

Via Hand Delivery

April 15, 2003

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-2003-74; Proposed Rule Change Regarding
Regulation of Activities of Members Experiencing Financial and/or
Operational Difficulties**

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 Sarah J. Williams, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8083; e-mail sarah.williams@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-2003-74
Consists of 34 Pages
April 15, 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”),¹ 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 3130, 3131 and the Rule 9410 Series to expand NASD’s authority to take expedited action against all member firms with capital deficiencies, to permit NASD to suspend a member that operates for any period of time with inadequate net capital and to make non-substantive clarifications to these provisions.

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

* * * * *

3130. Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties

(a) Application--For the purposes of this Rule, the term "member" shall be limited to any NASD member [of the Association who] that is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and SEC Rule 17d-1 thereunder. Further, the term shall not be applicable to any member [who] that is [subject to paragraphs (a)(2)(iv), (a)(2)(v) or (a)(2)(vi) of SEC Rule 15c3-1, or is otherwise exempt from the provisions of said rule or is] subject to Rule 3131.

(b) Each member subject to SEC Rule 15c3-1 shall comply with the net capital requirements prescribed therein and with the provisions of this Rule.

¹ 15 U.S.C. 78s(b)(1).

[(b)] (c) A member, when so directed by [the Association] NASD, shall not expand its business during any period in which:

(1) Any of the following conditions continue to exist, or have existed, for more than 15 consecutive business days:

(A) A firm's net capital is less than 150 percent of its net capital minimum requirement or such greater percentage thereof as may from time to time be prescribed by [the Association] NASD;

(B) If subject to the aggregate indebtedness requirement under SEC Rule 15c3-1, a firm's aggregate indebtedness is more than 1,000 per centum of its net capital;

(C) If, in lieu of paragraph [(b)](c)(1)(B) above, the specified percentage of the aggregate debit items in the Formula for Determination of Reserve Requirements for Brokers and Dealers under SEC Rule 15c3-3 (the alternative net capital requirement) is applicable, a firm's net capital is less than 5 percent of the aggregate debit items thereunder; or

(D) The deduction of capital withdrawals including maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in subparagraph (A), (B) or (C).

(2) [The Association] NASD restricts the member for any other financial or operational reason.

[(c)] (d) A member, when so directed by [the Association] NASD, shall forthwith reduce its business:

(1) to a point [enabling its available capital to comply with the standards] at which the member would not be subject to a prohibition against expansion of its business as set forth in paragraph [(b)](c)(1)(A), (B) or (C) of this Rule if any of the following conditions continue to exist, or have existed, for more than [fifteen (15)] 15 consecutive business days:

(A) A firm's net capital is less than 125 percent of its net capital minimum requirement or such greater percentage thereof as may from time to time be prescribed by [the Association] NASD;

(B) No Change.

(C) If, in lieu of paragraph [(c)](d)(1)(B) above, the specified percentage of the aggregate debit items in the Formula for Determination of Reserve Requirements for Brokers and Dealers, under SEC Rule 15c3-3 (the alternative net capital requirement) is applicable, a firm's net capital is less than 4 percent of the aggregate debit items thereunder; or

(D) If the deduction of capital withdrawals including maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in paragraph [(c)](d)(1)(A), (B) or (C) of this Rule.

(2) As required by [the Association] NASD when it restricts a member for any other financial or operational reason.

(e) A member shall suspend all business operations during any period of time when the member is not in compliance with applicable net capital requirements as set forth in SEC Rule 15c3-1.

* * * * *

3131. Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties

(a) Application--For the purposes of this Rule, the term "member" shall be limited to any member of [the Association] NASD registered with the Commission pursuant to Section 15C of the Act that is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and Rule 17d-1 thereunder. [Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department, or is otherwise exempt from the provisions of said rule].

(b) Each member subject to Section 402.2 of the rules of the Treasury Department shall comply with the capital requirements prescribed therein and with the provisions of this Rule.

[(b)](c) A member, when so directed by [the Association] NASD, shall not expand its business during any period in which:

(1) Any of the following conditions continue to exist, or have existed, for more than [fifteen (15)] 15 consecutive business days:

(A) A firm's liquid capital is less than 150 percent of the total haircuts or such greater percentage thereof as may from time to time be prescribed by [the Association] NASD.

