

Notice to Members

OCTOBER 2003

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management

KEY TOPICS

Rule 3130
Rule 3131
Rule 9160
Rule 9400 Series
Net Capital
SEC Rule 15c3-1

INFORMATIONAL

Amendments to NASD Rules Regarding the Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties

SEC Approves Proposed Changes to NASD Rules 3130
and 3131, Rule 9160, and the Rule 9410 Series;

Effective Date: December 1, 2003

Executive Summary

On September 4, 2003, the Securities and Exchange Commission (SEC) approved amendments to NASD Rules 3130, 3131, 9160, and the Rule 9410 Series.¹ The amended Rules 3130 and 3131 and Rule 9410 Series permit NASD to act on an expedited basis to place restrictions on the operations of any member when NASD's Department of Member Regulation (Member Regulation) has reason to believe that the member is experiencing financial or operational difficulties or suspend the operations of any member that is not in compliance with its applicable net capital requirements.

The amendments become effective on **December 1, 2003**. The text of the amendments is provided in Attachment A.

Questions/Further Information

Questions concerning this *Notice* may be directed to Susan DeMando Director, Financial Operations, at (202) 728-8411.

03-67

Background and Discussion

Prior to these amendments, NASD's authority under Rules 3130 and 3131 was limited to the ability to direct members with a net capital requirement of \$100,000 or more to either limit their business or not expand their business in order to maintain appropriate net capital levels; under these Rules, NASD did not have authority to require a member to suspend its business operations when it failed to maintain its minimum net capital.² Rules 3130 and 3131, as amended, and the Rule 9410 Series permit NASD to act on an expedited basis to place restrictions on the operations of **any** member, regardless of its minimum net capital requirement, when Member Regulation has reason to believe that the member is in financial or operational difficulty. These Rules also permit NASD to suspend the business operations of a member during any period of time when the member is not in compliance with its applicable net capital requirements.

Amendments to Rules 3130 and 3131

The amendments to Rules 3130 and 3131 have significantly expanded NASD's authority. Prior to the rule change, NASD could only direct members with a net capital requirement of \$100,000 or more either to limit their business or not expand their business in order to maintain appropriate net capital levels. Now, under amended Rules 3130 and 3131, NASD has the authority to regulate the activities of **all** member firms subject to the requirements of SEC Rule 15c3-1 (Net Capital Rule),³ regardless of their minimum capital requirement, and **all** member firms subject to the requirements of Section 402.2(c) (Liquid Capital Requirements for Government Securities Firms) of the rules of the Treasury Department.

Further, in addition to having authority to direct members either not to expand their business operations or to restrict their business operations, NASD may now direct members to suspend all business operations during any period of time when the member is not in compliance with its applicable net capital requirements as set forth in the SEC's Net Capital Rule or Section 402.2(c) of the rules of the Treasury Department. NASD's ability to direct members to suspend their business operations should protect investors, market participants, and the general public from the risks posed by members operating securities businesses without appropriate levels of capital.⁴

Rule 9410 Series

NASD's Rule 9410 Series provides the procedural framework for actions taken under Rules 3130 and 3131. The first step in the process requires Member Regulation to issue a notice directing a member experiencing financial and operational difficulties as described in Rules 3130 and 3131 to restrict its business activities, either by limiting or ceasing to conduct those activities. The notice will specify the grounds on which such restrictions are being imposed, the nature of the restrictions to be imposed, the effective date of the restrictions, a fitting sanction that will be imposed if the member fails to comply with any of the restrictions set forth in the notice, and the conditions for terminating such restrictions.

The member then has five days from the date of service of the notice to request a hearing. The request must state the specific grounds for withdrawing or modifying any of the restrictions specified in the notice. Generally, a request for hearing will stay the effective date of the notice. If a hearing is not requested, the restrictions prescribed in the notice become effective at least seven days after the date of service of the notice. If the member requests a hearing, the hearing must be held within 14 days of the notice. During that time, the parties will exchange exhibits and witness lists.

Within seven days after the hearing,⁵ the hearing panel will issue a written decision. The decision will approve, modify, or withdraw the restrictions specified in the notice. If the decision imposes restrictions, it will state the grounds for the restrictions, the conditions for termination of the restrictions, and provide for a fitting sanction to be imposed if the member fails to comply with the restrictions. If a member does not comply with the limitations described in any effective notice or remedial action imposed by a hearing panel, Member Regulation 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.

If a member continues to experience financial or operational difficulty, Member Regulation may issue a notice imposing additional restrictions, from which the member may seek relief by filing a written application for a hearing. If Member Regulation determines that any restrictions previously imposed should be reduced or removed, Member Regulation will so advise the member by written notice. Members have the right to have the SEC review any action taken by NASD pursuant to the Rule 9400 Series; however, the filing of an application for review will not stay the effectiveness of NASD action unless the SEC orders otherwise.

Endnotes

- 1 See Release No. 34-48438 (File No. SR-NASD-2003-74) (Sept. 4, 2003), 68 Federal Register 53766 (Sept. 12, 2003).
- 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 certain instances of net capital deficiencies.
- 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.
- 4 Members are reminded that notwithstanding NASD's authority under Rules 3130 and 3131 and the Rule 9400 Series to direct members that are experiencing financial and/or operational difficulties not to expand, restrict, or suspend business operations, NASD may also determine to take disciplinary action against such members when appropriate for the same conduct.
- 5 Rule 9160(g) was deleted because Member Regulation staff does not participate as an adjudicator in a Rule 9410 decision.

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EXHIBIT I

Below is the text of the proposed rule change. Additions are underlined; deletions are in brackets.

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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. The Department of Member Regulation may issue a notice to such member directing it to suspend all business operations; however, the member's obligation to suspend all business operations arises from its obligations under SEC Rule 15c3-1 and is not dependent on any notice that may be issued by the Department of Member Regulation.

(f) Any notice directing a member to limit or suspend its business operations shall be issued by the Department of Member Regulation pursuant to Rule 9412.

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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. The Department of Member Regulation may issue a notice to such member directing it to suspend all business operations; however, the member's obligation to suspend all business operations arises from its obligations under Section 402.2 of the rules of the Treasury Department and is not dependent on any notice that may be issued by the Department of Member Regulation.

(f) Any notice directing a member to limit or suspend its business operations shall be issued by the Department of Member Regulation pursuant to Rule 9412.

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9160. Recusal or Disqualification

No person shall participate as an Adjudicator in a matter governed by the Code as to which he or she has a conflict of interest or bias, or circumstances otherwise exist where his or her fairness might reasonably be questioned. In any such case the person shall recuse himself or herself, or shall be disqualified as follows:

(a) through (f) No change.

[(g) NASD Regulation Staff As Adjudicator]

[The President of NASD Regulation shall have authority to order the disqualification of a member of the staff of the Department of Member Regulation participating in a Rule 9410 Series decision.]

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

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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 any of 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. No change.

9415. Discretionary Review by the NASD Board Executive Committee

(a) through (c) No change.

(d) Decision of NASD Board Executive Committee, Including Remand

After review, the NASD Board Executive Committee may affirm, modify, or reverse the proposed written decision of the Hearing Panel. Alternatively, the NASD Board Executive Committee may remand the proceeding with instructions. The NASD Board Executive Committee shall prepare a written decision that includes all of the elements described in Rule [9414(k)(2)] 9413(k)(2).

(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.

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