

# Notice to Members

OCTOBER 2006

## SUGGESTED ROUTING

Legal and Compliance  
Operations  
Senior Management

## KEY TOPICS

Business Expansions  
IM-1011-1  
Material Change in Business  
Operations  
Rule 1017  
Safe Harbor

## GUIDANCE

### Business Expansions

SEC Approves Amendments to the Safe Harbor for Business Expansions; **Effective Date: November 3, 2006**

#### Executive Summary

On August 7, 2006, the Securities and Exchange Commission (SEC) approved amendments to Interpretative Material 1011-1 (Safe Harbor for Business Expansions) (IM-1011-1) to limit the types of violations of Rule 2110 (Standards of Commercial Honor and Principles of Trade) that would result in a member being ineligible to use the safe harbor for business expansions and made certain technical changes.<sup>1</sup> IM-1011-1, as amended, is set forth in Attachment A of this *Notice*. The amendments become effective on November 3, 2006.

#### Questions/Further Information

Questions regarding this *Notice* may be directed to Kathryn M. Moore, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 974-2974.

#### Background and Discussion

Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations) requires that a member submit an application to NASD for approval prior to, among other things, making a "material change in business operations," which is defined in Rule 1011.<sup>2</sup> IM-1011-1 creates a safe harbor for certain types of expansions that are presumed not to be a "material change in business operations" and therefore do not require NASD approval.<sup>3</sup>

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However, the safe harbor in IM-1011-1 is not available to any member that, among other things, has a “disciplinary history” as defined in IM-1011-1.<sup>4</sup> For purposes of IM-1011-1, disciplinary history means a finding of a violation by a member or a principal of the member in the past five years by the SEC, a self-regulatory organization or a foreign financial regulatory authority of one or more specified provisions (or comparable foreign provisions) or rules or regulations thereunder,<sup>5</sup> including Rule 2110.<sup>6</sup>

When a member or individual is charged with violating an NASD rule, NASD frequently charges a violation of Rule 2110 as part of NASD’s action (in both settled and litigated matters).<sup>7</sup> Thus, the inclusion of Rule 2110 in IM-1011-1, without any limitation, often results in members being ineligible to use the safe harbor if they (or any of their principals) have violated any other NASD rule, which was not the intended effect. Rather, the safe harbor specifically included a finite list of rules, the violation of which would preclude the member firm from using the safe harbor, and was not intended to capture violations of all NASD rules.

Accordingly, with respect to violations of Rule 2110, NASD has amended IM-1011-1 to provide that a member is ineligible to use the safe harbor only where the finding of a violation of Rule 2110 by the member or a principal of the member raises significant investor protection issues by involving unauthorized trading, churning, conversion, material misrepresentations or omissions to a customer, front-running, trading ahead of research reports or excessive markups.<sup>8</sup> Therefore, a member will not be eligible to rely on the safe harbor for material changes in business operations if the member or any of its principals have been found, within the past five years, to have violated Rule 2110 in the context of these enumerated activities (or to have violated any of the other rules specified in IM-1011-1).

In addition, NASD made a technical correction to the rule text with respect to the inclusion of Section 15(b)(4)(E) of the Securities Exchange Act of 1934 (Act) in the list of rules the violation of which would preclude a member from relying on the safe harbor under IM-1011-1. The amendment clarifies that a member would be ineligible to use the safe harbor in the event that a member or any of its principals has been found to have engaged in one or more violations of the type specified in Section 15(b)(4)(E) of the Act in the past five years.

The amendments become effective on November 3, 2006.

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## Endnotes

- 1 Exchange Act Release No. 54279 (August 7, 2006), 71 FR 46533 (August 14, 2006) (Approval Order of SR-NASD-2006-070).
- 2 A “material change in business operations” is defined in Rule 1011(i) and includes, but is not limited to: removing or modifying a membership agreement restriction; market making, underwriting or acting as a dealer for the first time; and adding business activities that require a higher minimum net capital under SEC Rule 15c3-1.
- 3 The safe harbor permits, within a one year period, (1) an increase of 10 persons if the firm has 10 or less associated persons in sales, or an increase of 10 persons or a 30 percent increase, whichever is greater, if the firm has 11 or more associated persons in sales; (2) an increase of three offices if the firm has five or less offices, or an increase of three offices or a 30 percent increase, whichever is greater, if the firm has six or more offices; and (3) an increase of 10 markets to be made if the firm makes 10 or less markets, or an increase of 10 markets or a 30 percent increase, whichever is greater, if the firm makes 11 or more markets.  
  
