

April 28, 2000

Katherine England, Esq.  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D. C. 20549

Re: **File No. SR-NASD-99-67; Amendments to Membership Rules;  
Amendment No. 1**

Dear Ms. England:

Pursuant to Rule 19b-4, NASD Regulation, Inc. proposes the following amendments to the above-numbered rule filing. We have enclosed a 3-1/2" disk containing a revised Exhibit 1 in Microsoft Word 7.0 to facilitate production of the Federal Register release.

On page 2, the rule filing states that the NASD Board of Governors would have an opportunity to review the proposed rule change at its December 9, 1999 meeting. At that meeting, the NASD Board did not call the proposed rule change for review. Also, on page 2, in the second full paragraph, insert "and March 29, 2000" before the first period in line 9 and "and March 30, 2000" before the period on line 12.

On page 4, beginning in line 12, and page 73, beginning in line 1, please delete "adding" and the rest of the sentence and insert in lieu thereof "market making, underwriting, or acting as a dealer for the first time; or adding business activities that require a higher minimum net capital".

In line 10 of page 5 and line 20 of page 73, please insert "or rules or regulations thereunder" after "provisions)". In lines 10 and 11, and lines 20 and 21, of those pages respectively, please substitute "Sections 15(b)(4)(E) and 15(c) of the Securities Exchange Act of 1934 (failure to supervise; fraud and manipulation);" for "Section 15(b)(4)(E) of the Securities Exchange Act of 1934 (failure to supervise);".

On page 6, in the first full paragraph, and page 74, in the second full paragraph, please delete the second full sentence. After the first full sentence, add the following footnote: "NASD Regulation is not proposing any change to the definition of sales practice violation on the Form U-4."

On page 9, fifth line from the bottom, and page 78, line 3, please substitute "the" for "it".

On page 10, at the end of the third full paragraph, and page 78, at the end of the last paragraph, please add the following footnote: "NASD Regulation also wishes to provide some guidance on how it treats unadjudicated violations under Rule 1014. The Rule permits the staff to consider unadjudicated violations as part of a decision on a membership application. In most cases, an unadjudicated violation by itself will not result in a restriction or a denial, but depending on the circumstances, may require heightened supervision. However, a particularly egregious allegation, e.g., a criminal charge involving a large number of customers, may cause the staff to consider a restriction or denial."

On pages 10 and 79, please substitute "[www.nasdr.com/4700\\_toc.htm](http://www.nasdr.com/4700_toc.htm)" for "[www.nasdr.com/4700\\_appendix\\_b.htm](http://www.nasdr.com/4700_appendix_b.htm)"

On pages 12, after line 3, and page 80, after the second full paragraph, please insert the following:

"NASD Regulation believes that the oversight function envisioned for the call for review provision, which has proved to be unworkable, is performed through a variety of other existing mechanisms. The Home Office of the Member Regulation Department employs a full time Membership Manager to coordinate and oversee the national program. Part of these responsibilities includes a quality control function. This function is carried out in several ways: maintenance of a Membership Procedures Manual; periodic advice memoranda sent to District Office staff ("MAP Bulletins"); regularly scheduled telephone conferences with District Office staff to discuss procedural and substantive issues arising in the program; and periodic training sessions for new and incumbent staff. To supplement these tools, Member Regulation's Office of Quality Assurance conducts periodic peer reviews of the membership admission program, most recently in 1998 and 1999. The purpose of these peer reviews was to assess the District Offices' application of the membership rules and procedures. The reviews included an examination of 265 files in recently issued membership decisions. The reviews included spot checks of source documents to confirm the facts underlying the decisions. In addition, peer reviews of the membership program will be conducted in the future."

On pages 13, line 11, and page 81, line 17, please change "market" to "markets".

On page 17, line 2, and page 85, line 7, please substitute "also has provided" for "is working on". On page 17, lines 4-5, and page 85, lines 9-10, please substitute "This guidance is posted at [www.nasdr.com/cm\\_apps\\_1.htm](http://www.nasdr.com/cm_apps_1.htm)." for "This guidance will be posted on the Web Site shortly." In the first full paragraph on page 17 and the second full paragraph of page 85, delete the last two sentences, and insert in lieu thereof "After further consideration of this comment by the Board, NASD Regulation determined to revise the definition of material change in business operations as proposed in Notice To Members 99-67 so that the definition would not apply to adding any new type of business, but only to adding market making, underwriting, or acting as a dealer for the first time."

On page 18, lines 13-14, and page 86, lines 17-18, please substitute "could be" for "are likely to be".

On page 20, lines 12-13, and page 88, lines 14-15, please delete "the definition of material change in business operations and".

On page 24, 1011(i)(2) is amended to read "market making, underwriting corporate securities, or acting as a dealer for the first time; and". Please delete 1011(i)(4) and (5).

In line 16 of page 26, please insert "or rules or regulations thereunder" after "provision)" and please substitute "Sections 15(b)(4)(E) and 15(c)" for "Section 15(b)(4)(E)".

On page 47, line 15, please change "may" to "[may] shall".

On page 58, lines 9-10, please delete everything after "1011(i)" until the period.

On page 63, in the second to last line, please change "may" to "shall".

If you have any questions, please contact Greg Dean, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8159; e-mail [gregory.dean@nasd.com](mailto:gregory.dean@nasd.com). The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Alden S. Adkins  
Senior Vice President and General Counsel

Enclosure

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-99-67 Amendment 1)  
April 28, 2000

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by NASD Regulation, Inc. Relating to Amendments to Membership Rules

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 2, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary NASD Regulation, Inc. ("NASD Regulation"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to amend the Rule 1010 Series, which concerns member admission. Additions are underlined; deletions are bracketed.

**1010. Membership Proceedings**

**1011. Definitions**

Unless otherwise provided, terms used in the Rule 1010 Series shall have the meaning as defined in Rule 0120.

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<sup>1</sup> 15 U.S.C. 78s(b)(1)

**(a) "Applicant"**

The term "Applicant" means a person [or entity] that applies for membership in the Association under Rule 1013[,], or a member that files an application [to remove or modify a restriction under Rule 1017, or files a notice and application for continuance in membership under Rule 1018] for approval of a change in ownership, control, or business operations under Rule 1017.

**(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.

**(c) "Department"**

The term "Department" means the Department of Member Regulation of NASD Regulation.

**(d) "Director"**

The term "Director" means a member of the NASD Regulation Board.

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<sup>2</sup> 17 C.F.R. 240.19b-4.

**(e) "district"**

The term "district" means a district established by the NASD Regulation Board.

**(f) "district office"**

The term "district office" means an office of NASD Regulation located in a district.

**(g) "Governor"**

The term "Governor" means a member of the NASD Board.

**(h) "Interested Association Staff"**

The term "Interested Association Staff" means an employee who directly participates in a decision under Rule 1014[, or 1017, [or 1018,] an employee who directly supervises an employee with respect to such decision, an employee who conducted an investigation or examination of a member that files an application under Rule 1017 [or a notice and application under Rule 1018], the District Director for the relevant district, and the head of the Department.

**(i) "material change in business operations"**

The term "material change in business operations" includes, but is not limited to:

- (1) removing or modifying a membership agreement restriction;
- (2) market making, underwriting, or acting as a dealer for the first time; and
- (3) adding business activities that require a higher minimum net capital under

SEC Rule 15c3-1.

**[(i)](j) "NASD Board"**

The term "NASD Board" means the Board of Governors of the NASD.

**[(j)](k) "NASD Regulation Board"**

The term "NASD Regulation Board" means the Board of Directors of NASD Regulation.

**(l) "principal place of business"**

The term "principal place of business" means the executive office from which the sole proprietor or the officers, partners, or managers of the Applicant direct, control, and coordinate the activities of the Applicant, unless the Department determines that the principal place of business is where: (1) the largest number of Associated Persons of the Applicant are located; or (2) the books and records necessary to provide information and data to operate the business and comply with applicable rules are located.

**[(k)](m) "sales practice [violations] event"**

The term "sales practice [violations] event" means any [conduct directed at or involving a customer that would constitute a violation of any Rule in the Rule 2000 or 3000; any provision of the Act, Securities Exchange Act of 1934; or any state statute prohibiting fraudulent conduct in connection with the offer, sale, or purchase of a security or in connection with the rendering of investment advice] customer complaint, arbitration, or civil litigation that has been reported to the Central Registration Depository, currently is required to be reported to the Central Registration Depository, or otherwise has been reported to the Association.

**[(l)](n) "Subcommittee"**

The term "Subcommittee" means a subcommittee of the National Adjudicatory Council that is constituted pursuant to Rule 1015 to conduct a review of a Department decision issued under the Rule 1010 Series.

**IM-1011-1. Safe Harbors 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 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 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: 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, 2310, 2330, 2440, 3010 (failure to supervise only), 3310, and 3330; and MSRB Rules G-19, G-30, and G-37(b) & (c).

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.

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

**Number of Markets Made**

|                   |                                                                  |
|-------------------|------------------------------------------------------------------|
| <u>1-10</u>       | <u>10 markets</u>                                                |
| <u>11 or more</u> | <u>10 markets or a 30 percent increase, whichever is greater</u> |

**1012. General Provisions**

**(a) [Service of Notices and Decisions;] Filing by Applicant or Service by the Association**

[A notice or a decision issued by the Association under the Rule 1010 Series with respect to an application shall be served promptly by first-class mail on the Applicant or its counsel, unless a Rule specifies a different method of service. Service by the Association or filing by an Applicant by mail shall be deemed complete upon mailing. Service by the Association or filing by an Applicant by commercial courier or facsimile shall be deemed complete on the date specified in the written confirmation of receipt.]

(1) An Applicant may file an application or any document or information requested under the Rule 1010 Series by first-class mail, overnight courier, or hand delivery. If the Department and the Applicant agree, the Applicant also may file a requested document or information by facsimile.

(2) The Association shall serve a notice or decision issued under the Rule 1010 Series by first-class mail on the Applicant or its counsel, unless a Rule specifies a different method of service.

