

Notices to Members

YEAR 2000 UPDATE



NASD
NASDAQ AMEX
NASD
REGULATION

August 1999

Broker/Dealer Day Zero Preparation

Over the weekend of January 1 and 2, 2000, broker/dealers will begin assessing the need to invoke their written contingency or disaster recovery plans. These plans should reflect potential scenarios that could be encountered during this unique transition. Firms will implement contingency and disaster recovery plans to the degree necessary to ensure a continuation of those business functions critical to maintain business as usual in the event of Year 2000-related problems.

A Year 2000 Contingency Plan should include the following:

1. Identification of primary business mission-critical functions.
2. Criteria for invoking the plan.
3. How long operations can continue in recovery mode.
4. Roles and responsibilities.
5. Assigning and reallocation of resources.
6. Procedures for returning to normal operating mode.
7. Procedures for recovering lost business events or data.
8. Criteria to abort the functions and relocate operations to a separate business continuity site.
9. Procedures to notify the National Association of Securities Dealers, Inc. (NASD¹) of the new business continuity location.¹
10. Scenarios and event plans that include a schedule of activities, dependencies, and resources.

Firms should prepare event scenarios to cover the loss of computers, telephones, building facilities, vendors, and electricity. The information below will assist firms in preparing scenarios by ensuring that answers and plans exist for each of the questions.

January 1, 2000 And January 2, 2000

1. Are key personnel in offices or available?
2. Are building locations accessible?
3. Are elevators and utilities operating?
4. Are all telephones, fax machines, and e-mail lines operational?
5. Are all computers, mainframes, and servers operational?
6. Are electronic links/connections operating?
7. Are you aware of any reports of industry or investor problems?

January 3, 2000 (1st Business Day)

1. Are key personnel in offices or available?
2. Are building locations accessible?
3. Are elevators and utilities operating?
4. Are all mission-critical trading and settlement systems up and running?
5. Are all telephones, fax machines, and e-mail lines operational?
6. Are all computers, mainframes, and servers operational?
7. Are order/entry/trading systems operating?
8. Are trade processing and overnight batch process operating?
9. Are connections to service bureaus operational?
10. Are pricing systems up and running?
11. Are connections to markets operational?
12. Were access and connections to clearing and settlement organizations made?
13. Does the firm have access to banks, fedwire, and other money mobilizations?
14. Are connections to foreign locations running?
15. Can the firm receive data from vendor links?

January 3, 2000 (End of Day)

1. Were there any business disruptions?
2. Did end-to-day processing run properly?
3. Were there any problems reported?

Footnote

¹Broker/dealers with plans to prepare another location as a business contingency site as part of their contingency plans do not have to register the site as a branch office at this time. However, if the site is activated, firms will be required to notify the NASD with site information and may need to register the site as a branch office depending on the types of activities conducted at the site.

YEAR 2000 UPDATE

Business Continuity Sites

If your business systems fail due to infrastructure-related issues that can be resolved by moving to a business continuity site, then such a site should be created and tested. The preparation of these sites must be continuously monitored for consistency with the primary sites to ensure ease of transition at the time of use.

Each self-regulatory organization (SRO) will be collecting information about its clearing and market-making members during this transition period. The Securities and Exchange Commission (SEC) is coordinating these efforts to minimize the numbers of parties collecting firm information at any one point in time. We expect to be able to publish the standardized questionnaire and procedures for use later this month.

The NASD Year 2000 Readiness Statement Program

To assist in the effort of communicating to investors the industry's preparedness, the NASD Year 2000 Program Office is currently developing an area on the Internet for NASD member firms to display information related to their Year 2000 preparedness efforts. Each NASD member firm will be given the opportunity to provide a letter on its letterhead stating its level of readiness for the transition into Year 2000. This information will be available on the NASD and NASD Regulation® Web Sites (www.nasd.com and www.nasdr.com).

The NASD Year 2000 Readiness Statement Program is being instituted so that members may have an additional venue to communicate Year 2000 preparedness efforts to customers, the general public, and the securities industry. The securities industry expects the new year to be "business and usual," and this is a chance for member firms to convey that expectation to our shared constituents.

These Year 2000 member readiness statements will be available to the public by mid-October and members can continuously update their statements as they feel appropriate.

More information on the details of this program will be provided in upcoming communications to members.

More Information/Questions

NASD Year 2000 Program Office

e-mail: y2k@nasd.com

phone: (888) 227-1330

Year 2000 Education And Events

The NASD Year 2000 Program Office is continuing to offer Virtual Workshops—conference call-in sessions. The NASD strongly encourages registration for these sessions by calling (888) 567-0578. After placing the call, listen to the greeting, and provide the following information when prompted: firm name, Broker/Dealer #, and workshop date. On the day of the session, call (800) 857-7323 and indicate the password and confirmation number provided for the specific workshop. See below for a list of these specific workshops organized by date of session, as well as a brief summary of the issues to be discussed.

August 24 **Contingency Strategies for Large Firms**

Password: Strategies
Conf. #: 3117500

Issues to be covered:

- ◆ Overview of typical large firm contingency planning challenges
- ◆ Trends in contingency planning
- ◆ Timeline vs. impact
- ◆ External/internal contingency planning

Sept. 14 **Certification of Year 2000 Compliance and SEC Rule 15b7-3T**

Password: Certification
Conf. #: 3117560

Issues to be covered:

- ◆ Certification and the Year 2000 issue
- ◆ Latest developments in certification
- ◆ Best practices for all types of firms

Sept. 21 **Peer Review of Best Practices III**

Password: Practices
Conf. #: 3117592

Issues to be covered:

- ◆ A year review of the biggest challenges faced by broker/dealers of all sizes
- ◆ Summary of the top 10 best practices to managing the Year 2000 issue

October 12 **State of Utilities and Other Critical Services**

Password: Utilities
Conf. #: 3117608

Issues to be covered:

- ◆ State of utilities and recent guidelines
- ◆ Other services
- ◆ Possible impact on broker/dealers
- ◆ Best practices in dealing with uncertainty

October 19 **State of the Securities Industry**

Password: Industry
Conf. #: 3117632

Issues to be covered:

- ◆ Industry summary and overview
- ◆ A look at clearing firms
- ◆ A look at Market Makers
- ◆ A look at introducing firms
- ◆ In-depth look at where your firm should be in achieving Year 2000 readiness

October 26 **Legal Review for Broker/Dealers**

Password: Review
Conf. #: 3117647

Issues to be covered:

- ◆ A review of legal issues for 1998 and 1999
- ◆ Current broker/dealer trends reviewed
- ◆ Checklist of what your firm may need to do with the little time remaining

November 2 **Day Zero Preparations**

Password: Day Zero
Conf #: 3117656

Issues to be covered:

- ◆ Day zero scenarios - the new year
- ◆ Broker/dealer strategic scenarios
- ◆ Helpful hints on day zero

November 10 **Contingency Planning and Reporting Requirements**

Password: Trends
Conf. #: 3117664

Issues to be covered:

- ◆ Developments in contingency planning trends
- ◆ Step-by-step guide to completing mandatory reporting to the SROs during the transition timeframes
- ◆ Global view

November 17 **Risk Management**

Password: Risk
Conf. #: 3117677

Issues to be covered:

- ◆ Key principles in risk management
- ◆ What the NASD is doing to manage risk
- ◆ What clearing firms and introducing firms can do
- ◆ Review of seven areas that can affect your business operations

Year 2000 Education And Events

NASD Year 2000 Event Calendar

Topic	Location	Date	Time
Contingency Strategies for Large Firms	Virtual	Aug. 24	11:00 a.m., ET
Certification of Year 2000 Compliance and SEC Rule 15b7-3T	Virtual	Sept. 14	11:00 a.m., ET
Peer Review of Best Practices III	Virtual	Sept. 21	11:00 a.m., ET
State of Utilities and Other Critical Services	Virtual	Oct. 12	11:00 a.m., ET
State of the Securities Industry	Virtual	Oct. 19	11:00 a.m., ET
Legal Review for Broker/Dealers	Virtual	Oct. 26	11:00 a.m., ET
Day Zero Preparations	Virtual	Nov. 2	11:00 a.m., ET
Contingency Planning and Reporting Requirements	Virtual	Nov. 10	11:00 a.m., ET
Risk Management	Virtual	Nov. 17	11:00 a.m., ET

NASD Notice to Members 99-63

SEC Approves And Adopts Revised Forms And Electronic Filing Requirement; New Member Applicants Should Continue To File Paper Forms

Suggested Routing

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

Executive Summary

The Securities and Exchange Commission (SEC) has approved revised Forms U-4 and U-5 and adopted revised Forms BD and BDW¹, all of which will be effective August 1, 1999. The SEC also approved amendments to National Association of Securities Dealers, Inc. (NASD[®]) Rule 1140—the Electronic Filing Rule—which requires such Forms (with the exception of initial Form BD applications) to be filed electronically, effective August 16, 1999. For details on the transition to electronic Forms and filings, see *Notice to Members 99-56* and visit the Web CRD Internet Page at www.nasdr.com/3400_web.htm.

New member applicants should continue to file Forms BD and U-4 on paper according to NASD Rule 1013.

Questions concerning this *Notice* may be directed to Ann E. Bushey, Assistant Director, CRD/Public Disclosure, NASD Regulation, Inc. (NASD Regulation[®]) at (301) 590-6389; Mary M. Dunbar, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8252; or Richard E. Pullano, Associate Director and Counsel, CRD/Public Disclosure, NASD Regulation, at (301) 212-3789.

Background And Discussion

In *Notice to Members 99-56*, NASD Regulation describes the scheduled August 1999 deployment of the new Internet-based Central Registration Depository system, Web CRDSM. As anticipated in that *Notice*, the SEC has approved the revised Forms U-4 and U-5 and

adopted revised Forms BD and BDW for use with Web CRD.² On August 1, 1999, all of these new Forms become effective, and the Interim Forms currently in use become obsolete.

The SEC also has approved amendments to the Electronic Filing Rule which become effective August 16, 1999.³ The entire text of the amended Rule appears in Attachment A.

Paper Filing For New Member Applicants

New member applicants should continue to file paper Forms BD and U-4 under NASD Rule 1013. New member applicants may use paper Interim Forms BD and U-4 until July 29, 1999; **however, such interim Forms must be received by NASD Regulation by close of business July 29**. Beginning on August 1, 1999, new member applicants should download the new Forms BD and U-4 from NASD Regulation's Web Site at www.nasdr.com and submit them in paper to CRD.⁴ CRD will then establish an electronic account that will allow new member applicants to submit all subsequent filings electronically. In the future, NASD Regulation may amend its rules to require new member applicants to file all Forms electronically.

See *Notice to Members 99-56* for more details on the transition to Web CRD and Securities Exchange Act Release No. 41594 for details on the adoption of revised Form BD. Visit the Web CRD Internet Page at: www.nasdr.com/3400_web.htm for all of the latest developments on the deployment of the new system.

Attachment A

Following is the entire text of revised Rule 1140.

1140. Electronic Filing Rules

(a) Filing Requirement

All forms required to be filed by Article IV, Sections 1, 7, and 8, and Article V, Sections 2 and 3, of the By-Laws shall be filed through an electronic process or such other process the Association may prescribe to the Central Registration Depository.

(b) Supervisory Requirements

(1) In order to comply with the supervisory procedures requirement in Rule 3010, each member shall identify a Registered Principal(s) or corporate officer(s) who has a position of authority over registration functions, to be responsible for supervising the electronic filing of appropriate forms pursuant to this Rule.

(2) The Registered Principal(s) or corporate officer(s) who has or have the responsibility to review and approve the forms filed pursuant to this Rule shall be required to acknowledge, electronically, that he/she is filing this information on behalf of the member and the member's associated persons.

(c) Form U-4 Filing Requirements

(1) Initial and transfer electronic application filings shall be based

on a signed Form U-4 provided to the member by the applicant. As part of the member's recordkeeping requirements, it shall retain the applicant's signed Form U-4 and make it available upon regulatory request.

(2) Fingerprint Cards

Upon filing an electronic Form U-4 on behalf of an applicant for registration, a member shall promptly submit a fingerprint card for the applicant. NASD Regulation may make a registration effective pending receipt of the fingerprint card. If a member fails to submit a fingerprint card within 30 days after NASD Regulation receives the electronic Form U-4, the person's registration shall be deemed inactive. In such case, NASD Regulation shall notify the member that the person must immediately cease all activities requiring registration and is prohibited from performing any duties and functioning in any capacity requiring registration. NASD Regulation shall administratively terminate a registration that is inactive for a period of two years. A person whose registration is administratively terminated may reactivate the registration only by reapplying for registration and meeting the qualification requirements of the applicable provisions of the Rule 1020 Series and the Rule 1030 Series. Upon application and a showing of good cause, the Association may extend the 30-day period.

(d) Form U-5 Filing Requirements

Initial filings and amendments of Form U-5 shall be submitted electronically. As part of the member's recordkeeping requirements, it shall make such records available upon regulatory request.

(e) Third Party Filing

A member may employ a third party to file the required forms electronically on its behalf.

Endnotes

¹Forms BD and BDW are joint forms used by the SEC, self-regulatory organizations (SROs), and the states. The forms are used, respectively, to register, and to terminate the registration of, broker/dealers. SROs and the states use Forms U-4 and U-5 to register, and terminate the registration of, associated persons of broker/dealers.

²See Exchange Act Rel. Nos. 41356 (April 30, 1999), 41560 (June 25, 1999), and 41594 (July 2, 1999).

³See Exchange Act Rel. No. 41575 (June 29, 1999).

⁴NASD Regulation will accept new Forms BD and U-4 during the System Transition Period; however, NASD Regulation will not enter these Forms into Web CRD until August 16.

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This *Special Notice to Members* was mailed to members on August 4, 1999.

Special NASD Notice to Members 99-64

NASD Informs Members Of Upcoming Nomination Procedures For Industry Member Vacancies On The National Adjudicatory Council

Suggested Routing

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

Executive Summary

The purpose of this *Special Notice to Members* is to advise members of the nomination procedures to fill upcoming vacancies on the National Adjudicatory Council (NAC). The terms of NAC members from the West Region and New York City are expiring in January 2000.

Members are encouraged to submit names of candidates to the appropriate Regional Nominating Committee Chairs (listed in Exhibit I), the NASDRSM District Director (listed in Exhibit I), or National Association of Securities Dealers, Inc. (NASD[®]) Corporate Secretary Joan Conley by September 1, 1999. The Chair or a District Director in the Region will provide each nominee with a biographical form for completion. The completed form will be provided to all Regional Nominating Committee members for review. On or about October 1, 1999, the Regional Nominating Committees will provide members with written notice of NAC candidates.

