

Notice to Members

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INFORMATIONAL

SUGGESTED ROUTING

Legal & Compliance

Membership

Senior Management

KEY TOPICS

New Membership Applications

Continuing Membership Applications

Rule 1011

Rule 1014

Rule 1017

Pending Arbitration Awards and Claims

Membership Application and Continuation Rules

SEC Approves Amendments to Membership Application and Continuation Rules (Rules 1011, 1014, and 1017)

Executive Summary

On December 22, 2003, the Securities and Exchange Commission (SEC) approved amendments to Rules 1011, 1014, and 1017 to add additional criteria for NASD's Department of Member Regulation (Department) to consider when reviewing an application for membership.¹ The Rule 1010 Series governs the membership application and membership continuation processes.

The amendments to Rule 1011 expand the definition of "associated persons" for purposes of the Rule 1010 Series to include non-natural persons. Rule 1014 provides the decisional criteria used by the Department in reviewing new and continuing membership applications. Amendments to Rule 1014 clarify that pending arbitrations and civil actions against the applicant or its associated persons are considered as part of the application process. In addition, the amendments to Rule 1014 require the Department to consider unpaid arbitration awards and other adjudicated customer awards against the 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. Amendments to Rule 1017 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 all non-New York Stock Exchange (NYSE) selling members to file an application for asset transfers covered by the rule. In addition, the amendments to Rules 1014 and 1017 create a rebuttable presumption that certain membership applications should be denied if the applicant possesses certain specified regulatory history.

Rules 1011, 1014, and 1017, as amended, are set forth in Attachment A. The amendments are effective as of March 24, 2004.

Questions concerning this *Notice* may be directed to Mary Sue Fisher, Special Counsel, Regulation Policy, Department of Member Regulation, Regulatory Policy and Oversight, NASD, at (212) 858-4754; or Kosha K. Dalal, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-6903.

Background and Discussion

The membership application and membership continuation processes have played an important role in investor protection by helping to ensure that new members and current members that make material changes to their businesses comply or continue to comply with rigorous standards. Rule 1014 establishes the standards for approval of both new member applications under Rule 1013 and continuing membership applications under Rule 1017.

NASD has experienced an increase in the number of member consolidations, company restructurings, and asset sales. 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. In some cases, the member will transfer its assets without a corresponding transfer of its liabilities. Because the corporate format used by many members operates to insulate the owners from liabilities of the member, a customer with an award or judgment against the member may only be able to be paid from the member's assets. Thus, an asset transfer may transform the member 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, the member.

To address concerns raised in such transactions, NASD has amended Rules 1011, 1014 and 1017 to: (1) expand NASD's authority to review asset transfers to include any transfer involving 25% or more of the assets and/or revenues that contribute 25% or more to earnings (measured on a rolling 36-month basis); (2) require that any seller that is not a member of the NYSE file an application for approval of proposed asset transfers covered by the rule even in the case where the buyer to the transaction is an NYSE member (which currently is a situation excluded from the application requirements of Rule 1017); (3) clarify that pending arbitration claims and civil actions against an applicant and its associated persons are considered as part of the application process; (4) create a new standard of admission explicitly identifying as decisional criteria unpaid arbitration awards or other adjudicated customer awards against the 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; and (5) expand the definition of “associated persons” for purposes of the Rule 1010 Series to include non-natural persons.

1. Review of Transfers Involving 25% or More of Assets/Revenues

NASD believes it is important that it has the opportunity to review all member transactions that can adversely affect current and former customers in a material way. Currently, Rule 1017(a)(3) requires a member to submit an application only upon the transfer of “substantially all” of the member's assets. However, this may potentially eliminate from NASD's review a member's piecemeal transfer 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. While NASD ultimately has authority to require an application under the Rule once it becomes clear that a member is in the process of transferring “substantially all” of its assets, there is potential for customer harm in the interim. The amendments to Rule 1017 broaden the scope of Rule 1017(a)(3). First, the amendments clarify that Rule 1017(a)(3) applies to transfers as well as sales of a firm's assets, including sales and transfers of assets to an affiliated entity. Second, the amendments to Rule 1017(a)(3) require members to submit applications to NASD 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.² The 36-month period will 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, NASD believes that the seller's remaining ability to meet liabilities and other obligations 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. As amended, Rule 1017(a) requires all non-NYSE selling members to submit an application regardless of whether the buyer is a NYSE member. NASD does not intend 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 review, if necessary.

3. Consideration of Arbitrations in Application Process

Rule 2110 applies to efforts by a firm and its owners to unfairly prejudice customers seeking relief in arbitration proceedings. This protective principle also applies in the membership process: NASD has authority to restrict or deny an application if the

transaction would have the effect of unfairly prejudicing customer claims. The amendments to Rule 1014 have the effect of making it explicit that NASD consider the following in reviewing new and continuing membership applications: pending arbitration claims and civil actions against the applicant and its associated persons, as well as unpaid arbitration awards and other adjudicated customer awards against the applicant or other persons that may have significant control or influence over the applicant, including 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.

