

# Special Notice to Members

JANUARY 2003

## SUGGESTED ROUTING

Executive Representatives  
Legal & Compliance  
Senior Management

## KEY TOPICS

NASD By-Laws  
Non-Payment of Arbitration Awards  
Definition of "Disqualification"

## Mail Vote

NASD Solicits Vote on Amendments to the NASD By-Laws Concerning the Definition of Disqualification and Failure to Pay Arbitration Awards; **Last Voting Date: February 10, 2003**

## Executive Summary

NASD invites members to vote to approve three amendments to the NASD By-Laws. The first amendment would make the definition of "disqualification" in the NASD By-Laws consistent with the definition of "statutory disqualification" in Section 3(a)(39) of the Securities Exchange Act of 1934 (Exchange Act). The second amendment would permit NASD to suspend for failure to pay an arbitration award former associated persons who terminated their registration before the award was entered. The amendment would provide that NASD can take such action for a period of two years after the award is entered. The third amendment would clarify that NASD may suspend the association, and not just the registration, of any person who fails to pay an arbitration award.

The text of the amendments appears in Attachment A.

The last voting date is February 10, 2003.

## Questions/Further Information

Questions concerning this *Notice* may be directed to T. Grant Callery, Senior Vice President and General Counsel, NASD Office of General Counsel, at (202) 728-8285, Shirley Weiss, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8844, or Sarah Williams, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8083.

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## Ballot Instructions

NASD Executive Representatives have been mailed a ballot as an enclosure to this *Notice to Members*, along with a return envelope. The ballot must be signed by the NASD member firm's NASD Executive Representative; failure to do so renders the ballot invalid and excludes it from tabulation. Mail the completed and signed ballot in the enclosed envelope addressed to: Corporate Election Services, P.O. Box 1150, Pittsburgh, PA 15230-1150. Ballots must be post-marked no later than February 10, 2003.

## Background and Discussion

### Amendment Regarding the Definition of "Disqualification"

As currently written, Article III, Section 4 of the NASD By-Laws (Definition of Disqualification) defines "disqualification" by listing certain grounds for statutory disqualification contained in Section 3(a)(39) of the Exchange Act. Section 4, however, does not include all of the grounds for statutory disqualification contained in Section 3(a)(39) of the Exchange Act. Specifically, Section 4 does not include certain categories of willful violations that are contained in Section 3(a)(39) or grounds for disqualification that recently were enacted in the Sarbanes-Oxley Act of 2002.<sup>1</sup>

In view of NASD's obligation to enforce the federal securities laws, it is imperative that the NASD By-Law definition of disqualification be consistent with Section 3(a)(39) of the Exchange Act and include each of the grounds for statutory disqualification contained in that provision. To avoid amending Section 4 each time the definition of "statutory disqualification" is amended in Section

3(a)(39) of the Exchange Act, the NASD Board of Governors (the Board) recommends amending Section 4 to provide that a person is subject to a "disqualification" if such person is subject to any "statutory disqualification" as defined in Section 3(a)(39) of the Exchange Act, as may be amended from time to time. Thus, in the future, the definition in Section 4 to the By-Laws will conform to any subsequent amendment to Section 3(a)(39).

### Amendment Regarding Former Associated Persons Who Fail to Pay Arbitration Awards

An associated person generally is subject to customer arbitration claims at any time for misconduct that occurred while such person was engaged in the securities business, regardless of whether such person was registered with NASD at the time the claim was filed. However, under the current By-Laws, NASD may take action against a former associated person who has failed to pay an arbitration award only if the person was associated with a member at the time he or she failed to pay the award.

Article VI, Section 3 of the NASD By-Laws (Dues, Assessments and Other Charges) allows NASD to seek suspensions or cancellations for failure to comply with an award or settlement agreement relating to an arbitration or mediation.<sup>2</sup> If a person becomes subject to an arbitration award or enters into a settlement agreement in arbitration while associated with a member, then terminates his or her association with the member before paying the arbitration award or settlement, NASD may bring an action against that former associated person based on his or her failure to pay. Such actions are permissible because Article V, Section 4 of the NASD By-Laws

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(Retention of Jurisdiction) provides that a person whose association with a member has terminated continues to be subject to NASD proceedings based on conduct that began before the termination, provided such proceeding is brought within two years after the termination.

In 1998, the NASD Board directed the Office of Hearing Officers to dismiss, for lack of jurisdiction, a proceeding alleging failure to pay an arbitration award against a person who terminated his association after the arbitration proceeding commenced but before an arbitration award was entered against him.<sup>3</sup> The Board held that because the conduct underlying the proceeding (*i.e.* the failure to pay an arbitration award) did not begin until after the person's association terminated, NASD did not have jurisdiction over the person under Article V, Section 4 of NASD By-Laws.

NASD is concerned that a person associated with a member will terminate his or her association with the member once aware that an arbitration award may be entered against him or her in order to avoid sanction by NASD for failure to pay any award or settlement agreement resulting from the proceeding. Therefore, the Board is recommending amendments to Article V, Section 4 of the By-Laws that would provide that, for the limited purpose of instituting proceedings for failure to pay arbitration awards or settlements, NASD retains, for a period of two years after the entry of the award or settlement, jurisdiction to impose suspensions against former associated persons if the award or settlement resulted from a claim submitted for arbitration or mediation pursuant to the NASD rules.