(B) through (C) No Change.

(2) [The Association] NASD restricts the member for any other financial or operational reason.

[(c)] (d) A member, when so directed by [the Association] NASD, shall forthwith reduce its business:

(1) To a point [enabling its available capital to comply with the standards] at which the member would not be subject to a prohibition against expansion of its business as set forth in subparagraphs [(b)](c)(1)(A), (B), or (C) of this Rule if any of the following conditions continue to exist, or have existed, for more than [fifteen (15)] 15 consecutive business days:

(A) A firm's liquid capital is less than 125 percent of total haircuts or such greater percentage thereof as may from time to time be prescribed by [the Association] NASD.

(B) through (C) No Change.

(2) As required by [the Association] NASD when it restricts a member for any other financial or operational reason.

(e) A member shall suspend all business operations during any period of time when the member is not in compliance with applicable net capital requirements as set forth in Section 402.2 of the rules of the Treasury Department.

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9400. [LIMITATION] PROCEDURES FOR ACTIONS TAKEN UNDER RULES 3130 AND 3131

* * * * *

Rule 9412. Notice [of Limitations]

The Department of Member Regulation may issue a notice directing a member to [limit] restrict its business activities, either by limiting or ceasing to conduct those activities, if the Department of Member Regulation has reason to believe that [any] a condition specified in Rule 3130 or Rule 3131 exists. The notice shall specify the grounds on which such [action is being

taken] restrictions are being imposed, the nature of the [limitations] restrictions to be imposed, the effective date of the restrictions [limitations], a fitting sanction that will be imposed if the member fails to comply with any [the] restrictions [limitations] set forth in the notice, and the conditions for terminating such [limitations] restrictions. The effective date of the [limitations] restrictions shall be at least seven days after the date of service of the notice. The notice also shall inform the member that it may request a hearing before the [Department of Member Regulation] Office of Hearing Officers under Rule 9413. The Department of Member Regulation shall serve the notice by facsimile or overnight courier.

9413. Hearing Panel Review

(a) Request for a Hearing

A member subject to a notice issued under Rule 9412 may file a written request for hearing before a Hearing Panel with the Office of Hearing Officers. The request shall state the specific grounds for withdrawing or modifying the [limitations] restrictions specified in the notice. The request shall be filed pursuant to Rules 9135, 9136, and 9137 within five days after service of the notice under Rule 9412. The member may withdraw its request at any time by filing a written notice with the Office of Hearing Officers pursuant to Rules 9135, 9136, and 9137. The time limits set forth herein are to be strictly construed and cannot be modified except for good cause shown.

(b) No Change.

(c) Stay

Unless otherwise ordered by the NASD Board Executive Committee, the [initiation of a review under this paragraph shall stay the decision of the Department of Member Regulation or an

uncontested notice until a decision constituting final action of the Association is issued] request for a hearing shall stay the effective date of the notice.

(d) through (h) No Change.

(i) Evidence Not Admitted

Evidence that is proffered but not admitted during the hearing shall not be part of the record, but shall be retained by the custodian of the record until the date when [the Association's] NASD's decision becomes final or, if applicable, upon the conclusion of any review by the Commission or the federal courts.

(j) Failure to Request Hearing

If a member does not request a hearing under paragraph (a), the [limitations] restrictions specified in the notice shall become effective on the date specified in the notice. Unless the Executive Committee calls the notice for review under Rule 9415, the [limitations] restrictions specified in the notice shall remain in effect until the Department of Member Regulation reduces or removes the [limitations] restrictions pursuant to Rule 9417(b).

(k) Decision

(1) Within seven days after the hearing, the Hearing Panel shall issue a written decision approving, modifying, or withdrawing the [limitations] restrictions specified in the notice. If the decision imposes [limitations] restrictions, the decision shall state the grounds for the [limitations] restrictions, the conditions for terminating such [limitations] restrictions, and provide for a fitting sanction to be imposed under Rule 9416 if the member fails to comply with the [limitations] restrictions. The Office of Hearing Officers shall promptly serve the decision by facsimile or overnight courier pursuant to Rules 9132

and 9134. The [limitations] restrictions imposed shall become effective upon service of the decision.

