

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Jonathan G. Katz,

Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38908; File No. SR-NASD-97-28]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 to the Proposed Rule Change, Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change, and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 3, 4, and 5 to Proposed Rule Change Regarding Membership Application Procedures, Disciplinary Proceedings, Investigations and Sanctions Procedures, and Other Conforming Changes

August 7, 1997.

On April 18, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹, and Rule 19b-4 thereunder.² The Association originally proposed to amend: (1) The By-Laws of the NASD; (2) the By-Laws of NASD Regulation, Inc. ("NASD Regulation" or "NASDR"); (3) the By-Laws of The Nasdaq Stock Market, Inc. ("Nasdaq"); (4) the Plan of Allocation and Delegation of Functions By NASD to Subsidiaries ("Delegation Plan"); (5) Rule 0120; (6) Rule IM-2210-4; (7) the Rule 1010 Series; (8) the Rule 8000 Series; and (9) the Rule 9000 Series.

On April 23, 1997, the NASD filed a technical amendment to the proposed rule change.³ Notice of the proposed rule change, including Amendment No. 1, was provided by issuance of a Commission release on April 24, 1997 and by publication in the **Federal**

Register on May 8, 1997.⁴ On July 10, 1997, the NASD filed Amendment No. 2, pertaining to changes to the 9400 Series (Members Experiencing Financial or Operational Difficulties), the 9500 Series (Summary and Non-Summary Suspensions, Cancellation, Bar, and Limitation or Prohibition on Access to NASD Services), and the 9600 Series (Procedures for Exemptions from Certain NASD Rules). Notice of Amendment No. 2 to the proposed rule change was provided by issuance of a Commission release on July 11, 1997 and by publication in the **Federal Register** on July 16, 1997.⁵ On July 11, 1997, the NASD filed Amendment No. 3 to the proposed rule change, making several clarifying changes to the investigations and sanctions, disciplinary, and member admission procedures.⁶ Amendment No. 3 also withdrew the proposed amendments to the by-laws of the NASD, NASD Regulation, and Nasdaq, as well as proposed amendments to these entities' restated Certificates of Incorporation and the Delegation Plan. These documents will be amended to reflect the corporate restructuring recently approved by the NASD Board of Governors and will be submitted in a separate rule filing at a later date. On July 21, 1997, the NASD filed Amendment No. 4 to the proposed rule change making several technical, nonsubstantive amendments.⁷ On August 4, 1997, the NASD filed Amendment No. 5 to the proposed rule change, which modified the timing of the effectiveness of the proposed rule change and included several technical amendments.⁸ The Commission

⁴ Securities Exchange Act Release No. 38545 (Apr. 24, 1997), 62 FR 25226 (May 8, 1997) (publishing notice of SR-NASD-97-28) ("Original Proposal").

⁵ Securities Exchange Act Release No. 38831 (July 11, 1997), 62 FR 38156 (July 16, 1997) ("Amendment No. 2").

⁶ Letter from Alden S. Adkins, General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated July 11, 1997 ("Amendment No. 3"). Except for technical, clarifying changes, a description of the proposed changes set forth in Amendment No. 3 regarding the investigations and sanctions, disciplinary, and member admission procedures is provided below. In addition to the NASD's proposed changes to the Original Proposal, the NASD included in Amendment No. 3 its response to the two submitted comment letters ("NASD Response"). See also Colish Letter and ABA Letter, *infra* note 9.

⁷ Letter from Alden S. Adkins, General Counsel, NASD Regulation, Inc. to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated July 21, 1997 ("Amendment No. 4").

⁸ Letter from Alden S. Adkins, General Counsel, NASD Regulation, Inc. to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated August 4, 1997 ("Amendment No. 5"). Certain minor modifications to the

received two comment letters on the proposal.⁹

I. Introduction and Background

On August 8, 1996, the Commission issued an order ("SEC Order") pursuant to Section 19(h)(1) of the Act. This order made certain findings about the NASD and conduct on Nasdaq and imposed remedial sanctions, including ordering the NASD to comply with certain undertakings ("Undertakings").¹⁰ The Commission determined that the NASD had not complied with the NASD's rules or satisfied its obligations under the Act to enforce its rules and the federal securities laws. In particular, the Commission determined that the NASD failed to thoroughly investigate certain misconduct by dealers and to take effective regulatory action. Moreover, the Commission determined that the NASD failed to enforce market makers' obligations to trade at their quotations, and report transactions on a timely and accurate basis. The Commission also determined that the NASD processed applications for membership of certain firms in a manner inconsistent with its rules.

In addition, the Commission found in its 21(a) Report, among other things, that market making firms were afforded a disproportionate representation on the boards and committees that govern the NASD, administer its disciplinary process, and operate the Nasdaq market. The Commission concluded in the 21(a) Report that market makers had unduly exerted their influence over the disciplinary process through their participation in the District Business Conduct Committees ("DBCCs").¹¹ In

Delegation Plan needed to ensure conformity to the changes in the rules of the NASD contained in this rule filing are set forth in Amendment No. 5 to SR-NASD-96-29, which is being temporarily approved concurrently with this filing. Securities Exchange Act Release No. 38909 (Aug. 7, 1997).

⁹ Letter from Faith Colish, Attorney, Faith Colish P.C., to Jonathan G. Katz, Secretary, Commission, dated June 9, 1997 ("Colish Letter"); letter from George S. Frazza, Chair, Section of Business Law and Barry F. McNeil, Chair, Section of Litigation, American Bar Association, to Jonathan G. Katz, Secretary, Commission, dated June 17, 1997 ("ABA Letter").

¹⁰ Securities Exchange Act Release No. 37538 (Aug. 8, 1996), SEC's Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, *In the Matter of National Association of Securities Dealers, Inc.*, Administrative Proceeding File No. 3-9056. SEC, Report and Appendix to Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Stock Market (Aug. 8, 1996) ("21(a) Report").

¹¹ The Commission found that the DBCCs performed a "grand jury" function, in which the NASD staff were required to seek DBCC authorization to initiate a disciplinary proceeding.

Continued

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.

³ Letter from Alden S. Adkins, General Counsel, NASD Regulation, Inc. to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated April 23, 1997 ("Amendment No. 1").

addition, the Commission noted that "undue influence of market makers and a lack of vigor and balance in the NASD's enforcement activities with respect to market maker firms" was inconsistent with the NASD's statutory obligation¹² to oversee the Nasdaq market and to enforce its rules and regulations fairly as to all member firms.¹³

Further, the Commission found that the NASD processed applications for membership of certain firms in a manner inconsistent with its rules.¹⁴ Specifically, the Commission found that the NASD failed to process certain applications within a reasonable time, required some applicants to satisfy criteria not enumerated in its rules, placed improper restrictions on those firms' activities as a condition to membership, and prevented such members, once admitted, from seeking modifications to their restriction agreements as permitted by the NASD's rules.

Based on the Commission's specific findings, the NASD agreed to certain undertakings, including, among other things, undertakings to improve public representation on its Boards and committees, to institute professional hearing officers, to confer sole discretion in the regulatory staff of the NASD as to prosecutorial and regulatory matters, and to promulgate and apply uniform standards for regulatory and other access issues.¹⁵ Under the general

In addition, the DBCCs served as adjudicative bodies, ruling on disciplinary proceedings and approving settlements. 21(a) Report, *supra* note 10, at 35 n.91. As examples of the DBCCs' undue influence over the disciplinary process, the Commission pointed to heightened enforcement efforts regarding Small Order Execution System violations and the NASD's laxity in enforcing firm quote obligations, trade reporting rules, and excused withdrawal rules. *Id.* at 36-39.

¹² Section 19(g)(1)(B) of the Act, 15 U.S.C. § 78s(g)(1)(B).

¹³ 21(a) Report, *supra* note 10, at 39.

¹⁴ SEC Order, *supra* note 10.

¹⁵ Undertakings one through six of the SEC Order require the Association:

1. To implement and maintain at least fifty percent independent public and non-industry membership in its Board of Governors, the Board(s) of Governors or Directors of all of its subsidiaries and affiliates that exercise or have delegated self-regulatory functions, and the following committees: the National Nominating Committee, the Trading/Quality of Markets Committee, the Arbitration Committee, the Market Surveillance Committee (now the Market Regulation Committee), the National Business Conduct Committee, the Management Compensation Committee, and all successors thereto.

2. To provide that NASDR and any successor thereto has, consistent with the NASD's By-Laws and Plan of Delegation, as amended from time to time and as approved by the Commission, primary day-to-day responsibility for the regulation, surveillance, examination, and disciplining of NASD member firms and registered persons, with

terms of certain of the Undertakings in the SEC Order, and in response to the Commission's conclusions in the 21(a) Report, the NASD is proposing to amend its Code of Procedure and Membership Application and Registration Procedures.

II. Description of the Proposal

The proposed changes to the NASD's membership and registration rules, investigations and sanctions rules, and the code of procedure are summarized below in the order that they appear in the rules.¹⁶

A. Changes to the Membership and Registration Rules

The Rule 1010 Series governs the procedures for becoming a member of

respect to market activities as well as other self-regulatory matters, with full access to the records of the Nasdaq market.

3. To institute the participation of professional Hearing Officers (who shall be attorneys with appropriate experience and training) to preside over disciplinary proceedings.

4. To provide for the autonomy and independence of the regulatory staff of the NASD and its subsidiaries such that the staff, subject only to the supervision of the Board of Governors of the NASD and the Boards of Directors of NASDR and Nasdaq, and any successor thereto, (a) has sole discretion as to what matters to investigate and prosecute, (b) has sole discretion to handle regulatory matters such as approval of applications for membership and the conditions and limitations that may be placed thereon, (c) prepares rule proposals, rule interpretations and other policy matters with any consultations with interested NASD constituencies made in fair and evenhanded manner, and (d) is generally insulated from the commercial interests of its members and the Nasdaq market. Among other things, the District Business Conduct Committees and the Market Surveillance Committee shall not have any involvement in deciding whether or not to institute disciplinary proceedings, nor shall the District Committees, or any subcommittee thereof, have any involvement in the review or approval of applications for membership in the NASD. Subject to the foregoing, the regulatory staff of the NASDR engaged in the disciplinary process may, solely on their own initiative, inform themselves on matters of market or other securities industry expertise by consulting with representatives of member firms or committees of the NASD or its subsidiaries.

5. To promulgate and apply on a consistent basis uniform standards for regulatory and other access issues, such as admission to the NASD as a member firm, and conditions to becoming a market maker; and institute safeguards to ensure fair and evenhanded access to all services and facilities of the NASD.

6. To ensure the existence of a substantial, independent internal audit staff which reviews all aspects of the NASD (including the regulatory function, the disciplinary process and the Nasdaq stock market and its systems) and reports directly to an audit committee of the NASD Board of Governors which includes a majority of public and non-industry Governors and is chaired by a public Governor.

¹⁶ For a more detailed description of the NASD's proposed rule change, see Original Proposal, *supra* note 4; Amendment No. 2, *supra* note 5; Amendment No. 3, *supra* note 6; Amendment No. 4, *supra* note 7; and Amendment No. 5, *supra* note 8.

the NASD. The proposed changes to the Rule 1010 Series will substantially alter the current procedures for membership application. The proposed Rule 1010 Series provides that NASD Regulation staff, rather than a District Committee, will make an initial decision on an application for membership. An applicant may appeal a staff decision to the National Business Conduct Committee ("NBCC"). The NBCC's decision is subject to discretionary review by both the NASD Regulation Board and the NASD Board. The proposed rule change also sets forth a more detailed and comprehensive list of the documents and information that must be submitted with a membership application and sets forth more detailed, comprehensive, and objective standards to be used to determine whether an applicant should be admitted to membership. The proposed rule change provides more procedural rights to applicants to ensure that applications are processed fairly and expeditiously, including limitations on the time within which the NASD must issue membership decisions.

