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THE USE OF NASD NOTICE TO MEMBERS BULLETINS AS PRECEDENT IN ARBITRATION PROCEEDINGS

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THE USE OF NASD NOTICE TO MEMBERS BULLETINS AS PRECEDENT IN ARBITRATION PROCEEDINGS

I. Introduction

This is the second of three articles dealing with sources of precedent and/or persuasive authority outside of state and federal court venued decisions. The first of three articles in this series was published in Securities Arbitration 1997 (Page 471-525, Practicing Law Institute) and was entitled, "The Use of Securities and Exchange Commission Decisions as Precedent in Arbitration Proceedings".

Attorneys representing parties in arbitration proceedings are increasingly being asked by Arbitration Panels to produce concise citations to authority to support their clients positions. Unlike exhaustive briefs which might be filed in federal court venued securities fraud cases, many arbitrators are simply looking for one or two cases to support an award. Since the ruling of the United States Supreme Court in Shearson/American Express v. McMahon, which has resulted in the majority of customer claims being resolved in arbitration proceedings versus court venued proceedings, there is a dearth of case law within the past ten years addressing the obligations of a brokerage firm to the investing public. The bulletins of the National Association of Securities Dealers, Inc., (known as NASD) Notice to Members offer guidance to the practitioner and Arbitration Panels on virtually any issue involving the obligations of the brokerage firm to the investor.

II. Historical Background

NASD Notice to Members, published by the National Association of Securities Dealers, Inc., have been relied upon in varying degrees in court cases and have offered guidance to the courts in fashioning theories of liability. See United States v. NASD, 422 U.S.; 95 Sct 2427; 45 L.Ed. 486 (1975); Harden v. Raffensperger Hughes & Co., 65 F 3d 1392 (7th Circuit 1995) at 1401; General Bond & Share Co. v. SEC, 39 F 3d 1451, 1456 (10th Cir. 1994); 932 F. Supp. 1509 and 1538.

NASD Notices to Members serve a number of different purposes including notifying members and affiliated members of the following:

1. Proposed changes or actual changes in rules or procedures regulating broker dealer conduct.

2. Summaries of NASD disciplinary proceedings.

3. Requests for comments from members on issues affecting broker dealers and their members.

4. Interpretations of policy and directives on broker dealer conduct and procedures.

Section 1(a)(3) of Article VI of the NASD By-Laws delegates interpretation of NASD Rules by the NASD Board of Governors to the staff of the NASD. NASD Notice to Members originate from the Offices of General Counsel of NASD, Inc., NASDAQ and/or NASD Regulation with most of them being issued from NASD Regulation. Unfortunately, the text of many NASD Notices to Members do not indicate which of the three General

Counsel Offices specific Notices to Members are issued from. Ultimately, the Offices of General Counsel of NASDAQ and NASD Regulation are accountable to the Office of General Counsel of NASD, Inc., and all Notices to Members have the implicit approval of NASD, Inc., even though they may have issued from NASDAQ or NASD Regulation.

Policy pronouncements announced in Notice to Members require approval of the Board of Governors of the NASD. Likewise, any intended rule changes to be made by the NASD which constitute a material change of policy or practice are required to be filed with the Securities and Exchange Commission for approval pursuant to SEC rule 19b-4 and Section 19(b) of the Securities and Exchange Act of 1934 (see also 36 CFR Section 240).

The full text of NASD Notices to Members from January 1, 1997, onward are available free of charge on the NASD Regulation web site (www.nasdr.com) with executive summaries of NASD Notice to Members issued in calendar year 1996 being accessible through the same web site. Although the NASD has incorporated and annotated index for NASD Decisions from January 1, 1998, through the present onto the web site, Notices to Members prior to January 1, 1996, are not accessible to the public free of charge, although all member firms receive Notices to Members as a matter of course with the understanding that rule changes and policy pronouncements and clarification are to be made available or otherwise made known to registered representatives and associated persons as part of an ongoing duty of broker dealer supervision and continuing education.