(2) Contents of Decision

The decision shall include:

(A) a description of the Department of Member Regulation's [decision] notice, including its rationale;

(B) a description of the principal issues regarding the imposition of [limitations] restrictions raised in the review and a statement supporting the disposition of such issues;

(C) No Change.

(D) a statement of whether the Department of Member Regulation's [decision] notice is affirmed, modified, or reversed, and a rationale therefor; and

(E) if any restrictions [limitations] are imposed:

(i) a description of the [limitations] restrictions and a statement describing a fitting sanction that will be imposed under Rule 9416 if the member fails to comply with any of the [limitations] restrictions; and

(ii) the conditions for terminating the [limitations] restrictions.

(I) Issuance of Decision After Expiration of Call for Review Period

The Hearing Panel shall provide its proposed written decision to the NASD Board Executive Committee. The NASD Board Executive Committee may call the proceeding for review pursuant to Rule 9415. If the NASD Board Executive Committee does not call the

proceeding for review, the proposed written decision of the Hearing Panel shall constitute the final action of [the Association] NASD.

(m) Ex Parte Communications

The prohibitions against ex parte communications in Rule 9143 shall become effective under the Rule 9410 Series when [Association] NASD staff has knowledge the NASD Board Executive Committee intends to review a decision on its own motion under this Rule.

9414. Reserved

9415. Discretionary Review by the NASD Board Executive Committee

(a) through (d) No Change.

(e) Issuance of Decision

The NASD Board Executive Committee shall issue and serve its written decision on the member and the Department of Member Regulation pursuant to Rules 9132 and 9134. The decision shall be effective upon service. The decision shall constitute the final action of [the Association] NASD, unless the NASD Board Executive Committee remands the proceeding.

9416. Enforcement of Sanctions

(a) Order

If the Department of Member Regulation determines that a member has failed to comply with any [limitations] restrictions imposed by a decision or an effective notice under the Rule 9410 Series that has not been stayed, the Department of Member Regulation shall issue an order imposing the sanctions set forth in the decision or notice and specifying the effective date and time of such sanctions. The Department of Member Regulation shall serve the order on the member by facsimile or overnight courier.

(b) through (c) No Change.

(d) Decision

Within four days after the hearing, the Hearing Panel shall affirm, modify, or reverse the order issued under paragraph (a). The Office of Hearing Officers shall serve the decision on the member pursuant to Rules 9132 and 9134. The decision shall become effective upon service and shall constitute final action of [the Association] NASD.

9417. Additional [Limitations] Restrictions; Reduction or Removal of [Limitations] Restrictions

(a) Additional [Limitations] Restrictions

If a member continues to experience financial or operational difficulty specified in Rule 3130 or 3131, notwithstanding an effective notice or decision under the Rule 9410 Series, the Department of Member Regulation may impose additional [limitations] restrictions by issuing a notice under Rule 9412. The notice shall state that the member may apply for relief from the additional [limitations] restrictions by filing a written application for a hearing under Rule 9413 and that the procedures in Rules 9413 through 9416 shall be applicable. An application for a hearing also shall include a detailed statement of the member's objections to the additional [limitations] restrictions.

(b) Reduction or Removal of [Limitations] Restrictions

If the Department of Member Regulation determines that any [limitations] restrictions previously imposed under the Rule 9410 Series should be reduced or removed, the Department of Member Regulation shall serve a written notice on the member pursuant to Rules 9132 and 9134.

9418. Application to Commission for Review

The right to have any action taken by [the Association] NASD pursuant to this Rule Series reviewed by the Commission is governed by Section 19 of the Act. The filing of an application for review shall not stay the effectiveness of the action taken by [the Association] NASD, unless the Commission otherwise orders.

9419. Other Action Not Foreclosed

Action by [the Association] NASD under the Rule 9410 Series shall not foreclose action by [the Association] NASD under any other Rule.

* * * * *

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 January 22, 2003, which authorized the filing of the rule change with the SEC. Counsel for 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 NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on January 23, 2003. 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 amend 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 Sarah J. Williams, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8083.