B. Changes to the Investigations and Sanctions Rules

The Rule 8100 Series currently governs complaints against NASD members. The Rule 8200 Series permits the NASD to investigate members' books, and requires members or associated persons to provide information in connection with investigations or proceedings conducted by the NASD. The Rule 8200 Series also currently provides the NASD with authority to suspend members or associated persons who do not comply with the Rule 8200 Series. The Rule 8300 Series currently provides for sanctions against members and persons associated with members for violations of NASD rules.

The NASD proposes to amend the Rule 8000 Series to reflect the proposed changes to the disciplinary procedures in the proposed Rule 9000 Series, discussed below, and to clarify and reorganize certain rule provisions in order to make them easier to read and understand. Currently, the decision to serve a complaint on a member pursuant to Rule 8130 is made by the NBCC. In addition, current Rule 8120 allows any person who believes he or she has been aggrieved by any act of any member or associated person to institute a formal disciplinary proceeding.

The NASD proposes to rescind current Rule 8120. The NASD believes it is no longer necessary to give "aggrieved persons" the right to invoke NASD processes to institute formal

disciplinary actions in view of the enhancements to the disciplinary process, including the change to staff-initiated disciplinary proceedings, enhancements to the arbitration process, and the institution of an expanded and independent NASD internal review function (including an Ombudsman Office). The NASD also proposes to delete current Rule 8130, which authorizes the DBCCs to file complaints, to comply with Undertaking 4, which prohibits DBCCs from having any involvement in the decision whether or not to institute disciplinary proceedings.

The NASD proposes significant changes to current Rule 8220, which authorizes the suspension of a member for failure to furnish the NASD with duly requested information or for failure to keep a membership application and supporting documents current. The proposed changes retain the NASD's summary suspension powers, but provide members and persons associated with members with enhanced procedural protections in connection with the suspension process. Under the proposed revisions to Rule 8221, the NBCC must provide written notice of the suspension to the member or associated person. The notice specifies the information that must be provided or the action that must be taken, and states that the failure to provide information or take the required action within 20 days after service of the notice constitutes grounds for suspension. The NBCC must serve notice of the suspension through personal service or commercial courier.

Proposed Rule 8222 makes explicit the right of a member or associated person to request a hearing before a subcommittee of the NBCC concerning the notice of suspension. Any subcommittee decision to impose a suspension must state the grounds for the suspension and the conditions for terminating it. Proposed Rule 8224 requires the NASD to provide to the entire NASD membership notice of any suspension imposed pursuant to Rule 8223, and proposed Rule 8226 requires that the NASD also serve the suspended member with a copy of a notice or decision served on the associated person.

Proposed Rule 8225 adds a new provision for termination of the suspension. Upon request by the suspended member or associated person, the head of the appropriate NASD Regulation department or office may terminate a suspension if the member or associated person has fully complied with a notice or decision issued under the Rule 8220 Series. If the

request is denied, the proposed rule provides the member or associated person with the right to apply to the NBCC for relief from the suspension on the grounds of full compliance with the notice issued under proposed Rule 8221 or the conditions specified in a decision issued under proposed Rule 8223.

Proposed Rule 8227 clarifies that any action taken under the Rule 8220 Series does not foreclose the NASD from taking action against the member or associated person under any other rule. Finally, the NASD also proposes to amend the Rule 8300 Series to make it conform with the proposed Rule 9000 Series and to make it shorter, clearer, and easier to understand.

C. Changes to the Code of Procedure

The NASD proposes numerous changes to the Code of Procedure. In particular, the Rule 9100 Series sets forth rules of general applicability to disciplinary proceedings and other proceedings brought against a member or a person associated with a member. The Rule 9200 Series sets forth the specific procedures for disciplinary proceedings, including settlements, letters of acceptance, waiver, and consent and minor rule plan violation letters, and the Rule 9300 Series sets forth the appeal or review procedures for a disciplinary proceeding. The Rule 9400 and 9500 Series set forth the procedures regarding members experiencing financial or operating difficulties; summary and nonsummary suspensions, cancellation, bar, and limitation or prohibition on access to NASD services; and eligibility proceedings. The Rule 9600 Series delineates the procedures for exemptions from certain NASD Rules.

1. Application and Purpose

The proposed Rule 9100 Series contains twenty proposed rules, setting forth a variety of important procedural modifications, including a detailed list of defined terms used throughout the Code of Procedure (proposed Rule 9120);¹⁷ a series of rules regarding

¹⁷ In Amendment No. 3, the NASD proposes to amend, add, and delete several terms set forth in proposed Rule 9120. First, unnecessary terms such as "Practicing before the NASD" and "Complainant" (because the only possible complainant is the Department of Enforcement) were deleted. A related change was made to the definition of "Party" now in proposed Rule 9120(v). Two new definitions were added. In proposed Rule 9120(d), "Counsel to the National Business Conduct Committee" was added to provide greater clarity with respect to the other proposed changes to the Rule 9300 Series described below. In proposed Rule 9120(l), "General Counsel" was defined in order to shorten several references in the text to "the General Counsel of NASD Regulation, or his or her delegatee," and to make explicit that the delegation

service¹⁸ and notice of various papers and filing requirements (proposed Rule 9130 Series); rules relating to the appearance of counsel (or other person authorized to act in a representative capacity) (proposed Rules 9141, 9142, 9150); a detailed provision prohibiting *ex parte* communications generally (proposed Rule 9143) and a related provision regarding separation of functions (proposed Rule 9144); a rule providing for a motions practice (proposed Rule 9146); a provision for disqualification of an adjudicator (proposed Rule 9160);¹⁹ and a provision prohibiting interlocutory review (proposed Rule 9148).

2. Disciplinary Proceedings

The proposed Rule 9200 Series contains thirty proposed rules. Under these rules, the roles of the District Committee and Market Regulation Committee are greatly reduced. Neither may initiate a complaint; instead, the Department of Enforcement may investigate a case and file a complaint to initiate a disciplinary proceeding (proposed Rule 9211(a)). Further, NASD Regulation has established an Office of Hearing Officers as an independent office within NASD Regulation. The Office of Hearing Officers is headed by the chief hearing officer, who is an executive vice president and reports directly to the president of NASD Regulation. The purpose of the Office of Hearing Officers is to provide a group of independent and professional hearing officers (comprised of attorneys with

by the General Counsel would extend only to certain persons directly reporting to the General Counsel with certain titles and/or responsibilities (e.g., an Associate General Counsel or an Assistant General Counsel). In addition, minor changes were also made to the definitions of "Adjudicator," "District Committee," "Extended Hearing Panel," "Extended Proceeding Committee," "Hearing Panel," "Interested Association Staff," "Statutory Disqualification Committee," and "Subcommittee," found, respectively, in proposed Rule 9120 (a), (f), (i), (k), (p), (q), (y), and (z). Some of these changes were made to conform the definitions to the proposed Rule 9400 Series and the proposed Rule 9500 Series. Amendment No. 3, *supra* note 6.

¹⁸ In Amendment No. 3, the NASD proposes to amend proposed Rule 9134(b)(2) so that service on an entity may be made by service on the contact person listed on the member's Form BD in addition to those persons already listed in the rule.

¹⁹ The term "Adjudicator" means: (1) A body, board, committee, group, or natural person that presides over a proceeding and renders a decision; (2) a body, board, committee, group, or natural person that presides over a proceeding and renders a recommended or proposed decision which is acted upon by an adjudicator described in (1); or, (3) a natural person who serves on a body, board, committee, or group described in (1) or (2). The term includes a "Subcommittee" as defined in paragraph (z), an "Extended Proceeding Committee" as defined in paragraph (k), and a "Statutory Disqualification Committee" as defined in paragraph (y) (proposed Rule 9120(a)).

appropriate experience and training) to preside over all formal NASD disciplinary proceedings.

Hearing panels or, if applicable, extended hearing panels,²⁰ are selected by a chief hearing officer, and are composed of a hearing officer (a professional NASD Regulation staff member) and two panelists, each selected from the securities industry and drawn from a pool of persons associated with a member or retired therefrom and who: (1) Currently serve or previously served on a District Committee; (2) previously served on the National Business Conduct Committee; (3) previously served on a disciplinary subcommittee of the National Business Conduct Committee, including a subcommittee, an extended proceeding committee, or their predecessor subcommittees; or (4) previously served as a director of NASD Regulation, a director of the Nasdaq Board of Directors, or a Governor of the NASD, but who do not serve currently in any of these positions.²¹ In addition, a person who currently serves on the Market Regulation Committee (or who previously served on the Market Regulation Committee not earlier than four years before the date the complaint was served upon the respondent)²² and who is associated with an NASD member or retired therefrom may be chosen by the chief hearing officer to serve as *one* of the panelists on a hearing panel or an extended hearing panel when the chief hearing officer determines that the complaint alleges at

least one cause of action involving a violation of a statute or a rule within the scope of proposed Rule 9120(r).²³ The hearing panel, or, if applicable, the extended hearing panel, issues the "trial level" decision in a disciplinary proceeding (proposed Rule 9268).

The NASD also proposes a number of procedural enhancements to the disciplinary procedures. Proposed Rule 9215(c) provides for the filing of a motion for a more definite statement (in addition to proposed Rule 9146, providing for the filing of motions generally), proposed Rule 9221 allows a hearing officer or a hearing panel to order a hearing if the adjudicator determines a hearing is necessary, notwithstanding that respondents have waived their rights to a hearing, and proposed Rules 9233 and 9234 set forth detailed disqualification provisions.

The proposed Rule 9240 Series and proposed Rule 9250 Series set forth requirements that parties participate in pre-hearing conferences, and exchange, before a hearing on the merits, documentary evidence, a list of witnesses and expert witnesses, and an outline of the case or defense. The same proposed rules also provide that the Department of Enforcement must provide documents to a respondent, and set forth procedures for doing so. Sanctions for not complying with requirements regarding the production of documents, other provisions of the Rule 9200 Series, or an order of an adjudicator in the Rule 9200 Series, or for other contemptuous conduct, are set forth in proposed Rule 9280.²⁴

Under proposed Rule 9262, a witness subject to the jurisdiction of the NASD is required to testify under oath or affirmation. Proposed Rule 9264 sets forth the rules allowing a party to file a motion for summary disposition.

²³ Proposed Rule 9120(r) (formerly proposed Rule 9120(q)) states that the term "Market Regulation Committee" means the committee of NASD Regulation designated to consider the federal securities laws and the rules and regulations adopted thereunder and various rules of the NASD and policies relating to:

- (1) the quotations of securities;
- (2) the execution of transactions;
- (3) the reporting of transactions; and
- (4) trading practices, including rules prohibiting manipulation and insider trading, and those Rules designated as Trading Rules (Rule 3300 Series), the Nasdaq Stock Market Rules (Rule 4000 Series), other Nasdaq and NASD Market Rules (Rule 5000 Series), NASD Systems and Programs Rules (Rule 6000 Series), and Charges for Services and Equipment Rules (Rule 7000 Series).