Specific Notices to Members can be obtained by written request to NASD Support Services Department, 1735 K Street, N.W., Washington DC 20006-1500. An annual

subscription is available to the public at large at the present annual subscription rate of $225.00 per year by writing NASD Media Source, P.O. Box 9403, Gaithersburg, MD 20898-9403.

The NASD Notice to Members bulletins addressed in this article will be limited primarily to this last category relating to interpretations of policy and directives on broker dealer conduct rules and procedures.

III. The Joint Regulatory Sales Practice Sweep; Heightened Supervisory Procedures NASD Notice to Members 97-19

NASD Regulation and the New York Stock Exchange recently made findings and recommendations in their Joint Regulatory Sales Practice Sweep focusing on the necessity of close supervision for certain registered representatives with regulatory or complaint histories with recommendations on hiring procedures and the need to implement heightened supervisory procedures for these brokers. The memorandum noted that:

> A firm that hires one or more registered representatives with a history of customer complaints, disciplinary actions, or arbitrations, or that employs a registered representative who develops such a record during his or her employment, should recognize that it has heightened supervisory responsibilities that will require it, at a minimum, to examine the circumstances at each such case and make reasonable determination whether it's standard supervisory and educational programs are adequate to address the issues raised by the record of any such registered representative.

The memorandum goes on to state that firms which do not have a standard supervisory policy in place to deal with such representatives have an operation to implement such policies to provide heightened supervisory procedures where warranted.

Specific recommendations in addressing problem registered representatives include the recommendation of "the individual who will oversee the activities of the registered representative such be adequately qualified and have the appropriate training and experience to provide adequate supervision", with a further recommendation that "the firm also should review the registered representatives CRD record and the nature of the activities in which he or she is, or will be, engaged (considering, for example, the types of products he or she plans to sell and reviewing the persons top accounts, including changes or trends in account activity and commissions earned)". With regard to the specifics of the structure of such heightened supervision, it was recommended that:

> The firm should consider meeting with the registered representative and the person who is or will be his or her supervisor, during which the supervisor's understanding of the prior conduct of the registered representative and willingness to accept responsibility of his or her supervision can be confirm.

With such specific recommendations there should be very little guess work as to what is required of brokerage firms when dealing with problem registered representatives.

The memorandum also directs that the actual structure and implementation of a heightened supervisory arrangement for a particular registered representative should be known to all parties participating in such an arrangement noting that:

> For such procedures to be effective, the firm should alert the registered representative and the supervisor to the terms of the special supervision, including the period of time the special supervisory procedures will be in effect...the firm could require the registered representative and his or her direct supervisor to sign an acknowledgment, indicating their understanding and their agreement to abide by the terms of the special supervision for the requisite time period...it is also advisable for the firm to document the termination of a period of special supervision, including an assessment of whether the

> objectives of the supervisory arrangement were met...it is important that firms retain evidence of special supervision.

The memorandum has made very clear of what is expected of broker dealers with a heightened supervisory obligation with problem brokers.

Specific recommendations were made in the memorandum relative to new account procedures and specifically, relating to completion of customer account information on new account form and initial trades in new accounts. Specifically, the memorandum recommends that "[i]n addition to the normal requirements for opening a new account set out in NASD Rule 3110...the manager might choose to speak with all or selected new account holders or to independently verify the customer information on the account form on a random or consistent basis, depending on the situation...[i]f the firm deemed it prudent in view of prior activities, it might prohibit any trading until the account information or the order information could be independently verified with the customer". This logical extension of a broker dealers duty of supervision would have to be adhered to in order to show full compliance.

The memorandum also recommends that the heightened supervisory requirements and restrictions might include that:

> [w]hen reviewing conduct to determine whether heightened supervision is warranted, firms should focus on whether a specific type of transaction was involved in prior problems, and should consider prohibiting light transactions, or requiring supervisory approval of all such transactions in advance of execution, as is routinely required in many firms in the case of low-priced securities, options and discretionary trade.

