

**Patrice M. Gliniecki**  
Vice President and  
Acting General Counsel

Direct: (202) 728-8014  
Fax: (202) 728-8264

January 17, 2002

Ms. Katherine A. England  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2002- 12 Proposed Rule Change to Subordination Agreement Requirements**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Shirley H. Weiss, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8844; e-mail Shirley.Weiss@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Patrice M. Gliniecki

Enclosures

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C.

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Form 19b-4

Proposed Rule Change

by

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.**

Pursuant to Rule 19b-4 under the

Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to require, as part of a subordination agreement, the execution of a Subordination Agreement Investor Disclosure Document ("Disclosure Document") in the form attached hereto as Exhibit 2.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on December 5, 2001, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market, Inc. and NASD Dispute Resolution, Inc. have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on December 6, 2001. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be approximately 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Shirley H. Weiss, Associate General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8844.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

To receive benefit under the SEC's net capital rule (Appendix D to SEC Rule 15c3-1d),<sup>1</sup> funds or securities loaned by an investor to a broker/dealer must be the subject of a satisfactory subordination agreement. Rule 15c3-1d sets forth the minimum and non-exclusive requirements for satisfactory subordination agreements. Rule 15c3-1d(a)(1) also provides that the "Examining Authority" may require "such other provisions as deemed necessary or appropriate to the extent such provisions do not cause the subordination agreement to fail to meet the minimum requirements of [Rule 15c3-1d]." Under Rule 15c3-1d(c)(6)(i), "[n]o proposed agreement shall be a satisfactory subordination agreement for the purposes of this section unless and until the Examining Authority has found the agreement acceptable and such agreement has become effective in the form found acceptable." As an Examining Authority, the NASD is proposing a rule change that will require each lender under Rule 15c3-1d to execute a Disclosure Document as part of every subordination agreement. The purpose of the Disclosure Document is to help lenders understand the risks associated with subordination agreements.

The NASD is concerned that an increasing number of retail investors may be entering into subordination agreements with broker/dealers without fully appreciating the risks or implications of such arrangements. For example, a number of investors in two recently failed

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<sup>1</sup> 17 CFR 240.15c3-1d.

firms found that entering into subordination agreements affected their rights to the protection of the Securities Investor Protection Corporation ("SIPC"). The proposed rule change will require members to make the Disclosure Document a part of the subordination agreement, and NASD Regulation staff will not consider a subordination agreement to be satisfactory under Rule 15c3-1d unless it includes a signed copy of the Disclosure Document.<sup>2</sup> Members will be advised of this requirement in the instructions for subordination agreements.

The proposed Disclosure Document, as set forth in Exhibit 2, outlines in "plain English" the risks to an investor of entering into a subordination agreement. The Disclosure Document first reviews the "key risks" associated with subordination agreements and then, in question and answer form, provides the prospective investor with additional information to heighten his or her understanding of what it means to enter into a subordination agreement.

Among other things, the Disclosure Document explains that money or securities loaned under subordination agreements are no longer customer assets that are subject to the protection of SIPC or, generally, any other insurance. The Disclosure Document also advises investors that once they invest in a broker/dealer, they will have no say in how the broker/dealer uses the funds. In addition, it advises investors that if they enter into a secured demand note agreement, the broker/dealer may borrow against any securities that are used to collateralize the note. It further explains that if the broker/dealer closes because of bankruptcy or other financial difficulties, the claims of investors who have entered into subordination agreements are subordinate to the claims

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<sup>2</sup> To help protect investors during the pendency of this proposed rule change, the NASD issued a *Notice to Members* announcing the rule proposal and urging members that enter into subordination agreements to adopt immediately, as a "best practice," procedures to deliver the Disclosure Document to, and obtain a signed copy from, all lenders.

of other parties, including customers, creditors, and employees of the firm. Because NASD Regulation staff review of subordination agreements is merely to ensure that the terms of such agreements are consistent with the requirements of Rule 15c3-1d, the Disclosure Document also advises prospective investors that they may wish to seek legal advice before entering into subordination agreements.

b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that the proposed rule change is designed to accomplish these ends by disclosing to investors certain key risks associated with subordination agreements.

4. Self-Regulatory Organization's Statement on Burden on Competition

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

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

Written comments were neither solicited nor received.<sup>3</sup>

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<sup>3</sup> This proposed rule change was not published for comment by the NASD through its Notice to Members process.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.
2. Proposed Subordination Agreement Investor Disclosure Document.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: \_\_\_\_\_  
Patrice M. Gliniecki  
Vice President and Acting General Counsel

Date: January 17, 2002

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2002-12)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Subordination Agreement Requirements

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing a rule change that would require, as part of a subordination agreement, the execution of a Subordination Agreement Investor Disclosure Document ("Disclosure Document") in the form attached hereto as Exhibit 2.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.