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

(a) Purpose

Background

Currently, NASD can take expedited action against a member when its Department of Member Regulation has reason to believe that the member maintains inadequate capital levels given the scope and nature of the firm's business. However, NASD is currently limited to taking action with respect to only those firms that must maintain a minimum net capital of greater than \$50,000 and can only issue notices (and institute an expedited proceeding when these notices are contested) requiring that such firms either limit their business or not expand their business in order to maintain appropriate net capital levels. Further, current rules do not address the capacity of NASD to suspend a firm from business on an expedited basis when it fails to maintain minimum net capital.²

NASD believes that enhanced tools are required to enable it to better address any situation where a member is not satisfying applicable capital requirements. Accordingly, NASD proposes amendments to Rules 3130, 3131 and the Rule 9410 Series as described below. These amendments expand NASD's authority to take expedited action against all member firms with

² NASD Rule 9512 (Summary Proceedings) is available to address severe financial or operational difficulties. However, because this procedure allows NASD to suspend a member before a hearing is held, and requires authorization from the Board of Governors, it is reserved for the most serious of circumstances and generally would be inappropriate to address most instances of net capital deficiencies.

capital deficiencies, permit NASD to suspend a member that operates for any period of time with inadequate net capital, and make non-substantive clarifications to the language of the rules.

Current NASD Rules Regarding Members Experiencing Financial Difficulties

NASD Rules 3130 and 3131 regulate the activities of members that are (1) required to maintain net capital in excess of \$50,000; and (2) experiencing certain financial and/or operational deficiencies.³ These rules provide that NASD may prescribe certain remedial courses of action for members experiencing financial or operational deficiencies, such as requiring them to limit their activities. NASD's Rule 9410 Series provides a procedural framework for actions taken under these provisions. Pursuant to the Rule 9410 Series, a member experiencing financial and operational difficulties as described in Rules 3130 and 3131 receives a notice of limitations describing the grounds for the notice, the effective date of the limitations described in the notice, and a fitting sanction that will be imposed if the member fails to comply with the limitations set forth in the notice. The member then has five days from the date of service of the notice to request a hearing. If a hearing is not requested, the limitations prescribed in the notice become effective. Following the hearing, if one is requested, any remedial action ordered by the hearing panel becomes effective. If a member does not comply with the limitations described in any effective notice or remedial action imposed by a hearing panel, NASD staff may order the sanction set forth in the notice or specified in the hearing panel decision against the member. The member has the opportunity to request a second hearing if such sanctions are ordered.

³ Rule 15c3-1 under the Securities Exchange Act of 1934 requires that firms maintain certain specified levels of net capital. Section 402.2 of the Treasury Department rules contains liquid capital requirements for government securities broker/dealers. NASD does not set net capital requirements, but enforces these provisions as part of its regulatory function. However, Rules 3130 and 3131 effectively allow NASD to require net capital and liquid capital requirements in excess of those respective capital requirements stated above.

Application of Rules to All Member Firms

Rules 3130 and 3131 generally provide that NASD may direct a member not to expand its business or to reduce its business if certain conditions are present for a period of 15 consecutive business days or more. Rule 3130 exempts firms with net capital requirements of \$50,000 or less; Rule 3131 exempts government securities firms with liquid capital requirements of \$50,000 or less.

NASD believes that these provisions should apply to all member firms regardless of their minimum capital requirements. Because capital compliance is fundamental to operating a broker-dealer, every firm that operates with inadequate capital poses a risk to other members and the investing public, and NASD should be able to take prompt action against any member that operates with inadequate capital. Accordingly, NASD proposes amendments to expand the scope of Rules 3130 and 3131 to include members with capital requirements of \$50,000 or less.

Suspension of Members For Net Capital Violations

As described above, Rules 3130 and 3131 allow NASD to require a member to take certain remedial actions if it is experiencing certain financial and/or operational deficiencies. The remedial actions could impose limitations on a member's business operations such that the member complies with net capital requirements applicable to the member's reduced business operations. However, in certain instances, a member may be operating with capital that is so inadequate that no limitation on its business activities could be imposed that would bring the firm into capital compliance. Alternatively, a firm that is not in compliance with capital requirements may have such minimal operations that NASD could impose no meaningful limitation on the member's operations. As a result, NASD is proposing to expand the remedies available to it to

address capital violations. Specifically, NASD proposes amendments that would allow it to suspend the registration of a member that operates for any period of time without complying with its minimum capital requirements.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁴ which requires, among other things, that NASD 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. Specifically, the proposed rule change is intended to ensure that investors, the securities industry and the general public are not put at risk by members operating securities businesses without appropriate levels of capital.