The recommendations in the memorandum could not be more specific - problem brokers should be closely monitored in order to assure that they do not repeat improper sales

activities which his or her firm has actual notice of. Notice to Members 97-19 followed on the heals of the "rogue broker" policy pronouncements of the Securities and Exchange Commission in 1995.

IV. Bank Brokerage NASD Notice to Members 97-89 -Requirements Applicable to Brokers/Dealers Operating on the Premises of Financial Institutions

With the gradual chipping away at the Glass-Steagall Act which required the separation of banking from the securities brokerage business, the investing public has been faced with the mushroom of branch banks on Main Street offering savings accounts and certificate of deposit accounts as well as securities brokerage services. The rapid growth of this phenomenon has been accompanied in many instances without a commensurate growth of an appropriate supervisory and compliance structure at banking institutions sufficient to supervise the activities of individual brokers at bank branch offices. Banks have been remiss in making known to the banking public that investments in the financial markets offer a wholly different risk profile than that of federally insured bank deposits.

The Securities and Exchange Commission approved NASDR Rule 2350 imposing specific requirements on broker/dealers transacting business on the premises of banking institutions (Release No. 34-39294, 11/4/97). The main thrust of this requirement is comprehensive customers disclosure and written acknowledgment "intended to assist investors in making investment decisions based on a better understanding of the distinction between insured deposits and uninsured securities products" with the requirement that investors in such situations provide a "written acknowledgment in all but rare

circumstances...at or prior to the time that a customer account is opened by a member on the premises of a financial institution where retail deposits are taken" to the effect the broker affiliate shall disclose orally and in writing, that the securities products purchased or sold in a transaction with the member:

i. are not insured by the Federal Deposit Insurance Corporation;

ii. are not deposits or other obligations of the financial institution and are not guaranteed by the financial institution; and

iii. are subject to investment risks, including possible loss of the principal invested with a further proviso that

the broker/dealer "make reasonable efforts to obtain from each customer during the account opening process a written acknowledgment" of the above (see NASDR Rule 2350).

Notice to Members 93-87 (December 1993) and Notice to Members 94-16 (March 1994) also deal with the interplay of banks and brokerage firms. These notices are directed to the respective obligations of banking institutions under the rules of fair practice to the investing public relative to the marketing of mutual funds as replacements for maturing certificates of deposits and communications and disclosures of material information about mutual funds sales.

In Notice to Members 97-89 (SEC Approves Bank Broker/Dealer Rule; effective February 15, 1998) members were advised of SEC approval of new NASD(R) rules 2350 in SEC release no. 34-39294 (11/4/97) which specified requirements applicable to broker/dealers operating in the premises of financial institutions. This Notice addresses 11 practical questions with comprehensive answers as to the exact manner in which bank

broker/dealers must comply with the comprehensive new guidelines regarding the provision of comprehensive disclosure to banking clients advising them of the separateness and different risk and security parameters of bank investing versus investing in the securities markets with a further requirement of obtaining a written acknowledgment from the client of advisement of the required disclosures.

V. Branch Office/Satellite Office Supervisory Obligations NASD Notice of Members 80-20; NASD Notice to Members 86-65; NASD Notice to Members 89-34 and NASD Notice to Members 92-18

i. Notice to Members 80-20 (November 12, 1980)

In Notice to Members 80-20 (May 12, 1980), the NASD set forth a supervisory check list to be used in branch office examinations in order to "provide those responsible for branch office supervision with some helpful reminders of what could be done to avoid unintentional violations of applicable rules and regulations". In issuing the same, the NASD sought to provide "a guide to members in developing and maintaining the supervision policies and procedures necessary to meet their own needs".

The supervisory checklist set forth in Notice to Members 80-20 consists of 8 pages of specific requirements addressing money and securities handling, books and records, sales practices, correspondence and advertising, options, municipal securities transactions, trading and order room operations, supervision of accounts, supervision of branch offices, supervision of other branch offices (for branches which have supervisory jurisdiction over other branches) and the need to assure compliance with applicable state laws. The supervisory check list contained in Notice to Members 80-20 can be a valuable tool in cases

involving supervisory shortcomings and can afford the framework for establishing supervisory standards in cases involving alleged trading improprieties in branch offices.

ii. Notice to Members 86-65, Compliance with NASD Rules of Fair Practice in the employment and supervision of off site personnel (9/12/86).