The Board believes this amendment is appropriate because it is limited in scope to former associated persons who have failed to pay arbitration awards resulting from industry-related conduct. Further, it reinforces the credibility of the arbitration process, a vital component of self-regulation.

#### **Amendment Regarding Sanctions Against Associated Persons Who Fail to Pay Arbitration Awards**

The Rule 9510 Series authorizes NASD to seek a suspension or cancellation for failure to comply with an award or settlement agreement relating to an arbitration or mediation pursuant to Article VI, Section 3 of the NASD By-Laws. Article VI, Section 3 specifies that NASD may suspend or cancel the registration of any person for failure to comply with arbitration awards or settlements. Persons suspended from registration with NASD for failing to pay arbitration awards arguably may seek to associate with member firms in unregistered capacities. The Board is recommending an amendment to Article VI, Section 3 that would provide that NASD may suspend any person from association with a member in any capacity for failure of such person to comply with an arbitration award or settlement.

The Board asks that you vote in favor of these three amendments.

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## Endnotes

- 1 Section 4 of the NASD By-Laws currently does not include the following grounds for disqualification contained in Section 3(a)(39)(F) of the Exchange Act:
  - (1) willful violations of the Securities Act of 1933 (Securities Act), the Exchange Act, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, (and any rules and regulations under those Acts), or rules of the Municipal Securities Rulemaking Board (MSRB) (hereafter referred to as “the federal securities laws”);
  - (2) willful aiding and abetting violations of the federal securities laws; and
  - (3) failure reasonably to supervise an individual who violates the federal securities laws.
- 2 The Rule 9510 Series describes the process by which NASD may suspend or cancel the membership of any member or the registration of any person for failure to pay an arbitration award or settlement agreement executed in connection with an arbitration or mediation occurring under NASD Rules.
- 3 See *Department of Enforcement v. Jonathan Winston*, Non-Summary Proceeding No. ARB980006 (Office of Hearing Officers, December 15, 1998).

Also currently not included in Section 4 of the NASD By-Laws is the ground for disqualification created by the Sarbanes-Oxley Act of 2002. This provision states that a person also is subject to a disqualification if he or she is subject to certain orders issued by a state securities commission (or any agency or officer performing like functions), state authority that supervises or examines banks, savings associations, or credit unions, state insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency, or the National Credit Union Administration that bar a person from association or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities and other final orders based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct.

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## ATTACHMENT A

New language is underlined; deletions are in brackets.

### Amendment Regarding the Definition of "Disqualification"

#### Article III

#### QUALIFICATIONS OF MEMBERS AND ASSOCIATED PERSONS

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##### Definition of Disqualification

**Sec. 4.** A person is subject to a "disqualification" with respect to membership, or association with a member, if such person[:] is subject to any "statutory disqualification" as defined in Section 3(a)(39) of the Act, as may be amended from time to time.

[(a) has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization, foreign equivalent of a self-regulatory organization, foreign or international securities exchange, contract market designated pursuant to Section 5 of the Commodity Exchange Act, or foreign equivalent of a contract market designated pursuant to any substantially equivalent foreign statute or regulation, or futures association registered under Section 17 of the Commodity Exchange Act or a foreign equivalent of a futures association designated pursuant to any substantially equivalent foreign statute or regulation, or has been and is denied trading privileges on any such contract market or foreign equivalent;]

[(b) is subject to]

[(1) an order of the Commission, other appropriate regulatory agency, or foreign financial regulatory authority:]

[(i) denying, suspending for a period not exceeding 12 months, or revoking such person's registration as a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or limiting such person's activities as a foreign person performing a function substantially equivalent to any of the above; or]

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[(ii) barring or suspending for a period not exceeding 12 months such person from being associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or foreign person performing a function substantially equivalent to any of the above;]

[(2) an order of the Commodity Futures Trading Commission denying, suspending, or revoking such person's registration under the Commodity Exchange Act (7 U.S.C. §1 et seq.); or]

[(3) an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof;]

[(c) by such person's conduct while associated with a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or while associated with an entity or person required to be registered under the Commodity Exchange Act, has been found to be a cause of any effective suspension, expulsion, or order of the character described in subsection (a) or (b) of this Section;]

[(d) by such person's conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subsection (a) or (b) of this Section;]

[(e) has associated with him or her any person who is known, or in the exercise of reasonable care should be known, to him or her to be a person described in subsection (a), (b), (c), or (d) of this Section;]

[(f) has willfully made or caused to be made in any application for membership in a self-regulatory organization, or to become associated with a member of a self-regulatory organization, or in any report required to be filed with a self-regulatory organization, or in any proceeding before a self-regulatory organization, any statement which was at the time, and in light of the circumstances under which it was made, false or misleading with respect to any

