

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal & Compliance
Senior Management

REQUEST FOR COMMENT ACTION REQUESTED BY SEPTEMBER 20, 2002

Membership Application Rules

NASD Requests Comment on Proposed Amendments to Rules 1014 and 1017; **Comment Period Expires September 20, 2002**

KEY TOPICS

Membership Application Process
Membership Continuation Process
Rule 1014
Rule 1017

Executive Summary

NASD requests comment on proposed amendments to Rules 1014 and 1017. Rule 1017(a) sets forth certain events relating to changes in a member's ownership, control, or business operations, which require a member to apply and obtain approval from NASD staff.¹ Rule 1014 establishes the standards for approval of both new member applications under Rule 1013 and "continuing member applications" under Rule 1017. NASD is proposing amendments to Rules 1014 and 1017 to clarify and further strengthen NASD's authority under these rules in an effort to stay abreast of market developments.

Specifically, NASD has experienced an increase in member consolidations, business restructurings, and asset sales. NASD has reviewed proposed transactions that could have an adverse effect on the payment of arbitration awards and satisfaction of other customer claims. To address concerns raised in such transactions, NASD seeks comment on amendments to Rules 1014 and 1017 that would: (1) expand NASD's authority to review asset transfers to include any transfer involving a material amount of assets and/or revenues that contribute materially to earnings; (2) require that any seller that is not a member of the New York Stock Exchange (NYSE) file an application for 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 review under Rule 1017); and (3) create a new standard of admission explicitly identifying as decisional criteria unpaid arbitration awards or other adjudicated customer awards, as well as pending arbitration claims by an applicant, its controlling persons, principals, registered representatives, any lender of 5% or more of the applicant's net capital, and any other member with respect to which these persons were a controlling person or a 5% lender of its net capital.

In addition, former members or their associated persons with a significant disciplinary history, including a history of unpaid arbitrations, may later seek to re-enter the securities industry. NASD is concerned about the investor protection issues and the potential adverse impact on the integrity of the marketplace posed by these persons. In this regard, as further outlined below, NASD is requesting comments on an amendment that would place the burden on applicants to demonstrate that their applications should be approved notwithstanding that the applicant has a history of certain regulatory events.

NASD further seeks comment on whether Rule 1014 should be amended to include reference to entities as controlling persons in light of the fact that NASD's current definition of "associated persons" does not include non-natural persons.

Questions/Further Information

Questions regarding this *Notice to Members* may be directed to the NASD Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071; or the NASD Member Regulation Department, Regulatory Policy and Oversight, at (202) 728-8221.

Request for Comment

NASD requests comment on the proposed amendments to Rules 1014 and 1017 described in this *Notice*. For your convenience, we have provided a checklist (see Attachment B) that offers a convenient method to participate in the comment process concerning the proposed amendments.

Comments must be received by **September 20, 2002**. Members and interested persons can submit their comments using the following methods:

- ✦ mail Attachment B—Request for Comment Form—along with written comments
- ✦ mail written comments
- ✦ e-mail written comments to pubcom@nasd.com
- ✦ submit written comments online on our Web Site (www.nasd.com)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Note: The only comments that will be considered are those submitted by mail, e-mail, or those submitted to the NASD Web Site.

Before becoming effective, any rule change developed as a result of responses received to this *Notice* must be approved by the Securities and Exchange Commission.

Background

The membership application and membership continuation processes have played an important role in investor protection by helping to ensure that new members and members that make a material change to their business comply and continue to comply with

rigorous standards. Rule 1014, which sets forth the standards used when reviewing new member and continuing member applications, specifically requires NASD to consider the public interest and protection of investors when reviewing applications.

Recently, there has been an increase in company restructurings, including the selling of company assets. Asset transfer applications filed pursuant to Rule 1017 are often time-sensitive and may be the first step in a member's withdrawal from the securities business. While asset transfers often serve legitimate business purposes, they also can raise customer protection issues. NASD has encountered several instances where the effect of a member attempting to restructure by transferring assets is to insulate the member and its owners from responsibility for payment of pending or unpaid arbitrations. In some cases, the member will transfer its assets without a corresponding transfer of its liabilities. Because the corporate format used by many members seeks 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, a member.

Discussion

Based on NASD's experience in applying the membership application procedures, especially in light of increasing concerns

regarding the potentially negative effects of asset transfers on former and current customers, NASD believes that Rules 1014 and 1017 should be amended to allow NASD to better identify and respond to applications that may leave pending arbitrations and customer claims unaccounted for.

1. Review of Material Transfer of Member's Assets

NASD believes it is important that it has the opportunity to review all member transactions that can materially adversely affect current and former customers. 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. In this regard, NASD proposes broadening the scope of Rule 1017(a)(3) to require members to submit applications prior to the transfer of a material amount of the member's assets or prior to the transfer of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings.² NASD further seeks comment on whether "material" should be more specifically defined in the Rule and, if so, the appropriate standard of materiality. For example, should NASD define "material" for these purposes to be 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. NASD seeks comment on whether some other standard is more appropriate.

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 situation should be reviewed in connection with all such transactions. Rule 1017(a) currently exempts selling members from the requirement to submit applications if the acquiring firm is a member of the NYSE. The proposed amendments would require all non-NYSE selling members to submit an application regardless of whether the buyer is an 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 additional review, if necessary.