In defending customer complaints of brokerage misdeeds involving their registered representatives, many firms try to distance themselves from the misdeeds of individual brokers by claiming that the individual broker is merely an independent contractor and not an employee of the firm. In addressing this issue in NASD Notice to Member 86-65, it was noted that:

> irrespective of an individuals 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 responsibility of the member...[T]he fact that an associated persons conducts business at a separate location or is compensated as an independent contractor does not alter the obligation of the individual and the firm to comply fully with all applicable regulatory requirements.

This Notice to Members noted that regardless of the full-or part-time status of a registered person and regardless of whether or not such registered persons are engaged in other business enterprises such as insurance, real estate sales, accounting or tax preparing, the fact of their location away of offices of members "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".

iii. NASD Notice to Members 89-34, Specific Recommendations on Supervision.

In NASD Notice to Members 89-34, Guidelines for Compliance with the NASD Rules of Fair Practice and Supervisory Requirements, (April 1989) clarifies previous amendments to former Article III, Section 27 of the Rules of Fair Practice.

Firstly, this Notice directed that the supervisory system established in compliance with Article III, Section 27 "must cover all aspects of the firm's investment banking and securities business, including back office; corporate financing; trading activity; market services such as SOES, OTC, NASDAQ/NMS trade reporting; and so forth". The Notice also set forth that a simple telephone interview is inadequate compliance with the annual compliance interview requirement of former Section 27(a)(7).

With regard to the type of records the firm should maintain to establish compliance with former Article III, Section 27 as amended, the Notice noted that the purpose of the requirement is three-fold:

1. To provide the member an opportunity to review the product mix and method of operation of each representative and emphasize compliance issues related thereto;

2. To provide the representative an opportunity to ask any questions he or she may have and receive authoritative guidance; and

3. To communicate regulatory developments, firm policies, and similar information to the representatives.

The Notice also sets forth the mode of record keeping required to evidence compliance with the above suggesting the maintenance of "records that reflect the date and location of the interview or meeting, the attendees, and the subjects discussed".

VI. Variable Annuity Contracts

Variable annuity contracts have been aggressively marketed by brokerage firms as evidenced by the astronomical growth in sales volume. In NASD Notice to Members 86-96 (December 1986), NASD Regulation reminded members and associated persons that sales of variable contracts are subject to NASD suitability requirements given their status as securities under the Securities Act of 1933 and set forth that all of the suitability requirements of Rule 2310 applicable to other securities are applicable to variable contracts. Specifically, the notice noted that, "...specific factors regarding a recommendation to purchase variable products that could be considered under the NASD suitability rule include:

i. A representation by a customer that his or her life insurance needs were already adequately met;

ii. The customer's express preference for an investment other than an insurance product;

iii. The customer's inability to fully appreciate how much of the purchase payment or premium is allocated to cover insurance or other costs, and a customer's ability to understand the complexity of a variable products generally;

iv. The customer's willingness to invest a set amount on a yearly basis;

v. The customer's need for liquidity and short term investment;

vi. The customer's immediate need for retirement income;

vii. The customer's investment sophistication and whether he or she is able to monitor the investment experience of the separate account.

These particulars form a precise frame work for any practitioner making an inquiry into a public customer case involving possible variable contract abuses.

Notice to Members, Notice No. 86-96 also highlighted the need to be vigilant for abuses in the area of variable contracts noting that:

> NASD Regulation is aware of the practice whereby a registered representative replaces a customers existing variable contract with a new variable contract that doesn't improve the customer's existing position, but generates a new sales commission for the registered representative.

Thus, any replacements of an existing variable contract with a new variable contract are subject to close scrutiny with the requirement that the solicitation of such a change be motivated primarily by suitability considerations as opposed to other concerns such as the generation of commissions (see Rule IM-2310.2(b)(2) of the NASD Conduct Rules).