²⁴ In proposed Rule 9280(b)(2), the NASD added an explicit reference to the Rule 9240 Series because the NASD believes that the parties' cooperation and timely disclosure of information in the proposed Rule 9240 Series is of equal importance to their obligations under the proposed Rule 9250 Series. Amendment No. 3, *supra* note 6.

In the post-hearing time frame, under proposed Rule 9266, a hearing officer may require a party to file proposed findings of fact, conclusions of law, and post-hearing briefs. The hearing officer prepares a decision representing the majority of the hearing panel or, if applicable, the extended hearing panel, under proposed Rule 9268. Proposed Rule 9268(c) allows a panelist or a hearing officer to write a dissenting opinion. Finally, under proposed Rule 9270, the NASD proposes to modify existing settlement procedures to provide specific procedures for a respondent to execute an offer of settlement prior to a determination on the merits.

3. Appeals and Reviews of Disciplinary Proceedings

In the current and proposed Rule 9300 Series, procedures are set forth for the appeal of a case by a party or the review of a case by the National Business Conduct Committee, the NASD Regulation Board and the NASD Board. The proposed Rule 9300 Series contains nineteen proposed rules. In the proposed Rule 9300 Series, changes include the right of the Department of Enforcement to appeal a disciplinary proceeding decision issued by a hearing panel or, if applicable, an extended hearing panel (proposed Rule 9311(a));²⁵ the requirement that persons subject to the jurisdiction of the NASD testify under oath or affirmation (proposed Rule 9346(h)); and the requirement that members of the NASD Regulation Board or the NASD Board shall have a specific period of time to review a disciplinary proceeding decision in order to determine whether to call a case for discretionary review by such board (proposed Rules 9351 and 9352). Proposed Rule 9360 provides that a sanction imposed in a final disciplinary action of the NASD becomes effective not earlier than thirty days after the date of service of the decision. In a proposed change designed to reflect current practice, proposed Rule 9370 provides that, in most cases, sanctions, other than a bar or expulsion, are stayed when a person files with the Commission a request for review of a final disciplinary action of the NASD.

²⁵ To provide the parties more time to file an appeal, the NASD proposes to amend Rule 9311(a) to extend from 15 days to 25 days the time for noticing an appeal. The NASD states that this conforms to the rules of the New York Stock Exchange and parallels a provision in the Rule 1010 Series. The NASD also amended proposed Rule 9311 to provide parties with prior notice and an opportunity to brief an issue that was previously waived if that issue arises and will be considered by the NBCC. Amendment No. 3, *supra* note 6.

²⁰ The chief hearing officer appoints an extended hearing panel if upon consideration of the complexity of the issues involved, the probable length of the hearing, or other factors, the chief hearing officer determines that a matter shall be an extended hearing (proposed Rule 9120(i) and proposed Rule 9120(h)). Designation of a matter as an extended hearing provides the chief hearing officer the ability to select, among other potential panelists, persons who are retired and may have both time and relevant experience to bring to an extended hearing (proposed Rule 9231(c)).

²¹ Amendment No. 3, *supra* note 6. In previously proposed Rule 9231, most but not all former members of a District Committee were eligible to serve as a panelist on either a hearing panel or an extended hearing panel; now all former District Committee members are eligible. In addition, recently retired persons who were previously associated with the securities industry were not eligible to serve on hearing panels but were eligible to serve on extended hearing panels. In Amendment No. 3, among other things, retired persons may serve on both types of panels, and persons who have been retired for more than four years remain eligible to serve as panelists. *Id.*

²² The NASD states that the period of four years was incorporated to define more clearly who is properly classified as a Market Regulation Committee panelist. This is important because the Code provides that only one Market Regulation Committee panelist may be appointed to serve on a hearing panel or an extended hearing panel. Amendment No. 3, *supra* note 6.

In Amendment No. 3 to the proposed rule change, the NASD added proposed Rule 9313, authorizing a counsel to the NBCC to perform various ministerial and administrative acts on behalf of the NBCC during the course of an appeal or review. Because the role of the counsel to the NBCC is purely administrative, counsel may not shorten any period, postpone or adjourn a hearing, or otherwise limit a right previously held by a party, without the consent of all of the parties to the disciplinary proceeding.²⁶

4. Members Experiencing Financial or Operating Difficulties; Summary and Non-Summary Suspensions Cancellation, Bar, and Limitation or Prohibition on Access to NASD Services; and Eligibility Proceedings

The NASD proposes to renumber, consolidate, reorganize, and clarify the procedures proposed for the Rule 9400 and 9500 Series. In the Original Proposal, the NASD requested temporary approval for five separate procedures for: (1) Regulating the activities of members experiencing financial or operating difficulty; (2) approving a change in business operations that will result in a change in exemptive status under SEC Rule 15c3-3 under the Act; (3) summary suspension as authorized by Section 15A(h)(3) of the Act; (4) non-summary suspension, cancellation, and bar; and (5) eligibility proceedings. Also in the Original Proposal, the NASD proposed eliminating the current expedited remedial proceedings.²⁷ The NASD stated that it would comprehensively review the proposed Rule 9400 and 9500 Series, as submitted in the Original Proposal, and would consider submitting a revision to the Original Proposal based on that review.

As a result of its review of the Rule 9400 and 9500 Series, the NASD submitted Amendment No. 2 to amend the Original Proposal to reduce the number of separate proceedings from five to three, and to seek permanent approval of these three procedures.²⁸ First, the NASD proposes that the current Rule 9510 Series, setting forth procedures for limitations on operations for firms experiencing financial or operational difficulties as specified in Rules 3130 and 3131, remain as a separate rule, and be renumbered as the Rule 9410 Series.²⁹

Second, the NASD proposes that the current Rule 9350 Series, setting forth procedures for a member wishing to change its exemptive status under SEC Rule 15c3-3, be eliminated. Under the proposed rules, a member wishing to change its exemptive status must apply for a change to its membership agreement, if the membership agreement covers the member's exemptive status, or file a notice and application for approval of a material change in the member's business operations if the membership agreement does not specifically address the member's exemptive status.³⁰ Procedures for applying for a change to a membership agreement or for approval of a material change in business operations are now set forth in the proposed Rule 1010 Series.³¹

Third, the NASD proposes to consolidate into the revised Rule 9510 Series summary suspension proceedings,³² non-summary suspension, cancellation, and bar proceedings,³³ and new denial of access procedures. The new denial of access procedures permit the NASD, after notice and opportunity for hearing, to deny a person access to services offered by the NASD or a member of the NASD if the NASD determines that the person does not meet the qualification requirements or other prerequisites for such access, or the person cannot be permitted to continue to have such access with safety to investors, creditors, members, or the NASD.

Finally, eligibility proceedings will remain in a separate rule series, and will be renumbered as the Rule 9520 Series.³⁴ The eligibility proceedings will continue to permit a person to become or remain associated with a member, notwithstanding the existence of a statutory disqualification as defined in Section 3(a)(39) of the Act. Further, the eligibility proceedings will continue to permit a current member or associated person to obtain relief from the eligibility or qualification requirements of the NASD By-Laws and Rules. Further, the revisions to the Rule 9520 Series will provide members and associated persons with enhanced procedural protections, and will conform these proceedings to the current corporate structure.

The NASD also proposes to amend the Rule 9400 and Rule 9500 Series to provide participants with enhanced

procedural protections in the conduct of these proceedings and to expedite the hearing and review processes, especially under the proposed Rule 9510 Series (which governs procedures for summary and non-summary suspension, cancellation, bar, and limitation or prohibition on access to the NASD's services). Specifically, the proposal, as amended by Amendment No. 2, adds a variety of new provisions, including provisions governing: the time within which a hearing requested by a member must be held; the disclosure of documents by NASD staff to the member prior to hearing; the exchange of exhibit and witness lists; the rights of parties at a hearing; the components of a written decision (including conditions for terminating a limitation, where appropriate); the preservation of evidence proffered but not accepted into the record; and the contents of the record for each proceeding. In addition, the proposal provides for discretionary review of lower decisions by the NASD Regulation and NASD Boards that is substantially similar to the procedures governing disciplinary proceedings.

5. Procedures for Exemptions From Certain NASD Rules

The NASD proposes a new Rule 9600 Series that requires members to apply to the staff for an exemption under various rules, and provides a right of appeal to the NBCC. The NASD also proposes to provide additional rights for participants in the proceedings; conform the series to the proposed Rule 9000 Series, as well as to the current corporate structure; and delete the current Rule 9630 Series, which governs expedited remedial proceedings.

Specifically, the NASD proposes a new Rule 9600 Series that would require members to apply to NASD Regulation staff for an exemption under various rules, and would provide a right of appeal to the NBCC. Under current NASD rules, the authority to grant exemptions has been granted to various standing committees. Pursuant to the proposal, a member seeking an exemption would be required to file a written application with the Office of General Counsel of NASD Regulation. Members applying for exemptions could receive confidential treatment of applications or decisions after a showing of good cause for confidential treatment. The proposed rules provide for a right to review before a subcommittee appointed by the NBCC. The NBCC's written decision, which would constitute final action of the NASD, would be based on the matters on appeal, the subcommittee's

²⁶ Amendment No. 3, *supra* note 6.

²⁷ The NASD also stated its intent to submit a separate rule filing to amend its expedited remedial proceedings. Original Proposal, *supra* note 4.

²⁸ Amendment No. 2, *supra* note 5.

²⁹ See current Rule 9510 Series.

³⁰ See current Rule 9530 Series.

³¹ The NASD has stated it will inform its membership of this change in procedure in a notice to members. Amendment No. 2, *supra* note 5.

³² See current Rule 9610 Series.

³³ See current Rule 9620 Series.

³⁴ See current Rule 9640 Series.

recommendation, and the NBCC's findings and conclusions.

*D. Effectiveness of the New Procedures*³⁵

Because the proposed rule change is effective upon approval by the Commission on the date of this release ("effective date"), the NASD proposes to establish the following schedule to address the transition from the current procedures to the proposed procedures approved in this rule filing.

1. Membership Admission Rules; Investigations and Sanctions

The Rule 1010 Series, the membership admission rules, will take effect on the effective date. Thus, if a membership application is received by the NASD before the effective date, the application will be considered under the current rules and procedures. However, if a membership application is received by the NASD on or after the effective date of the proposed Rule 1010 Series, the amended Rule 1010 Series will apply to the application process. In addition, the NASD proposes that the Rule 8000 Series will take effect on the effective date.

2. Complaints, Offers of Settlement

The proposed Rule 9100 Series through the Rule 9300 Series will generally apply to a respondent when the NASD staff first attempted service³⁶ of the complaint on or after the effective date. If the complaint is authorized and the first attempted service occurs prior to the effective date, a respondent will be subject to the current Code of Procedure,³⁷ except that if the decision is served on or after the effective date and the disciplinary proceeding is subsequently appealed to the NBCC or the NBCC calls the disciplinary proceeding for review, as described in greater detail below, the appeal or review will proceed under the proposed rules. In addition, if a respondent is negotiating an offer of settlement for a complaint authorized and attempted to be served before the effective date, and executes such offer of settlement after the effective date of this proposal, the offer of settlement will be reviewed and accepted or rejected under the current rules, rather than under proposed Rule 9270.³⁸ A respondent subject to the

current Code of Procedure may not seek consideration of whether the complaint should have been authorized under the proposed Code.