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

Written comments were neither solicited nor received.

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.⁵

⁴ 15 U.S.C. 78o-3(b)(6).

⁵ 15 U.S.C. 78s(b)(2).

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.

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

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

Date: April 15, 2003

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2003-74)

April 15, 2003

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Regarding Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties

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 , 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

NASD is proposing to amend NASD Rules 3130, 3131 and the Rule 9410 Series to expand NASD’s authority to take expedited action against all member firms with capital deficiencies, to permit NASD to suspend a member that operates for any period of time with inadequate net capital and to make non-substantive clarifications to these provisions.

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

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

* * * * *

3130. Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties

(a) Application--For the purposes of this Rule, the term "member" shall be limited to any NASD member [of the Association who] that is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and SEC Rule 17d-1 thereunder. Further, the term shall not be applicable to any member [who] that is [subject to paragraphs (a)(2)(iv), (a)(2)(v) or (a)(2)(vi) of SEC Rule 15c3-1, or is otherwise exempt from the provisions of said rule or is] subject to Rule 3131.

(b) Each member subject to SEC Rule 15c3-1 shall comply with the net capital requirements prescribed therein and with the provisions of this Rule.

[(b)] (c) A member, when so directed by [the Association] NASD, shall not expand its business during any period in which:

(1) Any of the following conditions continue to exist, or have existed, for more than 15 consecutive business days:

(A) A firm's net capital is less than 150 percent of its net capital minimum requirement or such greater percentage thereof as may from time to time be prescribed by [the Association] NASD;

(B) If subject to the aggregate indebtedness requirement under SEC Rule 15c3-1, a firm's aggregate indebtedness is more than 1,000 per centum of its net capital;

(C) If, in lieu of paragraph [(b)](c)(1)(B) above, the specified percentage of the aggregate debit items in the Formula for Determination of Reserve Requirements for Brokers and Dealers under SEC Rule 15c3-3 (the alternative net capital requirement) is applicable, a firm's net capital is less than 5 percent of the aggregate debit items thereunder; or

(D) The deduction of capital withdrawals including maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in subparagraph (A), (B) or (C).

(2) [The Association] NASD restricts the member for any other financial or operational reason.

[(c)] (d) A member, when so directed by [the Association] NASD, shall forthwith reduce its business:

(1) to a point [enabling its available capital to comply with the standards] at which the member would not be subject to a prohibition against expansion of its business as set forth in paragraph [(b)](c)(1)(A), (B) or (C) of this Rule if any of the following conditions continue to exist, or have existed, for more than [fifteen (15)] 15 consecutive business days:

(A) A firm's net capital is less than 125 percent of its net capital minimum requirement or such greater percentage thereof as may from time to time be prescribed by [the Association] NASD;

(B) No Change.

(C) If, in lieu of paragraph [(c)](d)(1)(B) above, the specified percentage of the aggregate debit items in the Formula for Determination of

Reserve Requirements for Brokers and Dealers, under SEC Rule 15c3-3 (the alternative net capital requirement) is applicable, a firm's net capital is less than 4 percent of the aggregate debit items thereunder; or

(D) If the deduction of capital withdrawals including maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in paragraph [(c)](d)(1)(A), (B) or (C) of this Rule.

(2) As required by [the Association] NASD when it restricts a member for any other financial or operational reason.

(e) A member shall suspend all business operations during any period of time when the member is not in compliance with applicable net capital requirements as set forth in SEC Rule 15c3-1.

* * * * *

3131. Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties

(a) Application--For the purposes of this Rule, the term "member" shall be limited to any member of [the Association] NASD registered with the Commission pursuant to Section 15C of the Act that is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and Rule 17d-1 thereunder. [Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department, or is otherwise exempt from the provisions of said rule].

(b) Each member subject to Section 402.2 of the rules of the Treasury Department shall comply with the capital requirements prescribed therein and with the provisions of this Rule.

[(b)](c) A member, when so directed by [the Association] NASD, shall not expand its business during any period in which:

(1) Any of the following conditions continue to exist, or have existed, for more than [fifteen (15)] 15 consecutive business days:

(A) A firm's liquid capital is less than 150 percent of the total haircuts or such greater percentage thereof as may from time to time be prescribed by [the Association] NASD.

(B) through (C) No Change.