Current Industry members of the NAC and their terms are listed in Exhibit I. The procedures to fill the NAC vacancies are outlined in Exhibit II. Questions concerning this *Special Notice to Members* may be directed to the District Directors in the Region noted or to Joan C. Conley, Corporate Secretary, NASD, at (202) 728-8381.

National Adjudicatory Council Membership And Function

Membership

The NAC consists of 12 members—six Industry members and six Non-Industry members. Five Industry members each represent one of the following geographic regions and the sixth Industry member is selected at large.

West Region: Hawaii, California, Nevada, Arizona, Colorado, New Mexico, Utah, Wyoming, Alaska, Idaho, Montana, Oregon, and Washington.

South Region: Alabama, Arkansas, Kentucky, Louisiana, Mississippi, Oklahoma, Tennessee, Texas, Florida, Georgia, North Carolina, South Carolina, Puerto Rico, Virginia, Canal Zone, and the Virgin Islands.

Central Region: Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Illinois, Indiana, Michigan, and Wisconsin.

North Region: Delaware, Maryland, Pennsylvania, West Virginia, District of Columbia, New Jersey, Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont, and New York (except for New York City).

New York: New York City.

Function

According to the NASD By-Laws, the NAC is authorized to act for the NASD Board of Governors in matters concerning:

- an appeal or review of a disciplinary proceeding, a statutory disqualification proceeding, or a membership proceeding;

- a review of an offer of settlement; a letter of acceptance, waiver, and consent; and a minor rule violation plan letter;
- the exercise of exemptive authority;
- and such other proceeding or actions authorized by the Rules of the Association.

The NAC also shall consider and make recommendations to the Board on policy and rule changes relating to the business and sales practices of NASD members and associated persons and enforcement policies, including policies regarding fines and other sanctions.

EXHIBIT I
1999 National Adjudicatory Council Industry Members

West Region

Districts 1, 2, 3a, and 3b

NAC Industry Member	Term Expiration
Nicholas C. Cochran American Investors Company	January 2000

NASD members are encouraged to submit names of candidates for this NAC member seat. Please submit candidates' names to any of the following:

Joan B. Seidel, Regional Nominating
Committee Chair
Morton Seidel & Company, Inc.
8730 Wilshire Blvd., Suite 530
Beverly Hills, CA 90211
(310) 360-7541

Elisabeth P. Owens, District 1 Director
525 Market Street, Suite 300
San Francisco, CA 94105
(415) 882-1200

Lani M. Sen Woltmann, District 2 Director
300 South Grand Avenue, Suite 1600
Los Angeles, CA 90071
(213) 627-2122

Frank J. Birgfeld, District 3a Director
Republic Plaza Building
370 17th Street, Suite 2900
Denver, CO 80202-5629
(303) 446-3100

James G. Dawson, District 3b Director
Two Union Square
601 Union Street, Suite 1616
Seattle, WA 98101-2327
(206) 624-0790

Joan Conley, NASD Corporate Secretary
1735 K Street NW
Washington, D.C. 20006
(202) 728-8381

South Region

Districts 5, 6, and 7

NAC Industry Member	Term Expiration
Raymond E. Wooldridge Southwest Securities, Inc.	January 2001

Central Region

Districts 4, 8a, and 8b

NAC Industry Member	Term Expiration
Ronald D. Brooks Banc One Capital Markets, Inc.	January 2001

North Region

Districts 9a, 9b, and 11

NAC Industry Member	Term Expiration
Richard J. DeAgazio Boston Capital Services, Inc.	January 2001

New York

District 10

NAC Industry Member	Term Expiration
David DeMuro Lehman Brothers, Inc.	January 2000

NASD members are encouraged to submit names of candidates for this NAC member seat. Please submit candidates' names to any of the following:

Joan Caridi, Regional Nominating Committee Chair
Citigroup, Inc.
425 Park Ave., 3rd Floor
New York, New York 10043
(212) 793-7181

David Leibowitz, District 10 Director
NASD Financial Center
33 Whitehall Street
New York, NY 10004
(212) 858-4000

Joan Conley, NASD Corporate Secretary
1735 K Street NW
Washington, D.C. 20006
(202) 728-8381

At Large NAC Industry Member

NAC Industry Member	Term Expiration
Theodore A. Levine PaineWebber Group, Inc.	January 2000

EXHIBIT II

1999 National Adjudicatory Council Nomination Procedures

1. NASD Regulation maintains Regional Nominating Committees in the manner specified in Article VI of the By-Laws of NASD Regulation, Inc.
2. Members located in the West Region and New York City are hereby notified of the upcoming election of members to the National Adjudicatory Council and are encouraged to submit names of potential candidates to their respective Chair of the Regional Nominating Committee, District Director (see Exhibit I), or to NASD Corporate Secretary Joan Conley by September 1, 1999.
3. Nominees will be asked to complete a biographical form which will be reviewed by the Regional Nominating Committee.
4. The Regional Nominating Committee shall review the background of the candidates and the description of the NASD membership provided by NASD Regulation staff and shall propose one or more candidates for nomination to the National Nominating Committee on or before September 24, 1999. In proposing a candidate for nomination, the Regional Nominating Committee shall endeavor to secure appropriate and fair representation of the region.
5. On or before October 1, 1999, the Regional Nominating Committee shall notify in writing the Executive Representatives and branch offices of the NASD members in the region the name(s) of the candidate(s) proposed for nomination to the National Adjudicatory Council.
6. If an officer, director, or employee of an NASD member in the region is not proposed for nomination by the Regional Nominating Committee and wants to seek the nomination, he or she shall send a written notice to the Regional Nominating Committee Chair or the Secretary of NASD Regulation within 14 calendar days after the mailing date of the Regional Nominating Committee's notice (#5 above) and proceed in accordance with the Contested Nomination Procedures found in Article VI of the NASDR By-Laws.
7. If no additional candidate comes forward within 14 calendar days, the Regional Nominating Committees shall certify their candidates to the National Nominating Committee.

Additional information pertaining to the District Election Procedures can be found in Article VI of the By-Laws of NASD Regulation. The By-Laws can be found in the on-line *NASD Manual* at www.nasdr.com.

NASD Notice to Members 99-65

SEC Approves Rule Changes To NASD Trade-Reporting Rules For Riskless Principal Transaction In Nasdaq And OTC Securities

Suggested Routing

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

Executive Summary

On March 24, 1999, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD[®] or Association) rules regarding trade reporting of riskless principal transactions by Market Makers. The rule change will permit Market Makers in Nasdaq[®] and other over-the-counter securities to report trades under the current riskless principal rules that exist for non-Market Makers. The effect of the change is that instead of reporting both "legs" of a riskless principal transaction, Market Makers (like non-Market Makers currently) now will only report one portion of the transaction if it meets the definition of riskless principal. The rule defines riskless principal as a trade in which a member, after having received an order to buy (sell) a security, buys (sells) the security at the same price, as principal, in order to satisfy the order to buy (sell).

This *Notice* includes questions and answers regarding the rule changes (Attachment A); and the text of the rule changes (Attachment B). These changes are effective as of September 30, 1999.

Questions/Further Information

Questions concerning this *Notice* may be directed to the Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8294; or Market Regulation Legal Section, NASD Regulation, Inc. (NASD Regulation[®]), at (301) 590-6410.

Background

The rules for reporting trades in Nasdaq securities have long existed in their current form. The rules were broadly designed to capture all trading activity by broker/dealers, both dealer-to-

dealer trades and trades with customers. These rules, and the trade reports that result, serve several important purposes. They form the basis for public dissemination of "last sale" transaction prices to the tape, thus providing transparency. Trade reports also are an integral part of the audit trail used by the NASD in its regulatory efforts to surveil and regulate firms' activities. Given the historical structure of the dealer markets and the need to provide a comprehensive view of all trading, and because Market Makers were always deemed to be "at risk" when trading from their principal accounts, NASD trade-reporting rules have required the reporting of all principal trades by Market Makers.

Non-Market Makers, however, generally do not report all principal trades under current rules, to the extent the trades are defined as "riskless" — that is, they involve a trade with another member, usually a Market Maker, which is used to offset a trade with a customer. This riskless principal exception to the general rule of reporting all principal trades results in one trade report even though the non-Market Maker firm is involved in two separate trades against its principal account.

In light of the growth and evolution of the structure of Nasdaq and the over-the-counter (OTC) market, the NASD is now extending the riskless principal exception to Market Makers in Nasdaq-listed securities (including Nasdaq convertible debt securities) as well as other securities traded over-the-counter (*e.g.*, OTCBB and pink sheets). Thus, certain matching principal trades involving a Market Maker are now explicitly included within the riskless definition, and reported to the public tape only once. For example, under the SEC Order Handling Rules, Nasdaq Market Makers now display customer limit orders in their public quotes. Those

orders are often filled by the Market Maker when that quote is accessed by another market participant.¹ Because Market Makers generally trade exclusively from a principal account, it is necessary to engage in two separate principal trades: one with the other market participant, and then another directly with the customer. Both of these trades are reported by Market Makers under current rules. In effect, however, these two trades can be viewed as one event – the execution of a customer order upon the execution of an offsetting transaction obtained by the Market Maker. Under the proposed rule change, these two trades are reported only once. One of the expected benefits of the extension of riskless principal trade reporting to Nasdaq and OTC Market Makers

is the reduction of SEC transaction fees, which generally are assessed to the seller in a transaction that is trade reported.

The new rules define “riskless principal” as a trade in which a member, after having received an order to buy (sell) a security, buys (sells) the security at the same price, as principal, in order to satisfy the order to buy (sell). In order to qualify for riskless principal trade reporting, the rule requires that the trades be executed at the “same price” (exclusive of a markup or markdown, commission equivalent, or other fee). Additionally, under the rules a portion of a transaction may be deemed riskless. That is, to the extent that any of the order is offset

with another principal execution at the same price, that portion is deemed riskless and should be reported only once.

In addition, the NASD has made certain technical changes to the existing rule. Specifically, while the current rule refers to orders received from a “customer”, the new rule simply refers to “an order.” This change ensures consistent application of the riskless principal trade-reporting rules to any order received by a member, regardless of the person or entity from whom it was received. Furthermore, the NASD has amended the rules to more clearly provide that riskless principal trades are reported exclusive of any fee, not just markups and markdowns.

Attachment A – Questions And Answers

General Questions

1. When do the new riskless principal trade-reporting rules go into effect?

The rules go into effect on September 30, 1999, at which time market participants will be required to report transactions according to the new rules.

2. Do the new riskless principal rules apply to Nasdaq securities, as well as all other securities traded in the over-the-counter market?

The new riskless principal rules apply to Nasdaq National Market® Securities (NNM), Nasdaq SmallCapSM Securities (SmallCap), Over-the-Counter Bulletin Board securities (OTCBB), Nasdaq convertible debt securities, and all other securities traded in the over-the-counter market (*e.g.*, pink sheet securities). The riskless principal rules described in this *Notice to Members* do **not** apply to Third-Market transactions in exchange-listed securities. Rather, a separate rule proposal that specifically covers transactions in the Third Market was recently approved by the SEC, which is separately described in *Notice to Members* 99-66.

3. Do the new rules define what is a “riskless principal” transaction?

Existing NASD trade-reporting rules define “riskless principal” transactions effected by non-Market Makers, and require non-Market Makers that execute riskless principal transactions to not report the offsetting transaction with the non-Market Maker’s customer to the tape. The new rules simply extend the existing riskless

principal trade-reporting rules to cover transactions effected by Market Makers, provided that the transactions are done at the same price.

Under the new rules, a Market Maker reports a “riskless” principal transaction once if the Market Maker receives an order to buy (sell) a security, and then purchases (sells) the security as principal at the same price as the order in hand to satisfy the order to buy (sell). Generally, a riskless principal trade involves two orders, the execution of one being dependent upon the receipt or execution of the other; hence, there is no “risk” in the interdependent transactions when completed. Only when the condition or dependency is satisfied is the offsetting trade effected, the transaction completed, and only a single trade report required. Such condition may involve an institutional customer order, the execution of which is dependent upon finding the other side, in whole or in part, or a transaction dependent upon the execution of all or a part of the order placed with another firm or market. To the extent that any of the order is offset with another principal execution, that portion is deemed riskless and should be reported only once. If a portion of the order is not offset with another principal transaction, that portion would represent risk and should be reported to the tape. **See** Question 16 for an example. Additionally, as set forth in more detail in Question 4, if a member finds the other side of an institutional order and matches off the orders, the presumption will be that the trade is riskless principal.

4. How does a member determine whether transactions are at the “same price”?

In order for a transaction to be reported as riskless under the new rules, the price of the initial

transaction and the offsetting transaction with the customer must be the same when the markup or markdown, commission equivalent, or other fee is excluded from the transaction prices. To determine whether two transactions are at the same price, members generally must compare the price reported to the Automated Confirmation Transaction ServiceSM (ACTSM) pursuant to NASD trade-reporting rules (which require members to exclude any markup or markdown, commission equivalent, or other fee when trade reporting) and the “net price” of the offsetting trade with the customer (*i.e.*, the price to the customer, exclusive of any markup or markdown, commission equivalent, or other fee). If the tape price and the net price to the customer are the same, then the transaction must be reported as riskless principal to ACT and the offsetting leg with the customer should not be reported to ACT.

Additionally, if a Market Maker is executing a large order through a series of trades and has an arrangement to charge the customer an average price based on the various executions received, the net price to the customer and the volume weighted average price (VWAP) of the trades must be the same for the transaction to receive riskless principal treatment. **See** Question 20 for an example. To this end, when a Market Maker is attempting to fill a large order through a series of trades during the trading day, the Market Maker must be able to identify which trades were effected from inventory to fill the customer order if the Market Maker is claiming riskless principal treatment for a transaction or a portion thereof; otherwise, the Market Maker is at risk and cannot report as riskless principal. **See** Question 17 for an example.

Finally, if a member is working an order for an institutional account (as defined in NASD Rule 3110(c)(4))

or of a block size (10,000 shares or greater and at least \$200,000) and the member finds the other side of the order, the presumption will be that the orders will be matched off at the same price (exclusive of any markup or markdown, commission equivalent, or other fee) and reported as riskless principal, unless the customer has specifically requested that the order be traded on a net basis at a different price.

5. Do riskless principal transactions *only* apply to retail customer orders and limit orders?

No. The rules apply to orders held by a member that are from a customer, another member, the customer of another member, or any other entity including non-member broker/dealers. Further, the rule covers both market and limit orders.

6. Do the rules prohibit “net” trading? In other words, do the rules require Market Makers to trade at one price when executing two offsetting institutional orders or when filling an institutional order out of a position the Market Maker accumulated to fill that order in hand?

