

January 16, 2003

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-2003-007 – Proposed Amendments to Membership Application Rules**

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 Kosha Dalal, Assistant General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-6903; e-mail: kosha.dalal@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2003-007
Consists of 43 Pages
January 16, 2003

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

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”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rules 1014 and 1017. The proposed amendments to Rule 1014 would clarify the current standards of membership admission by specifically identifying as a decisional criteria the existence of unpaid arbitration awards or other adjudicated customer awards, as well as pending arbitration claims, and expand the application of Rule 1014 to include entities as potential controlling persons. The proposed amendments to Rule 1017 would expand NASD’s authority to review asset transfers to include any transfer involving 25% or more of assets and/or revenues that contribute 25% or more to earnings (measured on a rolling 36-month basis) and require that any seller that is not a member of the New York Stock Exchange, Inc. (“NYSE”) file an application for asset transfers covered by the rule. In addition, amendments to Rules 1014 and 1017 would create a rebuttable presumption that certain membership applications should be denied if the applicant possess certain specified regulatory history. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

1014. Department Decision

(a) Standards for Admission

After considering the application, the membership interview, other information and documents provided by the Applicant, other information and documents obtained by the

Department, and the public interest and the protection of investors, the Department shall determine whether the Applicant meets each of the following standards:

(1) – (2) No Change.

(3) The Applicant and its Associated Persons are capable of complying with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association], including observing high standards of commercial honor and just and equitable principles of trade. In determining whether this standard is met, the Department may take into consideration whether:

(A) a state or federal authority or self-regulatory organization has taken permanent or temporary adverse action with respect to a registration or licensing determination regarding the Applicant or an Associated Person;

(B) an Applicant's or Associated Person's record reflects a sales practice event;

(C) an Applicant or Associated Person is the subject of a pending, adjudicated, or settled regulatory action or investigation by the Commission, the Commodity Futures Trading Commission, a federal, state, or foreign regulatory agency, or a self-regulatory organization; a pending, adjudicated, or settled investment-related civil action for damages or an injunction; or a criminal action (other than a minor traffic violation) that is pending, adjudicated, or that has resulted in a guilty or no contest plea; or an Applicant, its control persons, principals, registered representatives, other Associated Persons, any lender of 5% or more of the Applicant's net capital, and any other member with respect to which these persons were a control person or a

5% lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements, or pending arbitrations;

(D) an Associated Person was terminated for cause or permitted to resign after an investigation of an alleged violation of a federal or state securities law, a rule or regulation thereunder, a self-regulatory organization rule, or industry standard of conduct;

(E) a state or federal authority or self-regulatory organization has imposed remedial action, such as special training, continuing education requirements, or heightened supervision, on an Associated Person; and

(F) a state or federal authority or self-regulatory organization has provided information indicating that the Applicant or an Associated Person otherwise poses a threat to public investors.

(4) The Applicant has established all contractual or other arrangements and business relationships with banks, clearing corporations, service bureaus, or others necessary to:

(A) initiate the operations described in the Applicant's business plan, considering the nature and scope of operations and the number of personnel; and

(B) comply with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(5) The Applicant has or has adequate plans to obtain facilities that are sufficient to:

(A) initiate the operations described in the Applicant's business plan, considering the nature and scope of operations and the number of personnel; and

(B) comply with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(6) –(7) No Change.

(8) The applicant has financial controls to ensure compliance with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(9) No Change.

(10) The Applicant has a supervisory system, including written supervisory procedures, internal operating procedures (including operational and internal controls), and compliance procedures designed to prevent and detect, to the extent practicable, violations of the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association]. In evaluating the adequacy of a supervisory system, the Department shall consider the overall nature and scope of the Applicant's intended business operations and shall consider whether:

(A) the number, location, experience, and qualifications of supervisory personnel are adequate in light of the number, location, experience, and qualifications of persons to be supervised; the Central Registration Depository record or other disciplinary history of supervisory personnel and persons to be supervised; and the number and locations of the offices that the Applicant

intends to open and the nature and scope of business to be conducted at each office;

(B) the Applicant has identified specific Associated Persons to supervise and discharge each of the functions in the Applicant's business plan, and to supervise each of the Applicant's intended offices, whether or not such offices are required to be registered under [the] NASD Rules [of the Association];

(C) the Applicant has identified the functions to be performed by each Associated Person and has adopted procedures to assure the registration with NASD [the Association] and applicable states of all persons whose functions are subject to such registration requirements[.];

(D) each Associated Person identified in the business plan to discharge a supervisory function has at least one year of direct experience or two years of related experience in the subject area to be supervised;

(E) the Applicant will solicit retail or institutional business;

(F) the Applicant will recommend securities to customers;

(G) the location or part-time status of a supervisor or principal will affect such person's ability to be an effective supervisor;

(H) the Applicant should be required to place one or more Associated Persons under heightened supervision pursuant to Notice to Members 97-19;

(I) any remedial action, such as special training or continuing education requirements or heightened supervision, has been imposed on an

Associated Person by a state or federal authority or self-regulatory organization; and

(J) any other condition that will have material impact on the Applicant's ability to detect and prevent violations of the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(11) No Change.