II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

To receive benefit under the SEC's net capital rule (Appendix D to SEC Rule 15c3-1d),<sup>3</sup> funds or securities loaned by an investor to a broker/dealer must be the subject of a satisfactory subordination agreement. Rule 15c3-1d sets forth the minimum and non-exclusive requirements for satisfactory subordination agreements. Rule 15c3-1d(a)(1) also provides that the "Examining Authority" may require "such other provisions as deemed necessary or appropriate to the extent such provisions do not cause the subordination agreement to fail to meet the minimum requirements of [Rule 15c3-1d]." Under Rule 15c3-1d(c)(6)(i), "[n]o proposed agreement shall be a satisfactory subordination agreement for the purposes of this section unless and until the Examining Authority has found the agreement acceptable and such agreement has become effective in the form found acceptable." As an Examining Authority, the NASD is proposing a rule change that will require each lender under Rule 15c3-1d to execute a Disclosure

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<sup>3</sup> 17 CFR 240.15c3-1d.

Document as part of every subordination agreement. The purpose of the Disclosure Document is to help lenders understand the risks associated with subordination agreements.

The NASD is concerned that an increasing number of retail investors may be entering into subordination agreements with broker/dealers without fully appreciating the risks or implications of such arrangements. For example, a number of investors in two recently failed firms found that entering into subordination agreements affected their rights to the protection of the Securities Investor Protection Corporation ("SIPC"). The proposed rule change will require members to make the Disclosure Document a part of the subordination agreement, and NASD Regulation staff will not consider a subordination agreement to be satisfactory under Rule 15c3-1d unless it includes a signed copy of the Disclosure Document.<sup>4</sup> Members will be advised of this requirement in the instructions for subordination agreements.

The proposed Disclosure Document, as set forth in Exhibit 2, outlines in "plain English" the risks to an investor of entering into a subordination agreement. The Disclosure Document first reviews the "key risks" associated with subordination agreements and then, in question and answer form, provides the prospective investor with additional information to heighten his or her understanding of what it means to enter into a subordination agreement.

Among other things, the Disclosure Document explains that money or securities loaned under subordination agreements are no longer customer assets that are subject to the protection of SIPC or, generally, any other insurance. The Disclosure Document also advises investors that once they invest in a broker/dealer, they will have no say in how the broker/dealer uses the funds. In addition, it advises

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<sup>4</sup> To help protect investors during the pendency of this proposed rule change, the NASD issued a *Notice to Members* announcing the rule proposal and urging members that enter into subordination agreements to adopt immediately, as a "best practice," procedures to deliver the Disclosure Document to, and obtain a signed copy from, all lenders.

investors that if they enter into a secured demand note agreement, the broker/dealer may borrow against any securities that are used to collateralize the note. It further explains that if the broker/dealer closes because of bankruptcy or other financial difficulties, the claims of investors who have entered into subordination agreements are subordinate to the claims of other parties, including customers, creditors, and employees of the firm. Because NASD Regulation staff review of subordination agreements is merely to ensure that the terms of such agreements are consistent with the requirements of Rule 15c3-1d, the Disclosure Document also advises prospective investors that they may wish to seek legal advice before entering into subordination agreements.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that the proposed rule change is designed to accomplish these ends by disclosing to investors the risks associated with subordination agreements.

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

NASD Regulation does not believe that the proposed rule change will 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 were neither solicited nor received.

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 self-regulatory organization 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, N.W., Washington, D.C. 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 the file number in the

caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17  
CFR 200.30-3(a)(12).

Jonathan G. Katz

Secretary

**SUBORDINATION AGREEMENT**  
**INVESTOR DISCLOSURE DOCUMENT**

***PLEASE READ THIS DOCUMENT CAREFULLY BEFORE DECIDING TO ENTER INTO A SUBORDINATION AGREEMENT WITH A BROKER/DEALER. SUBORDINATION AGREEMENTS ARE AN INVESTMENT. THESE INVESTMENTS CAN BE RISKY AND ARE NOT SUITABLE FOR ALL INVESTORS. AN INVESTOR SHOULD NEVER ENTER INTO A SUBORDINATION AGREEMENT WITH A BROKER/DEALER UNLESS HE/SHE CAN BEAR THE LOSS OF THE TOTAL INVESTMENT.***

Subordination agreements are complicated investments. A subordination agreement is a contract between a broker/dealer (the borrower) and an investor (the lender), pursuant to which the lender lends money and/or securities to the broker/dealer. The proceeds of this loan can be used by the broker/dealer almost entirely without restriction. The lender agrees that if the broker/dealer does not meet its contractual obligations, his/her claim against the broker/dealer will be subordinate to the claims of other parties, including claims for unpaid wages. Lenders may wish to seek legal advice before entering into a subordination agreement.

