

# NASD Notice to Members 98-42

NASD Regulation  
Requests Comment  
On Proposed Rules  
Regarding Cease-And-  
Desist Proceedings;  
**Comment Period  
Expires July 31, 1998**

## Suggested Routing

- Senior Management
- Advertising
- Continuing Education
- Corporate Finance
- Executive Representatives
- Government Securities
- Institutional
- Insurance
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registered Representatives
- Registration
- Research
- Syndicate
- Systems
- Trading
- Training
- Variable Contracts

## Executive Summary

NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) requests comment on a series of National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) rules that would authorize NASD Regulation Department of Enforcement staff, after obtaining approval of the President or Chief Operating Officer of NASD Regulation, to initiate temporary cease-and-desist proceedings with respect to the rule violations that pose the most serious and immediate investor protection concerns. The proceeding would allow the Department of Enforcement, after notice and opportunity for a hearing, to order a member or individual to stop engaging in activity that violates certain securities laws or rules. The order could remain in place until a regular disciplinary proceeding is completed. It is expected that temporary cease-and-desist proceedings would be used only in egregious cases. Further, the rules would permit an accelerated proceeding to impose sanctions for violations of temporary or permanent cease-and-desist orders.

Questions concerning this *Request For Comment* should be directed to Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, at (202) 728-8332, or Peter R. Geraghty, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8227.

## Request For Comment

The NASD encourages all interested parties to comment on the proposed rules. Comments should be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, NW  
Washington, D.C. 20006-1500

or e-mailed to:  
[pubcom@nasd.com](mailto:pubcom@nasd.com)

Comments must be received **by July 31, 1998**. Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the Securities and Exchange Commission (SEC).

# NASD Regulation Request For Comment 98-42

## Executive Summary

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## Background And Discussion

The proposed microcap rules, which will be filed with the SEC shortly, would regulate broker/dealer and individual salesperson conduct in connection with the sale of smaller capitalization securities, which often have proved to be the source of significant fraudulent activity.<sup>1</sup> To fully address serious broker/dealer and salesperson misconduct, NASD Regulation staff believes it needs to introduce a quicker process by which

it can sanction such misconduct. The proposed Temporary Cease and Desist Order (TCDO) rule and the related proposed TCDO enforcement proceeding are designed to fulfill this need.

Specifically, the proposed rule would allow staff in an expedited proceeding to obtain an order prohibiting the continuing violation of specified rules where staff satisfies the required standard for issuance of the TCDO. Before a TCDO can be issued, the staff must show that the alleged rule violations are likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to completion of the regular disciplinary proceeding. To ensure that the rule is limited to the most serious offenses, such orders could only be sought for alleged violations of the following specified investor protection provisions or rules: (1) Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5, and NASD Rule 2120 (the SEC's and NASD's basic anti-fraud and manipulation rules); (2) SEC Rules 15g-1 to 15g-9 (the SEC's penny stock rules); and (3) NASD Rules 2110 and 2330, where the alleged violations include unauthorized trading, misuse or conversion of customer assets, or excessive markups.

If the firm or individual subject to a TCDO (or a permanent cease-and-desist order)<sup>2</sup> violates the order by continuing to violate the rules specified in the order, the proposed rule would permit an accelerated proceeding to impose sanctions for violations of the order. The President or Chief Operating Officer of NASD Regulation could authorize the initiation of an expedited disciplinary proceeding under Rule 9513, which could result in sanctions up to and including bars and expulsions for violations of the order, after the Respon-

dent was afforded a hearing. Because the proceeding would occur under Rule 9513, the Respondent would be afforded all the procedural protections of this rule. For example, the Respondent must be served with written notice initiating the proceeding; the Respondent would have 15 days to request a hearing; the hearing panel would be composed of a Director of NASD Regulation and a current or former Director of NASD Regulation, Governor of NASD, or member of the National Adjudicatory Council (NAC); the hearing panel's decision would have to address, among other things, the grounds for initiating the proceeding, findings of fact, a statement supporting the disposition of the main issue, and if a sanction is imposed, its effective date, time, and terms; and the hearing panel's decision would be subject to a call for review by the NASD Board of Governors.

In order to ensure that this authority is applied appropriately, a TCDO proceeding, as well as any proceeding to impose sanctions for violating the TCDO (or a permanent cease-and-desist order), could be initiated only with the written authorization of the President or Chief Operating Officer of NASD Regulation. This ensures that the prosecutorial judgment for such extraordinary proceedings is made at the highest staff levels. If the rule is approved, the staff will monitor its effectiveness and report to the Board of Directors of NASD Regulation, within two years after the effective date of the rule, on NASD Regulation's experience with the rule and obtain the Board's authorization to continue to exercise authority under the rule.