The rules do not prohibit Market Makers from trading on a net basis. Nor do the rules mandate the prices at which Market Makers must execute the various legs of “riskless principal” transactions. Thus, a Market Maker is not precluded from accumulating a position at one price and executing the offsetting trade with the customer at another price (with no markup, markdown, commission equivalent, or other fee), provided that such arrangement satisfies the member’s best execution obligations and is consistent with SEC and NASD statements regarding the matching

of limit and market orders.² The rules establish, however, the requirements of how transactions should be reported if they are riskless and meet the requirements/definition of riskless principal (*i.e.*, both legs of the transaction are effected at the same price).

The NASD recognizes that there are times when a Market Maker will, while holding a customer’s order, effect a buy (sell) at one price and an offsetting sell (buy) with the customer at another price, such as when a Market Maker is trading “net” with an institution. If what otherwise would appear to be a riskless principal trade is effected at two different net prices, a Market Maker would be required to report both legs of the transaction to the tape. However, if a member is working an order for an institutional account or a block size and the member finds the other side of the order, the presumption will be that the orders will be matched off at the same price (exclusive of any markup or markdown, commission equivalent, or other fee) and reported as riskless principal, unless the customer has specifically requested that the order be traded on a net basis at a different price.

The NASD believes that Market Makers should endeavor to trade at one price when executing riskless principal transactions because this will provide greater transactional integrity and will have the corollary benefit of reducing SEC transaction fees (commonly know as “Section 31 fees”). This is particularly true for customer limit orders as well as other limit orders that are not of a block size or for an institutional account.

As indicated above, the new rules do not change current trade-reporting requirements for non-Market Makers that effect riskless principal transactions.

7. Do the new rules preclude Market Makers from effecting and separately reporting riskless principal trades at different prices?

NASD rules do not prohibit Market Makers from reporting trades at two different prices of what essentially is a riskless principal trade, assuming of course the Market Maker is complying with best execution obligations. As noted above, however, if a member is working an order for an institutional account and the member finds the other side of the order, the presumption will be that the orders will be crossed at the same price (exclusive of any markup or markdown, commission equivalent, or other fee) and reported as riskless principal, unless the customer has specifically requested that the order be traded on a net basis at a different price.

8. How should I mark my ACT trade report for riskless principal trades?

Members should mark the ACT report with the capacity indicator for riskless principal (*i.e.*, click on the “Riskless” button under the P/A field on the ACT report).

9. If one leg of the transaction is executed through Nasdaq’s Small Order Execution SystemSM (SOESSM) or SelectNetSM system, the system automatically reports the trade for the market participants and appends a principal capacity indicator to the trade report when a Market Maker is involved. When this occurs and the trade is part of a riskless principal transaction, is the Market Maker required to go back into ACT and change the system-generated trade report to indicate the trade was riskless principal?

Generally, no. If a trade is executed through SOES or SelectNet, the trade is automatically reported to ACT and sent to the tape. When a trade involves a Market Maker, ACT defaults to a capacity indicator of "principal" on the trade report. For SOES and SelectNet trades, a Market Maker will **not** be required to go back into ACT and change the Nasdaq system-generated ACT report to indicate the trade was effected on a riskless principal basis. If, however, the Market Maker does not clear for the customer for which it executed the riskless principal trade, the Market Maker will be required to submit a "clearing-only" record to ACT and to the NSCC. In these instances, the Market Maker is required to indicate on the "clearing only" record that the trade was done on a riskless principal basis.

For example, MMA receives a customer limit order to buy at \$20 from another member, and displays that order in its quote. SOES executes against MMA's quote thus taking out the \$20 buy order, and SOES reports the trade to the tape at \$20 as principal for MMA. If MMA does not clear for the member from which it received the customer limit order, MMA would be required to enter a clearing-only record into ACT to reflect the offsetting sale to the member at \$20, and would be required to indicate on the clearing record that the trade was done on a riskless principal basis.

For riskless principal transactions that occur outside Nasdaq systems (e.g., phone orders or internal executions) the Market Maker must report the initial leg to ACT and mark the ACT report as riskless principal. Additionally, depending on whether the Market Maker clears for the customer, the Market Maker may also have to submit a "clearing only" record to ACT, which also must indicate the trade was done as riskless principal.

10. If a Market Maker does not report a trade with a customer to ACT because the trade qualifies for riskless principal treatment, is the Market Maker still required to input that information into the Order Audit Trail System (OATSSM)?

Yes. If Market Maker A (MMA), for example, represents in its quote a limit order to buy 100 shares at \$20, and Market Maker B (MMB) hits MMA's bid, MMA will not be required to report to ACT the offsetting sale of 100 shares at \$20 to the customer. MMA will, however, be required to report this information to OATS. Specifically, MMA should report the receipt of the order via a "New Order Report" and the execution of the customer order via an "OATS Execution Report." On the OATS Execution Report, MMA should supply a Reporting Exception Code of "M" (M = Market Maker side of Nasdaq execution system execution). The Reporting Exception Code indicates that there is no corresponding trade report in ACT.

11. Aren't Market Makers always at risk? For example, if a Market Maker is holding an order and is accumulating a position in an attempt to fill the order, isn't the Market Maker at risk because the customer may cancel the order before the Market Maker finds the other side and fills it? How will a firm know if a trade is riskless?

Market Makers are not necessarily **always** at risk for purposes of trade reporting. A Market Maker generally is not at risk if the Market Maker has two orders in hand that it is crossing at the same price or if the Market Maker has one order for which execution is contingent upon finding the other side at the same price.

As a rule of thumb, a Market Maker's responsibility to report to

ACT the second leg of the transaction with the customer is determined after the Market Maker has accumulated a position and/or found the other side, and the Market Maker wishes to effect an offsetting transaction with the customer. Generally, if after accumulating a position to fill a customer order, the Market Maker actually fills such order, the Market Maker is not at risk on the second leg of the transaction and will not report the customer fill to ACT. Conversely, if the customer cancels the order while the Market Maker is accumulating a position, the Market Maker becomes "at risk" for the amount it has accumulated and is holding in inventory. Accordingly, when the Market Maker attempts to liquidate that position, the Market Maker must report the associated trade(s) to the tape.

12. If a customer cancels an order while a Market Maker is in the process of accumulating a position to fill the customer's order, the ACT report will show a riskless principal modifier when these trades are really "at risk." Will this be a violation of NASD rules?

There may be times when a Market Maker has accumulated a portion or all of a position to satisfy a customer order in hand, has reported those transactions to the tape as riskless principal, and the customer cancels the order prior to the Market Maker filling it. The member will not be in violation of riskless principal rules provided that the member properly documents that the trade(s) was reported to ACT as riskless principal while the member was holding a customer order and that the customer canceled the order. The member should keep accurate records reflecting the time the customer order was received and canceled, as well as the execution time(s) of the trade(s) reported as riskless principal.

13. Are the new rules for riskless principal trade reporting mandatory?

Yes. If a transaction meets the definition of "riskless principal" in the new trade-reporting rules (*i.e.*, two orders that offset one another that are executed at the same price), market participants must report once and as riskless principal.

Maker and the customer (net price or reported trade price);

2) the price to the customer (gross price); and

3) the difference (if any) between the reported trade price and the price to the customer (*e.g.*, markup, markdown, commission equivalent, or other fee).

B) a price to the customer of \$20 1/4; and

C) a no differential.

If MMA had added a commission equivalent of 1/4, MMA would have confirmed:

A) a trade price of \$20 1/4;

B) a price to the customer of \$20; and

C) a differential of 1/4.

Trade-Reporting Requirements

14. Nasdaq Inside Market: \$20 - 20 1/4, 10 X 20

MMA is at the inside offer displaying its customer's limit order to sell 2,000 shares at \$20 1/4 when MMB lifts the offer using the phone. What are MMA's trade-reporting obligations?

MMA should report to ACT the sale of 2,000 shares to MMB and mark the report with a riskless principal capacity indicator. Since MMA then buys from the customer at a price of \$20 1/4, MMA will not report to ACT the offsetting buy at \$20 1/4 from the customer.

Under the riskless principal trade-reporting rules, if a Market Maker executes a riskless principal transaction where the tape price and the net price to the customer are the same, the Market Maker would not report the offsetting transaction with the customer to the tape. Thus, there technically would be no "reported trade price" (Item #1 above) for the purpose of Rule 10b-10 confirmation requirements, since the transaction with the customer would not be reported to the tape. After consultation with the SEC, it appears warranted that in these instances, the Market Maker would disclose on the confirmation:

A) the price that was reported to the tape for the first leg of the transaction, as the "reported trade price" (Item #1, above);

B) the price to the customer (*i.e.*, the gross price of the buy/sale to the customer); and

C) the difference (if any) between the reported trade price and the gross price to the customer (*i.e.*, Item A and Item B).

Members should note that while the disclosure requirements of SEC Rule 10b-10(a)(2)(ii)(B) do not apply to Market Makers in non-Nasdaq OTC securities (pink sheet and OTCBB securities), the NASD currently is considering adopting a parallel disclosure requirement for non-Nasdaq OTC Market Makers.

Finally, for riskless principal trades effected by non-Market Makers trading as principal in Nasdaq and OTC securities, SEC Rule 10b-10 confirmation requirements remain the same as they are today.³

16. Nasdaq Inside Market: \$10 - 10 1/4, 10 X 10

MMA receives from an institutional customer an order to sell 100,000 shares with instructions to work the order with a price limit (or "bottom") of \$10 1/8. The customer tells MMA that it is willing to pay a markdown, commission equivalent, or other fee of 1/8 below the \$10 1/8 price. Using the phone, MMA sells 75,000 shares to MMB at a price of \$10 1/8 per share. Instead of attempting to find the remaining 25,000 shares, MMA fills the entire customer order for 100,000 shares, for a price of \$10 1/8 per share (exclusive of any markdown, commission equivalent, or other fee), by

15. If I am a Market Maker in a Nasdaq-listed security and I am engaging in a riskless principal trade consistent with the new trade-reporting rule, how do I confirm the transaction to my customer under SEC Rule 10b-10? For example, what would I have to confirm in the transaction described in Question 14?

SEC Rule 10b-10(a)(2)(ii)(B) requires a Nasdaq Market Maker that trades as principal to disclose on the confirmation:

1) the "reported trade price" for the trade between the Market

With regard to Question 14, assume that MMA, which was reflecting a limit order to sell at 20 1/4, tacked on no markdown or other fee. In that case, MMA would confirm to the customer:

A) a trade price of \$20 1/4 (the first leg of the transaction that was reported to ACT by MMA);

trading the 25,000-share balance out of inventory. How is this trade reported? Is part of the order deemed to be "at risk" and part of the order considered to be riskless?

Only a portion of the 100,000-share transaction is deemed to be riskless – the 75,000 shares. The remaining 25,000 shares that were executed from MMA's inventory are considered to be "at risk," and must be reported to the tape. Thus, MMA will report the sale to MMB of 75,000 shares at \$10 1/8 in one ACT report, and separately report the offsetting buy of 25,000 at \$10 1/8 from its institutional customer. MMA reports only a buy of 25,000 and not a buy of 100,000 shares from its institutional customer because the 25,000 is deemed to be "at risk." The confirmation to the customer would show a reported price of \$10 1/8, a price to the customer of \$10, and a differential (markdown) of 1/8.

17. In the above example, it may not be easy for MMA to definitively say that 75,000 shares were riskless, because MMA may have accumulated these shares in multiple transactions throughout the entire day. Can MMA still report these as riskless principal?

No. In order for a Market Maker to report trades as riskless principal, the Market Maker must be able to identify a specific trade or a group of trades (which may be effected at one price level or multiple price levels if the customer is receiving a VWAP) as being those utilized to fill a customer order. If a member cannot identify which trade or series of trades were effected to offset a customer order, the Market Maker is at risk and cannot report as riskless principal.

Thus, in the question above where MMA was claiming 75,000 shares

were riskless principal, MMA must be able to tie a specific trade or trades to the 75,000. If MMA were reporting an average price of \$10, MMA would have to point to a series of transactions which had an average price of \$10 (exclusive of markups or markdowns, commission equivalents, or other fees) and which totaled 75,000 shares.

18. Nasdaq Inside Market: \$10 - 10 1/4, 10 X 10

MMA is at the inside bid displaying a customer limit order to buy 1,000 shares at \$10, when MMA receives a market order to sell 500 shares over SOES, which is automatically executed against MMA's quote and reported to the tape. What are MMA's trade-reporting obligations?

Under NASD Rule 2110 and IM-2110-2 (commonly known as "Manning"), MMA is obligated to execute at least 500 shares of the limit order it is holding. Thus, MMA can sell 500 shares on a riskless principal basis to the customer at \$10, not report the transactions to the tape, and display the remaining 500 shares in its quote. Alternatively, MMA can sell 1,000 shares to the customer limit order at \$10, and report 500 shares to the tape as the 500 are deemed to be at risk.

19. Nasdaq Inside Market: \$25 - 25 1/8, 10 X 10

MMA receives a not-held order from an institutional customer to buy 5,000 shares, with instructions to work the order with a price limit (or "top") of \$25 1/16. MMA's customer tells it that he wishes to trade net and does not wish to pay a markup, markdown, commission equivalent, or other fee over and above the \$25 1/16 top price.

Using SelectNet, MMA buys 5,000 shares from MMB at \$25, and SelectNet reports the transaction to the tape. What are MMA's reporting obligations?

Assuming that MMA sells the 5,000 shares to its customer at \$25 1/16 net, MMA must report this sale to the tape because the reported price via SelectNet and the offsetting sell to its customer were done at different prices.

If MMA were not trading net and, for example, sold to its customer at \$25, plus a 1/16 mark-up or sales credit, MMA would not report the sale to the customer to ACT since the two trades were done at the same price. Under SEC Rule 10b-10, the confirmation to the customer would show a reported price of \$25, a price to the customer of \$25 1/16, and a differential of 1/16. This answer is consistent with statements made by the NASD in *Notices to Members 95-67 and 96-10*, as well as the letter from Richard Lindsey, SEC, to Richard Ketchum, NASD, dated January 3, 1997.

20. Nasdaq Inside Market: \$10 - 10 3/8, 10 X 10

MMA receives a not-held order from an institutional customer to sell 6,000 shares, with instructions to obtain the best price available with a "bottom" of \$10 1/8. Using the phone, MMA sells 4,000 shares at \$10 3/8 to MMB and 2,000 shares at \$10 to MMC. What are MMA's trade-reporting obligations?

MMA must report to ACT the sell to MMB of 4,000 shares at \$10 3/8 and the sell to MMC of 2,000 shares at \$10. (Note that the VWAP for this trade is \$10 1/4). If MMA buys 6,000 shares from its customer at a VWAP of \$10 1/4, it will not be required to report to the tape the offsetting buy with the

customer. The NASD believes that it would be consistent with an SEC No-Action Letter regarding SEC Rule 10b-10 for MMA to disclose on the confirmation a reported price of \$10 1/4 — the VWAP — instead of a reported price for each individual transaction.⁴ The confirmation must contain a notation that the disclosed price is an average price, and must note that details regarding the actual prices are available to the customer upon request.⁵ If MMA charged a markdown, commission equivalent, or other fee on top of the \$10 1/4, it also would be permissible for the confirmation to disclose the fee as a single amount.