(3) Service by the Association or filing by an Applicant shall be deemed complete as follows:

(A) Service or filing by first-class mail shall be deemed complete on the date of postmark;

(B) Service or filing by overnight courier shall be deemed complete on the date of delivery to the overnight courier as specified in the airbill;

(C) Service or filing by hand delivery shall be deemed complete on the date of receipt as evidenced by a date stamp; and

(D) Service or filing by facsimile shall be deemed complete on the date specified in the document and on the written confirmation of transmission.

**(b) Lapse of Application**

(1) Absent a showing of good cause, an application filed under Rule 1013 or 1017 shall lapse if an Applicant fails to:

(A) respond fully within 60 days after service of an initial written request for information or documents under Rule 1013, within 30 days after service of an initial written request for information or documents under Rule 1017, within 30 days after service of a subsequent written request for information or documents under Rule 1013 or 1017, or within such other time period agreed to by the Department and the Applicant;

(B) appear at or otherwise participate in a scheduled membership interview pursuant to Rule 1013(b) or 1017(f); or

(C) file an executed membership agreement under Rule 1014(d) or Rule 1017(g)(4) within 25 days after service of the agreement, or within such other period agreed to by the Department and the Applicant.

(2) If an Applicant wishes to continue to seek membership or approval of a change in ownership, control, or business operations, then the Applicant shall be required to submit a new application and fee under Rule 1013 or 1017, respectively. The Association shall not refund any fee for a lapsed application.

**[(b)] (c) Ex Parte Communications**

(1) The prohibitions against ex parte communications shall become effective when Association staff has knowledge that an Applicant intends to file a written request for review by the National Adjudicatory Council under Rule 1015.

[(1)] (2) Unless on notice and opportunity for an Applicant and Interested Association Staff to participate, or to the extent required for the disposition of ex parte matters as authorized by the Rules of the Association:

(A) an Applicant, a counsel or representative of an Applicant, or an Interested Association Staff shall not make or knowingly cause to be made an ex parte communication relevant to the merits of a membership proceeding under the Rule 1010 Series to a Governor, a member of the National Adjudicatory Council or a Subcommittee thereof, or an Association employee who is participating or advising in a decision of such a person with respect to that proceeding; and

(B) a Governor, a member of the National Adjudicatory Council or a Subcommittee thereof, or an Association employee who is participating or advising in the decision of such a person with respect to a membership proceeding shall not make or knowingly cause to be made to an Applicant, a

counsel or representative of the Applicant, or an Interested Association Staff  
an ex parte communication relevant to the merits of that proceeding.

[(2)] (3) A Governor, a member of the National Adjudicatory Council or a Subcommittee thereof, or an Association employee participating or advising in the decision of such a person, who receives, makes, or knowingly causes to be made a communication prohibited by this paragraph shall place in the record of the membership proceeding:

(A) all such written communications;

(B) memoranda stating the substance of all such oral communications;

and

(C) all written responses and memoranda stating the substance of all oral responses to all such communications.

[(3)] The prohibitions against ex parte communications shall become effective when Association staff has knowledge that an Applicant intends to file a written request for review by the National Adjudicatory Council under Rule 1015.]

**[(c)] (d) Recusal or Disqualification**

A Governor or a member of the National Adjudicatory Council or a Subcommittee thereof shall not participate in a matter governed by the Rule 1010 Series as to which that person has a conflict of interest or bias, or if circumstances otherwise exist where his or her fairness might reasonably be questioned. In such a case, the person shall recuse himself or shall be disqualified as follows:

(1) The Chair of the NASD Board shall have authority to direct the disqualification of a Governor, and a majority of the Governors of the NASD Board excluding the Chair shall have authority to direct the disqualification of the Chair of the NASD Board.

(2) The Chair of the National Adjudicatory Council shall have authority to direct the disqualification of a member of the National Adjudicatory Council or a member of a Subcommittee appointed pursuant to Rule 1015, and the Vice Chair of the National Adjudicatory Council shall have authority to direct the disqualification of the Chair of the National Adjudicatory Council.

**[(d)] (e) Computation of Time**

**(1) Calendar Day**

In the Rule 1010 Series, "day" means calendar day.

**(2) Formula**

In computing a period of time under the Rule 1010 Series, the day of the act, event, default, or lapse from which the period of time designated begins to run shall not be included. The last day of the period so computed shall be included unless it is a Saturday, Sunday, or Federal holiday, in which event the period runs until the end of the next day that is not a Saturday, Sunday, or Federal holiday. Intermediate Saturdays, Sundays, and Federal holidays shall be excluded from the computation when the period prescribed is ten days or less.

**1013. New Member Application [and Membership] and Interview**

**(a) Filing of Application**

**(1) Where To File**

[Each Applicant for Association membership shall file its application in two parts. The first part of the application shall be filed with the Membership Department and shall include the following documents:]

An Applicant for Association membership shall file its application with the Department of Member Regulation at the district office in the district in which the Applicant intends to have its principal place of business as defined in Rule 1011(l).

**(2) Contents**

The application shall include:

(A) an original signed and notarized paper Form BD, with applicable schedules;

(B) an original signed paper Form U-4 for each Associated Person who is required to be registered under the Rules of the Association;

(C) an original NASD-approved fingerprint card for each Associated Person who will be subject to SEC Rule 17f-2;

(D) a new member assessment report;

[(E) a new member firm contact questionnaire; and]

[(F)] (E) a check for the appropriate fee[.];

[(2) The second part of the application shall be filed with the Department of Member Regulation at the district office in the district in which the Applicant intends to

have its principal place of business and shall include the following information and documents:]

[(A)] (F) a detailed business plan[, in a form prescribed by the Association,] that adequately and comprehensively describes all material aspects of the business that will be, or are reasonably anticipated to be, performed at and after the initiation of business operations, including future business expansion plans, if any, and includes:

(i) a trial balance, balance sheet, supporting schedules, and computation of net capital, each of which has been prepared as of a date that is within 30 days before the filing date of the application;

(ii) a monthly projection of income and expenses, with a supporting rationale, for the first twelve months of operations;

(iii) an organizational chart;

(iv) [a list of] the intended [locations] location of [all offices, ] the Applicant's principal place of business and all other offices, if any, whether or not such offices would be required to be registered under the Rules of the Association, and the names of the persons who will be in charge of each office;

(v) a list of the types of securities to be offered and sold and the types of retail or institutional customers to be solicited;

(vi) a description of the methods and media to be employed to develop a customer base and to offer and sell products and services

to customers, including the use of the Internet, telephone solicitations, seminars, or mailings;

(vii) a description of the business facilities and a copy of any proposed or final lease;

(viii) the number of markets to be made, if any, the type and volatility of the products, and the anticipated maximum inventory positions;

(ix) any plan to enter into contractual commitments, such as underwritings or other securities-related activities;

(x) any plan to distribute or maintain securities products in proprietary positions, and the risks, volatility, degree of liquidity, and speculative nature of the products; [and]

(xi) any other activity that the Applicant may engage in that reasonably could have a material impact on net capital within the first twelve months of business operations; and

(xii) a description of the communications and operational systems the Applicant will employ to conduct business with customers or other members and the plans and procedures the Applicant will employ to ensure business continuity, including: system capacity to handle the anticipated level of usage; contingency plans in the event of systems or other technological or communications problems or failures that may impede customer usage or firm order entry or execution;

system redundancies; disaster recovery plans; system security;  
disclosures to be made to potential and existing customers who may  
use such systems; and supervisory or customer protection measures  
that may apply to customer use of, or access to, such systems;

[(B) a copy of the Applicant's most recent Form BD;]

[(C)](G) a copy of any decision or order by a federal or state  
authority or self-regulatory organization taking permanent or temporary  
adverse action with respect to a registration or licensing determination  
regarding the Applicant or an Associated Person;

[(D)](H) a list of all Associated Persons[, the most recent Form U-4  
and Form U-5 for each Associated Person, any other document that discloses  
the disciplinary history of each Associated Person, and a list of any other  
persons or entities that will exercise control with respect to the Applicant's  
business];

[(E)](I) documentation of any of the following events, unless the event  
has been reported to the Central Registration Depository:

(i) a regulatory action against or investigation of the Applicant  
or an Associated Person by the Commission, the Commodity Futures  
Trading Commission, a federal, state, or foreign regulatory agency, or  
a self-regulatory organization that is pending, adjudicated, or settled;

(ii) an investment-related civil action for damages or an injunction against the Applicant or an Associated Person that is pending, adjudicated, or settled;

(iii) an investment-related customer complaint or arbitration [involving sales practice violations, theft, misappropriation, conversion, or breach of fiduciary duty, against the Applicant or an Associated Person that is pending, settled, or has resulted in an award or judgement] that is required to be reported on Form U-4; [and]

(iv) a criminal action (other than a minor traffic violation) against the Applicant or an Associated Person that is pending, adjudicated, or that has resulted in a guilty or no contest plea; and

[(F)](v) a copy of any document evidencing a termination for cause or a permitted resignation after investigation of an alleged violation of a federal or state securities law, a rule or regulation thereunder, a self-regulatory organization rule, or an industry standard of conduct;

[(G)](J) a description of any remedial action, such as special training [or], continuing education requirements, or heightened supervision, imposed on an Associated Person by a state or federal authority or self-regulatory organization;

[(H)](K) a written acknowledgment that heightened supervisory procedures and special educational programs may be required pursuant to

Notice To Members 97-19 for an Associated Person whose record[s]  
reflects[:

(i)] disciplinary actions [involving] or sales practice  
[violations] events;

[(ii) customer complaints; or

(iii) arbitrations that were resolved adversely to the  
Associated Person;]

[(I)](L) a copy of final or proposed contracts with banks, clearing  
entities, or service bureaus, and a general description of any other final or  
proposed contracts;

[(J)](M) a description of the nature and source of Applicant's capital  
with supporting documentation, including a list of all persons or entities that  
have contributed or plan to contribute financing to the Applicant's business,  
the terms and conditions of such financing arrangements, the risk to net capital  
presented by the Applicant's proposed business activities, and any  
arrangement for additional capital should a business need arise;

[(K)](N) a description of the financial controls to be employed by the  
Applicant;

[(L)](O) a description of the Applicant's supervisory system and a  
copy of its written supervisory procedures, internal operating procedures  
(including operational and internal controls), internal inspections plan, written  
approval process, and qualifications investigations required by Rule 3010;

[(M)](P) a description of the number, experience, and qualifications of supervisors and principals and the number, experience, and qualifications of persons to be supervised by such personnel, the other responsibilities of the supervisors and principals with the Applicant, their full-time or part-time status, any business activities that the supervisors or principals may engage in outside of their association with the Applicant, the hours per week devoted to such activities, and an explanation of how a part-time supervisor or principal will be able to discharge his or her designated functions on a part-time basis;

[(N)](Q) a description of Applicant's proposed recordkeeping system;

[(O)](R) a copy of the Applicant's written training plan to comply with Firm Element continuing education requirements described in Rule 1120(b), including the name of the Associated Person responsible for implementation; and

(P) [a copy of the documents described in paragraph (a)(1)] a Web CRD entitlement request form and a Member Contact Questionnaire user access request form.

