

firm is doing by means of an economically equivalent transaction that which it would otherwise be prohibited from doing. Such activity would undermine the effectiveness of the proposed Interpretation.

The proposed Interpretation specifically notes that the intent of the prohibition is to cover situations where the member firm is "purposefully" altering its inventory position in anticipation of the issuance of a favorable or unfavorable research report. In accord with that intent, the proposed Interpretation is not intended to halt all of a firm's trading activity in that security. Even if the trading desk knows of a forthcoming research report on a particular security, the trading desk is fully permitted to continue to trade with its retail customers or with other broker-dealers if such trading arises from unsolicited order flow. Similarly, the proposed Interpretation would not apply to situations where the firm conducts research solely for in-house use and such research is not made available for external distribution.

In addition, the proposed Interpretation encourages but does not require firms to establish Chinese Wall procedures to control the flow of information between their research and trading departments. Such Chinese Wall procedures are risk management control adopted by securities firms that include physical and informational barriers between different departments of firms to enhance the likelihood that knowledge of upcoming events will be isolated within a single group and not disclosed to other groups that might trade on or otherwise benefit from the information. Because many firms today already use Chinese Wall restrictions between the research and trading departments of their firms, the NASD decided that the policy should encourage but not require the use of Chinese Walls as the preferred method of complying with the new policy.

While the NASD's proposed Interpretation would not require a member to develop Chinese Wall procedures, the NASD believes that Chinese Wall restrictions are the most effective means for a member firm to demonstrate that any trading activity before its issuance of a research report had not been in violation of the proposed Interpretation. Accordingly, if a member decides not to implement Chinese Wall procedures, it would carry the significantly greater burden of proving that stock accumulations or liquidations prior to the issuance of a research report had not been purposeful if an NASD investigation into the firm's buying or selling activity were initiated.

Chinese Wall procedures are therefore, the recommended and preferred approval, but members are allowed to analyze their own environments and determine where Chinese Wall procedures were appropriate for their firm.

While some commenters on NTM 94-40 objected to the proposed policy, the NASD notes that such comments were almost equally balanced by comments expressing strong support for the proposed policy. Indeed, even those commenters objecting to the proposal recognized that there were significant investor protection concerns that could arise when a firm adjusted its inventory positions in anticipation of its issuance of a research report. While not disregarding such investor protection issues, such commenters were more concerned about how they believed the proposed Interpretation would impact the liquidity of less well-capitalized stocks, and the potential dissemination of research into such smaller companies. Several firms raising this issue argued that they should be permitted to "passively" accumulate inventory positions and pass along the advantageous cost of acquisition to its customers when the research report was released.

Such comments, however, did not deal with two fundamental issues: (1) Trading ahead of customers based on non-public information; and (2) fair pricing in subsequent resales. Accordingly, because the practice of purposefully adjusting inventory in anticipation of research report issuance raises such significant potential for disadvantaging public investors, the NASD believes that the better practice is to prohibit such activity as violative of just and equitable principles of trade.⁶ Accordingly, the NASD believes that the proposed rule change is consistent with Section 15A(b)(6) in that these proposed changes are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to facilitate transactions in these securities, to remove impediments to and to perfect the mechanism of a free and open market and a national market system, and in general to protect investors and the public interest. The NASD believes that any potential negative effects of the policy will be significantly outweighed by the increased confidence of investors

and their corresponding willingness to trade with member firms.

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

The NASD believes that the proposed rule change will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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

Written comments regarding the NASD's proposal in NTM 94-40 are summarized above.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the NASD consents, the Commission will:

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

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

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to SR-NASD-95-28 and should be submitted by July 19, 1995.

⁶ The issuance of research reports also may raise issues under the Securities Act of 1933 and the Act. See, e.g., Section 5 of, and Rules 137, 138 and 139 under, the Securities Act of 1933 and Rule 10b-6 under the Act.