Alternatively, if MMA trades on a net basis and buys 6,000 shares from its customer at \$10 1/8 (or any other price different from the VWAP of \$10 1/4), MMA would report the buy with its customer to the tape because VWAP and the buy from the customer were different prices. The confirmation would disclose a reported price of \$10 1/8, a price to the customer of \$10 1/8, and no differential.

21. Nasdaq Inside Market: \$10 - 10 1/4, 10 X 10

MMA receives an order to buy 10,000 shares at a limit price of \$10 1/8 from Institutional Customer 1, and simultaneously receives an order to sell 10,000 shares at a limit price of \$10 1/8 from Institutional Customer 2. MMA buys 10,000 shares from Institutional Customer 2 and sells 10,000 to Institutional Customer 1, both at \$10 1/8. How is this reported?

MMA reports the sale to Institutional Customer 1 as riskless principal of 10,000 shares at \$10 1/8, assuming that the trades were effected from MMA's market-making account. There will be no trade report for the buy from Institutional Customer 2. MMA will confirm the respective transactions to both customers consistent with SEC Rule 10b-10.

If the transaction had been effected as a pure agency cross and the trades were not run through MMA's market-making or proprietary account, MMA would report the

transaction as an agency cross, not as riskless principal.

22. Nasdaq Inside Market: \$10 - 10 1/4, 10 X 10

MMA receives an order to buy 100,000 shares at a limit price of \$10 1/8 from Institutional Customer 1, and simultaneously receives an order to sell 75,000 shares at a limit price of \$10 1/8 from Institutional Customer 2. MMA crosses 75,000 shares and in order to fill the remainder of Institutional Customer 1, sells 25,000 shares at \$10 1/8 to the customer. How is this trade reported?

One ACT report would indicate an agency cross of 75,000 since the trade was effected as agent and not through MMA's market-making account. MMA would submit a separate trade report that would indicate a sale of 25,000 shares at \$10 1/8 as principal. Note that the confirmation to Institutional Customer 1 would indicate that the firm acted both as principal and agent, consistent with the SEC No-Action Letter.⁶

Attachment B – Text Of Rule Changes

(Note: New text is underlined; deletions are in brackets.)

4630. Reporting Transactions in Nasdaq National Market Securities

4632. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price
and Volume

(1) through (3)(A) No Change

(B) Exception: A “riskless” principal transaction in which a member [that is not a market maker in the security] after having received [from a customer] an order to buy a security, purchases the security as principal [from another member or customer] at the same price to satisfy the order to buy or, after having received [from a customer] an order to sell, sells the security as principal [to another member or customer] at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the mark-up or mark-down, commission-equivalent, or other fee.

(e) through (f) No Change

4640. Reporting Transactions in Nasdaq SmallCap Market Securities

4642. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price
and Volume

(1) through (3)(A) No Change

(B) Exception: A “riskless” principal transaction in which a member [that is not a market maker in the security] after having received [from a customer] an order to buy a security, purchases the security as principal [from another member or customer] at the same price to satisfy the order to buy or, after having received [from a customer] an order to sell, sells the security as principal [to another member or customer] at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the mark-up or mark-down, commission-equivalent, or other fee.

(e) through (f) No Change

4650. Reporting Transactions in Nasdaq Convertible Debt Securities

4652. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price
and Volume

(1) through (3)(A) No Change

(B) Exception: A “riskless” principal transaction in which a member [that is not a market maker in the security] after having received [from a customer] an order to buy a security, purchases the bond as principal [from another member or customer] at the same price to satisfy the order to buy or, after

having received [from a customer] an order to sell, sells the bond as principal [to another member or customer] at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the mark-up or mark-down, commission-equivalent, or other fee.

(e) through (f) No Change

6600. Reporting Transactions In Over-The-Counter Equity Securities

6620. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price
and Volume

(1) through (3)(A) No Change

(B) Exception: A “riskless” principal transaction in which a member [that is not a market maker in the security] after having received [from a customer] an order to buy a security, purchases the security as principal [from another member or customer] at the same price to satisfy the order to buy or, after having received [from a customer] an order to sell, sells the security as principal [to another member or customer] at the same price to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the mark-up or mark-down, commission-equivalent, or other fee.

(e) No Change

Endnotes

¹In fact, NASD Rule IM-2110-2 (Limit Order Protection Rule) requires Market Makers to execute customer limit orders (regardless of whether the customer is theirs or that of another member) when trading as principal at prices that would satisfy the customer's limit order. In addition, pursuant to best execution obligations articulated by the SEC under the SEC Order Handling Rules, Market Makers generally must pass along any price improvement obtained when executing an incoming order at its published quote while holding an undisplayed limit order

priced better than that quote. *See Notice to Members 97-57.*

²*See* Exchange Act. Release No. 34-37619A (Sept. 6, 1996), 61 FR 48290 (Sept. 12, 1996) (Order Handling Rules Adopting Release); NASD *Notice to Members 96-65* (October 1996); NASD *Notice to Members 97-57* (September 1997).

³*See* SEC Rule 10b-10(a)(2)(ii)(A).

⁴*See e.g.*, SEC No-Action Letter from Catherine McGuire, SEC, to Eugene Lopez, The Nasdaq Stock Market, dated May 6,

1997 (permitting the issuance of a single confirmation at an average price and with multiple capacities for a single customer order effected with multiple executions).

⁵*See id.*

⁶*See id.*

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NASD Notice to Members 99-66

SEC Approves Prior Reference Price Trade Modifier, Changes To Bunching Rules, And Riskless Principal Trade-Reporting Rules For The Third Market

Suggested Routing

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- Trading
- Training
- Variable Contracts

Executive Summary

On July 8, 1999, the Securities and Exchange Commission (SEC or Commission) approved a rule change to:

- 1) implement a new trade report modifier to identify trades effected at a prior reference price (.PRP modifier);
- 2) eliminate the 10,000-share limitation on individual trades that may be "bunched" for trade-reporting purposes for trades that are effected on the first day of secondary market trading; and
- 3) require Market Makers in the Third Market to report trades under the current riskless principal rules that apply to non-Market Makers in the Third Market.

Additionally, on July 23, 1999, the SEC approved a rule change to eliminate an unnecessary provision in National Association of Securities Dealers, Inc. (NASD[®]) Rule 6420 relating to the reporting of transactions in exchange-listed securities traded in the Third Market.

This *Notice* includes questions and answers regarding the rule changes (Attachment A); and the text of the rule changes (Attachment B). The rule changes go into effect on September 30, 1999.

Questions/Further Information

Questions concerning this *Notice* may be directed to the Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8294 or the Legal Section, Market Regulation, NASD Regulation, Inc., (NASD Regulation[®]) at (301) 590-6410.

Discussion

1. Prior Reference Price Modifier

Nasdaq[®] is implementing a new modifier to report late executions (as distinguished from late trade reports), which will be used for trade reports in Nasdaq securities (both Nasdaq National Market[®] (NNM) and SmallCapSM securities) and non-Nasdaq over-the-counter equity securities (*e.g.*, OTC Bulletin Board[®] and pink sheets).

Recently there have been situations in which members execute certain transactions that, although reported timely, actually relate to an obligation to trade that arose at an earlier point in the day or that refer to a prior reference price. These situations include:

- 1) obligations to trade arising from a preferenced SelectNetSM order that was not executed timely;
- 2) orders that are owed the opening or closing price ("market on open" and "market on close") but that are not executed within 90 seconds of the open or close of the market, respectively; and
- 3) orders that may have been lost or misplaced and later filled.

In effect, these trades are late executions, not late reports of executions.

To enable market participants to more accurately report late executions (which many firms today report as .SLD trades), Nasdaq is implementing a new trade report modifier, called the ".PRP" modifier. This modifier must be appended to trade reports that reflect a price that is different from the current market because the execution is based on

a prior reference point in time. Additionally, when using the .PRP modifier, members are required to input the prior reference time (*i.e.*, the time the obligation to trade arose), which shall be placed in the execution time field on the Automated Confirmation Transaction ServiceSM (ACTSM) report.

The following principles and requirements apply to members when using the .PRP modifier:

- Members must use the .PRP modifier for trade reports in Nasdaq securities (both NNM and SmallCap securities), and non-Nasdaq over-the-counter equity securities (*e.g.*, OTC Bulletin Board and pink sheets). Members may not use the .PRP modifier for trades in exchange-listed stocks that are effected in the Third Market.
- Members may not use the .PRP modifier in “stop” stock situations.
- The .PRP modifier will not be required to be used if the report is made within 90 seconds of the prior reference time.
- It will no longer be appropriate for firms to use the .SLD modifier to report late executions; the .SLD modifier may only be used to report late reports of execution.
- Use of the .PRP modifier does not absolve the member of its obligation to provide best execution, in terms of both price and timely execution.

The following are some specific examples of when the .PRP modifier would be used:

Example 1. A member receives a preferred SelectNet order at the member’s quote (“liability order”) at

11:00 a.m. The member fails to execute the trade. Thirty minutes later, at 11:30 a.m., this is brought to the attention of the receiving member, which agrees that the trade should have taken place at 11:00 and at the price existing at 11:00. The receiving member then executes a trade at the 11:00 price. Under the rule change, the member must append a .PRP to the trade report and must input the time “11:00.”

Example 2. A member receives a large number of customer orders prior to the open, which are to be executed at the opening price. Once that price can be identified, the member’s system begins executing each trade at that price. Any such trade that is executed at the opening but due to heavy volume is not printed until after 9:31:30 should be identified with the .SLD identifier. If, however, at 9:45 the member discovers that a customer’s order that should have been executed at the open has not yet been executed, it would be appropriate to execute that customer’s order and append the .PRP modifier with the time “9:30.” This tells market participants that the execution price represents a price that relates to an earlier point in time (in this case, the open), and thus may not bear any relation to the current market, which may have moved in the interim.

2. Partial Elimination of the 10,000 Share Limitation on Bunching of Trades

NASD trade-reporting rules for NNM and SmallCap securities currently permit members to aggregate transactions into a “bunched” trade report in a variety of situations. In particular, the rules permit a member to aggregate transactions done at the same price when it would be impractical to report the trades individually. The

rule provides, however, that when reporting bunched trades no individual order of 10,000 shares or more may be aggregated and reported. The rule further provides that bunched trades must be reported within 90 seconds of the initial transaction and the report must include a “.B” modifier.

Under the rule change approved by the SEC, Nasdaq is removing the 10,000-share limitation for bunching *but only for trades effected on the first day of secondary market trading following an initial public offering (IPO)*. The 10,000-share cap will continue to apply for trades effected after the first day of secondary market trading of an IPO (*i.e.*, day two onward of secondary-market trading). The lifting of the cap for first-day secondary market trading will facilitate more efficient and timely reporting of large numbers of trades in the immediate aftermarket. As is the case today, bunching is optional and a member may continue to report trades individually.

3. Trade-Reporting Rules for Riskless Principal Trades in the Third Market

Under current trade-reporting rules for the Third Market, non-Market Makers generally do not report the offsetting trade with a customer when a “riskless principal” transaction is involved (*i.e.*, a transaction that involves a trade with another member, usually a Market Maker, which is used to offset a trade with a customer). This “riskless principal exception” results in one trade report even though the non-Market Maker firm is involved in two separate trades against its principal account.

Due to recent growth and changes in Third Market trading, including significant advances in technology and the implementation of the SEC’s order handling rules, Nasdaq

sees no significant reason to continue the distinction between Market Makers and non-Market Makers in the context of the Third Market, and thus is extending this riskless principal exception described above to Market Makers in the Third Market. Under the rule change, only one trade report will result for transactions where the Market Maker has encountered no risk and, although there are two trades effected, the economic reality is that the trades can be viewed as one trade. For example, if a Market Maker in an exchange-listed security does not assume a risk position on an Intermarket Trading System (ITS) commitment sent to another market center, the Market Maker will not reprint the trade in the Third Market when it receives confirmation of an execution on the commitment. This analysis applies to transactions that result from orders sent to the floor even when sent outside of the ITS linkage (e.g., through a floor broker or other automated execution system of the exchange) as well as other Market Makers in the Third Market.

The rule defines "riskless principal" as a trade in which a member, after having received an order to buy (sell), purchases (sells) the security as a principal in order to satisfy the order to buy (sell). Thus, a riskless principal trade generally is one that involves a conditional order rather than one immediately executable by the firm as principal. Such condition may involve a customer order for which execution is dependent upon finding the other side, or a transaction dependent upon the execution of a part of the order placed with another firm or market. For example, after receiving a customer's market order to buy 500 shares, a Market Maker in the Third Market sends an order to an exchange for 1,000 shares, where it is immediately executed. The Market Maker then satisfies the 500-share order for its customer.

The 1,000-share execution is reported by the exchange; under the new rules, the 500-share execution by the Market Maker will not be printed again in the Third Market. The remaining 500 shares that the Market Maker bought on the floor of the exchange, however, is deemed to be "at risk." Accordingly, if the Market Maker sells those 500 shares in a later transaction, the Market Maker will print the 500 shares in the Third Market.

Under the rule, there may be situations where only a portion of a transaction may be riskless and reported as such. That is, to the extent that the customer's order is greater than the first leg that is executed on an exchange or in the Third Market, only the portion of the second leg (i.e., the offsetting transaction with the customer) that is offset by the first leg will be deemed riskless; any balance would be "at risk" and reported as a separate trade. Thus, if a portion of a larger transaction is being filled from a Market Maker's inventory, that portion of the trade filled from inventory must be reported as principal. For example, after having received an order to buy 1,000 shares, a Market Maker in the Third Market fills 500 shares from inventory and sends an order for 500 shares to an exchange. The exchange reports back to the Market Maker an execution of 500 shares. The Market Maker then fills the 1,000-share customer order. The Market Maker would only report 500 shares in the Third Market (the amount filled from inventory) and would not report the 500-share execution received on the floor of the exchange because that portion of the trade is deemed riskless.

Marker Order Exception. Nasdaq also considered the extent to which the riskless principal definition would apply in situations where the first leg is a "marker" order. These

orders, usually of nominal size, are used to trigger obligations to other orders the firm may be holding. Marker orders serve as a mechanism to notify the Market Maker that the market has traded at that price and that a conditional order the Market Maker is holding has now become executable in accord with the firm's understanding with its customer. Marker orders generally are not intended to offset, to any significant degree, other executions by the Market Maker.