(12) The Applicant has completed a training needs assessment and has a written training plan that complies with the continuing education requirements imposed by the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(13) NASD [The Association] does not possess any information indicating that the Applicant may circumvent, evade, or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or [the] NASD Rules [of the Association].

(14) The application and all supporting documents otherwise are consistent with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(b) Granting or Denying Application

(1) In reviewing an application for membership, the Department shall consider whether the Applicant and its Associated Persons meet each of the standards in paragraph (a), provided the Applicant overcomes the presumption that the application should be denied where the Department determines that the Applicant and/or its

Associated Persons is the subject of the events set forth in Rule 1014(a)(3)(A) and (C) through (E).

(2) [(1)] If the Department determines that the Applicant meets each of the standards in paragraph (a), the Department shall grant the application for membership.

(3) [(2)] If the Department determines that the Applicant does not meet one or more of the standards in paragraph (a) in whole or in part, the Department shall:

(A) grant the application subject to one or more restrictions reasonably designed to address a specific financial, operational, supervisory, disciplinary, investor protection, or other regulatory concern based on the standards for admission in Rule 1014(a); or

(B) deny the application.

(c) – (d) No Change.

(e) Service and Effectiveness of Decision

The Department shall serve its decision and the membership agreement on the Applicant in accordance with Rule 1012. The decision shall become effective upon service and shall remain in effect during the pendency of any review until a decision constituting final action of NASD [the Association] is issued under Rule 1015 or 1016, unless otherwise directed by the National Adjudicatory Council, the NASD Board, or the Commission.

(f) No Change.

(g) Final Action

Unless the Applicant files a written request for a review under Rule 1015, the Department's decision shall constitute final action by NASD [the Association].

(h) Definition of Associated Person

For purposes of this Rule 1014, the term “Associated Person” shall mean (1) a natural person registered under NASD Rules; or (2) a sole proprietor, partner, officer, director, branch manager, or other natural person, company, government, or political subdivision, agency, or instrumentality of a government occupying a similar status or performing similar functions who will be or is anticipated to be associated with the Applicant, or a natural person or company, government, or political subdivision, agency, or instrumentality of a government engaged in the investment banking or securities business who will be or is anticipated to be directly or indirectly controlling or controlled by the Applicant, whether or not any such person or company, government, or political subdivision, agency, or instrumentality of a government is registered or exempt from registration under the NASD By-Laws or NASD Rules.

1017. Applications for Approval of Change in Ownership, Control, or Business Operations

(a) Events Requiring Application

A member shall file an application for approval of any of the following changes to its ownership, control, or business operations:

(1) a merger of the member with another member, unless both are members of the New York Stock Exchange, Inc. or the surviving entity will continue to be a member of the New York Stock Exchange, Inc.;

(2) a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the New York Stock Exchange, Inc.;

(3) [a] direct or indirect acquisitions or transfers of 25% or more in the aggregate [substantially all] of the member's assets or any asset, business or line of operation that generates revenues comprising 25% or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members [the acquirer is a member] of the New York Stock Exchange, Inc.;

(4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or

(5) a material change in business operations as defined in Rule 1011(i).

(b) – (f) No Change.

(g) Department Decision

(1) The Department shall consider the application, the membership interview, other information and documents provided by the Applicant or obtained by the Department, the public interest, and the protection of investors. In rendering a decision on an application submitted under Rule 1017(a), the Department shall consider whether the Applicant and its Associated Persons, as defined in Rule 1014(h), meet each of the standards in Rule 1014(a), provided the Applicant overcomes the presumption that the application should be denied where the Department determines that the Applicant and/or its Associated Persons is the subject of the events set forth in Rule 1014(a)(3)(A) and (C) through (E).

(A) In rendering a decision on an application for approval of a change in ownership or control, or an application for approval of a material change in business operations that does not involve modification or removal of a membership agreement restriction, the Department shall determine if the Applicant would continue to meet the standards in Rule 1014(a) upon approval of the application.

(B) In rendering a decision on an application requesting the modification or removal of a membership agreement restriction, the Department shall consider whether the maintenance of the restriction is appropriate in light of:

(i) the standards set forth in Rule 1014;

(ii) the circumstances that gave rise to the imposition of the restriction;

(iii) the Applicant's operations since the restriction was imposed;

(iv) any change in ownership or control or supervisors and principals; and

(v) any new evidence submitted in connection with the application.

(2) – (4) No Change.

(h) Service and Effectiveness of Decision

The Department shall serve its decision on the Applicant in accordance with Rule 1012. The decision shall become effective upon service and shall remain in effect during the

pendency of any review until a decision constituting final action of NASD [the Association] is issued under Rule 1015 or 1016, unless otherwise directed by the National Adjudicatory Council, the NASD Board, or the Commission.