As a reminder, *Notice to Members (NTM) 00-73* (October 2000) states: “If a proposed expansion is outside of the safe harbor provisions, it does not necessarily mean that the expansion is a ‘material change in business operations.’ The safe harbor provisions are meant to provide guidance on what changes will not be considered material.” Please refer to *NTM 00-73* for further guidance on how to assess if a proposed change is material.
- 4 The safe harbor is also generally not available to members with membership agreements that contain certain restrictions on number of personnel, offices and markets that may be made.
- 5 The applicable provisions are Sections 15(b)(4)(E) and 15(c) of the Securities Exchange Act of 1934; Section 17(a) of the Securities Act of 1933; SEC Rules 10b-5 and 15g-1 through 15g-9; NASD Rules 2110, 2120 (Use of Manipulative, Deceptive or Other Fraudulent Devices), 2310 (Recommendations to Customers (Suitability)), 2330 (Customers’ Securities or Funds), 2440 (Fair Prices and Commissions), 3010 (Supervision-failure to supervise only), 3310 (Publication of Transactions and Quotations) and 3330 (Payment Designed to Influence Market Prices, Other than Paid Advertising); and MSRB Rules G-19, G-30 and G-37(b) and (c).
- 6 Rule 2110 requires that “a member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.”
- 7 See *Joseph Abbondante*, Exchange Act Rel. No. 53066 (Jan. 6, 2006), 2006 SEC Lexis 23 at 36 (“It is well settled that a violation of a rule promulgated by the SEC or by NASD also violates Conduct Rule 2110.”).
- 8 The limits on violations of Rule 2110 mirror the limits on Rule 2110 with respect to the public release of disciplinary complaints. See IM-8310-2 (Release of Disciplinary and Other Information Through BrokerCheck) and the related *NTM 97-42* (July 1997).

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## ATTACHMENT A

New language is underlined, deletions are in brackets.

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### IM-1011-1. Safe Harbor[s] for Business Expansions

This interpretive material concerns the types of business expansions that will not require a member to submit a Rule 1017 application to obtain NASD's [Regulation's] approval of the expansion. This safe harbor applies to: (1) firms that do not have a membership agreement, and (2) firms that have a membership agreement that does not contain a restriction on the factors listed below.

The safe harbor is not available to a member that has a membership agreement that contains a specific restriction as to one or more of the factors listed below. In that case, the agreement takes precedence because NASD [Regulation] has determined that a particular restriction should apply as to one or more of the factors, and NASD [Regulation] has issued a decision with a rationale for that restriction. Similarly, the safe harbor also does not apply if the member has a membership agreement that permits expansion beyond the limits set forth below (e.g., an Applicant requests and obtains approval for ten registered representatives in the first six months with an additional ten registered representatives in the next year); in such case, [the Department]NASD has specifically considered the firm's expansion plans and approved them.

The safe harbor is not available to any member that has disciplinary history. For purposes of this Interpretation, "disciplinary history" means a finding of a violation by the member or a principal of the member in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the following provisions (or a comparable foreign provision) or rules or regulations thereunder: violations of the types enumerated in Section[s] 15(b)(4)(E) [and 15(c)] of the Securities Exchange Act of 1934; Section 15(c) of the Securities Exchange Act of 1934; Section 17(a) of the Securities Act of 1933; SEC Rules 10b-5 and 15g-1 through 15g-9; NASD Rules 2110 (only if the finding of a violation is for unauthorized trading, churning, conversion, material misrepresentations or omissions to a customer, front-running, trading ahead of research reports or excessive markups), 2120, 2310, 2330, 2440, 3010 (failure to supervise only), 3310, and 3330; and MSRB Rules G-19, G-30, and G-37(b) & (c).

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For those firms to which the safe harbor is available, the following types of expansions are presumed not to be a material change in business operations and therefore do not require a Rule 1017 application. For any expansion beyond these limits, a member should contact its district office prior to implementing the change to determine whether the proposed expansion requires an application under Rule 1017. Expansions in each area are measured on a rolling 12-month basis; members are required to keep records of increases in personnel, offices, and markets to determine whether they are within the safe harbor.

“Associated Persons involved in sales” includes all Associated Persons, whether or not registered, who are involved in sales activities with public customers, including sales assistants and cold callers, but excludes clerical, back office, and trading personnel who are not involved in sales activities.

<i>Number of Associated Persons Involved in Sales Period Without Rule 1017 Application</i>	<i>Safe Harbor – Increase Permitted Within One Year</i>
1-10	10 persons
11 or more	10 persons or a 30 percent increase, whichever is greater
 <i>Number of Offices (registered or unregistered)</i>	
1-5	3 offices
6 or more	3 offices or a 30 percent increase, whichever is greater
 <i>Number of Markets Made</i>	
1-10	10 markets
11 or more	10 markets or a 30 percent increase, whichever is greater

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