Nasdaq has determined to add an exception to the riskless principal trade-reporting rule for marker orders that are 10 percent or less than the full size of the order or group of orders being marked. That is, the execution of a marker order would appear to merit riskless principal treatment and would not be printed in the Third Market to the extent of the size of the marker order. However, given the purpose for which marker orders are used, a member should not be required to break up the order it is holding into two separate components to distinguish between a risk and riskless portion, if the marker order is no larger than 10 percent of the size of an execution or group of executions that it would trigger. This is because the nominal size of the marker order does not, to any material extent, change the overall risk profile of the order. (See Questions 16 and 17 in Attachment A for examples on handling marker orders.)

10b-10 Obligations. In the order approving the Third Market riskless principal rules, the SEC stated that Rule 10b-10 under the Act requires a broker/dealer acting as Market Maker in a riskless principal transaction in an exchange-listed security to confirm to its customer:

- 1) the reported trade price;

2) the price to the customer in the transaction; and

3) the difference, if any, between the reported trade price and the price to the customer (*i.e.*, any markup or markdown, commission equivalent, or other fee on top of the reported price).

The SEC further stated that under Rule 10b-10, the broker/dealer is required to report, as the “reported trade price”, the price at which the security was reported to the tape (Consolidated Tape Authority (CTA)) by the exchange or Market Maker in the Third Market when the member purchased the security for, or sold the security on behalf of, its customer. The Commission stated that this requirement remains in effect regardless of the fact that there is no corresponding requirement in the NASD rules to report the second leg of a riskless principal transaction to the tape.

4. Elimination of “Reasonably Related to the Market” Provision in NASD Rule 6420

In addition to the changes to Third Market trade-reporting rules described above, the SEC approved on July 23, 1999, a rule change that eliminates unnecessary provisions of NASD Rule 6420.

NASD Rule 6420(d)(3)(A), which is the general rule requiring NASD members to report all principal transactions in exchange-listed

securities in the Third Market, contains language requiring members to report transactions in a manner “reasonably related to the prevailing market taking into consideration all relevant circumstances...” (Reasonably Related to the Market Provision). The Reasonably Related to the Market Provision was added as part of broader changes in 1980 to the Third Market trade-reporting rules, which at the time required Market Makers in the Third Market to report to the tape transaction prices inclusive of any markup, markdown, commission equivalent, or other fee to the customer (collectively, charges).¹ In contrast, exchange rules at the time required their members to report to the tape transaction prices exclusive of any charges to the customer. The 1980 changes to the Third Market trade-reporting rules were intended to make comparable the reporting of Third Market trades with exchange transactions by requiring Market Makers in the Third Market to report trades exclusive of any charges.

Since the 1980 rule changes, Nasdaq has come to the conclusion that the Reasonably Related to the Market Provision is superfluous in the context of Third Market trading and does not serve any meaningful purpose with respect to the trade reporting for these securities. Indeed, this provision has served only to promote the misinterpretation that the rule provides flexibility in the manner in which NASD members may report Third Market transactions, which

has led some to believe there is inaccurate trade reporting in the Third Market. To be certain, NASD rules do not permit such discretion or latitude — Market Makers in the Third Market must report to the tape transaction prices **exclusive** of any charges. Additionally, under Exchange Act Rule 10b-10 Market Makers in the Third Market must confirm to the customer the price reported to the tape and any difference between the price reported to the tape and the price to the customer.

Additionally, as the SEC recently stated in the context of a proposal to extend the NASD’s ITS/CAES linkage to all exchange-listed securities, while the Commission appears to concur that the rules could be clarified, the rules are nonetheless the same for the reporting of both 19c-3 securities and non-19c-3 securities. Nasdaq believes that NASD rules and procedures, along with a member’s best execution obligations, provide the necessary protections to ensure accurate and appropriate trade reporting in exchange-listed securities. As the Commission has indicated on several occasions, an effective surveillance program along with the requirements of Exchange Act Rule 10b-10, ensure compliance with trade-reporting obligations and the proper disclosure of any markup or markdown.² Accordingly, Nasdaq is removing this less-than-clear language from the rule to ensure there are no continuing ambiguities or misinterpretations.

Attachment A — Questions And Answers

General Questions

1. When do the new riskless principal rules for the Third Market go into effect?

The rules go into effect on September 30, 1999, at which time NASD members which effect transactions in the Third Market will be required to report transactions according to the new rules.

2. Do the riskless principal rules described in this *Notice* apply only to transactions in exchange-listed securities effected in the Third Market?

Yes. The new riskless principal rules apply only to transactions in exchange-listed securities effected in the Third Market by NASD members. The rules described in this *Notice* are separate and different from the riskless principal rules that were recently adopted for Nasdaq and over-the-counter securities, which are described in more detail in NASD *Notice to Members 99-65*.

3. Do the new rules define what is a “riskless principal” transaction?

Existing NASD trade-reporting rules for the Third Market define “riskless principal” transactions effected by non-Market Makers, and require non-Market Makers that execute riskless principal transactions to not report the offsetting transaction with the non-Market Maker’s customer to the NASD. The new rules simply extend the existing riskless principal trade-reporting rules to cover transactions effected in the Third Market by Market Makers.

Under the new rules, a Market Maker reports a “riskless” principal transaction once if the Market Maker

receives an order to buy (sell) a security, and then purchases (sells) the security as principal to satisfy the order to buy (sell). Generally, a riskless principal trade involves two orders, the execution of one being dependent upon the receipt or execution of the other; hence, there is no “risk” in the interdependent transactions when completed. Only when the condition or dependency is satisfied is the offsetting trade effected, the transaction completed, and only a single trade report required. Such condition may involve an institutional customer order, the execution of which is dependent upon finding the other side, in whole or in part, or a transaction dependent upon the execution of all or a part of the order placed with another firm or market. To the extent that any of the order is offset with another principal execution, that portion is deemed riskless and should be reported only once. If a portion of the order is not offset with another principal transaction, that portion would represent risk and should be reported to the tape to the extent it is riskless. (As noted in Question 4, there is an exception to the general rule for marker orders.) **See** Question 14 below for an example.

Thus, for example, if a Market Maker receives a customer market or marketable limit order and the Market Maker sends the order to the floor of an exchange for execution, the exchange will print the trade. When the specialist reports the trade back to the Market Maker and the Market Maker subsequently effects the offsetting transaction with its customer, the Market Maker will not report the offsetting transaction to the tape.

Finally, the NASD wishes to clarify that orders received from other broker/dealers and non-customers qualify for riskless principal treatment, although the rule only specifically refers to “customer” orders.

4. Do “marker” orders that are sent to an exchange as part of a larger order qualify for riskless principal treatment?

If a marker order is 10 percent or less than the full size of the order or group of orders it is marking, then the marker order is not considered “riskless” and would be reported as part of the larger order(s) when the offsetting trade is effected in the Third Market. For an example, see Questions 16 and 17.

5. Do riskless principal transactions *only* apply to retail customer orders and limit orders?

No. The rules apply to orders held by a member that are from a customer, another member, the customer of another member, or any other entity including non-member broker/dealers. Further, the rule covers both market and limit orders.

6. How should a member mark a trade report for riskless principal trades?

Members should mark the trade report with the capacity indicator for riskless principal (*i.e.*, click on the “Riskless” button under the P/A field on the ACT report).

7. If one leg of the transaction is executed through Nasdaq’s Computer Assisted Execution SystemSM (CAESSM), the system automatically reports the trade for the market participants and appends a principal capacity indicator to the trade report when a Market Maker is involved. When this occurs and the trade is part of a riskless principal transaction, is the Market Maker required to go back into ACT and change the system-generated trade report to indicate the trade was riskless principal?

Generally, no. If a trade is executed through CAES where the trade is automatically reported to ACT and sent to the tape, ACT will default to a capacity indicator of "principal" when a Market Maker is involved. When this occurs, a Market Maker will **not** be required to go back into ACT and change the Nasdaq system-generated report to indicate the trade was effected on a riskless principal basis. If, however, the Market Maker does not clear for the customer for which it executed the riskless principal trade, the Market Maker will be required to submit a "clearing-only" record to ACT and to the National Securities Clearing Corporation (NSCC). In these instances, the Market Maker is required to indicate on the "clearing-only" record that the trade was done on a riskless principal basis.

For example, Market Maker A (MMA) receives a customer limit order to buy at \$20, and displays that order in its quote. Another Market Maker or market center sends an order through CAES, which executes against MMA's quote and takes out the \$20 buy order. CAES then reports the trade to the tape at \$20 as principal for MMA. If MMA does not clear for the customer from which it received the customer limit order, MMA will be required to enter a "clearing-only" record into ACT to reflect the offsetting sale to the customer at \$20, and will be required to indicate on the clearing record that the trade was done on a riskless principal basis.

For riskless principal transactions that occur over the phone in the Third Market or via a Market Maker's internal execution system, the Market Maker must report the initial leg to the tape and mark the trade report as riskless principal. Additionally, depending on whether the Market Maker clears for the customer, the Market Maker may also have to submit a "clearing-

only" record to ACT, which also must indicate the trade was done as riskless principal. Since trades which are executed on the floor of an exchange are reported by such exchange, NASD Market Makers need not report the trade to the tape or otherwise indicate the trade was done on a riskless principal basis.

8. Aren't Market Makers always at risk? For example, if a Market Maker is holding an order and is accumulating a position in an attempt to fill the order, isn't the Market Maker at risk because the customer may cancel the order before the Market Maker finds the other side and fills it? How will a firm know if a trade is riskless?

Market Makers are not necessarily **always** at risk for purposes of trade reporting. A Market Maker generally is not at risk if the Market Maker has two orders in hand that it is crossing or if the Market Maker has one order whose execution is contingent upon finding the other side at the same price.

As a rule of thumb, a Market Maker's responsibility to report to the tape the second leg of the transaction with the customer is determined after the Market Maker has accumulated a position and/or found the other side, and the Market Maker wishes to effect an offsetting transaction with the customer. Generally, if after accumulating a position to fill a customer order the Market Maker actually fills such order, the Market Maker is not at risk on the second leg of the transaction and will not report the customer fill to the tape. Conversely, if the customer cancels the order while the Market Maker is accumulating a position, the Market Maker becomes "at risk" for the amount it has accumulated and is holding in inventory. Accordingly, when the Market Maker attempts to liquidate that position, the Market

Maker must report the associated trade(s) to the tape.

9. If a customer cancels an order while a Market Maker is in the process of accumulating a position to fill the customer's order, the trade report will show a riskless principal modifier when these trades are really "at risk." Will this be a violation of NASD rules?

There may be times when a Market Maker has accumulated a portion or all of a position to satisfy a customer order in hand and reported those transactions to the tape as riskless principal, but the customer cancels the order prior to the Market Maker filling it. The member will not be in violation of riskless principal rules provided that the member properly documents that the trade(s) was reported to the tape as riskless principal while the member was holding a customer order and that the customer canceled the order. The member should keep accurate records reflecting the time the customer order was received and subsequently canceled, as well as the execution time(s) of the trade(s) reported as riskless principal.

10. Are the new rules for riskless principal trade reporting mandatory?

Yes. If a transaction meets the definition of "riskless principal" in the new trade-reporting rules, market participants must report once and as riskless principal.

Trade-Reporting Requirements

11. CQS Inside Market: \$20 - 20 1/4, 10 X 20

MMA, which is a Market Maker in the Third Market, is at the inside offer displaying its customer's limit order to sell 2,000 shares at

\$20 1/4 when Market Maker B (MMB—another Market Maker in the Third Market) lifts the offer using the phone. What are MMA’s trade-reporting obligations?

MMA must report to the tape the sale of 2,000 shares to MMB and mark the report with a riskless principal capacity indicator. MMA will not report to the tape the offsetting buy at \$20 1/4 from the customer.

12. CQS Inside Market: \$20 - 20 1/4, 10 X 20

MMA receives a 500-share market order to buy and sends the order to the floor of an exchange via the ITS linkage or other means (e.g., through a floor broker or other automated routing or execution system of the exchange). The specialist on the exchange floor executes the trade at \$20 1/4, and reports that price back to MMA. What are MMA’s trade-reporting obligations?

MMA should not report the offsetting trade with its customer to the tape, since this is a riskless principal transaction and the exchange has already reported the trade to the tape.

13. If I am a Market Maker in the Third Market and I am engaging in a riskless principal trade consistent with the new trade-reporting rules, how do I confirm the transaction to my customer under SEC Rule 10b-10? For example, what would I have to confirm in the transaction described in the previous question?

As noted above in the text of this Notice, the SEC stated in its approval order of the rule that Exchange Act Rule 10b-10 requires a broker/dealer acting as Market

Maker in a riskless principal transaction in an exchange-listed security to confirm to its customer:

- 1) the reported trade price;
- 2) the price to the customer in the transaction; and
- 3) and the difference, if any, between the reported trade price and the price to the customer (*i.e.*, any markup or markdown, commission equivalent, or other fee on top of the reported price).

The SEC further stated that under Rule 10b-10, the broker/dealer is required to report, as the reported trade price, the price at which the security was reported to the CTA when the member purchased the security for, or sold the security on behalf of, its customer. The Commission stated that this requirement remains in effect regardless of the fact that there is no corresponding requirement in the NASD rules to report the second leg of a riskless principal transaction to the tape.

For example, when a Market Maker receives an execution report from an exchange in a listed security through ITS and completes a riskless principal transaction by filling a customer order, the Market Maker must report on the confirmation to its customer the price of the transaction that was reported to the tape by the exchange (*i.e.*, the reported price). (The same would hold true if the transaction occurred in the Third Market between two Market Makers.) The Market Maker must also report the price to the customer and any markup or markdown or other fee charged by the Market Maker to the customer (*i.e.*, any difference between the price reported by the exchange and the price to the customer).

With regard to Question 12, where MMA sent a buy market order to the floor of an exchange and received a report back from the specialist of \$20 1/4, first assume that MMA charges the customer no markup, commission equivalent, or other fee. In that case, MMA would confirm to the customer:

- 1) a reported trade price of \$20 1/4 (the price reported by the exchange to CTA);
- 2) a price to the customer of \$20 1/4; and
- 3) a no differential.

If MMA had added a commission equivalent of 1/4, MMA would have confirmed:

- 1) a trade price of \$20 1/4 ;
- 2) a price to the customer of \$20 1/2; and
- 3) a differential of 1/4.

Finally, for riskless principal trades effected by non-Market Makers trading as principal in the Third Market, SEC Rule 10b-10 confirmation requirements remain the same as they are today.

14. CQS Inside Market: \$10 - 10 1/4, 10 X 10

MMA receives from an institutional customer an order to sell 100,000 shares with instructions to work the order with a price limit (or “bottom”) of \$10 1/16. MMA discloses that it will charge a commission equivalent of 1/16 on the trade. MMA sends a total of 25,000 shares (either through a single trade or multiple orders) to the floor of an exchange for execution, and MMA receives a report(s) back from the exchange of \$10 1/8 per share. Instead of attempting to find the remaining

75,000 shares, MMA fills the entire customer order for 100,000 shares, for a price of \$10 1/8 per share, by trading the 75,000-share balance out of inventory. How is this trade reported?