(i) Request for Review; Final Action

An Applicant may file a written request for review of the Department's decision with the National Adjudicatory Council pursuant to Rule 1015. The procedures set forth in Rule 1015 shall apply to such review, and the National Adjudicatory Council's decision shall be subject to discretionary review by the NASD Board pursuant to Rule 1016. If the Applicant does not file a request for review, the Department's decision shall constitute final action by NASD [the Association].

(j) – (k) No Change.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on July 24, 2002, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution 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 NASD to its Subsidiaries. The NASD Board of Governors reviewed the proposed rule change at its meeting on July 25, 2002. No other action by 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.

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 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Kosha K. Dalal, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD at (202) 728-6903.

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

(a) Purpose

The membership application and membership continuation processes have played an important role in investor protection by helping to ensure that new members and members that make a material change to their business comply or continue to comply with rigorous standards. Rule 1014, which sets forth the standards used when reviewing new member and continuing member applications, specifically requires NASD to consider the public interest and protection of investors when reviewing applications.

Recently, there has been an increase in company restructurings, including the selling of company assets. Asset transfer applications filed pursuant to Rule 1017 are often time-sensitive and may be the first step in a member's withdrawal from the securities business. While asset transfers often serve legitimate business purposes, they also can raise customer protection issues. NASD has encountered several instances where the effect of a member

attempting to restructure by transferring assets is to insulate the member and its owners from responsibility for payment of pending or unpaid arbitrations. Some firms may choose to transfer their assets without a corresponding transfer of their liabilities. Because the corporate format used by many firms insulates the owners from liabilities of the firm, a customer with an award or judgment against the firm may only be able to be paid from the firm's assets. Thus an asset transfer may transform the firm from an operating business that can generate value over time to a shell holding the firm's liquidated value, leaving behind customers with arbitration claims pending against, or arbitration awards unsatisfied by, a firm.

In light of the customer protection concerns raised in the application process, NASD is proposing a rule change that would clarify and expand NASD's authority to identify and respond to changes in a firm that may not account for pending arbitrations and customer claims.

1. Review of Material Transfer of Member's Assets

Applications submitted pursuant to Rule 1017 provide NASD with the opportunity to review member transactions that can materially adversely affect current and former customers. Rule 1017(a)(3) requires a member to submit an application upon the acquisition of substantially all of the member's assets. However, this may potentially eliminate from NASD's review a member's piecemeal sale of its assets that, while not "substantially all" in amount, may nevertheless have a material impact on the operations or profitability of the selling member.

The proposed rule change would clarify that Rule 1017(a)(3) applies to transfers as well as to sales of a firm's assets, including sales and transfers of assets to an affiliated entity.

The proposed rule change also would broaden the scope of Rule 1017(a)(3). In Notice to Members 02-54 (August 2002), which NASD issued to solicit comment on the proposed membership application rules, the proposal set forth in the Notice required members to submit applications prior to the transfer of a material amount of the member's assets or prior to the transfer of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings. Based on the comments received in response to the Notice, as discussed further in Section 5, NASD has revised the proposed rule change to include a more detailed materiality standard. The revised proposed rule change would require members to submit applications prior to the sale or transfer of 25% or more of the member's assets or any asset, business or line of operation that generates revenues of 25% or greater of the selling member's earnings over a rolling 36-month period. The 36-month period would be measured backwards from the date that the member initially notifies NASD of its intent to sell or transfer assets by submitting an application pursuant to Rule 1017.¹

2. Clarification of Members Required to Submit Applications

Because of concerns that a selling member's customers may be left unprotected following an asset transfer, the seller's situation should be reviewed in connection with all such transactions. Rule 1017(a) currently exempts selling members from the requirement to submit applications if the acquiring firm is a member of the NYSE. The proposed rule change would require all non-NYSE selling members to submit an application regardless of whether the acquiring firm is a NYSE member. The proposed rule change is not intended to

¹ In situations where NASD does not receive notice, the 36-month period will be measured from the date when notice was due. See Rule 1017(c)(1).

put applicants through duplicative approval processes where the transaction is otherwise subject to adequate customer protection safeguards. Rather, in requiring an application regardless of whether the acquirer is a member of the NYSE, NASD will be assured of receiving notice and will be in a position to target particular aspects of the transaction for additional review, if necessary.

3. Consideration of Arbitrations in Application Process

To encourage compliance with the terms of arbitration and other adjudicated customer awards, the proposed rule change would amend Rule 1014(a)(3) to include as specific factors in the consideration of both new and continuing member applications the unpaid arbitration awards or other adjudicated customer awards, as well as pending arbitration claims against an applicant and other persons that may have significant control or influence over the applicant, including its controlling persons, principals, registered representatives, other Associated Persons, any lender of 5% or more of the applicant's net capital, and any other member with respect to which these persons were a controlling person or a 5% lender of its net capital. Currently, NASD Rule 2110 would apply to efforts by a firm and its owners to unfairly prejudice customers seeking relief in arbitration proceedings and thus this is a cognizable factor in membership decisions. The proposed rule change would more explicitly make this part of the membership decisional criteria.