Conversely, a respondent is subject to the proposed Code if the complaint is authorized before the effective date, but the first attempted service occurs on or after the effective date of this proposal. In a multiple respondent disciplinary proceeding, all respondents will be subject to the proposed Code of Procedure if the complaint is authorized before the effective date, but NASD staff does not make the first attempted service as to any of the named respondents until on or after the effective date. A respondent who is subject to the proposed Code because the complaint was authorized before the effective date, but the first attempted service occurred on or after the effective date, may challenge the case for improper authorization based only on the current (or old) Code. Accordingly, in such circumstances, a respondent cannot challenge the authorization of the complaint based on the fact that it was not authorized under the proposed Code.³⁹ In any case in which the complaint is authorized on or after the effective date of the proposed Code, the respondents will be subject to the provisions of the proposed Code.

3. AWCs and MRVs

On the effective date of the proposed Rule 9100-9300 Series, the Department of Enforcement will have the ability to accept letters regarding acceptance, waiver, or consent ("AWCs"), and minor rule violations ("MRVs"). The application of the proposed rules to AWCs and MRVs is based upon when a member or an associated person executes such letters. Thus, if a member or an associated person executes an AWC or MRV before the effective date of this proposal, the AWC or MRV will be subject to review and acceptance under the current Code of Procedure. However, if a member or an associated person is engaged in negotiations about the terms of an AWC or MRV and the effective date occurs before the AWC or MRV is executed by the member or associated person, the AWC or MRV will be subject to review and acceptance under the proposed rules.

4. Appeals and Reviews—Application of Proposed Rule 9300 Series

The NASD also proposes that the proposed Rule 9300 Series, when

effective, apply to any appeal, call for review, or review of a decision rendered under Rule 9268 and Rule 9269 if the decision is: (a) served on a respondent on or after the effective date of the proposed Code of Procedure and (b) appealed, called for review, or reviewed. By doing so, the NASD notes that all of the new appellate and review procedural enhancements, with one exception, would apply to a completed "trial-level" proceeding on appeal, subject to a call for review, or reviewed on or after the effective date of the proposed Code of Procedure. The one exception would be that the right of the Department of Enforcement to appeal or cross-appeal a case would not apply. The NASD proposes that this provision in the proposed Rule 9300 Series not be applied to any disciplinary proceeding unless the disciplinary proceeding is based upon a complaint served on or after the effective date of the proposed Code because a respondent may believe that any retroactive application of this procedure may be unfair.⁴⁰

5. A Fourteen Calendar Day "Opt-In" Period

In the Original Proposal, the NASD proposed that in certain cases a respondent to a disciplinary proceeding be allowed to opt in to the proposed procedures during a thirty-day period following Commission approval of the new procedure.⁴¹ At the time the NASD proposed the opt in procedure, the NASD expected that the Commission would delay the effectiveness of the proposed Rule 9100-9300 Series for approximately thirty days. The Commission, however, will make the proposed Rule 9100-9300 Series effective on the same day that it approves such rules. The NASD continues to believe that it is appropriate or desirable to have a time period during which a respondent subject to the current Code of Procedure could opt to have the proceeding administered under the proposed (or new) Code of Procedure.⁴² The NASD proposes that this time period should be fourteen calendar days. Thus, a respondent who is named in a complaint that is authorized prior to the effective date may opt to have the disciplinary proceeding go forward under the proposed Code if the first attempted service upon the respondent occurs not earlier than fourteen calendar days before the effective date of this proposal. In a disciplinary proceeding involving more than one respondent, all

³⁵ See Amendment No. 5, *supra* note 8.

³⁶ First attempted service means the complaint has been mailed by NASD staff or delivered by NASD staff to a courier for transmission by the courier.

³⁷ In a multiple respondent disciplinary proceeding, all respondents will be subject to the current Code of Procedure if service was attempted on any one respondent before the effective date.

³⁸ *Supra* note 37.

³⁹ Telephone conversation between John Ayanian, Special Counsel, Division of Market Regulation, Commission, and Sharon Zackula, Senior Attorney, Office of General Counsel, NASD Regulation, on August 5, 1997.

⁴⁰ Amendment No. 5, *supra* note 8.

⁴¹ Original Proposal, *supra* note 4.

⁴² Amendment No. 5, *supra* note 8.

respondents must opt to have the proceedings administered under the new Code of Procedure for it to apply. NASD staff will specifically notify all parties eligible to opt in of the existence of this right and the limitations on this right.

6. Rule 9400–9500 Series

If a proceeding is initiated before the effective date, the proceeding will be administered under the current provisions relating to the proceeding. If a proceeding is initiated on or after the effective date, the proceeding will be administered under the new rules.

7. Rule 9600 Series

If a request for an exemption has been made before the effective date, the request will be administered under the current provisions relating to such proceedings. A request for an exemption initiated on or after the effective date will be administered under the new rules.

III. Comments and NASD Responses

The Commission received two comment letters regarding the Original Proposal. The Colish Letter generally addresses issues relating to premembership application procedures set forth in the proposed Rule 1010 Series. The ABA Letter addresses proposed changes to the Rule 8000 Series and the proposed Rule 9100 Series through the Rule 9300 Series.

A. Rule 1010 Series

The Commission received one comment letter concerning the membership application procedures.⁴³ Overall, the commenter agrees with the proposed rules, but believes the rules could be improved or supplemented in certain respects.

1. New Member Review

The commenter recommends that the new member review process be centralized at the NASD's headquarters.⁴⁴ The commenter is concerned that the examiners in the various District Offices may lack the necessary experience and training to adequately discharge the new responsibility of approving, disapproving, or setting conditions or limits on membership applications. In addition, the commenter believes that centralization would be the best way to ensure uniformity.

The NASD does not believe centralization is necessary.⁴⁵ The NASD believes that the District Offices obtain valuable insights into the applicants' business through the new member review process. It notes that significant initiatives are already underway to train examiners for their new responsibilities and that new policies and procedures are being established to ensure national uniformity and consistency in the treatment of membership applications. For example, training sessions focusing on the proposed rules have been conducted for supervisors and assistant directors, a comprehensive training program is being finalized for District Office examiners, and a staff steering committee chaired by an NASD Regulation vice president and staffed by senior District Office staff members is finalizing detailed procedures for District Offices to follow to help ensure uniformity and consistency.

2. Monthly Projections of Income and Expenses

The commenter asserts that it may be unrealistic for some applicants to furnish a monthly projection of income and expenses for the first twelve months of operations under proposed Rule 1013(a)(2)(A)(ii).⁴⁶ She notes that this would be especially difficult for firms that intend to engage in a significant amount of dealer business.

The NASD believes this information is reasonable and necessary to facilitate the NASD's ability to determine whether an applicant has a reasonable expectation of being able to comply with the net capital rule once the applicant commences business.⁴⁷ The NASD also believes it is not overly burdensome for applicants to prepare this information because most new firms already project the revenues necessary to meet fixed and other expenses for business reasons.

3. Use of Forms BD, U–4, and U–5

The commenter maintains that the NASD should not require applicants to submit Forms BD, U–4, and U–5 because the information contained on those forms is available to the NASD through the Central Registration Depository ("CRD").⁴⁸ The commenter does note, however, that it is not particularly onerous for applicants to include this information as part of their application materials. In any event, the commenter suggests that the NASD should request an applicant's current

composite Form BD because the most recent filing may be a partial amendment.

The NASD agrees with the comment concerning the submission of an applicant's current composite Form BD. Therefore, as part of Amendment No. 3, the NASD has made technical changes to proposed Rule 1013 to explicitly state that the original, signed, and notarized Form BD must be filed with the Membership Department in Rockville, Maryland.⁴⁹ With regard to submission of the forms, however, the NASD believes it is appropriate to require applicants to submit them because including the forms facilitates the NASD's ability to expeditiously process an application.

4. Capital Risks Posed by Proposed Business Activities

The commenter states that it is not clear what type of information would be required to satisfy the requirement of a description of the risk to capital presented by an applicant's proposed business activities under proposed Rule 1013(a)(2)(J).⁵⁰ In addition, the commenter notes that there currently is considerable variation among the District Offices regarding the application of this requirement.⁵¹ Finally, the commenter questions the relevance of this information.

In responding to these comments, the NASD asserts that this information is necessary to establish an appropriate level of net capital for a particular applicant that ensures customers are adequately protected.⁵² The NASD also notes, as described previously, that it has taken steps to ensure an appropriate degree of consistency and uniformity. For example, the NASD indicated that it will require memoranda or public offering documents containing information describing the risk to the applicant's capital.

5. Applicant's Best Practices and Supervisory System

The commenter states that the standards in proposed Rule 1014(a)(8), regarding the industry's best practices, and proposed Rule 1014(a)(9), concerning an applicant's supervisory

⁴⁹ Amendment No. 3, *supra* note 6; NASD Response, *supra* note 6, at 4.

⁵⁰ Colish Letter, *supra* note 9, at 6.

⁵¹ For example, the commenter criticizes the high degree of scrutiny given to the source of capital for an applicant she recently represented. The NASD maintains that it will continue to carefully review the source of each applicant's capital in order to properly identify the true owners of an applicant and ensure that the owners do not include improper parties (e.g., a person who has been barred from the industry).

⁵² NASD Response, *supra* note 6, at 5.

⁴³ Colish Letter, *supra* note 9.

⁴⁴ Colish Letter, *supra* note 9, at 4. The commenter agrees, however, that the restriction and change in ownership/control/operations processes should remain in the District Offices.

⁴⁵ NASD Response, *supra* note 6, at 4.

⁴⁶ Colish Letter, *supra* note 9, at 5.

⁴⁷ NASD Response, *supra* note 6, at 4.

⁴⁸ Colish Letter, *supra* note 9, at 5.

system, are somewhat redundant.⁵³ In addition, the commenter asserts that those standards may be subject to wide differences of opinion and subjective judgment.

The NASD maintains that these standards are distinct.⁵⁴ It explains that the standard in proposed Rule 1014(a)(8) is designed to focus on whether an applicant is adopting the industry's best practices in certain areas, while the standard in proposed Rule 1014(a)(9) encompasses an applicant's overall supervisory system. The NASD states that it does not anticipate that an applicant's failure to meet the requirements of proposed Rule 1014(a)(8) would, by itself, be grounds for denying an application. In contrast, the NASD expects that an applicant's failure to meet the supervision requirements could be a sole basis for denying an application.

B. Rule 8000 Series

The ABA comment letter addresses the Rule 8000 Series.⁵⁵ The commenter notes that proposed Rule 8210, which requires the submission of information, testimony and books to the NASD, does not differentiate between the NASD's right to obtain information or documents prior to the filing of a complaint and such requests once a proceeding has been initiated.⁵⁶ The commenter also suggests that post-complaint discovery under proposed Rule 8210 should be reciprocal, and that information and documents submitted to the NASD should be returned upon completion of a disciplinary matter. In response, the NASD notes that a change to proposed Rule 8210 to limit the NASD's ability to obtain information and documents would impede the NASD in its performance of its investigatory and enforcement functions.⁵⁷ The NASD also points out that pursuant to proposed Rule 9251(a), the Department of Enforcement has an obligation to turn over certain documents to a respondent. Further, under the Brady doctrine and the Jencks Act, the Department of Enforcement has a continuing obligation to produce documents to the respondent. The NASD also states it must retain information and documents obtained for a disciplinary proceeding for a number of reasons, including enabling the NASD to meet its regulatory and enforcement obligations, and allowing the NASD to comply with SEC Rule

17a-1(b), which requires the NASD to retain such documents for five years.