4. Rebuttable Presumption to Deny Application

NASD has seen instances where an applicant (both new member and change of ownership/control) and/or its associated persons have 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 an associated person on the broker/dealer is not appropriately restricted by the supervisory structures and procedures. Rule 1014(a)(3) requires NASD to determine whether an applicant and its associated persons "are capable of complying with" the 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. It is NASD's view that, when the applicant or its associated persons have experienced an event enumerated within the Rule as raising a question of capacity to comply with the federal securities laws and the rules of NASD, it should result in a rebuttable presumption to deny the application.

Consequently, the existence of any of the events enumerated in Rule 1014(a)(3)(A) and (C) through (E) will create a rebuttable presumption that the application should be denied. The enumerated events include: (1) adverse actions taken by a state or federal authority or self-regulatory organization with respect to registration or licensing regarding the applicant or its associated persons; (2) the applicant or an associated person is the subject of a pending, adjudicated, or settled regulatory action or investigation by the SEC, CFTC, a federal, state or foreign regulatory agency, or self-regulatory organization; (3) the applicant or an associated person is the subject of an adjudicated or settled investment-related civil action, or pending or adjudicated criminal action; (4) an applicant, its control persons, registered representatives, other associated persons, or 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, or unpaid arbitration settlements; (5) an associated person of the applicant was terminated for cause or permitted to resign after an investigation of an alleged violation of a federal or state securities law, or rule or regulation thereunder, a self-regulatory organization rule, or industry standard of conduct; and (6) 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. The rebuttable presumption will not apply where the only matters on the record of an applicant or its associated persons are sales practice events, pending arbitrations, or pending civil actions.

An applicant may overcome the presumption by demonstrating to NASD that it can meet each of the standards in Rule 1014(e), notwithstanding the existence of the event(s) of concern. In determining whether an applicant has overcome the presumption, NASD staff will consider the applicant's submission in light of the specific standards of Rule 1014(a), the public interest, protection of investors, and NASD's responsibility to provide a fair procedure in accordance with membership rules. The rebuttable presumption does not create a new standard for admission, but merely clarifies that applicants with certain regulatory history must affirmatively demonstrate that they should be allowed admission.

5. Expand Definition of "Associated Persons" to Non-Natural Persons

The amendments to Rule 1011 expand the definition of "Associated Person" in subsection (b) to include non-natural persons. The amended definition applies to the entire Rule 1010 Series. NASD believes applying the definition to the entire Rule 1010 Series provides for consistency in the membership application process.

Effective Date

The rule amendments become effective on March 24, 2004. The rule amendments will apply to all applications that are pending with NASD as of such date or filed with NASD on or after such date.

Endnotes

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| <p>1 See Release No. 34-48969 (December 22, 2003), 68 FR 75681 (December 31, 2003), File No. SR-NASD-2003-007.</p> <p>2 For purposes of Rule 1017, NASD construes the term "assets" in accordance with Generally Accepted Accounting Principles.</p> | <p>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).</p> |
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ATTACHMENT A

New language is underlined; deletions are in brackets.]

1010. Membership Proceedings

1011. Definitions

(a) No Change.

(b) “Associated Person”

[The term “Associated Person” means: (1) a natural person registered under the Rules of the Association; or (2) a sole proprietor, partner, officer, director, branch manager, or other natural person occupying a similar status or performing similar functions who will be or is anticipated to be associated with the Applicant, or a natural person 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 is registered or exempt from registration under the NASD By-Laws or the Rules of the Association.]

The term “Associated Person” means: (1) a natural person registered under NASD Rules; or (2) a sole proprietor, or any partner, officer, director, branch manager of the Applicant, or any person occupying a similar status or performing similar functions; (3) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the Applicant; (4) any employee of the Applicant, except any person whose functions are solely clerical or ministerial; (5) any person directly or indirectly controlling the Applicant whether or not such person is registered or exempt from registration under NASD By-Laws or NASD Rules; (6) any person engaged in investment banking or securities business controlled directly or indirectly by the Applicant whether such person is registered or exempt from registration under NASD By-Laws or NASD Rules; or (7) any person who will be or is anticipated to be a person described in (1) through (6) above.

(c) through (n) – No Change.

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) through (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]shall 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, a pending arbitration, or a pending private civil action;

(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,]an adjudicated, or settled investment-related private 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, or unpaid arbitration settlements;

(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). Where the Department determines that the Applicant or its Associated Persons are the subject of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E), a presumption exists that the application should be denied. The Applicant may overcome the presumption by demonstrating that it can meet each of the standards in paragraph (a), notwithstanding the existence of any 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].

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 meet each of the standards in Rule 1014(a). Where the Department determines that the Applicant or its Associated Persons are the subject of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E), a presumption exists that the application should be denied. The Applicant may

overcome the presumption by demonstrating that it can meet each of the standards in Rule 1014(a), notwithstanding the existence of any 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 [served]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.