Only a portion of the 100,000 share transaction is deemed to be riskless – the 25,000 shares. The remaining 75,000 shares that were executed from MMA's inventory are considered to be "at risk," and must be reported to the tape. Thus, MMA reports only a buy of 75,000, and not a buy of 100,000 shares, from its institutional customer because the 75,000 is deemed to be "at risk" and the remaining 25,000 is deemed riskless and previously reported by the exchange. The confirmation to the customer would show a reported price of \$10 1/8 (the price printed on the exchange and in the Third Market), a price to the customer of \$10 1/16, and a differential (commission equivalent) of 1/16.

15. In the above example, it may not be easy for MMA to definitively say that 25,000 shares were riskless, because MMA may have accumulated these shares in multiple transactions that were reported back to MMA throughout the entire day. Can MMA still report these as riskless principal?

No. In order for a Market Maker to report trades as riskless principal, the Market Maker must be able to identify a specific trade or a group of trades (which may be effected at one price level or multiple price levels if the customer is receiving a volume weighted average price (VWAP)) as being those utilized to fill a customer order. If a member cannot identify which trade or series of trades were effected to offset a customer order, the Market Maker is at risk and cannot report as riskless principal.

Thus, in the previous question where MMA was claiming 25,000 shares were riskless principal, MMA must be able to tie a specific trade or trades to the 25,000 shares. If MMA were reporting a VWAP of \$10 1/8 because MMA received multiple executions on a number of trades sent to the floor of an exchange, MMA would have to point to a series of transactions which had a volume weighted average price of \$10 1/8 and which totaled 25,000 shares.

16. CQS Inside Market: \$10 - 10 1/8, 10 X 10

After receiving a 5,000-share order to buy at \$10, MMA places a marker order to buy 500 shares at \$10 on an exchange. The marker order is executed and triggers the 5,000-share customer order. MMA then fills the 5,000-share customer order. What are MMA's trade-reporting obligations?

MMA would report the 5,000 shares in its entirety (not merely 4,500 shares) and would not exclude the 500 shares executed on and reported by the exchange, since the marker order represents only 10 percent of the 5,000-share order. As a variation of this example, assume the marker order triggers 10 different orders each to buy 500 shares at \$10, for a total of 5,000 shares. Similarly, the Market Maker would report each of these 500-share (*i.e.*, a total of 10) trades with its customers.

17. CQS Inside Market: \$10 - 10 1/8, 10 X 10

After receiving an order to buy 10,000 shares at \$10, MMA places a marker order to buy 2,500 shares at \$10 on an exchange. The marker order is executed and triggers the 10,000-share order. MMA then fills the 10,000-share customer order.

What are MMA's trade-reporting obligations?

The Market Maker would report the 7,500 shares in the Third Market, and would not report the remaining 2,500-marker order executed on the exchange because that order is greater than 10 percent of the 10,000-share customer order and is otherwise riskless.

18. CQS Inside Market: \$10 - 10 3/8, 10 X 10

MMA receives a not-held order from an institutional customer to sell 6,000 shares, with instructions to obtain the best price available with a "bottom" of \$10 1/8. MMA sells in the Third Market 4,000 shares at \$10 3/8 to MMB and 2,000 shares at \$10 to MMC. MMA then buys 6,000 shares at \$10 1/4 from its customer. What are MMA's trade-reporting obligations?

MMA must report to the tape the sell to MMB of 4,000 shares at \$10 3/8 and the sell to MMC of 2,000 shares at \$10. (Note that the VWAP for this trade is \$10 1/4). MMA would not report the offsetting purchase from its customer. The NASD believes that it would be consistent with an SEC No-Action Letter regarding SEC Rule 10b-10 for MMA to disclose on the confirmation a reported price of \$10 1/4 — the VWAP — instead of a reported price for each individual transaction.³ The confirmation must contain a notation that the disclosed price is an average price, and must note that details regarding the actual prices are available to the customer upon request.⁴ If the Market Maker charged a markdown, commission-equivalent, or other fee on top of the \$10 1/4, it also would be permissible for the confirmation to disclose the fee as a single amount.

19. CQS Inside 10 - 10 1/4, 10 x 10

MMA receives a limit order from its customer to sell 5,000 shares at \$10 1/16. Through its internal execution system, MMA immediately buys 5,000 shares from its customer at a price of \$10 1/16. To reduce its inventory position, MMA subsequently sends a limit order to sell 3,000 shares at \$10 1/16 (as principal) to the floor of an exchange or another Market Maker in the Third Market, where the order is filled. What are the reporting obligations here?

MMA would report to the tape that it bought from its customer 5,000 shares at \$10 1/16. Additionally, MMA's sell limit order of 3,000 at \$10 1/16 that was executed on the floor of the exchange would be reported by the exchange. (Note, if MMA had executed the sell limit order in the Third Market (instead of on the exchange) by, for example, hitting the bid of another Market Maker, MMA would report the sell to the tape.) Note that no part of this transaction constitutes a riskless principal trade because MMA did not have the other side (or a portion thereof) of the customer's buy limit order in hand when it

provided the internal execution. Thus, MMA incurred the risk that the market would move against it before MMA could send the offsetting order to the floor of the exchange to reliquify.

20. CQS Inside Market: \$10 - 10 1/4, 10 X 10

MMA receives an order to buy 10,000 shares at a limit price of \$10 1/8 from Institutional Customer 1, and simultaneously receives an order to sell 10,000 shares at a limit price of \$10 1/8 from Institutional Customer 2. MMA buys 10,000 shares from Institutional Customer 2 and sells 10,000 to Institutional Customer 1, both at \$10 1/8. How is this reported?

MMA reports the sale to Institutional Customer 1 as riskless principal for 10,000 shares at \$10 1/8, assuming that the trades were effected from MMA's market-making account. There will be no trade report for the buy from Institutional Customer 2. MMA will confirm the respective transactions to both customers consistent with SEC Rule 10b-10.

If transaction had been effected as a pure agency cross and the trades

were not run through MMA's market-making or proprietary account, MMA would report the transaction as an agency cross, not as riskless principal.

21. CQS Inside Market: \$10 - 10 1/4, 10 X 10

MMA receives an order to buy 100,000 shares at a limit price of \$10 1/8 from Institutional Customer 1, and simultaneously receives an order to sell 75,000 shares at a limit price of \$10 1/8 from Institutional Customer 2. MMA crosses 75,000 shares, and in order to fill the remainder of Institutional Customer 1, sells 25,000 shares at \$10 1/8 to the customer. How is this trade reported?

MMA would submit a trade report indicating an agency cross of 75,000 shares since the trade was effected as agent and not through MMA's market-making account. MMA would submit a separate trade report that would indicate a sale of 25,000 shares at \$10 1/8 as principal. Note that the confirmation to Institutional Customer 1 would indicate that the firm acted both as principal and agent, consistent with the SEC No-Action Letter.⁵

Attachment B – Text Of Rule Changes

(Note: New text is underlined; deletions are in brackets.)

4632. Transaction Reporting

(a)(1) through (a)(8) No Change

(9) All members shall append a trade report modifier as designated by the Association to transaction reports that reflect a price different from the current market when the execution is based on a prior reference point in time, which shall be accompanied by the prior reference time.

(b) through (f)(1)(C) No Change

(D) Orders received or initiated by the reporting member which are impractical to report individually and are executed at the same price within 60 seconds of execution of the initial transaction; provided however, that no individual order of 10,000 shares or more may be aggregated in a transaction report and that the aggregated transaction report shall be made within 90 seconds of the initial execution reported therein. Furthermore, it is not permissible for a member to withhold reporting a trade in anticipation of aggregating the transaction with other transactions. The limitation on aggregating individual orders of 10,000 shares or more for a particular security shall not apply on the first day of secondary market trading of an IPO for that security.

4642. Transaction Reporting

(a)(1) through (a)(8) No Change

(9) All members shall append a trade report modifier as designated by the Association to transaction reports that reflect a price different from the current market when the execution is based on a prior reference point in time, which shall

be accompanied by the prior reference time.

(b) through (f)(1)(C) No Change

(D) Orders received or initiated by the reporting member which are impractical to report individually and are executed at the same price within 60 seconds of execution of the initial transaction; provided however, that no individual order of 10,000 shares or more may be aggregated in a transaction report and that the aggregated transaction report shall be made within 90 seconds of the initial execution reported therein. Furthermore, it is not permissible for a member to withhold reporting a trade in anticipation of aggregating the transaction with other transactions. The limitation on aggregating individual orders of 10,000 shares or more for a particular security shall not apply on the first day of secondary market trading of an IPO for that security.

4652. Transaction Reporting

(a)(1) through (a)(7) No Change

(8) All members shall append a trade report modifier as designated by the Association to transaction reports that reflect a price different from the current market when the execution is based on a prior reference point in time, which shall be accompanied by the prior reference time.

6420. Transaction Reporting

(a) through (c) No Change

(d) Procedures for Reporting Price and Volume

Members which are required to report pursuant to paragraph (b) above shall transmit last sale reports for all purchases and sales in eligible securities in the following manner:

(1) through (2) No Change

(3) (A) For principal transactions, except as provided below, report each purchase and sale transaction separately and report the number of shares and the price. For principal transactions which are executed at a price which includes a markup, markdown or service charge, the prices reported shall exclude the markup, markdown or service charge. [Such reported price shall be reasonably related to the prevailing market, taking into consideration all relevant circumstances including, but not limited to, market conditions with respect to the security, the number of shares involved in the transaction, the published bids and offers with size at the time of the execution (including the reporting firm's own quotation), accessibility to market centers publishing bids and offers with size, the cost of execution and the expenses involved in clearing the transaction.]

(B) Exception: A "riskless" principal transaction in which a member [that is not a market maker in the security] after having received from a customer an order to buy, purchases the security as principal from another member or customer to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to another member or customer to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the markup or markdown. A riskless principal transaction in which a member purchases or sells the security on an exchange to satisfy a customer's order will be reported by the exchange and the member shall not report.

6620. Transaction Reporting

(a)(1) through (a)(5) No Change

(6) All members shall append a trade report modifier as designated by the Association to transaction reports that reflect a price different from the current market when the execution is based on a prior reference point in time, which shall be accompanied by the prior reference time.

Endnotes

¹See Exchange Act Release No. 16960, 45 FR 47291 (July 7, 1980) (approving SR-NASD-80-3).

²See e.g., Exchange Act Release No. 40260, n. 63 and 67 (July 24, 1998), 63 FR 40748 (July 30, 1998) (proposed amendments to National Market System plan); Exchange Act Release No. 18713 (May 6, 1982) 47 FR 20413, n.13 (May 12, 1982) (adoption of final amendments to National Market System plan).

³See, e.g., SEC No-Action Letter from Catherine McGuire, SEC, to Eugene Lopez, The Nasdaq Stock Market, dated May 6, 1997 (permitting the issuance of a single confirmation at an average price and with multiple capacities for a single customer order effected with multiple executions).

⁴See *id.*

⁵See *id.*

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NASD Notice to Members 99-67

NASD Requests
Comment On Proposed
Amendments To
Membership Rules;
Comment Period Expires
September 13, 1999

Suggested Routing

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

Executive Summary

NASD Regulation, Inc. (NASD Regulation®) is proposing to amend the rules governing new member applications and applications for approval of a change in a member's ownership, control, or operations. The text of the proposed amendments is included with this *Notice to Members—Request For Comment* (see Attachment A). A detailed explanation of the proposed rules follows in Attachment B.

Request For Comment

NASD Regulation encourages all interested parties to comment on the proposal. Comments must be received by **September 13, 1999**. Comments should be mailed to:

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

or e-mailed to:
pubcom@nasd.com

Important Note: The only comments that will be considered are those submitted via e-mail or in writing.

Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the National Association of Securities Dealers, Inc. (NASD®) Board of Governors, and must be approved by the Securities and Exchange Commission (SEC).

Questions/Further Information

As noted, written comments should be submitted to Joan Conley. Questions concerning this *Notice to*

Members—Request For Comment may be directed to Mary M. Dunbar, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8252; or to Jeffrey S. Holik, Director of Regulation Policy, Member Regulation, NASD Regulation, at (202) 728-8387.

Changes To Membership Rules

NASD Regulation invites members to comment on amendments to the Rule 1010 Series, which govern NASD membership. NASD Regulation staff and the Member Admission Review Committee (Committee),¹ an ad-hoc committee convened in August 1998, developed the proposed changes. NASD Regulation asked the Committee to suggest ways to streamline the rules and make them more efficient while preserving their investor protection function. The Board, as well as the Membership Committee, the National Adjudicatory Council (NAC), and the Small Firm Advisory Board, approved the proposed changes.

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

- 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;

- simplifying administrative procedures for submitting an application and calculating the various time limits that apply to the process;
- rescinding the NAC's authority to review membership decisions that are not appealed by an applicant;

- permitting the staff to stay membership applications if a firm or one of its principals is the subject of a disciplinary action; and
- permitting the staff to reject immediately applications that are not substantially complete.

Attachment A

Text Of Amendments

(Note: New text is underlined; deletions are in brackets.)

1010. Membership Proceedings

1011. Definitions

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

(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.

(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) adding a type of business listed in Item 12 of Form BD, regardless of the percentage of annual revenue expected to be generated by the activity;

(3) adding business activities that require a higher minimum net capital under SEC Rule 15c3-1;

(4) managing or co-managing for the first time: (A) a firm commitment underwriting; or (B) a conditional arrangement for the distribution of new securities, such as a best efforts commitment; unless the Association has given the member prior approval to act as manager or co-manager; or

(5) increasing the number of Associated Persons involved in sales or the number of offices or markets made in excess of any one or more of the safe harbors in Interpretive Material 1011-1.

~~(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 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): Section 15(b)(4)(E) 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 is required to 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.

<u>Number of Associated Persons Involved in Sales</u>	<u>Safe Harbor – Increase Permitted Within One Year Period Without Rule 1017 Application</u>
<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>

Number of Offices (registered or unregistered)	
<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 time 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 Form BD, with applicable schedules;

(B) an original signed 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)] (E) 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 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] reflect[s]:

(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; and

[(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)].

(3) Electronic Firm Contact Questionnaire [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.] The Applicant also shall submit an electronic firm contact questionnaire, including its electronic mail address.

(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 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 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:

(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 subparagraph.

[(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)] (i)(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), unless the Department determines that an application is not required.

(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. 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 apply for approval of a change in ownership, control, or business operations, the Applicant shall submit a new application and fee 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 may 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).

[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

A person aggrieved by final action of the Association under the Rule 1010 Series may apply for review by the Commission pursuant to Section 19(d)(2) of the Act. The

filing of an application for review shall not stay the effectiveness of a decision constituting final action of the Association, unless the Commission otherwise orders.