3. Consideration of Arbitrations in Application Process

Comporting with NASD's attempts to foster compliance with the terms of arbitration and other adjudicated customer awards, NASD proposes to amend Rule 1014(a)(3) explicitly to include as factors in the consideration of both new and continuing member applications the unpaid arbitration awards or other adjudicated customer awards, as well as pending arbitration claims against an applicant and other persons that may have significant control or influence over the applicant, including its controlling persons, principals, registered representatives, any lender of 5% or more of the applicant's net capital,

and any other member with respect to which these persons were a controlling person or a 5% lender of its net capital.³

4. Burden of Proof

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

NASD is proposing to further enhance its authority under Rule 1014(a), for all categories of applications, to consider the impact of an applicant's past behavior by creating a rebuttable presumption that the presence of any of the events enumerated in Rule 1014(a)(3)(A) and (C) though (E), places the burden on the applicant to demonstrate that the application should be approved notwithstanding the presence of that regulatory history. The rebuttable presumption does not create new standards for admission, but merely shifts the burden of proof to applicants to

show that they should be allowed admission. NASD believes that investor protection and service of the public interest demands that applicants with a regulatory history bear the burden of overcoming the rebuttable presumption that their application should be denied.

Additional Issue for Comment

Finally, NASD proposes to amend Rule 1014 to include reference to non-natural controlling persons in light of the fact that NASD's current definition of "associated persons" does not encompass non-natural persons.

Endnotes

- 1 The changes requiring application and approval are: mergers, the acquisition of a member, the acquisition of substantially all of a member's assets, a change in ownership or control of a member, and a material change in a member's business operations.
 - 2 As with other Rule 1017 applications, Rule 1017(c)(1) allows NASD to place interim restrictions on any asset transfer if NASD believes that the application does not meet Rule 1014 standards. These interim restrictions are meant for the protection of investors and ordinarily would not prevent a transaction from moving forward. However, there may be some instances where the protection of investors will require that interim restrictions will prohibit or delay a transaction from closing.
 - 3 NASD further notes that Rule 2110 applies to efforts by a firm and its owners to unfairly prejudice customers seeking relief in arbitration proceedings.
- © 2002. NASD. All rights reserved. Notices to Members attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

ATTACHMENT A

New language is underlined; deletions are in brackets.

1014. Department Decision

(a) Standards for Admission

After considering the application, the membership interview, other information and documents provided by the Applicant, other information and documents obtained by the Department, and the public interest and the protection of investors, the Department shall determine whether the Applicant meets each of the following standards:

(1) – (2) No Change.

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

(A) – (B) No Change.

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

(D) – (F) No Change.

(4) – (14) No Change.

(b) Granting or Denying Application

(1) In reviewing an application for membership, the Department shall consider whether the applicant meets each of the standards in paragraph (a), provided the Applicant overcomes the presumption that the application should be denied where one or more of the circumstances identified in Rule 1014(a)(3)(A) and (C) through (E) exist.

(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) – (g) No Change.

(h) Definition of Associated Person

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

1017. Application 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 acquisition of [substantially all] a material amount of the member's assets or any asset, business or line of operation that generates revenues comprising a material portion of the member's earnings, unless [the acquirer is a member] both the seller and acquirer are members 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 meets each of the standards in Rule 1014(a), provided the Applicant overcomes the presumption that the application should be denied where one or more of the circumstances identified in Rule 1014(a)(3)(A) and (C) through (E) exist.

(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) – (k) No Change.

ATTACHMENT B

Request For Comment Form

We have provided below a form that members and other interested parties may use in addition to written comments. This form is intended to offer a convenient way to participate in the comment process, but does not cover all aspects of the proposal described in the *Notice*. We therefore encourage members and other interested parties to review the entire *Notice* and provide written comments, as necessary.

Instructions

Comments must be received by **September 20, 2002**. Members and interested parties can submit their comments using the following methods:

- ✦ mail Attachment B—Request for Comment Form—
along with written comments
- ✦ mail written comments
- ✦ e-mail written comments to *pubcom@nasd.com*
- ✦ submit written comments online on our Web Site
(*www.nasd.com*)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Proposed Amendments to Rules 1014 and 1017

1. Is it appropriate for NASD to review transfers of a material amount of a member's assets or transfers of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings?
☐ Yes ☐ No ☐ See my attached written comments
2. In connection with the proposed expanded review of asset transfers, should NASD include a more specific standard of materiality in the Rules?
☐ Yes ☐ No ☐ See my attached written comments
3. Should NASD review other types of transactions that are not currently included in the Rules?
☐ Yes ☐ No ☐ See my attached written comments
4. Should NASD require all non-NYSE selling members to submit applications to NASD for approval prior to the transfer of assets?
☐ Yes ☐ No ☐ See my attached written comments
5. (a) Is it appropriate for applicants to bear the burden of proof to demonstrate that they should be approved for membership despite the presence of a regulatory history and,
☐ Yes ☐ No ☐ See my attached written comments
(b) if so, is it appropriate to impose this burden for pending matters such as pending investigations and arbitrations?
☐ Yes ☐ No ☐ See my attached written comments
6. Should the scope of Rule 1014 be expanded to include non-natural persons?
☐ Yes ☐ No ☐ See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

☐ An NASD Member

☐ An Investor

☐ A Registered Representative

☐ Other: _____