(2) [The Association] NASD restricts the member for any other financial or operational reason.

[(c)] (d) A member, when so directed by [the Association] NASD, shall forthwith reduce its business:

(1) To a point [enabling its available capital to comply with the standards] at which the member would not be subject to a prohibition against expansion of its business as set forth in subparagraphs [(b)](c)(1)(A), (B), or (C) of this Rule if any of the following conditions continue to exist, or have existed, for more than [fifteen (15)] 15 consecutive business days:

(A) A firm's liquid capital is less than 125 percent of total haircuts or such greater percentage thereof as may from time to time be prescribed by [the Association] NASD.

(B) through (C) No Change.

(2) As required by [the Association] NASD when it restricts a member for any other financial or operational reason.

(e) A member shall suspend all business operations during any period of time when the member is not in compliance with applicable net capital requirements as set forth in Section 402.2 of the rules of the Treasury Department.

* * * * *

9400. [LIMITATION] PROCEDURES FOR ACTIONS TAKEN UNDER RULES 3130 AND 3131

* * * * *

Rule 9412. Notice [of Limitations]

The Department of Member Regulation may issue a notice directing a member to [limit] restrict its business activities, either by limiting or ceasing to conduct those activities, if the Department of Member Regulation has reason to believe that [any] a condition specified in Rule 3130 or Rule 3131 exists. The notice shall specify the grounds on which such [action is being taken] restrictions are being imposed, the nature of the [limitations] restrictions to be imposed, the effective date of the restrictions [limitations], a fitting sanction that will be imposed if the member fails to comply with any [the] restrictions [limitations] set forth in the notice, and the conditions for terminating such [limitations] restrictions. The effective date of the [limitations] restrictions shall be at least seven days after the date of service of the notice. The notice also shall inform the member that it may request a hearing before the [Department of Member Regulation] Office of Hearing Officers under Rule 9413. The Department of Member Regulation shall serve the notice by facsimile or overnight courier.

9413. Hearing Panel Review

(a) Request for a Hearing

A member subject to a notice issued under Rule 9412 may file a written request for hearing before a Hearing Panel with the Office of Hearing Officers. The request shall state the specific grounds for withdrawing or modifying the [limitations] restrictions specified in the notice. The request shall be filed pursuant to Rules 9135, 9136, and 9137 within five days after service of the notice under Rule 9412. The member may withdraw its request at any time by filing a written notice with the Office of Hearing Officers pursuant to Rules 9135, 9136, and 9137. The time limits set forth herein are to be strictly construed and cannot be modified except for good cause shown.

(b) No Change.

(c) Stay

Unless otherwise ordered by the NASD Board Executive Committee, the [initiation of a review under this paragraph shall stay the decision of the Department of Member Regulation or an uncontested notice until a decision constituting final action of the Association is issued] request for a hearing shall stay the effective date of the notice.

(d) through (h) No Change.

(i) Evidence Not Admitted

Evidence that is proffered but not admitted during the hearing shall not be part of the record, but shall be retained by the custodian of the record until the date when [the Association's] NASD's decision becomes final or, if applicable, upon the conclusion of any review by the Commission or the federal courts.

(j) Failure to Request Hearing

If a member does not request a hearing under paragraph (a), the [limitations] restrictions specified in the notice shall become effective on the date specified in the notice. Unless the Executive Committee calls the notice for review under Rule 9415, the [limitations] restrictions specified in the notice shall remain in effect until the Department of Member Regulation reduces or removes the [limitations] restrictions pursuant to Rule 9417(b).

(k) Decision

(1) Within seven days after the hearing, the Hearing Panel shall issue a written decision approving, modifying, or withdrawing the [limitations] restrictions specified in the notice. If the decision imposes [limitations] restrictions, the decision shall state the grounds for the [limitations] restrictions, the conditions for terminating such [limitations] restrictions, and provide for a fitting sanction to be imposed under Rule 9416 if the member fails to comply with the [limitations] restrictions. The Office of Hearing Officers shall promptly serve the decision by facsimile or overnight courier pursuant to Rules 9132 and 9134. The [limitations] restrictions imposed shall become effective upon service of the decision.

(2) Contents of Decision

The decision shall include:

(A) a description of the Department of Member Regulation's [decision] notice, including its rationale;

(B) a description of the principal issues regarding the imposition of [limitations] restrictions raised in the review and a statement supporting the disposition of such issues;

(C) No Change.