4. Burden of Proof

NASD has seen instances where an applicant (both new member and change of ownership/control) has a disciplinary history of some concern that falls short of a statutory disqualification. Many of these cases involve applications from closely held firms where, even if the broker/dealer establishes heightened supervisory procedures, the influence of the

control person on the small broker/dealer may overcome the supervisory structures. Rule 1014(a)(3) requires NASD to determine whether an applicant and its associated persons “are capable of complying with” federal securities laws and the rules of NASD. A variety of specific events, including past and current disciplinary actions and customer claims, are among the considerations referenced in the rule.

To further enhance NASD’s authority under Rule 1014(a) to consider the impact of an applicant’s past behavior, the proposed rule change would create a rebuttable presumption that the presence of any of the events enumerated in Rule 1014(a)(3)(A) and (C) through (E), the application should be denied unless the applicant can make an appropriate affirmative showing that granting the application is in the public interest and consistent with investor protection. The rebuttable presumption would not create new standards for admission, but would merely clarify that applicants with certain regulatory history must affirmatively demonstrate that they should be allowed admission.

5. Applicability of Rule to Non-Natural Persons

The proposed rule change would amend Rule 1014 to include reference to non-natural controlling persons in light of the fact that NASD’s current definition of “associated persons” does not encompass non-natural persons. NASD may consider in the future whether to expand the definition of “associated persons” more generally to include non-natural persons.

(b) Statutory Basis

NASD 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 NASD’s rules 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 believes that the proposed rule change will improve its ability to detect and prevent conduct that can be harmful to public investors.

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

NASD 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

The proposed rule change was published for comment in NASD Notice to Members 02-54 (August 2002). Seven comments were received in response to the Notice. A copy of the Notice to Members is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3. Of the seven comment letters received, six were in favor of the proposed rule change and the seventh, while not opposed to the proposed rule change, expressed concerns that the proposed rule change would not be able to accomplish its objectives. The commenter expressed doubts about NASD's ability to monitor asset transfers and further believed that the amendments may be unnecessary as a plaintiff's attorney often had other means to recover judgments. A summary of the comments received is set forth below.

Review of Material Transfer of Member's Assets

Five of the commenters supported the proposal to require firms to submit an application prior to the transfer of a material amount of the member's assets or prior to the transfer of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings. While supporting the proposal, one

commenter noted that the proposed rule change should only apply to full service firms with specified minimum revenues, and not to advisory firms that do not handle customer accounts, cash or have retail customers. While not opposing the proposal, another commenter questioned whether NASD would be able to monitor these types of asset transfers and noted that requiring reviews of these types of transactions might force a firm into liquidation.

All six commenters who responded to the question of whether materiality should be more clearly defined agreed that the Rules should include a more specific definition of materiality. One commenter stated that a more specific plain English standard would help prevent confusion and errors. A second commenter suggested a minimum of 15% and a maximum of 25% standard. A third commenter noted that while a more specific standard would help ensure compliance, a standard that is too specific might make it easier for people to circumvent the rule. This same commenter also suggested that the definition of materiality include a time component as well as a percentage component to address concerns of “piecemeal” transfers (e.g., X% or greater if no other transfer has occurred within the last Y years or X/Y% if any such transfer has occurred within the last Y years). As described in Section 3(a) of this rule filing, in response to the comments received, NASD has revised its proposed rule change to include a more specific definition of materiality.

Of the six commenters who responded, five commenters thought that NASD should review other types of transactions not currently included in Rule 1014 or the rule proposal. One commenter believed that NASD should review all types of transactions commonly used to avoid liability and regulation, and a second commenter thought that the rule should be broad enough to allow NASD to review any transaction that could have an adverse effect on the payment of arbitration awards and other customer claims. One commenter did not think

NASD should review other types of transactions. NASD has determined not to expand its review to other types of transactions. Not only does the proposed rule change capture a much broader range of identifiable transactions that can cause potential customer harm, but there are also other means to capture violations outside of the membership application process. However, NASD may consider reviewing other types of transactions if it determines that any such transactions particularly raise investor protection issues.

Clarification of Members Required to Submit Applications

With respect to the proposal to require all non-NYSE selling members to submit an application to NASD regardless of whether the buyer is an NYSE member, a slight majority of the commenters supported the proposal. Of the six commenters who responded, four commenters supported the proposal. One commenter believed this type of review would help regulators better coordinate among themselves. Two commenters opposed this proposal. One commenter believed that an NASD review should depend upon the types of assets and scope of the transactions.

Burden of Proof

All the commenters supported the proposal that applicants bear the burden of proof to demonstrate that they should be approved for membership despite the presence of a regulatory history. Six of the commenters also responded to whether it is appropriate to impose the burden of proof for pending matters such as pending investigations and arbitrations. Of the six who responded, five thought it was appropriate to extend the language to pending investigations and arbitrations. One commenter thought it was inappropriate.