VII. Customer Complaints, NASD Notice to Members 93-73 (October 1993)

Reports of NASD Members to the Central Registration Depository (the CRD) relative to customer complaints and other required disclosures has been fraught until recently, with uncertainty and unclarity with the result that the investing public has been deprived of vital information which would bear upon a choice of brokers. Patterns of customer abuse and questionable trade practices were hidden from the public eye as broker dealers were able to claim that certain gray area matters were simply not reportable to the CRD under NASD Guidelines.

The SEC approved NASD(R) Rule 3070 (formerly Article III, Section 50 of the NASD Rules of Fair Practice) on September 8, 1995, to clarify the requirements of reporting

customer complaint information and other specified events to NASD Regulation, Inc., and ultimately, to the Central Registration Depository. The rules requires NASD member firms to disclose to NASD Regulation any occurrence which fit within ten (10) separately specified categories of events enumerated in NASD(R) Rule 3070. The rule requires the reporting by member firms of quarterly summary statistical information pertaining to written customer complaints. NASD(R) Rules 3070 became effective on October 15, 1995, and the first series of quarterly statistical electronic submissions were required to be filed with NASD Regulation by January 15, 1996.

As could be expected, even though NASD Regulation sought to specify the reporting obligation of member firms under NASD(R) Rule 3070, NASD Regulation was met with numerous inquiries by member firms regarding their customer complaint reporting obligation culminating in NASD Notice to Members No. 96-85 (December 1996).

This Notice to Members is very specific as to the mechanics in which reportable information must be forwarded to NASD Regulation in a timely fashion, including the specification of the use of certain communications software (NASDnet) to communicate with the NASD together with the use of member firm coding requirements with the further requirement that "[t]he ...members should maintain a systematic method (e.g. date stamping) for recording the dates that customer complaints are first received by the member".

The clarification of the reporting requirements in this Notice only requires that "the members should report the most egregious problem code alleged (e.g. fraud, misrepresentation, unauthorized transaction), the security associated with the most egregious

problem code, and the highest alleged damage amount" even though the customer complaint may contain numerous allegations involving a variety of securities or multiple damage amounts. It would appear that this clarification, however, still leaves considerable lee-way for member firm to engage in considerable selective reporting of complaints and reportable events.

The clarification in this notice also requires separate reports in circumstances under which more than one associated person is named in a customer complaint. Subsequent letters from the same customers must also be reported separately to NASD Regulation if it includes any new allegations.

The notice went on to direct that in circumstances under which a member and an associated person or persons are named as defendants or respondents or are subject to any claim for damages by a customer and, as a result of a judgment, award or settlement, the parties have joint and several liability over $25,000.00, two separate disclosure reports are required to be filed with NASD Regulation and reports for each event must be made under the rule, noting that:

> Any judgment, award or settlement in an amount over $15,000.00 for an associated person and over $25,000.00 for a firm, respectively, must be submitted to NASD Regulation...[s]ince the liability is joint and several, the amount for each named party must be aggregated and reported as if the member and associated person(s) are separately liable for the specified amount.

These guidelines appear to delegate a practice engaged by some firms wherein reports either went unfiled or were filed as against one party.

It is the total amount claimed by the customer that is taken into consideration whether to file with NASD Regulation, regardless of whether or not the firm rescinds the transaction complained of in favor of the customer. The same also applies to arbitration or civil litigation claims filed by customers after October 1, 1995, which settle in an amount in excess of the threshold amounts for a matter commenced prior to October 1, 1995.

Notice to Members 96-85 also covers the reporting responsibilities of a broker dealer in circumstances in which any registered person has been terminated as a result of an internal investigation. Under such circumstances, notwithstanding a timely filing of a form U-5 through the CRD system, the member must also submit a specified event item under number 10 [section (a)(10)], filing through the customer complaint reporting system at NASD Regulation. In circumstances wherein the customer complaint is forwarded to NASD Regulation and not the member firm, upon forwarding the same to the member firm by NASD Regulation, the member is obligated to report the complaint through the customer complaint reporting system.