(D) a statement of whether the Department of Member Regulation's [decision] notice is affirmed, modified, or reversed, and a rationale therefor; and

(E) if any restrictions [limitations] are imposed:

(i) a description of the [limitations] restrictions and a statement describing a fitting sanction that will be imposed under Rule 9416 if the member fails to comply with any of the [limitations] restrictions; and

(ii) the conditions for terminating the [limitations] restrictions.

(l) Issuance of Decision After Expiration of Call for Review Period

The Hearing Panel shall provide its proposed written decision to the NASD Board Executive Committee. The NASD Board Executive Committee may call the proceeding for review pursuant to Rule 9415. If the NASD Board Executive Committee does not call the proceeding for review, the proposed written decision of the Hearing Panel shall constitute the final action of [the Association] NASD.

(m) Ex Parte Communications

The prohibitions against ex parte communications in Rule 9143 shall become effective under the Rule 9410 Series when [Association] NASD staff has knowledge the NASD Board Executive Committee intends to review a decision on its own motion under this Rule.

9414. Reserved

9415. Discretionary Review by the NASD Board Executive Committee

(a) through (d) No Change.

(e) Issuance of Decision

The NASD Board Executive Committee shall issue and serve its written decision on the member and the Department of Member Regulation pursuant to Rules 9132 and 9134. The decision shall be effective upon service. The decision shall constitute the final action of [the Association] NASD, unless the NASD Board Executive Committee remands the proceeding.

9416. Enforcement of Sanctions

(a) Order

If the Department of Member Regulation determines that a member has failed to comply with any [limitations] restrictions imposed by a decision or an effective notice under the Rule 9410 Series that has not been stayed, the Department of Member Regulation shall issue an order imposing the sanctions set forth in the decision or notice and specifying the effective date and time of such sanctions. The Department of Member Regulation shall serve the order on the member by facsimile or overnight courier.

(b) through (c) No Change.

(d) Decision

Within four days after the hearing, the Hearing Panel shall affirm, modify, or reverse the order issued under paragraph (a). The Office of Hearing Officers shall serve the decision on the member pursuant to Rules 9132 and 9134. The decision shall become effective upon service and shall constitute final action of [the Association] NASD.

9417. Additional [Limitations] Restrictions; Reduction or Removal of [Limitations] Restrictions

(a) Additional [Limitations] Restrictions

If a member continues to experience financial or operational difficulty specified in Rule 3130 or 3131, notwithstanding an effective notice or decision under the Rule 9410 Series, the Department of Member Regulation may impose additional [limitations] restrictions by issuing a notice under Rule 9412. The notice shall state that the member may apply for relief from the additional [limitations] restrictions by filing a written application for a hearing under Rule 9413 and that the procedures in Rules 9413 through 9416 shall be applicable. An application for a hearing also shall include a detailed statement of the member's objections to the additional [limitations] restrictions.

(b) Reduction or Removal of [Limitations] Restrictions

If the Department of Member Regulation determines that any [limitations] restrictions previously imposed under the Rule 9410 Series should be reduced or removed, the Department of Member Regulation shall serve a written notice on the member pursuant to Rules 9132 and 9134.

9418. Application to Commission for Review

The right to have any action taken by [the Association] NASD pursuant to this Rule Series reviewed by the Commission is governed by Section 19 of the Act. The filing of an application for review shall not stay the effectiveness of the action taken by [the Association] NASD, unless the Commission otherwise orders.

9419. Other Action Not Foreclosed

Action by [the Association] NASD under the Rule 9410 Series shall not foreclose action by [the Association] NASD under any other Rule.

* * * * *

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 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

Background

Currently, NASD can take expedited action against a member when its Department of Member Regulation has reason to believe that the member maintains inadequate capital levels given the scope and nature of the firm's business. However, NASD is currently limited to taking action with respect to only those firms that must maintain a minimum net capital of greater than \$50,000 and can only issue notices (and institute an expedited proceeding when these notices are contested) requiring that such firms either limit their business or not expand their business in order to maintain appropriate net capital levels. Further, current rules do not

address the capacity of NASD to suspend a firm from business on an expedited basis when it fails to maintain minimum net capital.³

NASD believes that enhanced tools are required to enable it to better address any situation where a member is not satisfying applicable capital requirements. Accordingly, NASD proposes amendments to Rules 3130, 3131 and the Rule 9410 Series as described below. These amendments expand NASD's authority to take expedited action against all member firms with capital deficiencies, permit NASD to suspend a member that operates for any period of time with inadequate net capital, and make non-substantive clarifications to the language of the rules.