**KEY RISKS**

All investors who enter into Subordination Agreements with broker/dealers should be aware of the following ***key risks***:

Money or securities loaned under subordination agreements are not customer assets and are not subject to the protection of the Securities Investor Protection Corporation (SIPC). In other words, your investment in the broker/dealer is ***not*** covered by SIPC. Nor are subordination agreements generally covered by any private insurance policy held by the broker/dealer. Thus, if the broker/dealer defaults on the loan, the investor can lose all of his/her investment.

- The funds or securities lent to a broker/dealer under a subordination agreement can be used by the broker/dealer almost entirely without restriction.
- Subordination agreements cause the lender to be subordinate to other parties if the broker/dealer goes out of business. In other words, you, as an investor, would be paid after the other parties are paid, assuming the broker/dealer has any assets remaining.
- The NASD Regulation approval of subordination agreements is a regulatory function. It does ***not*** include an opinion regarding the viability or suitability of the investment. Therefore, NASD Regulation approval of a subordination agreement does not mean that NASD Regulation has passed judgment on the soundness of the investment or its suitability as an investment for a particular investor.

## **SIPC COVERAGE**

*Q. In general, what is SIPC coverage?*

A. SIPC is a non-profit, non-government, membership corporation created to protect customer funds and securities held by a broker/dealer if the broker/dealer closes because of bankruptcy or other financial difficulties. SIPC defines customers as persons who have securities or cash on deposit with a SIPC member for the purpose of, or as a result of, securities transactions.

*Q. Is an investor who enters into a subordination agreement covered by SIPC?*

A. No. SIPC considers these agreements to be investments in the broker/dealer. Once a customer signs a Subordinated Loan Agreement (SLA) or Secured Demand Note Agreement (SDN), the lender is no longer considered a customer of the broker/dealer relative to this investment. (These agreements are explained in further detail below.) For example, Mr. Jones has an IRA rollover account and a separate investment account with a Broker/Dealer. Mr. Jones enters into a subordination agreement with the broker/dealer and uses the investment account as collateral. This action would cause the investor to lose SIPC coverage for the investment account but not for the IRA account. If the lender pledges physical shares (*i.e.*, certificates) as collateral for the subordination agreement, as opposed to pledging an account, the investor will lose SIPC coverage for the shares pledged.

## **OTHER INSURANCE COVERAGE**

*Q. If my broker/dealer tells me that the firm has Fidelity Bond Coverage, will this coverage insure my investment?*

A. Fidelity Bond Coverage provides limited protection that generally would not benefit a subordinated lender under an SLA or SDN. In addition, NASD Regulation is not aware of any other insurance product that will protect an investor in this situation. If a broker/dealer claims that an SLA or SDN is covered by any type of insurance, the investor should insist on receiving that representation in writing from the insurance company.

## **GENERAL INFORMATION ABOUT SUBORDINATION AGREEMENTS**

*Q. Why would a broker/dealer ask an investor to enter into a subordination agreement?*

A. Subordination agreements add to the firm's capital and thereby strengthen the broker/dealer's financial condition.

*Q. What are the advantages and disadvantages for an investor to enter into a subordination agreement with a broker/dealer?*

A. An investor may be able to obtain a higher interest rate than from other investments. There are, however, key disadvantages. If the Broker/Dealer goes out of business, the investor's claims are subordinated to the claims of other parties, *i.e.*, customer and creditor claims will be paid before investors' claims. Thus, the subordinated investor may or may not get his/her funds or securities back, depending on the financial condition of the broker/dealer. **FINALLY, MONEY OR SECURITIES LOANED UNDER SUBORDINATION AGREEMENTS ARE NOT CUSTOMER ASSETS AND ARE NOT COVERED BY SIPC, OR IN GENERAL, ANY OTHER PRIVATE INSURANCE.**

*Q. Per the Lender's Attestation, the broker/dealer is required to give the prospective lender copies of various financial documents, including a certified audit. Why is this necessary?*

A. A subordination agreement is an investment in the broker/dealer. Therefore, the investor should assess the firm's financial condition to determine whether the loan makes good business sense. Financial documents can be complicated and the investor should consider consulting with an attorney or accountant.