Certain types of complaints have more stringent and accelerated submission requirements to NASD Regulation. For example, if a member receives a customer complaint alleging theft, misappropriation of funds or securities or forgery the member firm must not only file the appropriate specified event filing under Section (a)(2) with NASD Regulation within ten (10) days, the member must also submit a quarterly customer complaint filing with NASD Regulation regarding the same event.

Ironically, when a member receives notification that it or an associated person was named in an arbitration or civil litigation regarding a customer dispute, the member is not obligated to file either a specified event filing or a customer complaint filing with NASD Regulation. NASD Notice to Members 96-85 simply directs that "[u]nder the rule, a member is obligated to report only settled or completed arbitrations or civil litigation matters and only where the award, judgment or settlement exceeds a certain specified dollar amount". This notice also pointed out, however, that the member firm still may be required to report these matters to the NASD through the CRD system on forms U-4, U-5 and BD.

Given the heightened reporting requirements of NASD member firms and their affiliated persons as required by NASD(R) Rule 3070 and as further clarified in NASD Notice to Members 96-85, practitioners representing parties to arbitration proceedings should consider obtaining specified event and quarterly summary statistical information filings filed with NASD Regulation in addition to discovery requests such as U-4, U-5, RE-3's and CRD filings. Discovery requests in this regard should be all inclusive and not afford member firm any lee-way to not disclose all relevant customer complaints.

VIII. Selling Away - NASD Notice to Members 86-65 Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel

NASD Notice to Members 86-65 (9/12/86), noted that:

> [b]ecause 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...[c]onsequently, firms that employ such persons are responsible for monitoring their activities in a manner reasonable intended to detect violations.

Referring to former Article III, Section 40 of the NASD Rules of Fair Practice regarding Private Securities Transactions Notice to Members 86-65 imposes specific requirements on noted firms noting that:

> The rule requires that a member approves an associated persons involvement in private securities transactions for compensation to record the transactions on its books and records and supervised individuals participation "as if the transactions were executed on behalf of the member" and went on to recommend that the firm obtain ten separate categories of information including the following:
>
> A. The individual and the security involved;
> B. The amount and source of compensation;
> C. The names of the investors and the amounts and dates of the investments;
> D. The issuer, syndicator or any other broker/dealer involved; and
> E. The manner in which the firm undertook to supervise the associated persons participation.

And the Notice went on to note that "...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". Given such stringent and burdensome requirements, query whether any broker dealer would even consider permitting an associated person to engage in private securities transactions - the reasons would have to be compelling. Further yet, it would appear that the Joint Regulatory Sales Practice Sweep - Heightened Supervisor Procedures discussed in NASD Notice to Members 97-19 (April 1997) (see Point III in this article) imposes the most stringent and constant supervision of any affiliated member having any prior involvement with undisclosed private securities transactions or selling away activity.

IX. Collateralized Mortgage Obligations
NASD Notice to Members 93-85 (December 1993)

In NASD Notice to Members 93-73 (October 1993), the NASD reminded the members of the need to "be conversant in all of the characteristics of CMO's to assess adequately the suitability of CMO's for their customers" and to assure that "members must insure that their customers understand their characteristics and risks associated with CMO's". This Notice to Members followed up on Notice to Members 93-18 (Guidelines Regarding Communications with the Public About Collateralized Mortgage Obligations) and Notice to Member 92-59 imposing a pre-use filing requirement for CMO advertising.

1992 Amendments to the NASD Guidelines Regarding Communications With the Public About Collateralize Mortgage Obligations of Article III, Section 35 of the Rules of Fair Practice addressed in Notice to Members 93-85 (December 1993) highlighted the need for member firms to engage in a more affirmative obligation to clearly identify collateralized mortgage obligations to customers defining the term "Collateralized Mortgage Obligations (CMO) as a multi-class bond backed by a pool of mortgage pass-through securities or mortgage loans and interchangeably used the term "Real Estate Mortgage Investment Conduits" (REMICs) when referring to CMO's.