**(3) Electronic Filings** [The Applicant shall file both parts of the application simultaneously by commercial courier. The application shall be deemed received on the date specified in the written confirmation of receipt generated by the commercial courier for the delivery of the second part of the application to the district office.]

Upon approval of the Applicant's Web CRD entitlement request form, the Applicant

shall submit any amendments to its Forms BD or U-4, any additional Forms U-4, and any Form U-5 electronically via Web CRD. Upon approval of the Applicant's membership, the Applicant shall submit any amendments to its Member Contact Questionnaire electronically.

**(4) Rejection Of Application That Is Not Substantially Complete**

If the Department determines within 30 days after the filing of an application that the application is not substantially complete, the Department may reject the application and deem it not to have been filed. In such case, within the 30 day period, the Department shall serve a written notice on the Applicant of the Department's determination and the reasons therefor. The Association shall refund the application fee, less \$350, which shall be retained by the Association as a processing fee. If the Applicant determines to continue to seek membership, the Applicant shall submit a new application and fee under this Rule.

**(5) Request For Additional Documents Or Information**

Within 30 days after the [receipt] filing of an application, the Department shall [determine whether the application is complete and, if not, shall request] serve an initial request for any additional information or documents necessary to render a decision on the application. The Department may [request] serve subsequent requests for additional information or documents at any time during the membership application process.

[(5)] Unless otherwise agreed by the Department and the Applicant, the Applicant shall file any additional information and documents with the Department

within 60 days after service of the Department's initial request and 30 days after service of any subsequent request.

**[(b) Lapse of Application]**

[(1) Absent a showing of good cause, an application for membership shall lapse if an Applicant fails to:

(A) respond fully within 60 days after an initial request for information or documents, within 30 after any subsequent request, or within such other time period agreed to by the Department and the Applicant;

(B) appear at or otherwise participate in a scheduled membership interview pursuant to paragraph (c); or

(C) return an executed membership agreement under Rule 1014(c) within 25 days after service of the agreement.]

[(2) The lapse of an application shall require an Applicant continuing to seek membership to submit a new application under paragraph (a).]

**[(c)](b) Membership Interview**

**(1) Requirement for Interview**

Before the Department [issues a] serves its decision on an application for new membership in the Association, the Department shall conduct a membership interview with a representative or representatives of the Applicant.

**(2) Service of Notice**

At least seven days before the membership interview, the Department shall serve on the Applicant a written notice that specifies the date and time of the interview

and the representative or representatives of the Applicant who are required to participate in the interview. The Department shall serve the notice by facsimile or [commercial] overnight courier. The Applicant and the Department may agree to a shorter or longer period for notice or a different method of service under this subparagraph.

**(3) Time**

Unless the Department directs otherwise for good cause shown, a membership interview shall be scheduled to occur within 90 days after the [receipt] filing of an application or within 60 days after the [receipt] filing of all additional information or documents requested, whichever is later.

**(4) Place**

Unless the Department and the Applicant otherwise agree, the membership interview shall be conducted in the district office for the district in which the Applicant has or intends to have its principal place of business.

**(5) Updated Financial Documents**

On or before the date of the membership interview, the Applicant shall file an updated trial balance, balance sheet, supporting schedules, and computation of net capital. The Applicant shall prepare such documents as of a date that is within 45 days before the date of the membership interview, unless the Applicant and the Department agree on a longer period. The Applicant shall promptly notify the Department in writing of any material adverse change in its financial condition that occurs before a decision constituting final action of the Association is served on the Applicant.

**[(5)](6) Review of Standards for Admission**

During the membership interview, the Department shall review the application and the standards for admission to membership with the Applicant's representative or representatives.

**[(6)](7) Information From Other Sources**

During the membership interview, the Department shall provide to the Applicant's representative or representatives any information or document that the Department has obtained from the Central Registration Depository or a source other than the Applicant and upon which the Department intends to base its decision under Rule 1014. If the Department receives such information or document after the membership interview or decides to base its decision on such information after the membership interview, the Department shall promptly serve the information or document and an explanation thereof on the Applicant.

**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) The application and all supporting documents are complete and accurate.

(2) The Applicant and its Associated Persons have all licenses and registrations required by state and federal authorities and self-regulatory organizations.

(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) 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[s] reflects[: (i) disciplinary actions involving sales practice violations; (ii) customer complaints; or (iii) arbitrations that were resolved adversely to the Applicant or Associated Person] a sales practice event;

(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; [an investment-related customer complaint or arbitration alleging sales practice violations, theft, misappropriation, conversion, or breach of fiduciary duty that is pending, settled, or has resulted in an award or judgment;] 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;

(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 a remedial action, such as special training [or], 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 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 Rules of the Association.

(6) The communications and operational systems that the Applicant intends to employ for the purpose of conducting business with customers and other members are adequate and provide reasonably for business continuity in each area set forth in Rule 1013(a)(2)(F)(xii);

[(6)](7) The Applicant is capable of maintaining a level of net capital in excess of the minimum net capital requirements set forth in SEC Rule 15c3-1 adequate to support the Applicant's intended business operations on a continuing basis, based on information [that is current within 30 days before the membership interview] filed under Rule 1013(b)(5). The Department may impose a reasonably determined higher net capital requirement for the initiation of operations after considering:

(A) the amount of net capital sufficient to avoid early warning level reporting requirements, such as SEC Rule 17a-11;

(B) the amount of capital necessary to meet expenses net of revenues for at least twelve months, based on reliable projections agreed to by the Applicant and the Department;

(C) any planned market making activities, the number of markets to be made, the type and volatility of products, and the anticipated maximum inventory positions;

(D) any plan to enter into other contractual commitments, such as underwritings or other securities-related activities;

(E) any plan to distribute or maintain securities products in proprietary positions, and the risks, volatility, degree of liquidity, and speculative nature of the products; and

(F) any other activity that the Applicant will engage in that reasonably could have a material impact on net capital within the first twelve months of business operations.

[(7)](8) The Applicant has financial controls to ensure compliance with the federal securities laws, the rules and regulations thereunder, and the Rules of the Association.

[(8)](9) The Applicant has compliance, supervisory, operational, and internal control practices and standards that are consistent with practices and standards regularly employed in the investment banking or securities business, taking into account the nature and scope of Applicant's proposed business.

[(9)](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 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 [disciplinary history of such] Central Registration Depository record or other disciplinary history of supervisory personnel and persons to be supervised; [any criminal, civil, administrative, or arbitration actions or written customer complaints against such persons;] 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 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 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 the Association and applicable states of all persons whose functions are subject to such registration requirements.

[(C)] (D) each Associated Person identified in the business plan to discharge a supervisory function [in the business plan] has at least one year of direct experience or two years of related experience in the subject area to be supervised;

[(D)] (E) the Applicant will solicit retail or institutional business;

[(E)] (F) the Applicant will recommend securities to customers;

[(F)] (G) the location or part-time status of a supervisor or principal will affect such person's ability to be an effective supervisor;

[(G)] (H) [the records of an Associated Person reflect: (i) disciplinary actions involving sales practice violations; (ii) customer complaints; or (iii) arbitrations that were resolved adversely to the Associated Person] the Applicant should be required to place one or more Associated Persons under heightened supervision pursuant to Notice to Members 97-19;

[(H)] (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

[(I)] (J) any other condition that will have a material impact on the Applicant's ability to detect and prevent violations of the federal securities laws, the rules and regulations thereunder, and the Rules of the Association.

[(10)](11) The Applicant has a recordkeeping system that enables Applicant to comply with federal, state, and self-regulatory organization recordkeeping requirements and a staff that is sufficient in qualifications and number to prepare and preserve required records.

[(11)](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 Rules of the Association.

~~[(12)]~~(13) 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 Rules of the Association.

~~[(13)]~~(14) The application and all supporting documents otherwise are consistent with the federal securities laws, the rules and regulations thereunder, and the Rules of the Association.

**(b) Granting or Denying Application**

(1) If the Department determines that the Applicant meets each of the standards in paragraph (a), the Department shall grant the application for membership.

(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 [may] 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)]~~ Submission of Membership Agreement**

If the Department grants an application, with or without restriction, the Applicant's approval for membership shall be contingent upon the Applicant's submission of a written membership agreement, satisfactory to the Department, undertaking to:

(1) engage only in the business set forth in the business plan and the membership agreement;

- (2) abide by any restriction specified in the Department's decision;
- (3) obtain the Department's prior approval of the removal or modification of such a restriction pursuant to Rule 1017; and
- (4) notify and obtain the Department's approval of a change in ownership or control or a material change in business operations pursuant to Rule 1018.

The Applicant shall not waive the right to file a written request for review under Rule 1015 by executing a membership agreement under this paragraph.]

**[(d)] (c) Decision**

**(1) Time**

The Department shall [issue] serve a written decision on the membership application within 30 days after the conclusion of the membership interview or after the [submission] filing of additional information or documents, whichever is later.

**(2) Content**

If the Department denies the application, the decision shall explain in detail the reason for denial, referencing the applicable standard or standards in paragraph (a). If the Department grants the application subject to restrictions, the decision shall explain in detail the reason for each restriction, referencing the applicable standard or standards in paragraph (a) upon which the restriction is based and identify the specific financial, operational, supervisory, disciplinary, investor protection, or other regulatory concern that the restriction is designed to address and the manner in which the restriction is reasonably designed to address the concern.