Attachment B

Rule 1011

Associated Person

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

Material Change In Business Operations

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.

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 the 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. Nonetheless, the staff ultimately has the authority to determine whether a change not specified in the definition is material. If the staff determines that a change is indeed material after it is made, then the member potentially could be subject to disciplinary action for failure to file an application under proposed Rule 1017.

Safe Harbor Limits

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. NASD Regulation requests comment on whether the limitations in the Interpretive Material are set at appropriate levels.

The safe harbor would not be available to members that have “disciplinary history.” “Disciplinary history” means a finding of a violation in the past five years by the SEC, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the following provisions (or comparable foreign provisions):

- Section 15(b)(4)(E) of the Securities Exchange Act of 1934 (failure to supervise);
- 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 requirements 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).

NASD Regulation requests comment on whether this definition is appropriate, particularly the five-year limit. NASD Regulation also requests comment on whether the definition of disciplinary history should include violations by officers or principals of the member.

Principal Place Of Business

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.

Sales Practice Event

NASD Regulation proposes to redefine “sales practice violations” as “sales practice event” because the definition includes not only proven violations, but also unproven allegations. The current definition has become obsolete; it tracks a definition that was once used on Form U-4. 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 (CRDSM) or otherwise is required to be reported to the Association (*e.g.*, via Rule 3070).

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 Postal Service. NASD Regulation intends 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 Postal Service. 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 Rule.

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.

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 Forms BD and U-4), is sent directly to 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 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 a 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.² 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.

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. 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. NASD Regulation requests comment on what sort of certification would be appropriate, who may prepare it, and what it should contain.

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.

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 specifically must include procedures to ensure proper registrations are obtained by the firm. All other changes to the standards for admission are conforming changes.

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 online at www.nasdr.com/4700_appendix_b.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.³ Therefore, this provision is deleted.

When the proposed rules become effective, to ensure that 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 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.

NASD Regulation also requests comment on whether restrictions in a membership agreement should automatically sunset after a fixed period (e.g., five years) if the applicant does not have any disciplinary history.

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

Rule 1015

NASD Regulation proposes to delete the NAC's call for review authority. 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.

Member admission decisions do not lend themselves to calls for review. This is especially true for decisions that grant a membership application without restriction because they do not contain a rationale. (Only decisions that deny an application or grant it with a restriction contain a rationale. Decisions that grant an application without restriction simply state that the applicant has met all relevant standards.) Just reading the districts' decisions, without looking at the rest of the record, would not

be particularly useful. Unlike a call for review of a regular disciplinary decision, there is no hearing panel vote that might indicate a close or difficult issue. NASD Regulation believes that it would be duplicative of district staff work and inefficient to review every record in its entirety to determine if it supports the decision. NASD Regulation also considered whether certain categories of decisions could be reviewed, but was concerned that such a procedure might be perceived as biased against those firms that fell within the selected category.

Therefore, NASD Regulation has temporarily suspended calls for review of membership decisions, and proposes to delete this provision altogether. NASD Regulation headquarters staff will continue to exercise oversight of the district decision-making process.

NASD Regulation also proposes a new provision for dismissing appeals that are abandoned by an applicant.

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 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 indicate in its business plan that it intends to have 10 to 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 without prior review and approval by NASD Regulation to the extent permitted in the safe harbor in IM-1011-1.

Another type of change that triggers an application under proposed Rule 1017 is a direct or indirect change in the ownership or control of the member. 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/control change.

NASD Regulation proposes to discontinue its review of certain ownership or control 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 requests comment on whether a new provision should be added to proposed Rule 1017 to clarify what happens if a change in ownership is denied. For example, the Rule could provide that if the ownership change is denied, then the member cannot engage in the securities or investment banking business, and that the firm has a fixed period of time to find new owners or file a Form BDW. Of course, as under the current rules, a member could continue to operate with the approved owners if the transaction has not closed or otherwise could be unwound.

As part of its review of the Rule 1010 Series, NASD Regulation considered whether the time frames in proposed 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 is working on 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 will be posted on the Web Site in the future. 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.

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 proposed 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.

Summary of Requests for Specific Comments

NASD Regulation encourages members and other interested parties to comment on all aspects of the proposed rules discussed in this *Notice*. We also specifically solicit comment on the following issues:

- the definition of material changes in business operations in proposed Rule 1011(i);
- the safe harbor numbers set forth in proposed IM-1011-1;
- the definition of disciplinary history in proposed IM-1011-1;
- whether the definition of disciplinary history should include violations by officers or principals of the member;
- how an applicant should demonstrate that it can ensure business continuity under proposed Rule 1014(a)(6);
- whether restrictions in a membership agreement should automatically sunset after a fixed period (*e.g.*, five years) if the applicant does not have any disciplinary history; and
- whether a provision should be added to proposed Rule 1017 that clarifies what happens if a change in ownership is denied, *e.g.*, whether the Rule

specifically should provide that if the ownership change is denied, then the member cannot engage in the securities or investment banking business, and that the firm has a fixed period of time to find new owners or file a Form BDW.

Endnotes

¹Members 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.

²NASD Regulation also proposes to charge a \$350 processing fee for Rule 1017 applications that are not substantially complete. Currently, NASD Regulation does not charge a fee for Rule 1017 applications, but anticipates doing so in the future.

³In 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).

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NASD Notice to Members 99-68

NASD Regulation Announces Its Policy On Enforcement Of Disciplinary Sanctions During The Pendency Of Circuit Court Appeals

Suggested Routing

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

Executive Summary

NASD Regulation, Inc. (NASD Regulation®) announces its policy to refrain from enforcing disciplinary sanctions, other than bars and expulsions, during the pendency of appeals of National Association of Securities Dealers, Inc. (NASD®) disciplinary cases from the Securities and Exchange Commission (SEC) to Circuit Courts of Appeal.

Questions regarding this *Notice to Members* may be directed to Carla Carloni, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8019.

Discussion

In accordance with long-standing practice, NASD Regulation does not bill respondents for disciplinary fines during the course of Circuit Court appeals, notwithstanding whether sanctions are stayed in the matter. In the past, however, NASD Regulation enforced suspensions in cases in which sanctions were not stayed pending Circuit Court appeals. Thus, while NASD Regulation refrained from billing respondents for fines imposed in NASD disciplinary cases pending appeal to Circuit Courts of Appeal, it imposed suspensions and requalification requirements in the very same cases.

In order to harmonize NASD Regulation's sanction enforcement efforts in cases pending appeal to Circuit Courts of Appeal, NASD Regulation has revisited its policy and concluded that the most efficient and fairest method of dealing with the enforcement of sanctions at the Court of Appeals level (and during the pendency of petitions for certiorari or ongoing proceedings before the U.S. Supreme Court) is to follow the policy that it currently follows at the SEC appellate level, *i.e.*, enforce

only bars and expulsions (absent a stay), but refrain from enforcing all other sanctions, regardless of whether a stay is in effect. This method ensures investor protection by enforcing bars and expulsions while fairly providing respondents with the opportunity to pursue appeals without the threat of the enforcement of other sanctions.

Legally, NASD Regulation can enforce sanctions absent a stay while a matter is pending appeal in a Circuit Court of Appeals. NASD Regulation has concluded, however, that the fairer and more efficient policy is to refrain from doing so for the following reasons:

- 1) If a Court of Appeals reverses SEC/NASD findings, the sanctions may be eliminated. If an individual or a firm is forced to serve a suspension or to requalify while an appeal is pending, he/she will have done so for naught if the sanction ultimately is eliminated. NASD cannot return suspension time to an individual or a member firm if the findings are reversed, so the individual or firm loses that time in the industry.
- 2) Consistency is important in the area of enforcement of sanctions. Since NASD Regulation refrains from collecting fines and revoking respondents for failing to pay fines while an appeal is pending in a Circuit Court of Appeals, it is inconsistent to require that those same respondents serve suspensions while a matter is pending appeal.
- 3) An across-the-board policy to refrain from enforcing all sanctions (except bars and expulsions) while cases are on appeal will ensure that NASD Regulation does not inadvertently violate a stay

order. Although ideally NASD Regulation receives timely notice of all stay orders, since it is not always noticed as a party to Circuit Court appeals, there is a danger that timely notice may not be forthcoming.

- 4) The SEC readily grants stay requests when matters are pending appeal in a Circuit Court of Appeals. In many cases, a stay already is in

effect, so this policy change should not drastically alter the current state of affairs with respect to the enforcement of sanctions.

- 5) Since NASD Regulation always enforces bars and expulsions (absent a stay), the investing public is protected in cases involving more egregious misconduct.

NASD Regulation believes that this policy change will ensure the fair and efficient treatment of all disciplinary respondents with respect to the enforcement of sanctions pending Circuit Court appeals.

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NASD Notice to Members 99-69

NASD Regulation
Requests Comment On
Proposed Trading Halt
Rules; Comment Period
Expires **September 30,
1999**

Suggested Routing

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

Executive Summary

As part of the effort to address abuses in the trading and sales of thinly traded, thinly capitalized (microcap) securities and to increase investor protection in the trading of over-the-counter (OTC) securities, this *Notice* requests comment on a rule proposal that would authorize NASD Regulation, Inc. (NASD Regulation®) to halt quotations and trading in OTC securities under certain circumstances. For purposes of this rule, OTC securities include securities that are not listed on an exchange or on The Nasdaq Stock Market, Inc. (Nasdaq®) and securities that are not quoted on the OTC Bulletin Board® (OTCBB).

Under the proposed rule, NASD Regulation would be authorized to impose halts:

(1) in conjunction with regulatory trading halts imposed by foreign regulatory authorities because of potential fraudulent conduct; and

(2) when the security is a derivative of a security listed on Nasdaq or on a national securities exchange and Nasdaq or an exchange halts trading in the underlying security.

Nasdaq has filed a rule proposal with the Securities and Exchange Commission (SEC) requesting authorization for similar authority with regard to OTCBB securities.

Request For Comment

NASD Regulation encourages all interested parties to comment on the proposal. Comments must be received by **September 30, 1999**. Comments should be mailed to:

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

or e-mailed to:
pubcom@nasd.com

Important Note: The only comments that will be considered are those submitted via e-mail or in writing.

Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the National Association of Securities Dealers, Inc. (NASD®) Board of Governors, and must be approved by the SEC.

Questions/Further Information

As noted, written comments should be submitted to Joan Conley. Questions concerning this *Notice to Members—Request for Comment* may be directed to Mary Revell, Associate General Counsel, NASD Regulation, at (202) 728-8203.

Foreign Regulatory Authority Trading Halts

Currently, NASD rules do not provide for the implementation of trading or quotation halts in any security that is not listed on an exchange or on Nasdaq. Thus, NASD Regulation and Nasdaq are unable to impose trading halts in securities that are quoted on the OTCBB (OTCBB securities) or in securities that are quoted and traded in other quotation media, such as the National Quotation Bureau's Pink Sheets or Instinet (OTC securities).

This *Notice* solicits comment on whether NASD Regulation should have the authority to impose regulatory trading and quotation halts in OTC securities, in conjunction with certain halts imposed by a foreign securities exchange, market, or regulatory authority overseeing the foreign market (foreign regulatory authority). The proposed rule would apply only to OTC securities that are not included in the OTCBB and are not listed on a national securities exchange or Nasdaq.¹

Foreign regulatory authorities impose trading halts for various reasons, depending on the jurisdiction, including the dissemination of material news, an issuer's failure to meet regulatory filing requirements imposed by a foreign market or regulatory authority, operational reasons (*e.g.*, an order imbalance), and public interest reasons. The proposed rule would authorize NASD Regulation to impose trading and quotation halts in OTC securities in conjunction with a foreign regulatory authority halt that is imposed because of potential fraudulent conduct or other public interest concerns, when this is stated in the foreign trading halt order. NASD Regulation would not impose a halt in conjunction with a

foreign regulatory authority trading halt that is imposed solely for late filings, the dissemination of material news, or operational reasons.² The halt would be imposed for a maximum of five trading days. At that time, Market Makers would be required to fulfill their obligations under SEC Rule 15c2-11 prior to initiating either a priced or unpriced quotation in the security.³

NASD Regulation would notify the trading community and the public of the halt through the NASD Regulation and Nasdaq Trader Web Sites (*www.nasdr.com* and *www.nasdaqtrader.com*) and upon issuance of the notice will prohibit quotations in any quotation medium and trading by any NASD member. The trading halt notice (noting the beginning and end dates) would remain on the Web Sites for a period of time to inform the public and the trading community of the halt, and ensure ongoing compliance with Rule 15c2-11.⁴

Derivative Security Trading Halts

NASD Rule 4120 provides Nasdaq with the authority to halt trading in a derivative security, in conjunction with a halt imposed by Nasdaq or a national securities exchange in the underlying equity security, but only if the derivative is listed on Nasdaq. Thus, when Nasdaq or an exchange halts trading in a listed security, trading is allowed to continue in the underlying unlisted derivatives on the OTCBB and in other OTC quotation media. It is difficult to accurately price the derivative in the absence of current price information for the underlying security. This difficulty in pricing may lead to disorderly markets and investor confusion.

This *Notice* solicits comment on whether NASD Regulation should have the authority to halt trading in

OTC derivatives in conjunction with a trading halt imposed by Nasdaq or an exchange in the underlying listed security. Like the provision described above, this rule will apply only to OTC securities that are not included in the OTCBB and are not listed on a national securities exchange or Nasdaq.⁵

Plan of Allocation and Delegation of Functions

Finally, NASD Regulation proposes to amend the Plan of Allocation and Delegation of Functions to clarify that the Stockwatch section of Nasdaq would have the authority to handle trading halt functions for securities traded in the OTC market.

Text of Proposed Rule

(Note: *New text is underlined; deletions are in brackets.*)

Rule 3900. Trading and Quotation Halts in Non-Nasdaq, Non-OTCBB Over-the-Counter Securities

(a) Authority to Initiate Trading and Quotation Halts

In circumstances in which it is necessary to protect investors and the public interest, NASD Regulation may direct members, pursuant to the procedures set forth in paragraph (b), to halt trading and quotations in the over-the-counter ("OTC") market of an American Depositary Receipt ("OTC ADR") or a security ("OTC Security") that is traded in the OTC market and that is not otherwise listed on The Nasdaq Stock Market ("Nasdaq") or a national securities exchange or included in the OTCBB when:

(1) the OTC Security or the security underlying the OTC ADR is listed on or registered with a foreign securities

exchange or market, and the foreign securities exchange, market, or regulatory authority overseeing such issuer, exchange or market, halts trading in such security for regulatory reasons ("Foreign Regulatory Halt"); provided, however, that NASD Regulation will not impose a trading and quotation halt if the Foreign Regulatory Halt was imposed solely for the dissemination of material news, a regulatory filing deficiency, or operational reasons; or

(2) the OTC Security is a derivative or component of a security listed on a national securities exchange or Nasdaq ("listed security") and a national securities exchange or Nasdaq imposes a trading halt in the listed security.

