apply, no matter how much your package weighs.

This program includes:

- ◆ free pickup from most locations;
- ◆ greater savings for using an Airborne drop box;
- ◆ toll-free customer service;
- ◆ free shipping supplies; and
- ◆ savings on international shipping.

To obtain an enrollment package or additional information, call Airborne's marketing agent at (800) MEMBERS, that's (800) 636-2377, and just tell them you're an NASD member interested in the program.

NASD®

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