**(3) Failure to [Issue] Serve Decision**

If the Department fails to [issue] serve a decision within 180 days after [receipt] the filing of an application or such later date as the Department and the Applicant have agreed in writing, the Applicant may file a written request with the NASD Board requesting that the NASD Board direct the Department to [issue] serve a decision. Within seven days after [receipt] the filing of such a request, the NASD Board shall direct the Department to serve its written decision immediately or to show good cause for an extension of time. If the Department shows good cause for an extension of time, the NASD Board may extend the 180 day time limit by not more than 90 days.

**(d) Submission of Membership Agreement**

If the Department grants an application, with or without restriction, the Applicant's approval for membership shall be contingent upon the Applicant's filing of an executed written membership agreement, satisfactory to the Department, undertaking to:

(1) abide by any restriction specified in the Department's decision; and

(2) obtain the Department's approval of a change in ownership, control, or business operations pursuant to Rule 1017, including the modification or removal of a membership agreement restriction.

The Applicant shall not waive the right to file a written request for review under Rule 1015 by executing a membership agreement under this paragraph.

**(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 the Association is issued under Rule 1015 or 1016, unless otherwise directed by the National Adjudicatory Council, the NASD Board, or the Commission.

**(f) Effectiveness of Restriction**

A restriction imposed under this Rule shall remain in effect and bind the Applicant and all successors to the ownership or control of the Applicant unless:

(1) removed or modified by [the Department under Rule 1017] a decision constituting final action of the Association issued under Rule 1015, 1016, or 1017;

[(2) removed or modified by a decision constituting final action of the Association issued under Rule 1015 or 1016;] or

[(3)](2) stayed by the National Adjudicatory Council, the NASD Board, or the Commission.

**(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 the Association.

**1015. Review by National Adjudicatory Council**

**(a) Initiation of Review by Applicant**

**[(1) Request by Applicant]**

Within 25 days after service of a decision under Rule 1014[, ] or 1017 [or 1018], an Applicant may file a written request for review with the National Adjudicatory Council. A request for review shall state with specificity why the Applicant believes that the Department's decision is inconsistent with the membership standards set forth in Rule 1014, or otherwise should be set aside, and state whether a hearing is requested. The Applicant simultaneously shall [send] file by first-class mail a copy of the request to the district office where the Applicant filed its [membership] application.

**[(2) Notice by National Adjudicatory Council]**

A decision issued under Rule 1014, 1017, or 1018 shall be subject to a call for review by any member of the National Adjudicatory Council or the Review Subcommittee defined in Rule 9120 within 30 days after service of the decision. If the National Adjudicatory Council calls a decision for review, a written notice of review shall be served promptly on the Applicant by first-class mail. The written notice of review shall state the specific grounds for the review and whether a hearing is directed. If a decision is called for review by any member of the National Adjudicatory Council or the Review Subcommittee, the decision shall be reviewed by the National Adjudicatory Council. The National Adjudicatory Council simultaneously shall send

by first-class mail a copy of the notice to the district office where the Applicant filed its membership application.]

**(b) Transmission of Documents**

Within ten days after [receipt] the filing of a request for [or notice of] review, the Department shall:

(1) transmit to the National Adjudicatory Council copies of all documents that were considered in connection with the Department's decision and an index to the documents; and

(2) serve on the Applicant a copy of such documents (other than those documents originally submitted by Applicant) and a copy of the index.

**(c) Membership Application Docket**

The Department shall promptly record in the Association's membership application docket each request for [or notice of] review filed with the National Adjudicatory Council under this Rule and each material subsequent event, filing, and change in the status of a membership proceeding.

**(d) Appointment of Subcommittee**

The National Adjudicatory Council or the Review Subcommittee defined in Rule 9120 shall appoint a Subcommittee to participate in the review. The Subcommittee shall be composed of at least two members. One member shall be a current member of the National Adjudicatory Council. The remaining member or members shall be current or past Directors or past Governors.

**(e) Powers of Subcommittee**

If a hearing is requested [or directed], the Subcommittee shall conduct the hearing. If a hearing is not requested, the Subcommittee may serve a notice directing that a hearing be held. If a hearing is not requested or directed, the Subcommittee shall conduct its review on the basis of the record developed before the Department and any written submissions made by the Applicant or the Department in connection with the request for review.

**(f) Hearing**

**(1) Notice**

If a hearing is requested or directed, the hearing shall be held within 45 days after the [receipt] filing of the request [or service of the notice by] with the National Adjudicatory Council or service of the notice by the Subcommittee. The National Adjudicatory Council shall [send] serve written notice of the date and time of the hearing to the Applicant by facsimile or [commercial] overnight courier not later than 14 days before the hearing.

**(2) Counsel**

The Applicant and the Department may be represented by counsel at a hearing conducted pursuant to this Rule.

**(3) Evidence**

Formal rules of evidence shall not apply to a hearing under this Rule. Not later than five days before the hearing, the Applicant and the Department shall exchange copies of their proposed hearing exhibits and witness lists and provide copies of the same to the National Adjudicatory Council. If the Applicant or the

Department fails to provide copies of its proposed hearing exhibits or witness list within such time, the Subcommittee shall exclude the evidence or witnesses from the proceeding, unless the Subcommittee determines that good cause is shown for failure to comply with the production date set forth in this subparagraph.

**(4) Transcript**

The hearing shall be recorded and a transcript prepared by a court reporter. A transcript of the hearing shall be available for purchase from the court reporter at prescribed rates. The Applicant, the Department, or a witness may seek to correct the transcript. A proposed correction of the transcript shall be submitted to the Subcommittee within a reasonable period of time prescribed by the Subcommittee. Upon notice to the Applicant and the Department, the Subcommittee may direct the correction to the transcript as requested or sua sponte.

**[(5) Failure to Appear at Hearing]**

[If an Applicant fails to appear at a hearing for which it has notice, the National Adjudicatory Council may dismiss the request for review as abandoned, and the decision of the Department shall become the final action of the Association. Upon a showing of good cause, the National Adjudicatory Council may withdraw a dismissal entered pursuant to this subparagraph.]

**(g) Additional Information, Briefs**

At any time during its consideration, the Subcommittee or the National Adjudicatory Council may direct the Applicant or the Department to [submit] file additional information [and to file] or briefs. Any additional information or brief [submitted] filed shall be provided to all

parties before the National Adjudicatory Council renders its decision.

**(h) Abandonment of Request for Review**

If an Applicant fails to specify the grounds for its request for review under Rule 1015(a)(1), appear at a hearing for which it has notice, or file information or briefs as directed, the National Adjudicatory Council or the Review Subcommittee may dismiss the request for review as abandoned, and the decision of the Department shall become the final action of the Association. Upon a showing of good cause, the National Adjudicatory Council or the Review Subcommittee may withdraw a dismissal entered pursuant to this paragraph.

**[(h)] (i) Subcommittee Recommendation**

The Subcommittee shall present a recommended decision in writing to the National Adjudicatory Council within 60 days after the date of the hearing held pursuant to paragraph (f), and not later than seven days before the meeting of the National Adjudicatory Council at which the membership proceeding shall be considered.

**[(i)](j) Decision**

**(1) Proposed Written Decision**

After considering all matters presented in the review and the Subcommittee's recommended written decision, the National Adjudicatory Council may affirm, modify, or reverse the Department's decision or remand the membership proceeding with instructions. The National Adjudicatory Council shall prepare a proposed written decision pursuant to subparagraph (2).

**(2) Contents**

The decision shall include:

- (A) a description of the Department's decision, including its rationale;
- (B) a description of the principal issues raised in the review;
- (C) a summary of the evidence on each issue; and
- (D) a statement whether the Department's decision is affirmed,

modified, or reversed, and a rationale therefor that references the applicable standards in Rule 1014.

**(3) Issuance of Decision After Expiration of Call for Review Periods**

The National Adjudicatory Council shall provide its proposed written decision to the NASD Board. The NASD Board may call the membership proceeding for review pursuant to Rule 1016. If the NASD Board does not call the membership proceeding for review, the proposed written decision of the National Adjudicatory Council shall become final. The National Adjudicatory Council shall serve the Applicant with a written notice specifying the date on which the call for review period expired and stating that the final written decision will be served within 15 days after such date. The National Adjudicatory Council shall serve its final written decision within 15 days after the date on which the call for review period expired. The decision shall constitute the final action of the Association for purposes of SEC Rule 19d-3, unless the National Adjudicatory Council remands the membership proceeding.

**(4) Failure to Issue Decision**

If the National Adjudicatory Council fails to serve its final written decision within the time prescribed in subparagraph (3), the Applicant may file a written request with the NASD Board requesting that the NASD Board direct the National Adjudicatory Council to serve its decision immediately or to show good cause for an extension of time. Within seven days after [receipt] the filing of such a request, the NASD Board shall direct the National Adjudicatory Council to serve its written decision immediately or to show good cause for an extension of time. If the National Adjudicatory Council shows good cause for an extension of time, the NASD Board may extend the 15 day time limit by not more than 15 days.

**1016. Discretionary Review by NASD Board**

**(a) Call for Review by Governor**

A Governor may call a membership proceeding for review by the NASD Board if the call for review is made within the period prescribed in [sub]paragraph [(2)] (b).

**(b) 15 Day Period; Waiver**

A Governor shall make his or her call for review at the next meeting of the NASD Board that is at least 15 days after the date on which the NASD Board receives the proposed written decision of the National Adjudicatory Council. By unanimous vote of the NASD Board, the NASD Board may shorten the period to less than 15 days. By an affirmative vote of the majority of the NASD Board then in office, the NASD Board may, during the 15 day period, vote to extend the period to more than 15 days.

**(c) Review At Next Meeting**

If a Governor calls a membership proceeding for review within the time prescribed in paragraph (b), the NASD Board shall review the membership proceeding not later than the next meeting of the NASD Board. The NASD Board may order the Applicant and the Department to file briefs in connection with review proceedings pursuant to this paragraph.

**(d) Decision of NASD Board, Including Remand**

After review, the NASD Board may affirm, modify, or reverse the proposed written decision of the National Adjudicatory Council. Alternatively, the NASD Board may remand the membership proceeding with instructions. The NASD Board shall prepare a written decision that includes all of the elements described in Rule 1015[(i)(2)] (j)(2).