*Q. Outside counsel can be expensive. What if my broker/dealer provides an attorney for me at its expense?*

A. It may not be desirable to use a broker/dealer's attorney to assist you in the transaction. To ensure independent, objective representation, an investor should retain his/her own attorney.

*Q. How many types of subordination agreements are there?*

A. In general, there are only two, the Subordinated Loan Agreement and the Secured Demand Note Agreement.

## **SUBORDINATED LOAN AGREEMENTS (SLA)**

*Q. What is an SLA?*

A. If an investor lends cash to a broker/dealer, the investor will usually do this as part of an SLA. The SLA discloses the terms of the loan, including the identities of the broker/dealer and investor, the amount of the loan, the interest rate, and the date on which the loan is to be repaid.



*Q. Can the lender restrict the broker/dealer's use of the loan?*

A. No. Language in the SLA precludes the lender from placing restrictions on how the broker/dealer may use the funds. Therefore, investors *should not* rely on side agreements with a broker/dealer that purport to limit the use of the loan proceeds. These agreements are inconsistent with the SLA and may not be enforceable.

## **SECURED DEMAND NOTE AGREEMENTS (SDN)**

*Q. What is an SDN?*

A. An SDN is a promissory note, in which the lender agrees to give cash to the broker/dealer on demand during the term of the SDN. *This "promissory note" must be backed by collateral, generally the lender's securities.* The lender/customer retains his/her status as beneficial owner of the collateral, but the securities must be in the possession of the broker/dealer and registered in its name. As securities can fluctuate in value, the lender must give sufficient securities to the broker/dealer so that when the securities are discounted, the net value of the securities will be equal to or greater than the amount of the SDN. This "discounting" is required by regulation. The rate of the discount varies and can be as high as 30 percent in the event common stock is used as collateral.

For example, assuming common stock is used as collateral, for every \$1,000 of face amount of the SDN, the investor must give the broker/dealer collateral that has a market value of at least \$1,429. Therefore, collateral for a \$15,000 SDN would require common stock that has a current market value of at least \$21,435.

*Q. What happens to the securities that I pledge as collateral under an SDN?*

- The investor gives up the right to sell or otherwise use the securities that have been pledged to the broker/dealer under an SDN. Once securities are pledged as collateral for an SDN, the broker/dealer has exclusive use of the securities.
- The investor may *exchange* or substitute the securities that have been pledged to the broker/dealer with different securities, but the value of the new securities (after applying the appropriate discount) must be sufficient to collateralize the SDN.
- The broker/dealer may use them as collateral, *i.e.*, the broker/dealer may borrow money from another party using the securities the investor has pledged as collateral under the SDN as collateral for the new loan.
- If the securities pledged as collateral decline in value so that their discounted value is less than the face amount of the SDN, the investor must deposit additional securities with the broker/dealer to keep the SDN at the proper collateral level. If the investor does not give

the broker/dealer additional collateral, the broker/dealer may sell some or all of the investor's securities.

- If the broker/dealer makes a demand for cash under an SDN, and the investor does not provide the broker/dealer with the cash, the broker/dealer has discretion to sell some or all of the investor's collateral (or securities). The SDN gives the broker/dealer the discretion to choose which of the investor's collateral to sell.
- All securities pledged as collateral for the SDN, including excess collateral, are subordinated to the claims of the broker/dealer's customers and creditors. Thus, if the firm becomes insolvent, the lender's ability to retrieve his/her collateral may be at risk.

### **THE NASD REGULATION APPROVAL PROCESS**

*Q. What is involved in the NASD Regulation approval process?*

- A. NASD Regulation will review the subordination agreement to ensure that it meets all technical requirements of Appendix D of SEC Rule 15c3-1 and to verify and that the broker/dealer has actually received the investor's funds or securities. This review is done to enable the borrower broker/dealer to use the subordination agreement as part of its regulatory capital. As previously stated, NASD Regulation does *not* review subordination agreements to determine whether the investment is viable or suitable for the investor. The investor must make this determination.

By signing below, the investor attests to the fact that he/she has read this Subordination Agreement Investor Disclosure Document.

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Investor Name

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Investor Signature

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Date

**FOR NASD USE ONLY**

Effective Date: \_\_\_\_\_

LOAN Number: \_\_\_\_\_

NASD ID Number: \_\_\_\_\_

Date Filed: \_\_\_\_\_