Expansion of Scope of Rule 1014 to Include Non-Natural Persons

All six commenters who responded to the proposal to expand Rule 1014 to include non-natural persons supported the proposal. One commenter noted that the proposed rule change would clarify any confusion.

6. Extension of Time Period for Commission Action

NASD 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. NASD Notice to Members 02-54 (August 2002).

3. Comments received in response to Notice to Members 02-54 (August 2002).

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

NASD, INC.

BY: _____
Barbara Z. Sweeney , Senior Vice President and
Corporate Secretary

Date: January 16, 2003

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD- 2003-007)
[date]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. to Amend NASD Rules 1014 and 1017 to

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on January __, 2003, the National Association of Securities Dealers, Inc. (“NASD”) 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. 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

Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * *

1014. Department Decision

(a) Standards for Admission

After considering the application, the membership interview, other information and documents provided by the Applicant, other information and documents obtained by the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Department, and the public interest and the protection of investors, the Department shall determine whether the Applicant meets each of the following standards:

(1) – (2) No Change.

(3) The Applicant and its Associated Persons are capable of complying with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association], including observing high standards of commercial honor and just and equitable principles of trade. In determining whether this standard is met, the Department may take into consideration whether:

(A) a state or federal authority or self-regulatory organization has taken permanent or temporary adverse action with respect to a registration or licensing determination regarding the Applicant or an Associated Person;

(B) an Applicant's or Associated Person's record reflects a sales practice event;

(C) an Applicant or Associated Person is the subject of a pending, adjudicated, or settled regulatory action or investigation by the Commission, the Commodity Futures Trading Commission, a federal, state, or foreign regulatory agency, or a self-regulatory organization; a pending, adjudicated, or settled investment-related civil action for damages or an injunction; or a criminal action (other than a minor traffic violation) that is pending, adjudicated, or that has resulted in a guilty or no contest plea; or an Applicant, its control persons, principals, registered representatives, other Associated Persons, any lender of 5% or more of the Applicant's net capital, and any

other member with respect to which these persons were a control person or a 5% lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements, or pending arbitrations;

(D) an Associated Person was terminated for cause or permitted to resign after an investigation of an alleged violation of a federal or state securities law, a rule or regulation thereunder, a self-regulatory organization rule, or industry standard of conduct;

(E) a state or federal authority or self-regulatory organization has imposed remedial action, such as special training, continuing education requirements, or heightened supervision, on an Associated Person; and

(F) a state or federal authority or self-regulatory organization has provided information indicating that the Applicant or an Associated Person otherwise poses a threat to public investors.

(4) The Applicant has established all contractual or other arrangements and business relationships with banks, clearing corporations, service bureaus, or others necessary to:

(A) initiate the operations described in the Applicant's business plan, considering the nature and scope of operations and the number of personnel; and

(B) comply with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(5) The Applicant has or has adequate plans to obtain facilities that are sufficient to:

(A) initiate the operations described in the Applicant's business plan, considering the nature and scope of operations and the number of personnel; and

(B) comply with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(6) –(7) No Change.

(8) The applicant has financial controls to ensure compliance with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(9) No Change.

(10) The Applicant has a supervisory system, including written supervisory procedures, internal operating procedures (including operational and internal controls), and compliance procedures designed to prevent and detect, to the extent practicable, violations of the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association]. In evaluating the adequacy of a supervisory system, the Department shall consider the overall nature and scope of the Applicant's intended business operations and shall consider whether:

(A) the number, location, experience, and qualifications of supervisory personnel are adequate in light of the number, location, experience, and qualifications of persons to be supervised; the Central Registration Depository

record or other disciplinary history of supervisory personnel and persons to be supervised; and the number and locations of the offices that the Applicant intends to open and the nature and scope of business to be conducted at each office;

(B) the Applicant has identified specific Associated Persons to supervise and discharge each of the functions in the Applicant's business plan, and to supervise each of the Applicant's intended offices, whether or not such offices are required to be registered under [the] NASD Rules [of the Association];

(C) the Applicant has identified the functions to be performed by each Associated Person and has adopted procedures to assure the registration with NASD [the Association] and applicable states of all persons whose functions are subject to such registration requirements[.];

(D) each Associated Person identified in the business plan to discharge a supervisory function has at least one year of direct experience or two years of related experience in the subject area to be supervised;

(E) the Applicant will solicit retail or institutional business;

(F) the Applicant will recommend securities to customers;

(G) the location or part-time status of a supervisor or principal will affect such person's ability to be an effective supervisor;

(H) the Applicant should be required to place one or more Associated Persons under heightened supervision pursuant to Notice to Members 97-19;

(I) any remedial action, such as special training or continuing education requirements or heightened supervision, has been imposed on an Associated Person by a state or federal authority or self-regulatory organization; and

(J) any other condition that will have material impact on the Applicant's ability to detect and prevent violations of the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(11) No Change.