**(e) Issuance of Decision**

The NASD Board shall serve its written decision on the Applicant within 15 days after the meeting at which it conducted its review. The decision shall constitute the final action of the Association for purposes of SEC Rule 19d-3, unless the NASD Board remands the membership proceeding.

**1017. [Removal or Modification of Business Restriction] Application for Approval of Change in Ownership, Control, or Business Operations**

**(a) Events Requiring Application**

[A member of the Association may seek modification or removal of a restriction on its business activities imposed pursuant to the Rule 1010 Series by filing a written application with the Department at the district office for the district in which the member's principal place of business is located. The application shall present facts showing that the circumstances that

gave rise to the restriction have changed and state with specificity why the restriction should be modified or removed in light of the standards set forth in Rule 1014 and the articulated rationale for the imposition of the restriction. A copy of the decision and membership agreement pertaining to such restriction shall be appended to the 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 of the member's assets, unless 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) Filing and Content of Application**

(1) The member shall file the application with the Department at the district office in the district in which the member's principal place of business is located. If the application involves a merger between members with principal places of business in

two or more districts, the application shall be filed and processed by the district office wherein the surviving firm's principal place of business will be located.

(2) The application shall describe in detail the change in ownership, control, or business operations and include a business plan, pro forma financials, an organizational chart, and written supervisory procedures reflecting the change.

(A) If the application requests approval of a change in ownership or control, the application also shall include the names of the new owners, their percentage of ownership, and the sources of their funding for the purchase and recapitalization of the member.

(B) If the application requests the removal or modification of a membership agreement restriction, the application also shall:

(i) present facts showing that the circumstances that gave rise to the restriction have changed; and

(ii) state with specificity why the restriction should be modified or removed in light of the standards set forth in Rule 1014 and the articulated rationale for the imposition of the restriction.

(C) If the application requests approval of an increase in Associated Persons involved in sales, offices, or markets made, the application shall set forth the increases in such areas during the preceding 12 months.

**(c) Effecting Change and Imposition of Interim Restrictions**

(1) A member shall file an application for approval of a change in ownership or control at least 30 days prior to such change. A member may effect a change in

ownership or control prior to the conclusion of the proceeding, but the Department may place new interim restrictions on the member based on the standards in Rule 1014, pending final Department action.

(2) A member may file an application to remove or modify a membership agreement restriction at any time. An existing restriction shall remain in effect during the pendency of the proceeding.

(3) A member may file an application for approval of a material change in business operations, other than the modification or removal of a restriction, at any time, but the member may not effect such change until the conclusion of the proceeding, unless the Department and the member otherwise agree.

**(d) Rejection Of Application That Is Not Substantially Complete**

If the Department determines within 30 days after the filing of an application that the application is not substantially complete, the Department may reject the application and deem it not to have been filed. In such case, within the 30 day period, the Department shall serve a written notice on the Applicant of the Department's determination and the reasons therefor. If the Applicant determines to continue to apply for approval of a change in ownership, control, or business operations, the Applicant shall submit a new application under this Rule.

**[(b)] (e) Request for Additional Documents and Information**

Within 30 days after the [receipt] filing of an application [to remove or modify a restriction], the Department shall [determine whether the application is complete, and if not, shall] serve a request for any additional information or documents necessary

to render a decision [under paragraph (e)] on the application. The Department may serve subsequent requests for additional information or documents at any time during the application process. Unless otherwise agreed by the Department and the Applicant, the Applicant shall file any additional information and documents with the Department within 30 days after service of a request.

**[(c) Lapse]**

[(1) Absent a showing of good cause, an application to modify or remove a restriction shall lapse if an Applicant fails to:

(A) respond fully within 30 days after a request for information or documents;

(B) appear at or otherwise participate in a scheduled membership interview pursuant to paragraph (d); or

(C) return an executed membership agreement under paragraph (e)(4) within 25 days after service of the agreement.

(2) The lapse of an application shall require the Applicant to submit a new application to modify or remove a restriction under paragraph (a).]

**[(d)] (f) Membership Interview**

(1) The Department may require the Applicant to participate in a membership interview within 30 days after the [receipt] filing of the application, or if the Department requests additional information or documents, within 30 days after the filing of the additional information or documents by the Applicant.

(2) At least seven days before the membership interview, the Department shall serve on the Applicant a written notice that specifies the date and time of the interview and [the representative or representatives of the Applicant] persons who are required to participate in the interview. The Department shall serve the notice by facsimile or [commercial] overnight courier. The Applicant and the Department may agree to a shorter or longer period for notice or a different method of service.

(3) Unless the Department and the Applicant otherwise agree, the membership interview shall be conducted in the district office for the district in which the Applicant has its principal place of business.

(4) During the membership interview, the Department shall review the application and the considerations for the Department's decision set forth in paragraph [(e)(1)] (g)(1). The Department shall provide to the Applicant's representative or representatives any information or document that the Department has obtained from the Central Registration Depository or a source other than the Applicant and upon which the Department intends to base its decision under paragraph [(e)](g). If the Department receives such information or document after the membership interview or decides to base its decision on such information after the membership interview, the Department shall promptly serve the information or document and an explanation thereof on the Applicant.

**[(e)] (g) Department Decision**

(1) [In evaluating an application submitted under paragraph (a)] 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.

(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 maintenance of the restriction is appropriate in light of:

[(A)](i) the standards set forth in Rule 1014;

[(B)](ii) the circumstances that gave rise to the imposition of the restriction;

[(C)](iii) the Applicant's operations since the restriction was imposed;

[(D)] (iv) [a] any change in ownership or control or supervisors and principals; and

[(E)](v) any new evidence submitted in connection with the application.

(2) The Department shall [issue] serve a written decision on the application within 30 days after the conclusion of the membership interview or the [submission] filing of additional information or documents, whichever is later. If the Department does not require the Applicant to participate in a membership interview or request additional information or documents, the Department shall [issue] serve a written decision within 45 days after the [receipt] filing of the application under paragraph (a). The decision shall state whether the application [to modify or remove the restriction] is granted or denied in whole or in part, and shall provide a rationale for the Department's decision, referencing the applicable standard in Rule 1014.

(3) If the Department fails to [issue] serve a decision within 180 days after [receipt] filing of an application or such later date as the Department and the Applicant have agreed in writing, the Applicant may file a written request with the NASD Board requesting that the NASD Board direct the Department to issue a decision. Within seven days after [receipt] the filing of such a request, the NASD Board shall direct the Department to issue a written decision immediately or to show good cause for an extension of time. If the Department shows good cause for an extension of time, the NASD Board may extend the time limit for issuing a decision by not more than 30 days.

(4) If the Department [modifies or removes a restriction on the Applicant's business activities, the] approves an application under this Rule in whole or part, the Department shall require an Applicant to file an executed membership agreement [submitted under Rule 1014 shall be modified accordingly].

**[(f)](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 the Association is [issued] served under Rule 1015 or 1016, unless otherwise directed by the National Adjudicatory Council, the NASD Board, or the Commission.

**[(g)](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 a review, the Department's decision shall constitute final action by the Association.

**[(h)](j) Removal or Modification of Restriction on Department's Initiative**

The Department shall modify or remove a restriction on its own initiative if the Department determines such action is appropriate in light of the considerations set forth in paragraph [(e)(1)](g)(1). The Department shall notify the member in writing of the Department's determination and inform the member that it may apply for further modification or removal of a restriction by filing an application under paragraph (a).

**[(k) Lapse or Denial of Application for Approval of Change in Ownership**

If an application for approval of a change in ownership lapses, or is denied and all

appeals are exhausted or waived, the member shall, no more than 60 days after the lapse or exhaustion or waiver of appeal:

- (1) submit a new application;
- (2) unwind the transaction; or
- (3) file a Form BDW.

For the protection of investors, the Department may shorten the 60 day period. For good cause shown by the member, the Department may lengthen the 60 day period. The Department shall serve written notice on the Applicant of any change in the 60-day period and the reasons therefor. During the 60-day or other imposed period, the Department may continue to place interim restrictions on the member for the protection of investors.

**[1018. Change in Ownership, Control, or Operations]**

**[(a) Notice]**

At least 30 days prior to the occurrence of any of the following changes in ownership, control, or operations, a member shall file a written notice and application for continuance in membership with the Department at the district office in the district in which the member's principal place of business is located:

- (1) a merger of the member with another member;
- (2) an acquisition by the member of another member;
- (3) an acquisition of substantially all of the member's assets;
- (4) a change in the equity ownership or partnership capital of the member that results in one person or entity owning or controlling 25 percent or more of the equity or partnership capital; or

(5) a material change in the member's business operations.]

**[(b) Review and Imposition of Interim Restrictions**

The Department shall review a change in ownership, control, or operations described in paragraph (a) prior to the change taking effect. The Department may maintain existing restrictions on the member's business activities and place new interim restrictions on the member based on the standards in Rule 1014, pending final Department action.]

**[(c) Request for Information**

Within 30 days after receipt of the notice and application under paragraph (a), the Department shall request any additional information or documents necessary to render a decision under paragraph (f). Unless otherwise agreed by the Department and the Applicant, the Applicant shall file such additional information or documents with the Department within 30 days after the Department's request. The Department may request additional information and documents at any time during the application process; unless the Applicant and the Department agree otherwise, the Applicant shall file such information or documents within 30 days after the Department's request.]

**[(d) Lapse**

(1) Absent a showing of good cause, an application for continuance in membership shall lapse if an Applicant fails to:

(A) respond fully within 30 days after a request for information or documents;

(B) appear at or otherwise participate in a scheduled membership interview pursuant to paragraph (e); or

(C) return an executed membership agreement under paragraph (g) within 25 days after service of the agreement.

(2) The lapse of an application shall require the Applicant to submit a new application under paragraph (a).]

**[(e) Membership Interview**

(1) The Department may require the Applicant to participate in a membership interview. The membership interview shall be held within 30 days after the receipt of the application, or if the Department requests additional information or documents, within 30 days after the filing of such additional information or documents by the Applicant.

(2) At least seven days before the membership interview, the Department shall serve on the Applicant a written notice that specifies the date and time of the interview and the representative or representatives of the Applicant who are required to participate in the interview. The Department shall serve the notice by facsimile or commercial courier. The Applicant and the Department may agree to a shorter or longer period for notice or a different method of service.