Member firms are directed in this notice to refrain from using proprietary names for CMO's with the further admonition "[t]o prevent confusion and the possibility of misleading the reader, communications should not contain comparisons between CMO's and any other

investment vehicle, including Certificates of Deposit". Thus, the abuses sought to be remedied and addressed in Notice to Members 93-85 are obvious.

The Notice also advised members that "...members are required to offer to customers educational material which covers the following matters:

A. A discussion of CMO characteristics as investments and their attendant risks;

B. An explanation of the structure of a CMO, including the various types of tranches;

C. A discussion of mortgage loans and mortgage securities;

D. Features of CMO's, including credit quality, prepayment rates and average lives, interest rates (including effect on values and prepayment rates, tax considerations, minimum investments, transactions, costs and liquidity.

E. Questions an investor should ask before investing, and a glossary of terms that may be helpful to an investor considering an investment".

Given the concise directives to broker dealers in Notice to Members 93-85 regarding their obligation to the investing public when selling CMO's it would appear that the days of comparing CMO's to government backed or corporate bonds without any explanation of attendant risks are a distant memory.

X. The Applicability of the NASD Rules of Fair Practice to Direct Participation Programs, Notice to Members 91-69 (November 1991)

Notice to Members 91-69 noted that the investing public purchased over 90 billion dollars worth of direct participation program securities in the 1970's and 80's by more than

10 million investors in industries including real estate, oil and gas, cable television, commodities and equipment leasing. Many broker dealers try to skirt the applicability of the suitability requirements of the NASD by structuring direct participation program investment products so as not to constitute a security as defined by the Federal Securities Law in order to avoid civil liability not only for the unsuitable sale of securities but also for the unregistered sale of securities.

In addressing the topic of suitability of recommendations relative to direct participation programs, Notice to Members 91-69 (November 1991) noted that:

> NASD members and associated persons are required pursuant to Article III, Section 2 and appendix F to Article III, Section 34 of the Rules of Fair Practice, when recommending to an investor the purchase, sale or exchange of a DPP Security, to have reasonable grounds to believe that the recommendation is suitable for the customer based on the customer's investment objectives, other investments, financial situation and needs, tax status, and any other information known by the member or associated person...[a]dditionally, the member and associated person must determine that the investor has the appropriate investment objectives, is in a position to fully understand the risks and benefits of the transaction and has a net worth sufficient to sustain the risks involved in an investment in a DPP Security.

These heightened suitability requirements applicable to direct participation might very well explain the proliferation of telemarketing firms selling oil and gas, computer, product marketing and telecommunications direct investments which firms have no affiliation with the NASD, thereby avoiding self-regulatory scrutiny. (See also NASD Notice to Members No. 73-50 (7/13/93) - "SEC release on NASD Proposed Tax Shelter Rules" page 57-60, 85-101-111).

On the heels of the explosion of limited partnership related arbitration filings, the NASD, in March of 1997 in Notice to Members 97-8, made known the approval by the Securities and Exchange Commission in Release No. 34-38132, of proposed NASD Rules permitting the quotation of direct participation programs and limited partnerships in the OTC Bulletin Board Service (OTCBB) which further requires that all transactions in these investments be reported in the Automated Confirmation Transaction Service (ACT) with the requirement that the transactions be reported beginning May 15, 1997.

XI. NASD Notice to Members 94-16 (March 1994) - "NASD Reminds Members of Mutual Fund Sales Practice Obligations"

The directive contained in Notice to Members 94-16 (March 1994) are clear and concise and can be helpful to any practitioner involved in any arbitration proceeding involving a complaint of a public customer relative to mutual fund dispute. This Notice addresses fundamental issues such as disclosure, breakpoints, "switching", SIPC coverage, suitability, internal controls and advertising/marketing. The issuance of this Notice to Members was precipitated by the phenomenon whereby "vast sums have moved into mutual funds as investors have searched for hire-yielding investment opportunities...[t]he trend has substantially increased the attention members devote to mutual fund sales and has generated explosive growth in mutual fund sales by bank-affiliated broker/dealers and broker/dealers participating in networking arrangements with banks".