(12) The Applicant has completed a training needs assessment and has a written training plan that complies with the continuing education requirements imposed by the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(13) NASD [The Association] does not possess any information indicating that the Applicant may circumvent, evade, or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or [the] NASD Rules [of the Association].

(14) The application and all supporting documents otherwise are consistent with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(b) Granting or Denying Application

(1) In reviewing an application for membership, the Department shall consider whether the Applicant and its Associated Persons meet each of the standards in paragraph (a), provided the Applicant overcomes the presumption that the application should be denied where the Department determines that the Applicant and/or its Associated Persons is the subject of the events set forth in Rule 1014(a)(3)(A) and (C) through (E).

(2) [(1)] If the Department determines that the Applicant meets each of the standards in paragraph (a), the Department shall grant the application for membership.

(3) [(2)] If the Department determines that the Applicant does not meet one or more of the standards in paragraph (a) in whole or in part, the Department shall:

(A) grant the application subject to one or more restrictions reasonably designed to address a specific financial, operational, supervisory, disciplinary, investor protection, or other regulatory concern based on the standards for admission in Rule 1014(a); or

(B) deny the application.

(c) – (d) No Change.

(e) Service and Effectiveness of Decision

The Department shall serve its decision and the membership agreement on the Applicant in accordance with Rule 1012. The decision shall become effective upon service

and shall remain in effect during the pendency of any review until a decision constituting final action of NASD [the Association] is issued under Rule 1015 or 1016, unless otherwise directed by the National Adjudicatory Council, the NASD Board, or the Commission.

(f) No Change.

(g) Final Action

Unless the Applicant files a written request for a review under Rule 1015, the Department's decision shall constitute final action by NASD [the Association].

(h) Definition of Associated Person

For purposes of this Rule 1014, the term "Associated Person" shall mean (1) a natural person registered under NASD Rules; or (2) a sole proprietor, partner, officer, director, branch manager, or other natural person, company, government, or political subdivision, agency, or instrumentality of a government occupying a similar status or performing similar functions who will be or is anticipated to be associated with the Applicant, or a natural person or company, government, or political subdivision, agency, or instrumentality of a government engaged in the investment banking or securities business who will be or is anticipated to be directly or indirectly controlling or controlled by the Applicant, whether or not any such person or company, government, or political subdivision, agency, or instrumentality of a government is registered or exempt from registration under the NASD By-Laws or NASD Rules.

1017. Applications for Approval of Change in Ownership, Control, or Business Operations

(a) Events Requiring Application

A member shall file an application for approval of any of the following changes to its ownership, control, or business operations:

(1) a merger of the member with another member, unless both are members of the New York Stock Exchange, Inc. or the surviving entity will continue to be a member of the New York Stock Exchange, Inc.;

(2) a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the New York Stock Exchange, Inc.;

(3) [a] direct or indirect acquisitions or transfers of 25% or more in the aggregate [substantially all] of the member's assets or any asset, business or line of operation that generates revenues comprising 25% or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members [the acquirer is a member] of the New York Stock Exchange, Inc.;

(4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or

(5) a material change in business operations as defined in Rule 1011(i).

(b) – (f) No Change.

(g) Department Decision

(1) The Department shall consider the application, the membership interview, other information and documents provided by the Applicant or obtained by the Department, the public interest, and the protection of investors. In rendering a decision on an application submitted under Rule 1017(a), the Department shall consider whether the Applicant and its Associated Persons, as defined in Rule 1014(h), meet each of the standards in Rule 1014(a), provided the Applicant overcomes the presumption that the application should be denied where the Department determines that the Applicant and/or its Associated Persons is the subject of the events set forth in Rule 1014(a)(3)(A) and (C) through (E).

(A) In rendering a decision on an application for approval of a change in ownership or control, or an application for approval of a material change in business operations that does not involve modification or removal of a membership agreement restriction, the Department shall determine if the Applicant would continue to meet the standards in Rule 1014(a) upon approval of the application.

(B) In rendering a decision on an application requesting the modification or removal of a membership agreement restriction, the Department shall consider whether the maintenance of the restriction is appropriate in light of:

(i) the standards set forth in Rule 1014;

(ii) the circumstances that gave rise to the imposition of the restriction;

(iii) the Applicant's operations since the restriction was imposed;

(iv) any change in ownership or control or supervisors and principals; and

(v) any new evidence submitted in connection with the application.

(2) – (4) No Change.

(h) Service and Effectiveness of Decision

The Department shall serve its decision on the Applicant in accordance with Rule 1012. The decision shall become effective upon service and shall remain in effect during the pendency of any review until a decision constituting final action of NASD [the Association] is issued under Rule 1015 or 1016, unless otherwise directed by the National Adjudicatory Council, the NASD Board, or the Commission.