The initiation of the TCDO proceeding and any resulting order could be publicized under Interpretive Material 8310-2.

The proposed rule is modeled on a rule providing similar authority to the SEC, although unlike the SEC rule, the NASD rule does not include a provision for orders issued without the Respondent having any opportunity to be heard (so-called "ex parte" orders). Also, unlike the SEC rule, the proposed NASD rule is limited in the types of violations that the TCDO proceeding may be used to address.

The NASD Board of Directors and the National Adjudicatory Council approved the issuance of a *Notice to Members*. The Small Firm Advisory Board was supportive of the issuance of a *Notice*, but took no formal position. A subcommittee of the Legal Advisory Board reviewed and unanimously supported the issuance of a *Notice to Members*.

### Request For Comment

The NASD encourages all interested parties to comment on the proposed rules. Comments should be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, NW  
Washington, D.C. 20006-1500

or e-mailed to:  
[pubcom@nasd.com](mailto:pubcom@nasd.com)

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## Text Of Proposed Rule

(Note: All language is new.)

### 9800. Temporary Cease-And-Desist Orders

### 9810. Initiation of Proceeding

#### (a) Department of Enforcement

With the prior written authorization of the President or Chief Operating Officer of NASD Regulation, Inc., the Department of Enforcement ("Department") may initiate a temporary cease-and-desist proceeding with respect to alleged violations of Section 17(a) of the Securities Act of 1933; Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder; SEC Rule 15g-1 through 15g-9; or NASD Rule 2110 (if the alleged violation includes unauthorized trading, misuse or conversion of customer assets, or excessive markups), 2120, or 2330 (if the alleged violation includes misuse or conversion of customer assets). The Department shall initiate the proceeding by serving a notice on a member or associated person (hereinafter "Respondent") and filing a copy thereof with the Office of Hearing Officers. The Department shall serve the notice by personal service, overnight commercial courier, or facsimile.

#### (b) Contents of Notice

The notice shall set forth the rule or statutory provision that the Respondent is alleged to have violated and the temporary relief sought against the Respondent, including whether the Department is requesting that the Respondent be required to take action to prevent the dissipation or conversion of assets. The notice shall be accompanied by: (1) a declaration of facts, signed by a person with knowledge of the facts contained therein, that specifies the acts or omissions that constitute the

alleged violation; and (2) a proposed order that specifically describes the temporary relief sought, including any act or acts that the Respondent would be required to take or refrain from taking.

### **(c) Filing of Underlying Complaint**

If the Department has not issued a complaint under Rule 9211 against the Respondent relating to the subject matter of the temporary cease-and-desist proceeding and alleging violations of the rule or statutory provision specified in the notice described in paragraph (b), the Department shall serve such a complaint with the notice.

### **9820. Appointment of Hearing Officer and Hearing Panel**

As soon as practicable after the Department files a copy of the notice of the initiation of a temporary cease-and-desist proceeding with the Office of Hearing Officers, the Chief Hearing Officer shall assign a Hearing Officer to preside over the temporary cease-and-desist proceeding. The Chief Hearing Officer shall appoint two Panelists to serve on a Hearing Panel with the Hearing Officer. The Panelists shall be current or former Governors, Directors, or National Adjudicatory Council members, and at least one Panelist shall be an associated person.

### **9830. Hearing**

#### **(a) When Held**

The hearing shall be held not later than 15 days after service of the notice of the initiation of the temporary cease-and-desist proceeding.

#### **(b) Service of Notice of Hearing**

The Hearing Officer shall serve a notice of date, time, and place of the hearing on the Department and the

Respondent not later than three days before the hearing, unless otherwise ordered by the Hearing Officer. Service shall be made by personal service, overnight commercial courier, or facsimile.

### **(c) Authority of Hearing Officer**

The Hearing Officer shall have authority to do all things necessary and appropriate to discharge his or her duties as set forth under Rule 9235.

### **(d) Witnesses**

A person who is subject to the jurisdiction of the Association shall testify under oath or affirmation. The oath or affirmation shall be administered by a court reporter or a notary public.

### **(e) Additional Information**

At any time during its consideration, the Hearing Panel may direct a Party to submit additional information. Any additional information submitted shall be provided to all Parties before the Hearing Panel renders its decision.