(3) Unless the Department and the Applicant otherwise agree, the membership interview shall be conducted in the district office for the district in which the Applicant has or intends to have its principal place of business.

(4) During the membership interview, the Department shall review the application and the considerations for the Department's decision set forth in paragraph (f). The Department shall provide to the Applicant's representative or representatives

any information or document that the Department has obtained from the Central Registration Depository or a source other than the Applicant and upon which the Department intends to base its decision under paragraph (f). If the Department receives such information or document after the membership interview or decides to base its decision on such information after the membership interview, the Department shall promptly serve the information or document and an explanation thereof on the Applicant.]

**[(f) Department Decision**

(1) In evaluating an application submitted under paragraph (a), the Department shall consider whether the Applicant continues to meet the standards set forth in Rule 1014 in light of the change in ownership, control, or operations, and whether current restrictions, if any, or new restrictions are necessary for the Applicant to continue to meet such standards.

(2) The Department shall issue a written decision within 30 days after the membership interview or the submission of additional information or documents, whichever is later. If the Department does not require the Applicant to participate in a membership interview or submit additional information or documents, the Department shall issue a written decision within 45 days after receipt of an application under paragraph (a). The decision shall state the terms for continuance in NASD membership, whether current restrictions, if any, are maintained or new restrictions are imposed, and shall provide a rationale for the Department's decision, referencing the applicable standard in Rule 1014.

(3) If the Department fails to issue a decision within 180 days after receipt of an application or such later date as the Department and the Applicant have agreed in writing, the Applicant may file a written request with the NASD Board requesting that the NASD Board direct the Department to issue a decision. Within seven days after receipt of such a request, the NASD Board shall direct the Department to issue a written decision immediately or to show good cause for an extension of time. If the Department shows good cause for an extension of time, the NASD Board may extend the time limit for issuing a decision by not more than 30 days.]

**[(g) Submission of Membership Agreement**

The Department may condition approval of an application for continuance in membership on the Applicant's submission of a new written membership agreement pursuant to Rule 1014(c).]

**[(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 the Association is 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 a 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 action shall constitute the final action of the Association.]

**1018. Stay of Application During Pendency of Criminal or Other Proceeding**

(a) The Department may stay an application filed under Rule 1013 or 1017 if:

(1) a state or federal authority files criminal charges against the Applicant or a principal or proposed principal of the Applicant;

(2) the Commission files a complaint or a request for injunctive relief against the Applicant or a principal or proposed principal of the Applicant; or

(3) the Association, another self-regulatory organization, or a state files a disciplinary complaint against the Applicant or a principal or proposed principal of an Applicant alleging a violation of a law or rule listed in IM-1011-1 (or a comparable state law, rule, or regulation).

In such case, the application shall be stayed during the pendency of the proceeding. If the Department has imposed interim restrictions under Rule 1017(c), the restrictions shall remain in effect during the stay.

(b) If the Applicant or principal or proposed principal prevails in the proceeding, the stay shall be lifted automatically.

(c) If there is a material change in the circumstances that gave rise to the stay, the Applicant may file a written request with the Department to lift the stay. The Department shall serve a written response on the Applicant within 14 days after the filing of the request by the Applicant. If the Department denies the request, the Applicant may file a written request for

review with the National Adjudicatory Council. The National Adjudicatory Council or the Review Subcommittee shall serve a written response on the Applicant within 30 days.

**1019. Application to Commission for Review**

No change.

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**Rule 1140. Electronic Filing Rules**

(a) Filing Requirement

Except as provided in Rule 1013(a)(2), all [All] forms required to be filed by the By-Laws shall be filed through an electronic process or such other process the Association may prescribe to the Central Registration Depository.

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II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

NASD Regulation proposes to amend the Rule 1010 Series, which governs NASD membership. NASD Regulation staff worked with the Member Admission Review Committee (Committee),<sup>3</sup> an ad-hoc committee convened in August 1998, to develop the proposed changes. The purpose of the proposed rule change is to streamline the Rules and make them more efficient while preserving their investor protection function.

The most significant changes are as follows:

- reorganizing and consolidating some of the current rules to make them easier to use;
- clarifying the rules and policies that apply to business expansions by—
  - adopting a policy of building expansion plans into membership agreements,
  - defining in the rules what kinds of "material changes in business operations" require a member to file an application for approval with NASD Regulation, and

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<sup>3</sup> Members of the Committee are: Faith Colish, New York, New York; Linda Lerner, All-Tech Investment Group, Inc., Montvale, New Jersey; Brian T. Shea, Pershing, Jersey City, New Jersey; Theodore W. Urban, Ferris, Baker & Watts, Incorporated, Washington, D.C.; and Richard P. Woltman, Spelman & Co., Inc., San Diego, California. Mr. Urban chairs the Committee.

- providing a safe harbor for modest expansions that will not require an application,

which together are intended to provide more even-handed treatment among members for various business expansions, provide more certainty regarding which expansions require approval, and eliminate unnecessary applications;

- permitting the staff to stay membership applications if a firm or one of its principals is the subject of a disciplinary action;
- permanently rescinding the National Adjudicatory Council's authority to review membership decisions that are not appealed by an Applicant;
- simplifying administrative procedures for submitting an application and calculating the various time limits that apply to the process; and
- permitting the staff to reject immediately applications that are not substantially complete.

A detailed explanation of the proposed rule change follows.

### **Proposed Rule 1011**

The definition of "Associated Person" is amended to clarify that it includes only natural persons.

The term "material change in business operations" is defined for the first time. The definition is significant because it triggers a requirement for a member to apply to the district office for approval of the change under proposed Rule 1017. The term is

defined to include removing or modifying a membership agreement restriction;<sup>4</sup> market making, underwriting, or acting as a dealer for the first time; or adding business activities that require a higher minimum net capital.

NASD Regulation does not believe that it is possible to develop an exhaustive definition of the term "material change in business operations." If a change in a member's business falls outside of the definition, or the safe harbor described below (e.g., because it exceeded the safe harbor limits or the member has disciplinary history), then member may contact the district office to determine if the district would deem the change to be material. A member is not required to contact the district office if the member believes the change is not material. However, if the staff later determines that the change is indeed material, then the member potentially could be subject to disciplinary action for failure to file an application under proposed Rule 1017.

Proposed Interpretive Material 1011-1 (IM-1011-1) is added to create a safe harbor for certain changes that are presumed not to be material and therefore do not require a member to submit an application for approval of the change. The safe harbor would not be available to members that have a "disciplinary history." "Disciplinary history" means a finding of a violation by the member or a principal of the member in the past five years by the Commission, a self-regulatory organization, or a foreign financial

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<sup>4</sup> NASD Regulation included removing or modifying a restriction in this definition to effect the consolidation of current Rules 1017 and 1018. The rationale for the consolidation is set forth in the section titled "Proposed Rule 1017," below.

regulatory authority of one or more of the following provisions (or comparable foreign provisions) or rules or regulations thereunder: Sections 15(b)(4)(E) and 15(c) of the Securities Exchange Act of 1934 (failure to supervise; fraud and manipulation); Section 17(a) of the Securities Act of 1933 (fraudulent interstate transactions); SEC Rules 10b-5 (fraud and manipulation), and 15g-1 through 15g-9 (penny stock rules); NASD Rules 2110 (just and equitable principles of trade), 2120 (fraud and manipulation), 2310 (suitability), 2330 (protection of customer securities and funds), 2440 (fair prices and commissions), 3010 (failure to supervise only), 3310 (manipulative and deceptive quotations), and 3330 (payments to influence market prices); and MSRB Rules G-19 (suitability), G-30 (prices and commissions), and G-37(b) & (c) (political contributions).

The term "principal place of business" is defined for the first time. An Applicant's principal place of business determines which district office will process its application.

"Principal place of business" means the location where the officers, partners, or managers direct and control the activities of the Applicant, unless NASD Regulation staff designates a different location. That location may be where the largest number of associated persons are located or where the books and records are kept. This definition is designed to prevent an Applicant from trying to select a particular district office to process its application through its designation of a principal place of business.

NASD Regulation proposes to redefine "sales practice violations" as "sales practice event" because the definition includes not only proven violations, but also

unproven allegations.<sup>5</sup> The proposed definition includes any customer complaint, arbitration, or civil litigation that has been or is required to be reported to the Central Registration Depository ("CRD") or otherwise is required to be reported to the Association (e.g., via Rule 3070).

The terms "Applicant" and "Interested Association Staff" are amended to make them consistent with other rule changes.

### **Proposed Rule 1012**

NASD Regulation proposes to amend the service and filing provisions to permit additional methods of delivery and to use consistent terminology for calculating deadlines. The term "commercial courier" is replaced with "overnight courier" to clarify that Applicants and NASD Regulation staff may use the overnight delivery service offered by the United States Post Office. NASD Regulation interprets the term "overnight courier" to refer to any entity that regularly provides such overnight delivery services, such as Federal Express, DHL, or the United States Post Office. Use of the term "overnight courier" is not intended to imply that only actual overnight delivery may be used under the Rule. Overnight delivery should be used if it is available. However, if overnight delivery is not available for a particular location, the Applicant or NASD Regulation staff may use the most rapid delivery option available (e.g., two day service) from the overnight courier and still be in compliance with the proposed Rule.

Throughout the proposed rules, the term "file" is used uniformly to refer to submissions by an Applicant, and the term "serve" is used uniformly to refer to delivery

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<sup>5</sup> NASD Regulation is not proposing any change to the definition of sales practice violation on the Form U-4.

of requests, decisions, and the like by the Association; other terminology, such as "issuance" or "receipt" is deleted.<sup>6</sup> These changes provide greater clarity in calculating deadlines in accordance with proposed Rule 1012(a).

The lapse of application provisions are consolidated and moved from Rules 1013(b), 1017(c), and 1018(d) to proposed Rule 1012(b) for ease of reference. The lapse rule, which is discussed in greater detail in the next section, permits the staff to discontinue processing an application if an Applicant does not timely provide requested information or documents. The only changes to the lapse rule are to permit the staff and the Applicant to agree on a submission date for the membership agreement, rather than requiring that all agreements be submitted within 25 days, and clarify that fees are not refunded for lapsed applications.