(i) Request for Review; Final Action

An Applicant may file a written request for review of the Department's decision with the National Adjudicatory Council pursuant to Rule 1015. The procedures set forth in Rule 1015 shall apply to such review, and the National Adjudicatory Council's decision shall be subject to discretionary review by the NASD Board pursuant to Rule 1016. If the Applicant does not file a request for review, the Department's decision shall constitute final action by NASD [the Association].

(j) – (k) No Change.

* * * * *

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

In its filing with the Commission, NASD 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 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

The membership application and membership continuation processes have played an important role in investor protection by helping to ensure that new members and members that make a material change to their business comply or continue to comply with rigorous standards. Rule 1014, which sets forth the standards used when reviewing new member and continuing member applications, specifically requires NASD to consider the public interest and protection of investors when reviewing applications.

Recently, there has been an increase in company restructurings, including the selling of company assets. Asset transfer applications filed pursuant to Rule 1017 are often time-sensitive and may be the first step in a member's withdrawal from the securities business. While asset transfers often serve legitimate business purposes, they also can raise customer protection issues. NASD has encountered several instances where the effect of a member

attempting to restructure by transferring assets is to insulate the member and its owners from responsibility for payment of pending or unpaid arbitrations. Some firms may choose to transfer their assets without a corresponding transfer of their liabilities. Because the corporate format used by many firms insulates the owners from liabilities of the firm, a customer with an award or judgment against the firm may only be able to be paid from the firm's assets. Thus an asset transfer may transform the firm from an operating business that can generate value over time to a shell holding the firm's liquidated value, leaving behind customers with arbitration claims pending against, or arbitration awards unsatisfied by, a firm.

In light of the customer protection concerns raised in the application process, NASD is proposing a rule change that would clarify and expand NASD's authority to identify and respond to changes in a firm that may not account for pending arbitrations and customer claims.

1. Review of Material Transfer of Member's Assets

Applications submitted pursuant to Rule 1017 provide NASD with the opportunity to review member transactions that can materially adversely affect current and former customers. Rule 1017(a)(3) requires a member to submit an application upon the acquisition of substantially all of the member's assets. However, this may potentially eliminate from NASD's review a member's piecemeal sale of its assets that, while not "substantially all" in amount, may nevertheless have a material impact on the operations or profitability of the selling member.

The proposed rule change would clarify that Rule 1017(a)(3) applies to transfers as well as to sales of a firm's assets, including sales and transfers of assets to an affiliated entity. The proposed rule change also would broaden the scope of Rule 1017(a)(3). In Notice to Members 02-54 (August 2002), which NASD issued to solicit comment on the proposed membership application rules, the proposal set forth in the Notice required members to submit applications prior to the transfer of a material amount of the member's assets or prior to the transfer of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings. Based on the comments received in response to the Notice, as discussed further in Section 5, NASD has revised the proposed rule change to include a more detailed materiality standard. The revised proposed rule change would require members to submit applications prior to the sale or transfer of 25% or more of the member's assets or any asset, business or line of operation that generates revenues of 25% or greater of the selling member's earnings over a rolling 36-month period. The 36-month period would be measured backwards from the date that the member initially notifies NASD of its intent to sell or transfer assets by submitting an application pursuant to Rule 1017.³

2. Clarification of Members Required to Submit Applications

Because of concerns that a selling member's customers may be left unprotected following an asset transfer, the seller's situation should be reviewed in connection with all such transactions. Rule 1017(a) currently exempts selling members from the requirement to submit applications if the acquiring firm is a member of the NYSE. The proposed rule

³ In situations where NASD does not receive notice, the 36-month period will be measured from the date when notice was due. See Rule 1017(c)(1).

change would require all non-NYSE selling members to submit an application regardless of whether the acquiring firm is a NYSE member. The proposed rule change is not intended to put applicants through duplicative approval processes where the transaction is otherwise subject to adequate customer protection safeguards. Rather, in requiring an application regardless of whether the acquirer is a member of the NYSE, NASD will be assured of receiving notice and will be in a position to target particular aspects of the transaction for additional review, if necessary.

3. Consideration of Arbitrations in Application Process

To encourage compliance with the terms of arbitration and other adjudicated customer awards, the proposed rule change would amend Rule 1014(a)(3) to include as specific factors in the consideration of both new and continuing member applications the unpaid arbitration awards or other adjudicated customer awards, as well as pending arbitration claims against an applicant and other persons that may have significant control or influence over the applicant, including its controlling persons, principals, registered representatives, other Associated Persons, any lender of 5% or more of the applicant's net capital, and any other member with respect to which these persons were a controlling person or a 5% lender of its net capital. Currently, NASD Rule 2110 would apply to efforts by a firm and its owners to unfairly prejudice customers seeking relief in arbitration proceedings and thus this is a cognizable factor in membership decisions. The proposed rule change would more explicitly make this part of the membership decisional criteria.