The commenter notes that proposed Rule 8210 does not differentiate between parties and non-parties in requests for information or documents. Finally, the commenter states that proposed Rule 8210 does not address privileges otherwise available at law as a basis for objecting to a request for information or documents by the NASD, and suggests that the NASD create a mechanism to enable non-parties to limit the use of submitted materials. The NASD states that it interprets proposed Rules 9235 and 9146, setting forth the powers of a hearing officer, to authorize a hearing officer in appropriate circumstances to issue a protective order during the course of disciplinary proceedings.⁵⁸ The NASD has added subparagraph (k) to proposed Rule 9146 to clarify that the hearing officer has authority to issue a protective order upon the motion of a party or other person. The NASD points out, however, that this authority would not negate the NASD's obligation to respond to a subpoena, or the NASD's right or obligation to provide information to federal, state, and foreign regulatory authorities, as well as other self-regulatory organizations ("SROs").⁵⁹

The commenter adds that the comments made regarding proposed Rule 8210 above also apply to proposed Rules 8220 through 8225.⁶⁰ Further, the commenter states that the proposed rules should explicitly provide for less harsh sanctions than suspension in the case of a failure to provide requested information under proposed Rule 8210. The NASD states that most actions taken by the NASD in response to a failure to provide requested information pursuant to a Rule 8210 request are not brought under proposed Rule 8220, but are instead brought as disciplinary proceedings.⁶¹ The NASD adds that as disciplinary proceedings, the Sanctions Guidelines apply, permitting a less severe sanction than a suspension. The NASD also notes that it has changed the verb in proposed Rules 8221 (a) and (b) from "shall" to "may," clarifying that the NASD has other avenues, aside from proposed Rule 8220, to address the failure to provide requested information.

The commenter also suggests that proposed Rule 8310, relating to sanctions for violations of the NASD's rules, should contain a reference to the

NASD Sanctions Guidelines.⁶² The commenter believes that use of and reference in the rule to the Sanctions Guidelines would ensure consistency in the application of sanctions. The NASD does not believe that the Sanctions Guidelines should be incorporated into the Code of Procedure, noting that the Guidelines by their terms are flexible guidelines and not absolute rules.⁶³

Further, the commenter suggests that the period for payment of fines, pursuant to proposed Rule 8320, should be extended to thirty days from the seven days proposed in the rule.⁶⁴ In its response, the NASD points out that the notice to a respondent issued pursuant to proposed Rule 8320 is actually the third communication a respondent has received regarding a payment of fines, other monetary sanctions, or costs. The first letter to the respondent (stating that payment is due within ten business days from the date of the letter) is prepared after the forty-sixth day after service of a disciplinary decision that is not appealed or called for review. A second letter is sent when payment has not been received within ten to fifteen business days of the first letter. After ten additional business days, the NASD prepares the Rule 8320 notice.

Finally, the commenter requests that the NASD's practice of accepting installment payment plans for fines of \$5,000 or greater be continued and incorporated into the rule.⁶⁵ The NASD confirms in its response to the comment letter that it will inform its members of the existence of payment plans through the inclusion of information regarding installment plans in the NASD's Sanctions Guidelines, which are publicly available.⁶⁶

C. Rule 9100 Through Rule 9300 Series

The ABA's letter also addresses the proposed Rule 9100 through the Rule 9300 Series. The commenter expresses general support for the NASD's proposed changes to its disciplinary process, but also sets forth specific comments and recommends certain modifications, as discussed below.⁶⁷

1. Rule 9100 Series

The commenter makes several specific comments regarding the proposed Rule 9100 Series. The commenter believes that the text of proposed Rule 9136 regarding the filing of papers should be combined with proposed Rule 9266 regarding proposed

⁵³ Colish Letter, *supra* note 9, at 7.

⁵⁴ NASD Response, *supra* note 6, at 5.

⁵⁵ ABA Letter, *supra* note 9.

⁵⁶ ABA Letter, *supra* note 9, at 8.

⁵⁷ NASD Response, *supra* note 6, at 6.

⁵⁸ NASD Response, *supra* note 6, at 6-7.

⁵⁹ Amendment No. 3, *supra* note 6.

⁶⁰ ABA Letter, *supra* note 6, at 13-14.

⁶¹ NASD Response, *supra* note 6, at 7.

⁶² ABA Letter, *supra* note 9, at 18.

⁶³ NASD Response, *supra* note 6, at 7.

⁶⁴ ABA Letter, *supra* note 9, at 19.

⁶⁵ ABA Letter, *supra* note 9, at 20.

⁶⁶ NASD Response, *supra* note 6, at 8.

⁶⁷ ABA Letter, *supra* note 9.

findings of fact, conclusions of law and post-hearing briefs, and include a twenty-five page limitation.⁶⁸ The NASD believes that reordering the special pagination requirement that is now set forth in proposed Rule 9266 would introduce a level of detail well beyond that appropriate for the Code of Procedure.⁶⁹

The commenter recommends that proposed Rule 9142 regarding the withdrawal by an attorney or representative should be amended to allow an attorney or representative the ability to withdraw from representation of a party, upon notice, at any time. Proposed Rule 9142 requires an attorney or representative of a party to give at least 30 days notice of withdrawal, and show good cause for the withdrawal. The commenter believes that these requirements do not provide sufficient flexibility to withdraw in compliance with the Code when such withdrawal is required under the Model Rules of Professional Conduct or is otherwise necessary. The commenter also recommends that a separate motion be required under Proposed Rule 9222(b), in the event that a hearing panel becomes concerned that counsel is withdrawing as a pretext to postpone or disrupt a hearing.⁷⁰

The NASD agrees that the current version of proposed Rule 9142 does not afford an attorney or representative with sufficient flexibility to withdraw under the circumstances described above. The NASD therefore proposes to amend the provision to allow an attorney to withdraw in less than thirty days where circumstances do not permit thirty days notice. Further, the NASD agrees with the approach suggested by the commenter that a separate motion may be filed under proposed Rule 9222(b) to determine whether a hearing should be postponed.⁷¹

The commenter agrees with the NASD's efforts to separate the adjudicatory and prosecutorial functions, and prohibit *ex parte* communication with adjudicators. The commenter recommends, however, that proposed Rule 9143 regarding *ex parte* communications be amended to allow participants to a proceeding to respond to allegations or contentions contained in a prohibited *ex parte* communication.⁷² The commenter also expresses concern that the Office of Hearing Officers is accountable to the

President of NASD Regulation. The commenter recommends that, to avoid the perception of unfairness and bias regarding the separation of functions provisions set forth in proposed Rule 9144, the Office of Hearing Officers should report to the President of the NASD, rather than to the "senior enforcer" of NASD Regulation.⁷³

In response to the commenter, the NASD proposes to incorporate into proposed Rule 9143 a provision allowing participants to a proceeding to respond to allegations or contentions contained in a prohibited *ex parte* communication.⁷⁴ The NASD has determined, however, that the Office of Hearing Officers should report to the President of NASD Regulation. The NASD notes that various measures have been implemented to assure the independence of the chief hearing officer and the hearing officers. For example, if the President of NASD Regulation terminates a hearing officer, the hearing officer has the right to appeal to the Audit Committee of the NASD Board of Governors. The NASD also notes that measures have been adopted to ensure that if the President of NASD Regulation participates in a discussion regarding a proposed issuance of a complaint, he or she will recuse him or herself and not attempt to influence an adjudicator or participate as an adjudicator in that disciplinary action.⁷⁵

The commenter also recommends that the NASD explicitly provide in proposed Rule 9145 (regarding rules of evidence and official notice), as well as proposed Rule 9263 (regarding evidence admissibility), and Rule 9346(g) (regarding evidence in NBCC proceedings) that the Federal Rules of Evidence will serve as a guide to adjudicators in ruling on evidentiary matters that arise in disciplinary proceedings. The commenter believes that this would promote both fairness and uniformity in the disciplinary proceedings, while preserving the adjudicators' flexibility in ruling on evidentiary matters. The commenter also suggests that the official notice provision in Rule 9145 is vague and overbroad and is not consistent with the Federal Rules of Evidence provision stating that a judicially noticed fact must be "not subject to reasonable dispute." The commenter is concerned that, by allowing an adjudicator to take official notice of "other matters within the specialized knowledge of the NASD

as an expert body" (proposed Rule 9145(b)), certain matters that may be subject to a reasonable dispute and potentially the subject of expert testimony might be deemed to be true under the standard set forth in the proposed rule.⁷⁶

The NASD does not believe it is appropriate to incorporate a reference to the Federal Rules of Evidence into proposed Rule 9145(a), Rule 9263, or Rule 9346(g). The NASD notes that formal rules of evidence traditionally have not been applied in SRO proceedings—e.g., hearsay may be admitted as evidence in SRO proceedings and the use of telephone testimony is accepted. The NASD believes that hearsay and telephone testimony should continue to be used as appropriate in a disciplinary proceeding administered under the Code.

Further, the NASD does not believe it is appropriate for the NASD to adopt the commenter's suggestion for proposed Rule 9145 regarding official notice. The NASD notes that the official notice procedure will not be a substitute for expert testimony, nor be frequently used. If a technical matter is the subject of debate or controversy, the NASD notes that it would not be officially noticed under proposed Rule 9145. Moreover, the NASD states that a party has the right to oppose or otherwise comment if an adjudicator proposes to take official notice.⁷⁷

The commenter also proposes that the right to an interlocutory appeal, as set forth in proposed Rule 9148, should be available to contest any ruling denying a claim of attorney-client privilege or work-product privilege and any situation in which a panelist refuses to recuse him or herself. First, the commenter believes that the right to an interlocutory appeal regarding privilege claims will ensure that every effort has been taken to carefully examine the claim before disclosure is compelled. Second, the commenter believes that the interlocutory appeal of a panelist failing to recuse him or herself will help to eliminate a possible perception of unfairness in the proceeding.⁷⁸

In response to the commenter's recommendation, the NASD notes that under the proposed Rule 9146 regarding general motions, a party and certain non-parties may file a motion seeking relief or guidance with regard to privilege issues. Further, the NASD notes that Rule 9251 authorizes the hearing officer to review relevant documents *in camera*. The NASD

⁶⁸ ABA Letter, *supra* note 9, at 30–31.

⁶⁹ NASD Response, *supra* note 6, at 8.

⁷⁰ ABA Letter, *supra* note 9, at 34.

⁷¹ NASD Response, *supra* note 6, at 8. See also Amendment No. 3, *supra* note 6.

⁷² ABA Letter, *supra* note 9, at 38.

⁷³ ABA Letter, *supra* note 9, at 39–40.

⁷⁴ NASD Response, *supra* note 6, at 8–9. See also Amendment No. 3, *supra* note 6.

⁷⁵ NASD Response, *supra* note 6.

⁷⁶ ABA Letter, *supra* note 9, at 41.

⁷⁷ NASD Response, *supra* note 6, at 9.