Current NASD Rules Regarding Members Experiencing Financial Difficulties

NASD Rules 3130 and 3131 regulate the activities of members that are (1) required to maintain net capital in excess of \$50,000; and (2) experiencing certain financial and/or operational deficiencies.⁴ These rules provide that NASD may prescribe certain remedial courses of action for members experiencing financial or operational deficiencies, such as requiring them to limit their activities. NASD's Rule 9410 Series provides a procedural framework for actions taken under these provisions. Pursuant to the Rule 9410 Series, a member experiencing financial and operational difficulties as described in Rules 3130 and

³ NASD Rule 9512 (Summary Proceedings) is available to address severe financial or operational difficulties. However, because this procedure allows NASD to suspend a member before a hearing is held, and requires authorization from the Board of Governors, it is reserved for the most serious of circumstances and generally would be inappropriate to address most instances of net capital deficiencies.

⁴ Rule 15c3-1 under the Securities Exchange Act of 1934 requires that firms maintain certain specified levels of net capital. Section 402.2 of the Treasury Department rules contains liquid capital requirements for government securities broker/dealers. NASD does not set net capital requirements, but enforces these provisions as part of its regulatory function. However, Rules 3130 and 3131 effectively allow NASD to require net capital and liquid capital requirements in excess of those respective capital requirements stated above.

3131 receives a notice of limitations describing the grounds for the notice, the effective date of the limitations described in the notice, and a fitting sanction that will be imposed if the member fails to comply with the limitations set forth in the notice. The member then has five days from the date of service of the notice to request a hearing. If a hearing is not requested, the limitations prescribed in the notice become effective. Following the hearing, if one is requested, any remedial action ordered by the hearing panel becomes effective. If a member does not comply with the limitations described in any effective notice or remedial action imposed by a hearing panel, NASD staff may order the sanction set forth in the notice or specified in the hearing panel decision against the member. The member has the opportunity to request a second hearing if such sanctions are ordered.

Application of Rules to All Member Firms

Rules 3130 and 3131 generally provide that NASD may direct a member not to expand its business or to reduce its business if certain conditions are present for a period of 15 consecutive business days or more. Rule 3130 exempts firms with net capital requirements of \$50,000 or less; Rule 3131 exempts government securities firms with liquid capital requirements of \$50,000 or less.

NASD believes that these provisions should apply to all member firms regardless of their minimum capital requirements. Because capital compliance is fundamental to operating a broker-dealer, every firm that operates with inadequate capital poses a risk to other members and the investing public, and NASD should be able to take prompt action against any member that operates with inadequate capital. Accordingly, NASD proposes amendments to expand

the scope of Rules 3130 and 3131 to include members with capital requirements of \$50,000 or less.

Suspension of Members For Net Capital Violations

As described above, Rules 3130 and 3131 allow NASD to require a member to take certain remedial actions if it is experiencing certain financial and/or operational deficiencies. The remedial actions could impose limitations on a member's business operations such that the member complies with net capital requirements applicable to the member's reduced business operations. However, in certain instances, a member may be operating with capital that is so inadequate that no limitation on its business activities could be imposed that would bring the firm into capital compliance. Alternatively, a firm that is not in compliance with capital requirements may have such minimal operations that NASD could impose no meaningful limitation on the member's operations. As a result, NASD is proposing to expand the remedies available to it to address capital violations. Specifically, NASD proposes amendments that would allow it to suspend the registration of a member that operates for any period of time without complying with its minimum capital requirements.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁵ which requires, among other things, that NASD 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. Specifically, the proposed rule change is intended to ensure that investors, the securities

⁵ 15 U.S.C. 78o-3(b)(6).

industry and the general public are not put at risk by members operating securities businesses without appropriate levels of capital.

(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

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 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.⁶

Margaret H. McFarland
Deputy Secretary

⁶ 17 CFR 200.30-3(a)(12).