(b) Procedure for Initiating a Trading and Quotation Halt

(1) For a halt initiated under subparagraph (a)(1) of this rule, NASD Regulation will promptly evaluate information received from a foreign securities exchange or market on which the OTC Security or the security underlying the OTC ADR is listed or registered or from a foreign regulatory authority overseeing such issuer, exchange, or market about a Foreign Regulatory Halt and determine whether a trading and quotation halt in the OTC Security is appropriate.

(2) For a halt initiated under subparagraph (a)(2) of this rule, NASD Regulation will promptly evaluate information received from Nasdaq or a national securities exchange about a trading halt imposed in a listed security and determine whether a trading and quotation halt in the OTC Security is appropriate.

(3) Should NASD Regulation determine that a basis exists under this Rule for initiating a trading and quotation halt, NASD Regulation shall disseminate appropriate public notice that a trading and quotation halt is in effect and the commencement of the trading and quotation halt will be effective simultaneous with appropriate public notice.

(4) Trading and quotations in the OTC market may resume when NASD Regulation determines that the basis for the halt no longer exists or when five business days have elapsed from the date NASD Regulation initiated the trading and quotation halt in the security, whichever occurs first. NASD Regulation shall disseminate appropriate public notice that a trading and quotation halt is no longer in effect.

(c) Violation of OTC Trading and Quotation Halt Rule

If a security is subject to a trading and quotation halt initiated pursuant to this rule, it shall be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member:

(i) to effect, directly or indirectly, a trade in such security; or

(ii) publish a quotation, a priced bid and/or offer, an unpriced indication of interest (including "bid wanted" and "offer wanted" indications), or a bid or offer accompanied by a modifier to reflect unsolicited customer interest, in any "quotation medium." For purposes of this Rule, "quotation medium" shall mean any quotation system, publication, electronic communication network, or any other device, including any

issuer or inter-dealer quotation system, that is used to regularly disseminate quotations or indications of interest in transactions in equity securities.

Plan Of Allocation And Delegation Of Functions By NASD To Subsidiaries

I - III. No Change

IV. Stockwatch

The Stockwatch section handles the trading halt functions for The Nasdaq Stock Market *securities*, exchange-listed securities traded in the over-the-counter market (i.e., the Third Market), *securities quoted in the Over-the-Counter Bulletin Board [.]*, and all other securities traded in the over-the-counter market.⁶ Review of all questionable market activity, possible rule infractions or any other matters that require any type of investigative or regulatory follow-up will be referred to and conducted by NASD Regulation, which will assume sole responsibility for the matter until resolution. This responsibility will include examinations, investigations, document requests, and any enforcement actions that NASD Regulation may deem necessary. NASD Regulation staff at all times will have access to all records and files of the Stockwatch function.

Endnotes

¹Nasdaq has filed a proposed rule change with the SEC seeking similar authority with respect to OTCBB securities. File No. SR-NASD-99-33, submitted to the SEC on July 13, 1999. NASD Rule 4120 already provides Nasdaq with the authority to halt trading of Nasdaq-listed securities and exchange-listed securities traded OTC.

²NASD Regulation and Nasdaq do not propose to halt for the dissemination of material news because Nasdaq does not have any

listing agreement with OTC issuers and thus cannot compel the full disclosure and dissemination of material news. NASD Regulation and Nasdaq do not propose to halt trading if an issuer fails to meet filing requirements imposed by a foreign regulatory authority on OTC issuers when such requirements may not currently exist in the United States for such issuers. Finally, NASD Regulation and Nasdaq are not proposing to halt trading based on a foreign exchange's operational halt, such as for an order imbalance, because Nasdaq does not generally halt trading for operational reasons.

³SEC Rule 15c2-11, with certain exemptions, prohibits a broker/dealer from publish-

ing a quotation for an OTC security in any quotation medium unless the broker/dealer reviews the information specified in the Rule regarding the security and its issuer and has a reasonable belief that the information is accurate and from a reliable source. NASD Rule 6740 requires a broker/dealer to make a filing on Form 211 with the NASD demonstrating compliance with SEC Rule 15c2-11 prior to publishing a quotation for an OTC security.

⁴When informed, NASD Regulation would also publish notice of foreign regulatory halts imposed for late regulatory filings on the Web Sites even though NASD Regulation will not impose a simultaneous trading halt.

NASD Regulation will not provide notice or impose a trading halt if a foreign regulatory authority halts trading for the dissemination of material news or for operational reasons (e.g., an order imbalance).

⁵The proposed rule change described in footnote 1 also seeks authority for Nasdaq to halt trading in OTCBB derivatives.

⁶Italics indicate language proposed to be added in rule filing described in footnote 1.

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NASD Notice to Members 99-70

NASD Regulation
Announces New Web-
Based FOCUS Filing
System—To Be Available
For September 1999
Filings

Suggested Routing

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

Executive Summary

NASD Regulation, Inc. (NASD Regulation®) is announcing the replacement of the current PC FOCUSSM application with a Web-based, Internet version. Web-based FOCUS will be available to members for the September 1999 FOCUS filing.

Please note that the PC FOCUS application, which operates through Sprint, will not be available for the September filing. In this regard, it is imperative that you immediately forward this Notice to the Financial & Operational Principal at your firm.

Questions concerning this Notice may be directed to Elizabeth Wollin, Member Regulation, NASD Regulation, at (301) 590-6743.

Preparing For Web-Based FOCUS

To prepare for filing monthly, quarterly, and annual FOCUS filing through Web-based FOCUS, members must complete the appropriate entitlement forms (*User Account Acknowledgment Form* and *Account Administrator Entitlement Form*—see below). The forms are being mailed to members. Members will not be able to access Web-based FOCUS until the entitlement forms are fully and accurately completed and submitted. Members must take the following steps:

- Read and execute the “User Account Acknowledgment Form (UAAF).” The original UAAF must be signed and returned to NASD Regulation via mail or courier. Faxed copies will not be accepted. Web-based FOCUS application utilizes the same entitlement functionality as the Web Central Registration Depository

(CRDSM) system. The UAAF is a modified version of the form members completed to authorize Web CRD entitlement. Members may designate their Web CRD Account Administrator to also serve as their Web-based FOCUS Account Administrator.

- Complete and return the “Account Administrator Entitlement Form” so that specific privileges may be assigned to the Account Administrator.

Members must complete and submit these forms no later than **August 31, 1999**. If this deadline is missed, the setup of Web-based FOCUS accounts may be delayed. Once these forms are processed, a confirmation package will be sent to members’ Account Administrators with user account and initial password information. For assistance in completing the entitlement forms, please call (800) 321-NASD.

System Highlights Of Web-Based FOCUS

- Create and submit FOCUS forms—Schedule I, Part II, and Part IIA.
- View a list of upcoming filing requirements.
- Print FOCUS filings from your printer.
- Upload a FOCUS filing from your computer.
- Access Web-based FOCUS from any workstation running either Microsoft’s Internet Explorer 4.01 SP2 or Netscape’s browser version 4.05 or higher. Members will not need to install any additional software on their workstation.

- Utilize the Secure Socket Layer (SSL) security built into your browser to protect your data.
- Access any historical FOCUS filings online.
- Download your filings in existing PC FOCUS format over the Internet to meet your company's record retention

needs and submit the filings to other agencies.

- PIN numbers will no longer be required. However, users will have to be 'entitled' to access the application.
- Access is controlled using a user identification and password. Web-based FOCUS

uses the same security mechanisms as Web CRD. A single individual may have his/her identification authorized to access both the CRD and FOCUS systems.

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NASD Notice to Members 99-71

Labor Day: Trade Date—Settlement Date Schedule

Labor Day: Trade Date-Settlement Date Schedule

The Nasdaq Stock Market® and the securities exchanges will be closed on Monday, September 6, 1999, in observance of Labor Day. "Regular way" transactions made on the business days noted below will be subject to the following schedule:

<u>Trade Date</u>	<u>Settlement Date</u>	<u>Reg. T Date*</u>
Aug. 31	Sept. 3	Sept. 8
Sept. 1	7	9
2	8	10
3	9	13
6	Markets Closed	—
7	10	14

Suggested Routing

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

*Pursuant to Sections 220.8(b)(1) and (4) of Regulation T of the Federal Reserve Board, a broker/dealer must promptly cancel or otherwise liquidate a customer purchase transaction in a cash account if full payment is not received within five business days of the date of purchase or, pursuant to Section 220.8(d)(1), make application to extend the time period specified. The date by which members must take such action is shown in the column titled "Reg. T Date."

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NASD Notice to Members 99-72

Fixed Income Pricing
System Additions,
Changes, And Deletions
As Of June 22, 1999

Suggested Routing

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

As of June 22, 1999, the following bonds were added to the Fixed Income Pricing SystemSM (FIPSSM).

Symbol	Name	Coupon	Maturity
AWAS.GD	Allied Waste North American Inc.	7.625	01/01/06
BFIT.GB	Bally Total Fitness Holding Corp. Series D	9.875	10/15/07
CFTR.GA	Conseco Finl Trust III	8.796	04/01/27
CHCA.GF	Chancellor Media Corp.	8.000	11/01/08
CLSP.GA	Carrols Corp.	9.500	12/01/08
CMS.IH	CMS Energy Corp. Series B	6.750	01/15/04
COL.GI	Columbia/HCA Healthcare Corp.	6.410	06/15/00
COL.GJ	Columbia/HCA Healthcare Corp.	7.690	06/15/25
CQB.GI	Chiquita Brands Intl. Inc.	10.000	06/15/09
DAHX.GA	Decrane Aircraft Holdings Inc. Series B	12.000	09/30/08
DMNS.GA	Dominos Inc. Series B	10.375	01/15/09
DSYG.GA	Dobson/Sygnnet Communications	12.250	12/15/08
FLO.GE	R&B Falcon Corp.	9.500	12/15/08
FLO.GF	R&B Falcon Series B	9.125	12/15/03
FPTU.GA	First America Cap Tr I	8.500	04/15/12
FTVC.GA	Frontiervision LP/Capital Series B	11.875	09/15/07
HPCA.GA	Hospital Corp. Amer	0.000	06/01/01
HPCA.GB	Hospital Corp. Amer	0.000	06/01/02
HSE.GC	H S Resources Inc.	9.250	11/15/06
ICIX.GG	Intermedia Communications Inc. Series B	12.250	03/01/09
ICIX.GH	Intermedia Communications Inc. Series B	9.500	03/01/09
INLP.GB	Insilco Holding Co. Series B	12.000	08/15/07
JIT.GA	Pentacon Inc. Series B	12.250	04/01/09
JORD.GG	Jordan Industries Inc. Series D	10.375	08/01/07
LVLT.GB	Level 3 Communications Inc.	10.500	12/01/08
MLWL.GB	Mail-Well I Corp. Series B	8.750	12/15/08
NTRP.GA	NTL Communications Corp. Series B	12.375	10/01/08
NTRP.GB	NTL Communications Corp. Series B	11.500	10/01/08
NXTL.GH	Nextel Communications Inc.	12.000	11/01/08
OGLE.GA	Oglebay Norton Co.	10.000	02/01/09
OXAU.GC	Oxford Automotive Inc. Series D	10.125	06/15/07
PAW.GA	Florida Panthers Holdings	9.875	04/15/09
PGHI.GA	Premier Graphics Inc.	11.500	12/01/05
PKS.GE	Premier Parks Inc.	9.750	06/15/07
PXCP.GA	Phoenix Color Corp.	10.375	02/01/09
TDGM.GA	Transdigm Inc.	10.375	12/01/08
THM.GA	Thermwood Corp.	12.000	04/27/14
UHSP.GB	Universal Hospital Svs Inc.	10.250	03/01/08
URI.GD	United Rentals Inc. Series B	9.250	01/15/09
VPI.GC	Vintage Petroleum Inc.	9.750	06/30/09
VRIO.GC	Verio Inc.	11.250	12/01/08
WRC.GA	World Color Press Inc.	7.750	02/15/09

As of June 22, 1999, the following bonds were deleted from FIPS.

Symbol	Name	Coupon	Maturity
AMMB.GD	Amresco Inc.	8.750	07/01/99
ANN.GC	Ann Taylor Inc.	8.750	06/15/00
CNLP.GB	Conn Light & Power Co.	7.250	07/01/99
CNLP.GC	Conn Light & Power Co.	7.375	12/01/25
CNLP.GD	Conn Light & Power Co.	5.750	07/01/00
CNLP.GG	Conn Light & Power Co.	6.125	02/01/04
CNLP.GJ	Conn Light & Power Co.	7.875	10/01/24
CNLP.GK	Conn Light & Power Co.	7.750	06/01/02
CPU.GA	CompUSA Inc.	9.500	06/15/00
GRYH.GA	Greystone Homes Inc.	10.750	03/01/04
GSNP.GA	Garden State Newspapers Inc.	12.000	07/01/04
LRGY.GA	LaSalle Energy Corp.	11.750	07/01/99
MCCC.GA	McCrorry Corp.	7.770	07/15/94
MCCC.GD	McCrorry Corp.	7.750	09/15/95
MGL.GA	Magellan Health Services Inc.	11.250	04/15/04
PAHD.GA	PA Holdings Corp.	13.750	07/15/99
PLTC.GB	Plastic Containers Inc.	10.000	12/15/06
RHR.GB	Rohr Industry Inc.	11.625	05/15/03
RYK.GA	Rykoff-Sexton Inc.	8.875	11/01/03
SHVC.GA	Shop Vac Corp.	10.625	09/01/03
TSXC.GA	Transco Energy Co.	11.250	07/01/99
USAR.OM	U.S. Air Inc. Series 88-B	10.180	06/27/99
USAR.ON	U.S. Air Inc. Series 88-C	10.180	06/27/99
USAR.OO	U.S. Air Inc. Series 88-A	10.180	06/27/99
USAR.OP	U.S. Air Inc. Series 88-D	10.180	06/27/99
WSIN.GA	Wesco International Inc. Series B	11.125	06/01/08

As of June 22, 1999, changes were made to the symbols of the following FIPS bonds:

New Symbol	Old Symbol	Name	Coupon	Maturity
BVC.GA	BVCC.GA	Bayview Capital Corp.	9.125	08/15/07

All bonds listed above are subject to trade-reporting requirements. Questions pertaining to FIPS trade-reporting rules should be directed to Stephen Simmes, Market Regulation, NASD Regulation®, at (301) 590-6451.

Any questions regarding the FIPS master file should be directed to Cheryl Glowacki, Nasdaq® Market Operations, at (203) 385-6310.

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