⁷⁸ ABA Letter, *supra* note 9, at 46–48.

recognizes that privilege issues are very important, but believes that to grant interlocutory review as a right regarding every contested privilege issue would "cripple the SRO's adjudicatory process from the beginning."⁷⁹

The NASD also believes that the failure of a panelist to recuse him or herself should not be the subject of an interlocutory appeal because if a panelist fails to recuse him or herself, a party may challenge the panelist through a disqualification motion. In addition, persons other than parties may inform the chief hearing officer or hearing officer of disqualifying factors, providing another avenue to remove a panelist from a hearing panel. Further, the NASD believes that such appeals would "unduly burden the forum, would impose great costs, and would not further the public interest in the fair and speedy resolution of all disciplinary matters."⁸⁰

The commenter generally supports the provision in proposed Rule 9150 authorizing hearing panels to exclude persons if they engage in contemptuous, unethical or improper professional conduct.⁸¹ The commenter recommends that the NASD clarify that a representative excluded under Rule 9150 may seek review as provided under proposed rule 9280(c). The NASD has amended proposed Rule 9150 to clarify the relationship between Rule 9150 and Rule 9280(c).⁸²

The commenter also recommends that proposed Rule 9160 regarding recusal or disqualification set forth procedural steps that must be followed in seeking disqualification of Governors, Directors, NBCC Committee members, and certain NASD Regulation staff when serving an adjudicatory role.⁸³ The NASD believes this is unnecessary because an adjudicator will recuse him or herself when he or she has a conflict of interest or a bias, and other members of a board or committee have the ability to suggest recusal or seek disqualification if the member does not act promptly to recuse him or herself. Moreover, the NASD generally does not believe that it is appropriate to codify internal board procedures. With respect to paragraph (g) (now paragraph (h)), the NASD also believes that the President of NASD Regulation may consider disqualification issues as appropriate. For the same reasons, the NASD does

not believe specific procedures under which the President of NASD Regulation must act are necessary.⁸⁴

2. Rule 9200 Series

The commenter also makes several specific comments regarding the proposed Rule 9200 Series. The commenter agrees with the proposal to transfer the authority to issue complaints to the Department of Enforcement, as set forth in proposed Rule 9211. To ensure that the process by which the Department of Enforcement authorizes and issues complaints is open and fair, the commenter recommends that the NASD provide guidance to the industry regarding the mechanics of the process through the issuance of a resolution of the Board of Governors or publication of a notice to members.

Further, the commenter suggests that the NASD should consider developing a pre-complaint forum for discussions between enforcement staff and counsel regarding any proposed charges. The commenter believes that both the enforcement staff and the potential respondents would benefit from discussions prior to the initiation of a formal proceeding. In addition, the commenter recommends that the NASD adopt a formal "Wells-type submission" process. The commenter also suggests that the NASD should adopt procedures for notifying affected persons or firms when an investigation has been terminated without the filing of a complaint.⁸⁵

The NASD agrees with the commenter's suggestion that the NASD should provide guidance regarding the complaint authorization and issuance process. The NASD proposes to do so in a notice to members, which will describe the roles of the various parties in developing a disciplinary proceeding, and authorizing and issuing a complaint. The NASD notes that disciplinary proceedings are initiated in NASD district offices, the Department of Market Regulation, and the national office of the Department of Enforcement. The NASD states that the notice will describe each department's role in identifying and organizing the evidence that is the foundation of the disciplinary proceeding and drafting a complaint, and the role of the national office of the Department of Enforcement and the Office of Disciplinary Policy in authorizing the complaint. The notice to members will also provide guidance on the NASD's use of the "Wells-type procedure" by which a potential

respondent may make a written submission to the Department of Enforcement prior to the issuance of a complaint. The NASD, however, does not propose to codify the use of the "Wells-type procedure," or the use of letters informing affected persons that an investigation has been terminated.⁸⁶

The commenter also suggests that proposed Rule 9216 regarding AWCs should provide greater clarification concerning the pre-complaint settlement process. In addition, the commenter recommends that the proposed rule contain a provision explicitly permitting a potential respondent to consent to the issuance of an AWC without admitting or denying the facts or allegations contained in the AWC.⁸⁷

The NASD agrees that the industry should be informed of how to initiate settlement discussions or pre-complaint discussions, and states that such guidance will be included in the notice to members described above. Further, in response to the recommendation that the Code contain a provision "explicitly permitting a respondent to consent to the issuance of an AWC without admitting or denying the facts or allegations contained in the AWC" and a second provision "reflecting the fact that the settlement is being offered (and accepted) without any prior adjudication or evidentiary hearing, so as to minimize any potential collateral consequences," the NASD believes that the terms of a settlement or an AWC should be based on the applicable law and the particular facts and circumstances of each case. The NASD notes that the terms of settlement documents or AWCs will change as federal and state law evolves. Accordingly, the NASD does not believe that it is appropriate to attempt to codify standardized settlement language.⁸⁸

The commenter recommends that proposed Rule 9221 regarding requests for hearing should require that at least one person serving as a panelist on a hearing panel or extended hearing panel "be engaged in similar activities within the securities industry as the respondent." The commenter believes that this requirement will provide a higher level of expertise and a better perspective to a hearing panel. In addition, the commenter suggests that the minimum notice period prior to a hearing as provided in proposed Rule 9221(d) should be expanded from twenty-eight to sixty days. The commenter is concerned that

⁷⁹ NASD Response, *supra* note 6, at 10.

⁸⁰ NASD Response, *supra* note 6, at 10.

⁸¹ ABA Letter, *supra* note 9, at 49-50. See *infra* discussion regarding ABA comments on proposed Rule 9280.

⁸² NASD Response, *supra* note 6. See also Amendment No. 3, *supra* note 6.

⁸³ ABA Letter, *supra* note 9, at 52.

⁸⁴ NASD Response, *supra* note 6, at 11.

⁸⁵ ABA Letter, *supra* note 9, at 53-57.

⁸⁶ NASD Response, *supra* note 6, at 11.

⁸⁷ ABA Letter, *supra* note 9, at 64-65.

⁸⁸ NASD Response, *supra* note 6, at 11-12.

respondents will not have sufficient time to prepare for the hearing.⁸⁹

The NASD agrees that persons with securities industry expertise should be fully represented on the hearing panels, and notes that proposed Rules 9231 and 9232 provide that the chief hearing officer will consider "expertise" and "the absence of any conflict of interest or bias, and any appearance thereof" as factors in selecting panelists. The NASD believes that these provisions ensure that the panelist selection process will provide panelists with a sufficient level of expertise and perspective. Accordingly, the NASD declines to amend proposed Rule 9221(a) (or other related provisions) as recommended above.

The NASD further believes that the commenter's recommendation to expand the notice period prior to a hearing is not necessary. The NASD notes that in most cases parties will be notified several months in advance of the hearing, but that there will be occasions when it will be in the public interest to proceed as quickly as possible. In addition, very simple cases may be dealt with expeditiously to the benefit of both parties.⁹⁰

In proposed Rule 9222(b)(1), the NASD proposed a list of factors for a hearing officer when ruling on a motion for postponement or adjournment of a hearing. The commenter suggests that the hearing officer should not be required to consider any particular factors, but to the extent that the NASD codifies specific factors, it should include additional factors, such as "the amount of time that has passed since the commencement of the investigation and the issuance of the complaint; whether there is any outstanding discovery; the amount of notice the parties had of the hearing; the complexity of the case; and prior commitments of counsel."⁹¹

The NASD believes that the standards as originally proposed are appropriate, and consistent with Commission standards. The NASD believes that there is a bias in favor of denying postponements and adjournments because of the need to proceed expeditiously toward a resolution in order to further the public interest and benefit the parties involved in such proceedings. The NASD also states that the proposed rules relating to timing, including postponements, will be applied fairly, but postponements will not be granted each time a motion is made.⁹²

The commenter makes several recommendations regarding proposed Rule 9231 (Appointment by the Chief Hearing Officer of Hearing Panel or Extended Hearing Panel) and proposed Rule 9232 (Criteria for Selection of Panelists and Replacement Panelists). First, the commenter supports the concept of hearing panels, as set forth in the rules, as "appropriate to achieve a balance between 'peer justice' and more uniform and professional rulings."⁹³ The commenter believes, however, that the criteria used by the chief hearing officer to select panelists is "unclear and open-ended."⁹⁴ In particular, the commenter believes that proposed Rule 9232 provides the chief hearing officer with too much discretion to choose panelists from anywhere in the country, rather than selecting members from the primary district committee.⁹⁵ The commenter also states that it is unclear under proposed Rule 9232(d) whether someone who has served frequently or infrequently on hearing panels is more likely to be selected.⁹⁶ In addition, the commenter is concerned that the Department of Enforcement may be able to "pre-select" panelists from the Market Regulation Committee (current or former members) by alleging at least one violation set forth in proposed Rule 9120(r),⁹⁷ thereby affecting the selection process.⁹⁸

The NASD believes that it is necessary to provide the chief hearing officer with flexibility to both appoint panelists with expertise and to avoid selecting panelists with perceived or real bias or conflicts of interest. In addition, the NASD states that the chief hearing officer will attempt to ensure broad-based participation by all segments of the securities industry; the NASD desires that more people be involved in the adjudicatory process so the perception and the reality is that disciplinary proceedings are fair.⁹⁹ The NASD also proposes to amend Rule 9232(d)(4) to clarify that the Office of Hearing Officers will be less likely to select a person who has served frequently on a disciplinary panel than a person who has not.¹⁰⁰

Further, the NASD points out that the comment reflects a misunderstanding of the scope of proposed Rule 9120(r), the

definition of the Market Regulation Committee. The NASD notes that proposed Rule 9120(r) does not intend to place all federal and state securities laws, rules, and regulations under the advisory jurisdiction of the Market Regulation Committee. A current or former member of the Market Regulation Committee will serve on a panel only when the matter relates to certain subjects, including: quotations of securities; execution of transactions; reporting of transactions; and trading practices. The NASD further notes that the chief hearing officer, while provided with flexibility to choose panelists nationwide under proposed Rule 9232 (c), (d), and (e), cannot pre-select panelists and will not allow the Department of Enforcement to pre-select panelists.¹⁰¹

Pursuant to proposed Rule 9241, pre-hearing conferences are discretionary upon a motion by a party or at the request of the hearing officer. The commenter believes that the pre-hearing conference, in most cases, should be mandatory. In addition, the commenter recommends that the time period from the date of the answer to the pre-hearing conference be extended from twenty-one to forty-five days. The commenter also suggests that the list of subjects to be covered at the pre-hearing conference be expanded to include "non-party discovery, confidentiality, and privilege issues and the issuance of protective orders."¹⁰²

The NASD does not believe it is appropriate to change proposed Rule 9241 so that a pre-hearing conference takes place within forty-five days after the answer has been filed instead of the twenty-one day period, as currently proposed. The NASD must ensure that disciplinary proceedings move forward as expeditiously as is possible while maintaining a fair forum for the parties. The NASD believes that for disciplinary proceedings where simple issues are involved, or with multiple pre-hearing conferences, creating a delay beyond twenty-one days is not a proper use of NASD or panelist resources and imposes an unnecessary cost on a respondent. The NASD also believes that it is unnecessary to include additional subjects to be covered at the pre-hearing conference because proposed Rule 9241(c)(10) encourages the parties to request that the hearing officer consider any issue not specifically listed in the rule.¹⁰³

Proposed Rule 9242 regarding pre-hearing submissions indicates that the

⁸⁹ ABA Letter, *supra* note 9, at 67.

⁹⁰ NASD Response, *supra* note 6, at 12-13.

⁹¹ ABA Letter, *supra* note 9, at 69.

⁹² NASD Response, *supra* note 6, at 13.

⁹³ ABA Letter, *supra* note 9, at 71.

⁹⁴ ABA Letter, *supra* note 9, at 73.

⁹⁵ Proposed Rule 9232 sets forth criteria for the chief hearing officer to consider when designating a particular district committee as the primary district committee.