On the topic of required disclosures Notice to Members 94-16 reminded members that:

> [t]o the extent there are sales charges associated with such a purchase or sale, such as contingent deferred sales charges on either the fund to be liquidated or the fund to be purchased, members should discuss with the customer the effect of those charges on the anticipated return on investment...if a member recommends the purchase of a fund from a particular fund family based on the ability to switch easily between funds in the family, the member should disclose all fees or charges that may be imposed.

These heightened disclosure requirements impose a more affirmative duty on the part of the broker dealers and their members with respect to disclosure on these fundamental issues such as sales charges and fund family switches which the investing public by and large is quite ignorant of.

On the topic of mutual fund breakpoints (reductions in mutual fund sales charges based upon the dollar volume of a purchase exceeding a certain minimum) this notice stated that "members must affirmatively advise their customers of the impact of particular breakpoints on the contemplated transactions". This affirmative obligation has been spelled out to include that:

> [i]f a proposed fund or fund family offers breakpoint discounts, members should disclose the existence of the breakpoints to enable the customer to evaluate the desirability of making a qualifying purchase...members should be aware that recommending diversification among several funds with similar investment objectives may not be in the best interests of a customer, especially if the sales of those funds occur at prices just below the breakpoints of one or more of the funds sold".

Thus, the breakpoint notification requirement is an affirmative duty owed by the broker dealer and affiliated members to the investing public.

Notice to Members 94-16 also addressed the practice of "switching", the recommendation of a switch or sale from one fund for the purchase of another fund noting

that "[s]witching among certain fund types may be difficult to justify financial gain or investment objective to be achieved by the switch is undermined by the transaction fee associated with the switch" without overstating the obvious, the recommendation of a "switch" should, in the first instance and in all instances, be in the customers best financial interests and in accordance with the customers investment objectives.

XII. New Developments: SEC Approves Rules Regarding Supervisor, Review and Record Retention of Correspondence, NASD Notice to Members 98-11 (January 1998)

Notice to Members 98-11 (January 1998) addressed SEC Approval of Amendments to Rules 3010 and 3110 of the Rules of the NASD with an effective date of February 15, 1998. This Notice addresses required rules and procedures in the area of e-mail and Internet correspondence between associated persons and their customers or prospective customers and includes requirements for record retention as well as the implementation of supervisory procedures to be followed in order to regulate and monitor correspondence between brokers and customers. Amended rule 3010(d)(1) and new rule 3010(d)(2) require that all correspondence related to a member's investment banking or securities business received in electronic format (e.g., e-mail and facsimile) will be subject to the overall supervisory and review procedures required to be established by NASD members pursuant to these provisions. The new provisions of rule 3010 require the formulation of comprehensive procedures for reviewing and supervising electronic correspondence and rule 3110 imposes archiving and record retention in compliance with rule 17a-4 under the Securities Exchange Act of 1934.

This Notice went on to note that rule 3110 amends supervisory policies and procedures to:

> Prohibit registered representatives and other employees use of electronic correspondence to the public unless such communications are subject to supervisory and review procedures developed by the firm...[f]or example, NASD Regulation would expect members to prohibit correspondence with customers from employee's home computers or through third party systems unless the firm is capable of monitoring such communications.

In this day in age of electronic correspondence, the NASD has made known in Notice to Members in 98-11 the procedural and supervisory requirements demanded of its members. Practitioners representing parties to arbitration proceedings would be wise to make inquiry into these procedures and the extent to which they may or may not have been implemented in a particular case.

Conclusion

NASD Notices to Members set forth standards of conduct and a supervisory procedures required of its member firms and associated persons on a continual basis and the practitioner would be wise to keep abreast of these developments in order to afford clients comprehensive representation in arbitration proceedings. This author submits that the outcome of many arbitration proceedings can turn upon the effective use of NASD Notices to Members which can be resorted to by expert witnesses and/or provided to arbitration panelists in whole text, hard copy or hearing brief format.