### **(f) Transcript**

The hearing shall be recorded by a court reporter and a written transcript thereof shall be prepared. A transcript of the hearing shall be available to the Parties for purchase from the court reporter at prescribed rates. A witness may purchase a copy of the transcript of his or her own testimony from the court reporter at prescribed rates. Proposed corrections to the transcript may be submitted by affidavit to the Hearing Panel within a reasonable time determined by the Hearing Panel. Upon notice to the participants in the hearing, the Hearing Panel may order corrections to the transcript as requested or *sua sponte*.

### **(g) Record and Evidence Not Admitted**

The record shall consist of the notice of the initiation of the proceeding, the declaration, and the proposed order described in Rule 9810(b); the transcript of the hearing; and all evidence considered by the Hearing Panel. The Office of Hearing Officers shall be the custodian of the record. Prof-fered evidence that is not accepted into the record by the Hearing Panel shall be retained by the custodian of the record until the date when the Association's decision becomes final or, if applicable, upon the conclusion of any review by the Commission or the federal courts.

### **(h) Failure to Appear at Hearing**

If a Respondent fails to appear at a hearing for which it has notice, the allegations in the notice and accompanying declaration shall be deemed admitted, and the Hearing Panel may issue a temporary cease-and-desist order without further proceedings.

### **9840. Issuance of Temporary Cease-and-Desist Order by Hearing Panel**

#### **(a) Basis for Issuance**

The Hearing Panel shall issue a written decision stating whether a temporary cease-and-desist order shall be imposed. A temporary cease-and-desist order may be imposed if the Hearing Panel finds that the alleged violation or threatened violation specified in the notice, or the continuation thereof, is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the disciplinary proceeding under the Rule 9200 and 9300 Series. The Hearing Panel shall issue the decision not later than seven days after the conclusion of the hearing.

**(b) Content, Scope, and Form of Order**

A temporary cease-and-desist order shall:

(1) describe the basis for its issuance, including the alleged or threatened violations and the significant dissipation or conversion of assets or other significant harm to investors that is likely to result without the issuance of an order;

(2) describe in reasonable detail the act or acts the Respondent is to take or refrain from taking; and

(3) include the date and hour of its issuance.

**(c) Duration of Order**

A temporary cease-and-desist order shall remain effective and enforceable until the issuance of a decision under Rule 9268 in the related disciplinary proceeding, unless the decision in the related disciplinary proceeding is appealed by the Respondent under Rule 9311. In such case, the order shall remain in effect for no more than 180 days after the Respondent files a written notice of appeal, or such longer time as consented to by the Respondent.

**(d) Service**

The Hearing Officer shall serve the Hearing Panel's decision and any temporary cease-and-desist order by personal service, overnight commercial courier, or facsimile. The temporary cease-and-desist order shall be effective upon service.

**9850. Review by Hearing Panel**

At any time after the Hearing Panel serves the Respondent with a temporary cease-and-desist order, a Party may apply to the Hearing Panel to have the order modified, set aside, limited, or suspended. The application shall set forth with specificity the facts that support the request. The Hearing Panel shall respond to the request in writing within ten days after receipt of the request. The Hearing Panel response shall be served on the Respondent via personal service, overnight commercial courier, or facsimile. The filing of an application under this Rule shall not stay the effectiveness of the temporary cease-and-desist order, unless the Hearing Panel otherwise orders.

**9860. Violation of TCDO**

A Respondent who violates a temporary cease-and-desist order imposed under this Rule Series may have its association or membership suspend-

ed or canceled under the Rule 9510 Series. The President or Chief Operating Officer of NASD Regulation, Inc., must authorize the initiation of any such proceeding.

**9870. Application to Commission for Review**

The right to have any action under 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 a temporary cease-and-desist order, unless the Commission otherwise orders.

**Endnotes**

<sup>1</sup> Among other things, the proposed micro-cap rules would require members to review current issuer financial statements prior to recommending a transaction in an over-the-counter (OTC) security to a customer and require members to provide certain disclosures on the trade confirmation for customer transactions in an OTC equity security. Also, the rules prohibit a member from quoting a security on the OTC Bulletin Board unless the issuer has made current filings with the Securities and Exchange Commission or other regulatory authority.

<sup>2</sup> A permanent cease-and-desist order could be issued as part of the final resolution of a regular disciplinary proceeding conducted under NASD Rules 9100-9300.

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