⁹⁶ ABA Letter, *supra* note 9, at 74-75.

⁹⁷ *Supra* note 23.

⁹⁸ ABA Letter, *supra* note 9, at 75.

⁹⁹ NASD Response, *supra* note 6, at 13-14.

¹⁰⁰ Amendment No. 3, *supra* note 6.

¹⁰¹ NASD Response, *supra* note 6, at 13-14.

¹⁰² ABA Letter, *supra* note 9, at 81.

¹⁰³ NASD Response, *supra* note 6, at 14.

appropriate adjudicator may, at his or her discretion, order the exchange and/or furnishing of information prior to a hearing. The commenter believes that this should be mandatory. In addition, the commenter argues that such an exchange of information should be made at least thirty days before the hearing.¹⁰⁴ The NASD does not believe that it is appropriate in every case to require a hearing officer to order the parties to furnish information regarding the case. The NASD believes that the hearing officer has been provided appropriate discretion to control the proceeding, and determine if a pre-hearing exchange of the information is necessary.¹⁰⁵

The commenter recommends several changes to the discovery rules set forth in proposed Rule 9251. First, the commenter believes that the proposed rule should not include a standard regarding materiality and relevance in the post-complaint time frame. If a relevance standard is required, the enforcement staff should be required to provide a list of all documents it obtains to the respondent, and the hearing officer, not the enforcement staff, should make determinations of relevance.¹⁰⁶ The commenter also recommends that if the staff fails to make documents available, the staff, rather than the respondent, should have the burden to prove that such failure constituted harmless error.¹⁰⁷

The commenter also believes that the only documents that the staff should be able to withhold pursuant to proposed Rule 9251(b) are privileged documents or documents constituting attorney work product. The commenter also believes that the proposed rule should contain a provision that addresses privilege and work-product immunity for both the staff and respondents. Further, the commenter suggests that Federal Rule of Evidence 501 (for privilege issues) and Federal Rule of Civil Procedure 26(b)(3) (for work-product immunity issues) should be used as a model. The commenter suggests that if the staff wants to withhold documents on any other basis, a motion for protective order should be required. In addition, the commenter recommends that the NASD consider the impact of Fifth Amendment claims before the NASD. The commenter believes that expulsion from the NASD for asserting the Fifth Amendment is too severe and will continue to result in

constitutional challenges to the self-regulatory system.¹⁰⁸

The NASD believes that a secondary production of documents should be subject to a material relevance standard so that the Department of Enforcement only has to turn over documents that are relevant to the proceeding initiated and not other documents that may relate to a potential, but yet-to-be named respondent as part of the same investigation file. In addition, in the NASD's view, its enforcement efforts would be impaired if all internal memoranda were required to be produced. The NASD notes that not all examinations are done by lawyers, and therefore the resulting documents and reports may not be privileged.¹⁰⁹

Further, the NASD believes it would be inappropriate to mandate a withheld document list in every case. The NASD notes that a withheld document list in certain cases could enable a reader to trace the course of an investigation, forcing improper disclosure about the investigation and the investigatory process in circumstances that could impede a continuing investigation of another member or associated person. The NASD notes, however, that the hearing officer may request *in camera* inspection of documents, and may order the production of a list of withheld documents, on a case-by-case basis. In the NASD's view, requiring a list in every case would be burdensome and costly.¹¹⁰ Accordingly, the NASD has added a sentence to proposed Rule 9251(c) stating: "[a] motion to require the Department of Enforcement to produce a list of documents withheld pursuant to paragraph (b) shall be based upon some reason to believe that a document is being withheld in violation of the Code."¹¹¹

The NASD also believes it would be undesirable to adopt Federal Rule of Evidence 501 for privilege issues and Federal Rule of Civil Procedure 26(b)(3) regarding work-product immunity. The NASD states that it must provide a fair process but is not limited by the specific evidentiary rules relating to privilege in the Federal Rules of Evidence and the Federal Rules of Civil Procedure.

In addition, the NASD believes that the suggested change to the harmless

error provision is unnecessary. The NASD notes that the provision is based upon the Commission's rule and recognizes that proposed Rule 9251 affords the respondent the right to receive the documents and information in preparation for his defense in a disciplinary matter.

The NASD further states that it would be inappropriate to change its position that there is no Fifth Amendment privilege in an SRO disciplinary investigation or proceeding. A respondent therefore may not claim the Fifth Amendment without sanction.¹¹²

The commenter recommends that the minimum time for pre-hearing exchange of proposed exhibits and witness lists, as set forth in proposed Rule 9261, should be expanded from ten to thirty days. The commenter believes that ten days will not provide parties enough time to prepare for a hearing.¹¹³

The NASD believes it would be inappropriate and unnecessary to amend the minimum period for pre-hearing exchange of proposed exhibits and witness lists. As noted earlier with respect to the NASD's comments regarding the twenty-eight day notice given prior to a hearing in proposed Rule 9221(d), there are cases in which a hearing may or should proceed expeditiously in order to serve the interest of all the parties, to protect the public interest, or to preserve resources. With respect to difficult or large cases, the NASD's Office of Hearing Officers has indicated that parties will be required to exchange such information much earlier than ten days before the hearing.¹¹⁴

The commenter notes that proposed Rule 9262 regarding testimony does not address whether telephone testimony will be permitted. The commenter believes that the use of telephone testimony raises fairness issues.¹¹⁵ Accordingly, the commenter recommends that the proposed rule should prohibit telephone testimony unless all parties agree to such testimony. As an alternative, the commenter recommends that for good cause shown, a witness should be able to present a pre-hearing videotaped testimony.¹¹⁶

The NASD states that to fulfill its SRO enforcement responsibilities, it must rely upon the voluntary cooperation of firm customers. The NASD needs to

¹⁰⁸ ABA Letter, *supra* note 9, at 89-90.

¹⁰⁹ Further, the NASD proposes to expand the category of documents that may be withheld by the Department of Enforcement from the respondent under proposed Rule 9251(b)(1)(C), to exclude from production, among other things, correspondence between the NASD and a state, federal, or foreign regulatory authority or an SRO. Amendment No. 3, *supra* note 6.

¹¹⁰ NASD Response, *supra* note 6, at 14-15.

¹¹¹ Amendment No. 3, *supra* note 6.

¹¹² NASD Response, *supra* note 6, at 14-15.

¹¹³ ABA Letter, *supra* note 9, at 93.

¹¹⁴ NASD Response, *supra* note 6, at 15-16.

¹¹⁵ The commenter believes that it would be difficult to cross-examine and to determine the demeanor of a witness during telephone testimony. ABA Letter, *supra* note 9, at 95.

¹¹⁶ ABA Letter, *supra* note 9, at 95.

¹⁰⁴ ABA Letter, *supra* note 9, at 82.

¹⁰⁵ NASD Response, *supra* note 6, at 14.

¹⁰⁶ ABA Letter, *supra* note 9, at 85.

¹⁰⁷ ABA Letter, *supra* note 9, at 89.

remain flexible in obtaining the cooperation of customers, including obtaining testimony to be used in a disciplinary proceeding. Thus, the NASD believes it would be undesirable to ban telephone testimony from use in a disciplinary proceeding. The NASD notes that the circumstances of each case will be reviewed and considered in determining whether to allow telephone testimony and how to weigh the testimony. To address credibility issues, the hearing officer may request that the party on whose behalf the telephone testimony is sought provide a notary at the site of the witness to swear in the witness, or obtain an affidavit or declaration from the witness, acknowledging that the testimony will be given under oath. The hearing officer may alternatively require that the witness review the transcript of his or her telephone testimony, attach it to an affidavit or declaration, and swear to the veracity of the attached testimony. Finally, in certain cases, unsworn testimony will be admitted, but its weight shall be considered in light of the circumstances in which it was taken.

In response to the comment regarding video-taped testimony, the NASD interprets the proposed Code in appropriate circumstances to authorize a hearing officer to order a party to video-tape the pre-hearing testimony of a person who will not be physically present at the hearing. The NASD notes, however, that extensive use of video-taped testimony would be costly and, therefore, will not occur routinely.¹¹⁷

The commenter commends the incorporation of proposed Rule 9264 regarding motions for summary disposition, but suggests that NASD make several modifications. First, the commenter recommends that hearing panels be instructed that the option to defer a decision on a proposed Rule 9264 motion for summary disposition not be used to avoid determining whether the Department of Enforcement staff has a case that it can prove. Second, the commenter recommends that the Department of Enforcement should not have the ability to move for summary disposition after a hearing on the merits has commenced, or after the Department of Enforcement has completed its case. Third, the commenter recommends that the rules should expressly state that dispositive motions against respondents should be granted only in "completely clear-cut circumstances." Fourth, the commenter recommends a technical revision to proposed Rule 9264(d) which provides

that, in ruling on motions for summary disposition, the hearing panel shall take as true "the facts alleged in the pleadings against whom the motion is made" unless those facts are contradicted by "uncontested affidavits" or "stipulations or admissions made by the non-moving party." The commenter suggests that the word "uncontested" should be deleted and the moving party be required to support its motion with affidavits or other materials showing that there is no genuine issue for trial.¹¹⁸

The NASD agrees that hearing panels be instructed that the option to defer a decision on a proposed Rule 9264 motion for summary disposition should not be used to avoid determining whether the Department of Enforcement has a case that it can prove. Dispositive motions play a valuable role in cases where the evidentiary basis is lacking or where a legal claim is not set forth in the complaint. However, the NASD does not believe that it is appropriate to codify such instructions.

In addition, the NASD states that it will amend proposed Rule 9264(b) to eliminate the ability of the Department of Enforcement to move for summary disposition after a hearing on the merits has commenced. While the NASD recognizes that in the pre-hearing context of proposed Rule 9264(a) such dispositive motions should be granted against a respondent only in very clear cases, it does not propose to codify this policy. Further, the NASD agrees with the commenter that paragraph (d) of proposed Rule 9264 should be amended.¹¹⁹

The commenter recommends that the NASD adopt changes to proposed Rule 9270 to provide guidance as to what constitutes a frivolous offer, to apply the Sanctions Guidelines to such offers, and to specify the procedures that should govern an offer of settlement once a hearing has begun. The commenter also recommends that the NASD consider designating hearing officers as a "Duty Officer" on a rotating basis to consider settlement offers to eliminate any appearance of unfairness from hearing officers being allowed to reject offers of settlement and later conduct the hearing on the merits.¹²⁰

The NASD does not believe that it is necessary or appropriate to adopt these proposed changes to proposed Rule 9270. First, the NASD does not believe it is appropriate to codify "standardized language" to be used routinely in

settlement documents. Second, in the NASD's view, the application of the Sanctions Guidelines to a particular disciplinary proceeding should not be codified. Third, the NASD does not believe it is appropriate to amend proposed Rule 9270(c) based on the commenter's concern that a hearing panel or an extended hearing panel may view with prejudice some aspect of a respondent's case if the respondent previously submitted an offer of settlement that the hearing panel or the extended hearing panel rejected. The NASD notes that although some jurisdictions provide settlement judges, in most jurisdictions, a judge continues to preside over the case throughout the disciplinary process, even after approving or disapproving a settlement. The NASD notes further that it is the duty of the hearing officer sitting on the hearing panel or the extended hearing panel to instruct the panelists to disregard the proposed settlement therefore allowing the respondent to obtain a fair hearing on the merits.¹²¹

Proposed Rule 9280 sets forth a list of sanctions that may be imposed upon a party and/or a party's attorney for conduct in violation of an order or "other contemptuous conduct during a proceeding." The commenter recommends that the NASD define "contemptuous conduct" in the proposed rule.¹²² The commenter does not believe it is clear to what extent the hearing panel must consider an attorney's ethical obligation to vigorously represent a client in determining the limits of acceptable conduct. Further, the commenter suggests that an attorney subject to an exclusion order should have the right to an oral argument before the NBCC.¹²³

The NASD believes it is unnecessary to define "contemptuous conduct." The NASD does not believe that the use of proposed Rule 9280 against a counsel will compromise zealous advocacy of a client; in any case, the NASD will analyze any interpretive questions on a case-by-case basis. Further, the NASD does not believe it is appropriate to codify that an attorney has the right to oral argument before the NBCC in every case as a matter of right if the attorney is appealing a proposed Rule 9150 exclusion order. The NASD notes that under proposed Rule 9150 and

¹²¹ NASD Response, *supra* note 6, at 17-18.