The subparagraphs of Rule 1012(c) are reordered for ease of reading.

### **Proposed Rule 1013**

One of the major changes to this Rule is to simplify application submission procedures. Currently, this Rule requires Applicants to submit their applications in two parts. Part One, which includes primarily forms and fees (e.g., the initial Forms BD and U-4), is sent directly to the CRD in Rockville, Maryland, for processing. Part Two, which includes all remaining documents required for member admission, is sent to the district office that will review the application. At the time the rule was adopted, the staff thought it would be more efficient to send each part to the location where it would be processed. In practice, this has created problems when both parts of the application are not submitted at the same time, or one or both parts are incomplete, making it difficult to determine when the application should be

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<sup>6</sup> See, e.g., proposed Rule 1013(a)(5) and (b)(1), Rule 1014(c)(3).

treated as filed and when the staff should begin reviewing it. The application filing date is critical because the 180-day limitation placed on the staff for rendering a decision on the application is measured from this date.

To alleviate these problems, NASD Regulation recommends one point of entry for the entire application, the district office. District staff will review the entire application to determine if it is substantially complete. If so, they will forward any documents that need to go to CRD and continue processing the application.

NASD Regulation proposes a new rule for dealing with applications that are not substantially complete at the time of submission. Currently, the staff does not have any authority to refuse to begin processing an inadequately prepared application. Instead, they attempt to begin processing such an application by sending a request for further information to the Applicant. If the Applicant does not timely provide the requested information, then the rules permit the staff to "lapse" the application. The staff then notifies the Applicant that the application has lapsed, all fees are forfeited, and the Applicant is required to start over with the application process if it still wants to become an NASD member. These procedures can consume as much as 90 days and a considerable amount of staff and Applicant resources, but still result in a rejected application.

Under the proposed rule, if an application is so deficient upon initial submission that the staff cannot begin processing it (e.g., it is missing major components of the application, such as written supervisory procedures or a business plan), then the staff may reject the application. The staff would have no more than 30 days after submission to do this, and would be required to provide reasons for its action in writing. NASD Regulation proposes a

\$350 processing fee for the rejection of an application that is not substantially complete.

NASD Regulation considered but rejected defining the term "substantially complete" because the determination will vary depending on the type and complexity of the proposed business, among other things. The lapse rules will still apply to those situations where an Applicant stops providing information in the middle of the application process.

Rule 1013 also is simplified by removing requirements for Applicants to submit information that has already been submitted to CRD. The district staff has full access to CRD and can obtain the information they need directly from it. This change will make the application process simpler for Applicants by eliminating duplicative submissions to NASD Regulation.

Under the proposed Rule 1013(a)(2), an Applicant will continue to submit only its initial Forms BD and U-4 in paper along with the rest of the application. The Applicant also will submit a Web CRD entitlement request form with its application. Under proposed Rule 1013(a)(3), upon approval of the Web CRD entitlement request form by NASD Regulation, the Applicant must make all subsequent Form filings and amendments electronically via Web CRD<sup>sm</sup>. A conforming change is proposed for Rule 1140. This process will be in conformity with Commission requirements for the submission of Form BD and amendments to it.<sup>7</sup> Similarly, the initial Member Contact Questionnaire and user access request form also are submitted on paper; upon approval of a membership application, the member may update the Member Contact Questionnaire electronically.

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<sup>7</sup> See Exchange Act Rel. No. 41594 (Jul. 2, 1999), 64 FR 37586 (Jul. 12, 1999).

The proposed rule adds new requirements for Applicants to submit information concerning their ability to ensure business continuity, including information about the capacity of their communications and operational systems, contingency plans, disaster recovery plans, and the like. NASD Regulation also proposes a new standard for admission that requires that such systems, plans, and procedures be adequate in proposed Rule 1014(a)(6). The staff would not be required to investigate the adequacy themselves; rather, the Applicant would certify that the systems, plans, and procedures are adequate for the Applicant's business. The Applicant may self-certify or may rely on a third party (e.g., a vendor of such a system) to provide the certification if the Applicant so chooses.

NASD Regulation also wishes to clarify that under Rule 1013(b)(4), the Applicant and the staff may agree to hold the membership interview at the Applicant's place of business.

Rule 1013 is amended by adding new subparagraph (b)(5) to require Applicants to provide updated financial information at the time of their membership interview.

#### **Proposed Rule 1014**

NASD Regulation proposes few changes with respect to the standards for admission. NASD Regulation proposes a new standard with respect to business continuity, as described above. NASD Regulation also proposes that the Applicant's supervisory procedures must specifically include procedures to ensure proper registrations are obtained by the firm. All other changes to the standards for admission are conforming changes.<sup>8</sup>

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<sup>8</sup> NASD Regulation also wishes to provide some guidance on how it treats unadjudicated violations under Rule 1014. The Rule permits the staff to consider unadjudicated violations as part of a decision on a membership application. In most cases, an unadjudicated violation by itself will not result in a restriction or a denial, but

NASD Regulation also considered the requirement of Rule 1014(a)(9)(C) that prospective supervisors have at least one year of direct experience or at least two years of related experience in the subject area to be supervised. NASD Regulation believes that this requirement should continue to be imposed and has published interpretive guidance on this subject in [How To Become A Member](#), which is available at [www.nasdr.com/4700\\_toc.htm](http://www.nasdr.com/4700_toc.htm). NASD Regulation does not believe that supervisory experience requirements should be increased.

Rule 1014(c), which concerns the submission of membership agreements, is amended by deleting the requirement that any member with a membership agreement obtain approval from NASD Regulation of any change in business outside the terms of the agreement. NASD Regulation believes that this provision is too restrictive, particularly for firms with no disciplinary history. The provision also puts members with a membership agreement at a disadvantage vis-à-vis members that do not have a membership agreement.<sup>9</sup> Therefore, this provision is deleted. When the proposed rule change becomes effective, to ensure that

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depending on the circumstances, may require heightened supervision. However, a particularly egregious allegation, e.g., a criminal charge involving a large number of customers, may cause the staff to consider a restriction or denial.

<sup>9</sup> In 1984, the SEC approved a codification of the NASD's member admission procedures, which included a requirement that any restriction on a member's business be included in a membership agreement executed by the member. See Exchange Act Rel. No. 21159, 49 FR 30268 (Jul. 27, 1984) (File No. SR-NASD-82-24). Thus, a member admitted before 1984 or a member admitted without any restriction from 1984 to 1997 may not have a membership agreement. In 1997, NASD Regulation began requiring all new members to execute a membership agreement, regardless of whether NASD Regulation imposed any restriction. See NASD Rule 1014(c); Exchange Act Rel. No. 38908 (Aug. 7, 1997); 62 FR 43385 (Aug. 13, 1997) (File No. SR-NASD-97-28).

members are treated equally, NASD Regulation will permit members that are eligible for the safe harbor to use it, even if their membership agreement includes a general requirement to obtain approval from NASD Regulation of any change in business outside the terms of the agreement. When NASD Regulation examines a member, it will update the membership agreement to reflect the new rule. As part of the proposed rule change, paragraphs 1014(c) and (d) also are reordered for ease of reading.

In addition, upon adoption of the proposed rules, NASD Regulation will begin including business expansions plans in membership agreements to the extent practicable.

### **Proposed Rule 1015**

Under current Rule 1015, the NAC or the Review Subcommittee may call for review a district decision on a membership application, even if the Applicant does not appeal the decision. NASD Regulation considered at length whether a procedure or policy could be developed to implement this provision effectively, but ultimately determined that it is unworkable. NASD Regulation has temporarily suspended calls for review of membership decisions and proposes to delete this provision altogether for the reasons set forth in Exchange Act Rel. No. 41311 (Apr. 20, 1999), 64 FR 20347 (Apr. 26, 1999) (File SR-NASD-99-15).

NASD Regulation believes that the oversight function envisioned for the call for review provision, which has proved to be unworkable, is performed through a variety of other existing mechanisms. The Home Office of the Member Regulation Department employs a full time Membership Manager to coordinate and oversee the national program. Part of these responsibilities includes a quality control function. This function is carried out in several ways:

maintenance of a Membership Procedures Manual; periodic advice memoranda sent to District Office staff ("MAP Bulletins"); regularly scheduled telephone conferences with District Office staff to discuss procedural and substantive issues arising in the program; and periodic training sessions for new and incumbent staff. To supplement these tools, Member Regulation's Office of Quality Assurance conducts periodic peer reviews of the membership admission program, most recently in 1998 and 1999. The purpose of these peer reviews was to assess the District Offices' application of the membership rules and procedures. The reviews included an examination of 265 files in recently-issued membership decisions. The reviews included spot checks of source documents to confirm the facts underlying the decisions. In addition, peer reviews of the membership program will be conducted in the future.

NASD Regulation also proposes a new paragraph (h) for dismissing appeals that are abandoned by an applicant, which includes failing to appear at a hearing as set forth in current Rule 1015(f)(5), among other things.

### **Proposed Rule 1017**

Current Rule 1017, which addresses applications for removal or modification of a business restriction, and Rule 1018, which addresses applications for approval of changes in ownership, control, or operations, are consolidated in a proposed Rule 1017. Sometimes a member initiates business changes that involve both rules, which creates confusion as to which rule should be used. Therefore, NASD Regulation proposes to consolidate these rules to make them easier for staff and applicants to use and to eliminate any confusion that may arise from overlapping provisions.

This consolidation is achieved in part by defining the term "material change in business operations" in proposed Rule 1011(i) to include the removal or modification of a business restriction. All material changes in business operations would trigger a review under proposed Rule 1017. Members should note that a "restriction" is specifically labeled as such in the membership agreement, and NASD Regulation issues a decision that states the rationale for the restriction.

A restriction is distinct from other limitations that a member may set forth in its business plan that may be recited as part of the "Business Activities" section of a membership agreement. For example, an applicant may include in its business plan that it intends to have 10-20 registered representatives and make markets in no more than 10 stocks. If the NASD approves the application, these self-imposed limitations, which have been considered as part of the application, may be included in the "Business Activities" section of the membership agreement. These types of limitations are not considered "restrictions" under the Rules because they are not imposed by NASD Regulation, and therefore NASD Regulation does not have to include a rationale for them in the decision in the application. Under the proposed Rules, a member that has such limitations in its membership agreement may expand beyond those limitations to the extent permitted in the safe harbor in IM-1011-1.