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material fact, or has omitted to state in any such application, report, or proceeding any material fact which is required to be stated therein;]

[(g)(1) has been convicted within ten years preceding the filing of any application for membership in the NASD, or to become associated with a member of the NASD, or at any time thereafter, of any felony or misdemeanor or of a substantially equivalent crime by a foreign court of competent jurisdiction which:]

[(i) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, any substantially equivalent activity however denominated by the laws of the relevant foreign government, or conspiracy to commit any such offense;]

[(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, investment adviser, bank, insurance company, fiduciary, transfer agent, foreign person performing a function substantially equivalent to any of the above, or any entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation;]

[(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities, or substantially equivalent activity however denominated by the laws of the relevant foreign government; or]

[(iv) involves the violation of Sections 152, 1341, 1342, or 1343 or Chapters 25 or 47 of Title 18, United States Code, or a violation of a substantially equivalent foreign statute;]

[(2) has been convicted within ten years preceding the filing of any application for membership in the NASD, or to become associated with a member of the NASD, or at any time thereafter of any other felony;]

[(h) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent, foreign person performing a function substantially equivalent to any of the above, entity or person required to be registered under the Commodity Exchange Act, or any substantially equivalent foreign statute or regulation, or as an affiliated person or employee of any

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investment company, bank, insurance company, foreign entity substantially equivalent to any of the above, or entity or person required to be registered under the Commodity Exchange Act or any substantially equivalent foreign statute or regulation, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security;]

[(i) has been found by a foreign financial regulatory authority to have—]

[(1) made or caused to be made in any application for registration or report required to be filed with a foreign financial regulatory authority, or in any proceeding before a foreign financial regulatory authority with respect to registration, any statement that was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to the foreign financial regulatory authority any material fact that is required to be stated therein;]

[(2) violated any foreign statute or regulation regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade; or]

[(3) aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of any statutory provisions enacted by a foreign government, or rules or regulations thereunder, empowering a foreign financial regulatory authority regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded or subject to the rules of a contract market or any board of trade, or has been found, by a foreign financial regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of such statutory provisions, rules, and regulations, another person who commits such a violation, if such other person is subject to such person's supervision.]



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Amendment Regarding Former Associated Persons Who Fail to Pay  
Arbitration Awards

Article V

REGISTERED REPRESENTATIVES AND ASSOCIATED PERSONS

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Retention of Jurisdiction

Sec. 4. (a) A person whose association with a member has been terminated and is no longer associated with any member of [the] NASD or a person whose registration has been revoked or canceled shall continue to be subject to the filing of a complaint under the NASD Rules [of the Association] based upon conduct [which] that commenced prior to the termination, revocation, or cancellation or upon such person's failure, while subject to [the] NASD's jurisdiction as provided herein, to provide information requested by [the] NASD pursuant to the NASD Rules [of the Association], but any such complaint shall be filed within:

[a] (1) two years after the effective date of termination of registration pursuant to Section 3, provided, however that any amendment to a notice of termination filed pursuant to Section 3(b) that is filed within two years of the original notice [which] that discloses that such person may have engaged in conduct actionable under any applicable statute, rule, or regulation shall operate to recommence the running of the two-year period under this subsection;

[b] (2) two years after the effective date of revocation or cancellation of registration pursuant to the NASD Rules [of the Association]; or

[c] (3) in the case of an unregistered person, [within] two years after the date upon which such person ceased to be associated with a member.

(b) A person whose association with a member has been terminated and is no longer associated with any member of NASD shall continue to be subject to a proceeding to suspend, consistent with Article VI, Section 3 of the By-Laws, his or her right to associate with a member based on such person's failure to comply with an arbitration award or a written and executed settlement agreement obtained in connection with an arbitration or mediation submitted for disposition pursuant to the NASD Rules, provided that such proceeding is instituted within two years after the date of entry of such award or settlement.

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Amendment Regarding Sanctions Against Persons Who Fail to Pay  
Arbitration Awards

Article VI

DUES, ASSESSMENTS AND OTHER CHARGES

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Suspension or Cancellation [of Membership or Registration]

**Sec. 3.** (a) [The] NASD after 15 days notice in writing, may suspend or cancel the membership of any member or the registration of any person in arrears in the payment of any fees, dues, assessments, or other charges or for failure to furnish any information or reports requested pursuant to Section 2[, or for failure to comply with an award of arbitrators properly rendered pursuant to the Rules of the Association, where a timely motion to vacate or modify such award has not been made pursuant to applicable law or where such a motion has been denied, or for failure to comply with a written and executed settlement agreement obtained in connection with an arbitration or mediation submitted for disposition pursuant to the Rules of the Association].

(b) NASD after 15 days notice in writing, may suspend or cancel the membership of any member or suspend from association with any member any person, for failure to comply with an award of arbitrators properly rendered pursuant to the NASD Rules, where a timely motion to vacate or modify such award has not been made pursuant to applicable law or where such a motion has been denied, or for failure to comply with a written and executed settlement agreement obtained in connection with an arbitration or mediation submitted for disposition pursuant to the NASD Rules.