above-mentioned proposed rule changes (File Nos. SR–MCC–95–01 and SR–MSTC–95–04) be, and hereby are, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority. 9

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 95–20154 Filed 8–14–95; 8:45 am]

[Release No. 34-36077; File No. SR-NASD-95-28]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by National Association of Securities Dealers, Inc., Regarding Trading in Anticipation of the Issuance of a Research Report

August 9, 1995.

On May 25, 1995, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed a proposed rule change with the Securities and Exchange Commission ("SEC" or "Commission") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") 1 and Rule 19b–4 thereunder.² The proposed rule change amends Article III, Section 1 of the NASD Rules of Fair Practice 3 by adding a new Interpretation prohibiting purposeful trading that affects a member firm's inventory position in a given security prior to the firm's issuance of a research report in that same security ("Interpretation").

Notice of the proposed rule change, together with the substance of the proposal as initially filed, was provided by issuance of a Commission release (Securities Exchange Release No. 35877, June 21, 1995) and by publication in the **Federal Register** (60 FR 33444, June 28, 1995). Two comment letters were received.⁴ This order approves the proposed rule change.

I. Introduction

Certain broker-dealers that have research departments may prepare research reports for customers with respect to certain identified securities. A research report may advise customers to buy or sell the security that is the subject of that report.

Certain of these broker-dealers may intentionally establish a proprietary position in the security that is to be the subject of a report in anticipation of meeting expected customer demand in response to the research report. A broker-dealer that intends to issue a positive research report may accumulate stock before issuing the research report. Once it issues the research report, it would then commence solicitation of orders, expecting to fill customers orders from the inventory position it has accumulated.

In 1991, the New York Stock Exchange ("NYSE"), in NYSE Information Memo 91–8, issued a policy statement regarding stock accumulations by a NYSE member organization in advance of that member's issuance of research reports. NYSE Information Memo 91–8 stated that an NYSE member organization would engage in conduct inconsistent with just and equitable principles of trade if it purposefully acquired a position in an NYSE-listed security in contemplation of its issuance of a favorable research report.

II. Description and Scope of the Proposed Rule Change

In 1994 the NASD solicited member comment on developing a formal policy deeming trading in anticipation of a research report to be a violation of Article III, Section 1 of the NASD Rules of Fair Practice. Purposeful inventory adjustments made in anticipation of customer trading activity as a result of the firm's research report could appear to, and at times would, conflict with the firm's fiduciary duties toward its customers. Therefore, the Interpretation approved today provides that an NASD member will violate just and equitable principles of trade if it purposefully adjusts its inventory position in a Nasdaq security, in an exchange listed security that is traded in the third market, or in a derivative product of any such security in anticipation of the issuance of a research report in that security. Such purposeful activity can create an appearance of impropriety that harms the perception of the marketplace and could cause a loss of investor

The Interpretation approved today is intended to enhance the overall perception of Nasdaq and the third market and encourage investors to participate in those markets, thereby promoting liquidity. The Interpretation also is intended to be consistent with the policy found in NYSE Information Memo 91–8, thereby promoting

consistency among self-regulatory organizations and helping to alleviate compliance burdens for member firms that operate in multiple markets. However, unlike NYSE Information Memo 91–8, the Interpretation also provides that a member firm will violate just and equitable principles of trade if it purposefully decreases or liquidates its position in a security because it was about to issue a negative research report.

The Interpretation applies to third market trading in listed securities that are the subject of a firm's research report as well as to Nasdaq securities. The Interpretation covers third market trading because there could be a significant gap in customer protection rules on exchange-listed securities traded in the third market absent the inclusion of those securities.

Finally, the Interpretation prohibits a member firm from attempting to do indirectly what it is not permitted to do directly. For example, a member firm may trade in options on an underlying security that is to be the subject of a research report in order to do by means of an economically equivalent transaction that which it would otherwise be prohibited from doing.

Therefore, the Interpretation prohibits a member firm from purposefully establishing, increasing, decreasing or liquidating a derivative security position in anticipation of the firm's issuance of a research report on the security underlying the derivative position.

The Interpretation specifically notes that it is intended to apply to situations in which the member firm "purposefully" alters its inventory position in anticipation of the issuance of a favorable or unfavorable research report in anticipation of meeting expected customer demand in response to the research report. The 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, it may continue to trade with its retail customers or with other broker-dealers if such trading arises from unsolicited order flow. The Interpretation also does 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 Interpretation encourages but does not require firms to establish information barriers (also known as Chinese Wall procedures or Chinese Walls) to control the flow of information between their research and trading departments. Information barriers are risk management controls

^{9 17} CFR 200.30-3(a)(12) (1994).

^{1 15} U.S.C. § 78s(b)(1).

^{2 17} CFR 240.19b-4.

 $^{^3}$ NASD Manual, Rules of Fair Practice, Art. III, Sec. 1 (CCH) ¶ 2151.

⁴ See Letter from Brian C. Underwood, Vice President-Director of Compliance, A.G. Edwards & Sons, Inc. ("A.G. Edwards"), to Jonathan G. Katz, Secretary, SEC, dated July 18, 1995 ("A.G. Edwards Letter"); and Letter from Joseph McLaughlin Esq., Brown & Wood, to Jonathan G. Katz, Secretary, SEC, dated July 21, 1995 ("Brown & Wood Letter").