In contrast, for example, NASD Regulation may specifically restrict the number of markets a member makes because NASD Regulation determines and issues a decision stating that the member cannot adequately supervise a large number of markets. In such a case, the restricted member cannot take advantage of the safe harbor in proposed Rule 1011 and must apply under proposed Rule 1017 to lift the restriction.

Another type of change that triggers an application under proposed Rule 1017 is a change in the equity ownership or partnership capital of the member that results in one person or entity owning or controlling 25 percent or more of the equity or partnership capital. NASD Regulation wishes to clarify that a group of individuals acting in concert to obtain control of 25 percent or more of the equity or partnership capital of a member will be deemed to be an "entity" under the Rule, and as such, trigger the requirement to submit an application to obtain approval of the ownership change.

NASD Regulation proposes to discontinue its review of certain changes. Under proposed Rule 1017, NASD Regulation would discontinue review of member mergers and acquisitions that are reviewed by the New York Stock Exchange, thereby eliminating duplication by self-regulatory organizations.

Proposed Rule 1017 also sets forth for the first time what type of information should be included in an application and the content of the staff's decision on an application under this Rule. The Rule also clarifies when the application should be filed and what changes can be effected prior to obtaining NASD Regulation's approval.

NASD Regulation proposes a new paragraph (k) to clarify what happens if a change in ownership application lapses or is denied. The proposed rule change provides that if the ownership change application lapses or is denied, then the member has a fixed period of time to submit a new application,<sup>10</sup> unwind the transaction, or file a Form BDW. Of course, as under the current rules, a member could continue to operate with the approved owners if the

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<sup>10</sup> A lapsed Applicant may propose the same owners; a denied Applicant must propose new owners.

transaction has not closed. The Department may shorten the 60-day period for the protection of investors or lengthen it upon good cause shown by the Applicant. The Department may continue to place interim restrictions on the member during the 60-day (or other imposed) period. NASD Regulation's practice has been to inform Applicants of these options, but not impose particular deadlines. The purpose of the proposed rule change is to provide more structure to this process and ensure that members who do not timely obtain approvals of ownership changes are not doing business with the public.

As part of its review of the Rule 1010 Series, NASD Regulation considered whether the time frames in Rule 1017 could be shortened so that the overall process would be completed in 90 days. NASD Regulation determined not to shorten the time frames at this time because other rule revisions (e.g., defining material change in operations and listing the documents required for the application), should speed up processing of applications. NASD Regulation also intends to publish on its Web site further guidance to members on what types of documents and information the staff will require if a member requests approval to engage in certain specialized areas of the securities or investment banking business. NASD Regulation believes that these changes should be given a chance to work before any time frames are shortened. NASD Regulation will reconsider the issue one year after the rule revisions have become effective and more information is available about the processing time for applications.

### **Proposed Rule 1018**

NASD Regulation proposes to adopt a new Rule 1018, which would permit the staff to stay a membership application under Rule 1013 or 1017 if a state or federal authority files criminal charges against the Applicant or a principal or proposed principal of the Applicant;

the SEC files a complaint or a request for injunctive relief against the Applicant or a principal or proposed principal of the Applicant; or the NASD, another self-regulatory organization, or a state files a complaint alleging a violation of one of the laws or rules listed in IM-1011-1 (or a comparable state provision).

Under the proposed rule, the stay would be lifted automatically if the Applicant prevailed in the disciplinary action. The staff also would be authorized to lift the stay if circumstances changed. If the staff denied the request to lift the stay, the Applicant could appeal to the National Adjudicatory Council.

## 2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. Section 15 (a)(b)(18) requires that a national securities association establish rules providing a fair procedure for the denial of membership in such association. NASD Regulation believes that the proposed rule change is consistent with these Sections because it provides better notice to applicants about the various requirements of the application processes, simplifies and clarifies the rules, and better protects investors by circumscribing expansions by members with disciplinary histories and by permitting the Association in certain circumstances to stay applications by members who are subject to disciplinary action. The proposed rule change also provides better notice to applicants whose change in ownership is denied by informing them of their options once the denial is final.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The proposed rule change was published for comment in NASD Notice to Members 99-67. Two comments were received in response to the Notice. A copy of the Notice to Members is attached as Exhibit 2. A copy of the comment letters received in response to the Notice are attached as Exhibit 3.

The commenters raised several issues. One commenter, the Jeffrey Matthews Financial Group LLC, stated that the staff has been given too much time to review an Applicant's submission and request additional information. As part of its deliberations on the proposed rules, NASD Regulation considered shortening certain deadlines. NASD Regulation determined not to shorten the time frames at this time because other rule revisions (e.g., defining material change in operations and listing the documents required for the application) should speed up processing of applications. NASD Regulation also has provided additional guidance to members on what types of documents and information the staff will require if a member requests approval to engage in certain specialized areas of the securities or investment banking business. This guidance is posted at [www.nasdr.com/cm\\_apps\\_1.htm](http://www.nasdr.com/cm_apps_1.htm). NASD Regulation concluded that these changes should be given a chance to work before any time frames are shortened. NASD Regulation will reconsider the issue one year after the rule revisions have become effective and more

information is available about the processing time for applications. In the meantime, NASD Regulation will make every effort to respond promptly and within the time limits to each submission of information.

This same commenter also suggested that a member should be permitted to add business activities without approval from NASD Regulation if the revenues from the activity are less than five percent of total revenue. Certain types of business expansions (adding a limited numbers of sales personnel, offices, and markets) are permitted under the proposed safe harbor. After further consideration of this comment by the Board, NASD Regulation determined to revise the definition of material change in business operations as proposed in Notice To Members 99-67 so that the definition would not apply to adding any new type of business, but only to adding market making, underwriting, or acting as a dealer for the first time.

The California Association of Independent Broker-Dealers ("CAIBD") also submitted a comment letter. CAIBD stated that: (1) the staff has too much discretion in determining whether a member should be permitted to expand; (2) NASD Regulation does not need to ask for lease arrangement information or descriptions of communications and operations systems; (3) supervisory experience should not be required; (4) membership interviews should be waived in certain circumstances; (5) a list of persons to be registered should not be required; and (6) an Applicant should not be required to describe the volatility of its products.

First, NASD Regulation does not believe that the staff has too much discretion in rendering a decision on a member's application to expand its business. Indeed, the criteria for approval of membership applications is set forth in detail in Rule 1014. To the extent a

decision on an application is denied in whole or in part or approved subject to restrictions, the rules require that the reason for the denial or imposition of restrictions be specifically explained, referencing the applicable standard for membership upon which the decision is based.

Furthermore, as part of its proposal, NASD Regulation is creating a safe harbor that will permit members to undertake certain types of business expansions without obtaining NASD Regulation approval. NASD Regulation believes that it is appropriate to continue exercising discretion in reviewing expansions outside of the safe harbor because such expansions could be material.

Second, NASD Regulation has routinely required Applicants to provide information about their lease arrangements. This permits NASD Regulation to verify certain aspects of an application. For example, an Applicant that proposed to have a very small number of registered persons in most cases would lease space commensurate with staffing. If that Applicant instead leased a very large space, NASD Regulation would most likely request further information about the business purpose for the lease and to ensure that the Applicant was not planning an unapproved expansion. Likewise, if an applicant proposed to employ a large number of associated people in a relatively small space, NASD Regulation would question the Applicant's ability to support the number of personnel proposed from both a supervisory and operational standpoint.

Third, NASD Regulation determined that it should begin asking Applicants for information about their ability to ensure business continuity, including information about the capacity of their communications and operational systems, contingency plans, disaster

recovery plans, and the like. The staff would not be required to investigate the adequacy themselves; rather, the applicant would certify that the systems, plans, and procedures are adequate for the applicant's business. The applicant may rely on a third party (e.g., a vendor of such a system) to provide the certification if the applicant so chooses. This review will be less extensive in the case of an introducing broker-dealer that is relying on the systems of a clearing broker.

Fourth, NASD Regulation staff, as well as the NAC and the District Committees, have expressed the view that the experience requirement for supervisors is appropriate. In some cases, NASD Regulation has appropriately denied membership or a business expansion application where the Applicant has not demonstrated any experience in the proposed business line.<sup>11</sup> NASD Regulation believes that this experience requirement serves an important investor protection function.

Fifth, NASD Regulation believes that membership interviews are essential for new member Applicants under Rule 1013. The in-person interview plays an important role in determining whether the Applicant and its principals are knowledgeable about the legal and regulatory requirements of operating a broker-dealer and can demonstrate that they are capable of complying with all laws and regulations, as required by the membership standard in proposed Rule 1014(a)(3). Interviews with a current member applying to remove a restriction or expand its business are not required by the rules, but may be held at the election of staff under proposed Rule 1017.

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<sup>11</sup> In the Matter of Sierra Nevada Securities, Inc., Exchange Act Rel. No. 41330, 1999 SEC LEXIS 833, Apr. 26, 1999.

Sixth, a list of prospective registered persons is also essential to rendering a decision under proposed Rule 1014. NASD Regulation must check the disciplinary history of all such persons in determining whether an Applicant meets the standards set forth in proposed Rule 1014(a)(3) and (10).

Finally, NASD Regulation believes taking the volatility of a firm's products into consideration is necessary in order to assess a firm's ability to maintain an adequate net capital level under SEC Rule 15c3-1 and the adequacy of the firm's procedures for supervising its financial and operational functions.

NASD Regulation requested, but did not receive, comment on several issues in NTM 99-67. NASD Regulation has determined to retain the safe harbor numbers as proposed in the Notice. However, NASD Regulation has determined that the definition of disciplinary history should be amended to include violations by officers or principals of the member. NASD Regulation also has determined that restrictions in a membership agreement should not automatically sunset after a fixed period (e.g., five years) if the applicant does not have any disciplinary history; instead, restrictions will continue to be individually reviewed. Finally, NASD Regulation determined that it should clarify what happens if a change in ownership is denied and has proposed Rule 1017(k) to address this situation.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND  
TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it

finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-99-67 and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

Jonathan G. Katz  
Secretary

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<sup>12</sup> 17 CFR 200.30-3(a)(12).