4. Burden of Proof

NASD has seen instances where an applicant (both new member and change of ownership/control) has a disciplinary history of some concern that falls short of a statutory disqualification. Many of these cases involve applications from closely held firms where, even if the broker/dealer establishes heightened supervisory procedures, the influence of the control person on the small broker/dealer may overcome the supervisory structures. Rule 1014(a)(3) requires NASD to determine whether an applicant and its associated persons “are capable of complying with” federal securities laws and the rules of NASD. A variety of specific events, including past and current disciplinary actions and customer claims, are among the considerations referenced in the rule.

To further enhance NASD’s authority under Rule 1014(a) to consider the impact of an applicant’s past behavior, the proposed rule change would create a rebuttable presumption that the presence of any of the events enumerated in Rule 1014(a)(3)(A) and (C) though (E), the application should be denied unless the applicant can make an appropriate affirmative showing that granting the application is in the public interest and consistent with investor protection. The rebuttable presumption would not create new standards for admission, but would merely clarify that applicants with certain regulatory history must affirmatively demonstrate that they should be allowed admission.

5. Applicability of Rule to Non-Natural Persons

The proposed rule change would amend Rule 1014 to include reference to non-natural controlling persons in light of the fact that NASD’s current definition of “associated persons”

does not encompass non-natural persons. NASD may consider in the future whether to expand the definition of “associated persons” more generally to include non-natural persons.

(b) Statutory Basis

NASD 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 NASD’s rules 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 believes that the proposed rule change will clarify and expand NASD’s authority to identify and respond to changes in a firm.

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

NASD 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

The proposed rule change was published for comment in NASD Notice to Members 02-54 (August 2002). Seven comments were received in response to the Notice. A copy of the Notice to Members is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3. Of the seven comment letters received, six were in favor of the proposed rule change and the seventh, while not opposed to the proposed rule change, expressed concerns that the proposed rule change would not be able to accomplish its objectives. The commenter expressed doubts about NASD’s ability to monitor asset transfers and further believed that the amendments may be unnecessary as a

plaintiff's attorney often had other means to recover judgments. A summary of the comments received is set forth below.

Review of Material Transfer of Member's Assets

Five of the commenters supported the proposal to require firms to submit an application prior to the transfer of a material amount of the member's assets or prior to the transfer of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings. While supporting the proposal, one commenter noted that the proposed rule change should only apply to full service firms with specified minimum revenues, and not to advisory firms that do not handle customer accounts, cash or have retail customers. While not opposing the proposal, another commenter questioned whether NASD would be able to monitor these types of asset transfers and noted that requiring reviews of these types of transactions might force a firm into liquidation.

All six commenters who responded to the question of whether materiality should be more clearly defined agreed that the Rules should include a more specific definition of materiality. One commenter stated that a more specific plain English standard would help prevent confusion and errors. A second commenter suggested a minimum of 15% and a maximum of 25% standard. A third commenter noted that while a more specific standard would help ensure compliance, a standard that is too specific might make it easier for people to circumvent the rule. This same commenter also suggested that the definition of materiality include a time component as well as a percentage component to address concerns of "piecemeal" transfers (e.g., X% or greater if no other transfer has occurred within the last Y years or X/Y% if any such transfer has occurred within the last Y years). As described in

Section 3(a) of this rule filing, in response to the comments received, NASD has revised its proposed rule change to include a more specific definition of materiality.

Of the six commenters who responded, five commenters thought that NASD should review other types of transactions not currently included in Rule 1014 or the rule proposal. One commenter believed that NASD should review all types of transactions commonly used to avoid liability and regulation, and a second commenter thought that the rule should be broad enough to allow NASD to review any transaction that could have an adverse effect on the payment of arbitration awards and other customer claims. One commenter did not think NASD should review other types of transactions. NASD has determined not to expand its review to other types of transactions. Not only does the proposed rule change capture a much broader range of identifiable transactions that can cause potential customer harm, but there are also other means to capture violations outside of the membership application process. However, NASD may consider reviewing other types of transactions if it determines that any such transactions particularly raise investor protection issues.

Clarification of Members Required to Submit Applications

With respect to the proposal to require all non-NYSE selling members to submit an application to NASD regardless of whether the buyer is an NYSE member, a slight majority of the commenters supported the proposal. Of the six commenters who responded, four commenters supported the proposal. One commenter believed this type of review would help regulators better coordinate among themselves. Two commenters opposed this proposal. One commenter believed that an NASD review should depend upon the types of assets and scope of the transactions.

Burden of Proof

All the commenters supported the proposal that applicants bear the burden of proof to demonstrate that they should be approved for membership despite the presence of a regulatory history. Six of the commenters also responded to whether it is appropriate to impose the burden of proof for pending matters such as pending investigations and arbitrations. Of the six who responded, five thought it was appropriate to extend the language to pending investigations and arbitrations. One commenter thought it was inappropriate.

Expansion of Scope of Rule 1014 to Include Non-Natural Persons

All six commenters who responded to the proposal to expand Rule 1014 to include non-natural persons supported the proposal. One commenter noted that the proposed rule change would clarify any confusion.

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 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).

Margaret H. McFarland
Deputy Secretary