¹²² In a previous comment regarding proposed Rule 9150 (Exclusion from Rule 9000 Series Proceeding), the commenter also recommends that the NASD ensure that an attorney's obligations under the Model Rules of Professional Conduct are not compromised by the application of this proposed rule.

¹²³ ABA Letter, *supra* note 9, at 116.

¹¹⁷ NASD Response, *supra* note 6, at 16.

¹¹⁸ ABA Letter, *supra* note 9, at 98-103.

¹¹⁹ NASD Response, *supra* note 6, at 16-17. See also Amendment No. 3, *supra* note 6.

¹²⁰ ABA Letter, *supra* note 9, at 112-114.

proposed Rule 9280, attorney exclusion is the only contested order following which an interlocutory appeal is granted as a matter of right. The NASD states that the Code need only provide that an attorney (or a representative) may request oral argument before the NBCC when he or she is appealing a proposed Rule 9150 exclusion order, as the proposed Rule currently does.¹²⁴

3. Rule 9300 Series

The rules provide for two levels of discretionary review of disciplinary proceedings by the NASD Regulation Board of Directors (proposed Rules 9351) and the NASD Board of Governors (proposed Rule 9352). The commenter recommends that the proposed rules should restrict a call for review to either the NASD Regulation Board, or the NASD Board, but not both.¹²⁵ The NASD generally agrees with the comment regarding the two levels of discretionary review of disciplinary proceedings. The NASD states that a central feature of the corporate restructuring recently approved by the NASD Board of Governors, and shortly to be submitted to the Commission, is to eliminate such unnecessary levels of discretionary review.¹²⁶

The commenter also recommends that a bar or expulsion become effective thirty days after service rather than effective upon service as set forth in proposed Rule 9360. In addition, the commenter recommends that the bar or expulsion be effective only upon personal service on the member.¹²⁷

The NASD proposes to amend proposed Rule 9360 to reflect the concern of the commenter that a person subject to a sanction of a bar or an expulsion be personally served. Because such persons are often very difficult to serve, the NASD proposes to amend proposed Rule 9360 to provide that the NASD shall take reasonable steps to obtain personal service of a respondent when the sanction is a bar or an expulsion.¹²⁸ A bar or expulsion will continue to be effective upon service. The NASD states that a party may seek a stay of the effectiveness of the sanction from the Commission or from the appropriate federal court.¹²⁹

The commenter notes that proposed Rule 9370 stays the effectiveness of any sanction other than a bar or an expulsion upon application for review by the Commission pursuant to Section

19(d)(2) of the Act. The commenter recommends that bars and expulsions should also be stayed pending appeal under proposed Rule 9370.¹³⁰ The NASD, however, believes that a bar or an expulsion should not be stayed automatically upon an application for review by the Commission pursuant to Section 19(d)(2) of the Act.¹³¹ As noted in the NASD's response to proposed changes to proposed Rule 9360, an aggrieved person may seek a stay from the Commission or from the appropriate federal court.¹³²

IV. Discussion

As discussed more fully herein, the Commission has determined at this time to approve the NASD's proposed rule change. The standard by which the Commission must evaluate a proposed rule change is set forth in Section 19(b) of the Act. The Commission must approve a proposed NASD rule change if it finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that govern the NASD.¹³³ In evaluating a given proposal, the Commission examines the record before it and all relevant factors and necessary information. In addition, Section 15A of the Act establishes specific standards for NASD rules against which the Commission must measure the NASD proposal.¹³⁴

As discussed below, the Commission has evaluated the NASD's proposed change in light of the standards and objectives set forth in the Act and, in particular, Sections 15A¹³⁵ and 3(f)¹³⁶ of the Act. The Commission believes the

NASD's proposed rule change is consistent with the Act. The Commission also believes the rule change proposed by the NASD is consistent with the NASD's Undertakings in the SEC Order and is reasonably taken in furtherance of the Undertakings. The Commission expects that the NASD's rule change should strengthen the NASD's operational and disciplinary procedures, which are important in governing its members in a free, open, and competitive market. Further, in the Commission's view, the proposed change should enhance the dispassionate application of rules and fairness in the disciplinary process and bring greater consistency and fairness to the membership application and other regulatory processes.

A. Changes to the Membership and Registration Rules

For the reasons discussed below, the Commission believes the proposed rule change regarding membership decisions is consistent with the Act and the rules and regulations thereunder applicable to a national securities association. In particular, the proposal is consistent with Sections 15A(b)(3), 15A(b)(8), 15A(g)(3), and 15A(h)(2) of the Act.¹³⁷ This change improves the current system by implementing safeguards to ensure that decisions regarding membership are addressed in a fair and efficient manner. Moreover, the rule change is reasonably taken in furtherance of the Undertakings and is consistent with the Undertakings.

That portion of the settlement between the Commission and the NASD concerning the admission of member firms to the NASD requires the regulatory staff of the NASD, subject only to the supervision of the Board of Governors of the NASD and the Board of Directors of NASD Regulation, to have sole discretion to handle the approval of applications for membership and the conditions and limitations on membership.¹³⁸ The District Committees (including any subcommittees) may not be involved in the review or approval of applications for membership in the NASD.¹³⁹ Moreover, the NASD agreed to promulgate and apply on a consistent basis uniform standards regarding admission to the NASD and to institute safeguards to ensure fair and

¹³⁰ ABA Letter, *supra* note 9, at 138–39.

¹³¹ Under proposed Rule 9370, other sanctions are stayed when an application for review is filed.

¹³² NASD Response, *supra* note 6, at 19.

¹³³ 15 U.S.C. § 78s(b).

¹³⁴ 15 U.S.C. § 78o–3.

¹³⁵ For example, Section 15A(b)(8) requires that the rules of an association provide a fair procedure for the disciplining of members and persons associated with members, the denial of membership, the barring of any person becoming associated with a member thereof, and for the prohibition or limitation by the association of any person with respect to access to services offered by the association. Section 15A(h)(2) requires a registered securities association when determining whether a person shall be denied membership, barred from becoming associated with a member, or prohibited or limited with respect to access to services offered by the association or member thereof, to notify such person of and give him an opportunity to be heard upon, the specific grounds for denial, bar, or prohibition or limitation under consideration and keep a record. Section 15A(h)(3) governs when a registered securities association may summarily suspend a member or a person associated with a member.

¹³⁶ In approving this proposal, the Commission notes that it has considered the proposed rule change's impact on efficiency, competition, and capital formation. 15 U.S.C. § 78c(f).

¹³⁷ 15 U.S.C. §§ 78o–3(b)(3), 78o–3(b)(8), 78o–3(g)(3), and 78o–3(h)(2).

¹³⁸ SEC Order, *supra* note 10; *see also* Undertaking 4, *supra* note 15.

¹³⁹ SEC Order, *supra* note 10; *see also* Undertaking 4, *supra* note 15.

¹²⁴ NASD Response, *supra* note 6, at 18.

¹²⁵ ABA Letter, *supra* note 9, at 135–36.

¹²⁶ NASD Response, *supra* note 6, at 18–19.

¹²⁷ ABA Letter, *supra* note 9, at 137.

¹²⁸ Amendment No. 3, *supra* note 6.

¹²⁹ NASD Response, *supra* note 6.

evenhanded access to the NASD's services.¹⁴⁰

1. Processing Membership Applications

The Commission noted in the 21(a) Report that the District Committee (or a subcommittee it created called the Pre-Membership Interview ("PMI") Subcommittee) at the New York City District 10 office of the NASD encouraged the close scrutiny of applicants who appeared likely to engage in active SOES trading.¹⁴¹ This scrutiny substantially hindered or delayed a number of these applications, even though the NASD's rules provided for reasonable review periods.

The current membership application procedures require an applicant to file its application with the District Office where the applicant intends to have its principal place of business. The District Office will then schedule a premembership interview within a reasonable time after it receives the application and supporting documents. Within thirty days after the conclusion of the premembership interview, a subcommittee will consider the application and notify the applicant in writing whether its application has been granted, denied, or granted subject to restrictions, and provide the rationale for such determination. If an application is denied, the applicant has the right to file an appeal with the District Committee within fifteen days. The District Committee will consider the record developed before it and notify the applicant in writing within a reasonable time after the close of the record whether its application has been granted, denied, or granted subject to restrictions on its business activities. The applicant also has the right to appeal the District Committee's decision to the NBCC. The NBCC will consider the record developed before it and notify the applicant in writing within a reasonable time after the close of the record whether its application has been granted, denied, or granted subject to restrictions on its business activities. Determinations of the NBCC may be called for review by either the Board of NASD Regulation or the Board of the NASD.

Rather than requiring the NASD to simply act within a "reasonable time frame," the proposed rule change sets forth a schedule for the membership application process and allows applicants to ensure that their applications are being processed expeditiously. The process begins with

the submission of an application to the NASD. The first part of the application must be filed with the Membership Department,¹⁴² and the second part of the application must be filed with the Department of Member Regulation at the District Office in the District in which an applicant intends to have its principal place of business.¹⁴³ The Department will notify an applicant within thirty days after it receives an application whether the application is complete.¹⁴⁴ Within ninety days after the receipt of the application or within sixty days after the receipt of all additional information, whichever is later, the Department will schedule a membership interview.¹⁴⁵ The Department will issue its written decision within thirty days after the conclusion of the membership interview or within thirty days after the submission of additional information, whichever is later.¹⁴⁶

If the Department fails to issue its decision within 180 days after the receipt of an application, or such later date as the Department and an applicant have agreed to in writing, an applicant may petition the NASD Board in writing to direct the Department to issue a decision.¹⁴⁷ Within seven days of receiving such a request, the NASD Board will instruct the Department to serve its written decision immediately or show good cause for an extension of time. If the Department establishes good cause for an extension of time, the NASD Board may grant the Department

an extension of no more than ninety days.¹⁴⁸

If the Department denies an application, the applicant may request that the NBCC review the decision.¹⁴⁹ If a hearing is requested, it shall be conducted by a subcommittee of the NBCC within forty-five days after the receipt of the request.¹⁵⁰ The subcommittee will present its recommended decision to the NBCC within sixty days after the date of the hearing.¹⁵¹ The NBCC will then provide the NASD Regulation Board with its proposed written decision.¹⁵² If the decision is not called for review by the NASD Regulation Board, the NBCC will transmit its proposed written decision to the NASD Board.¹⁵³ If the NASD Board does not call the decision for review, the NBCC will serve the applicant with written notice specifying the date on which the call for review period expired and stating that the final written decision will be served within fifteen days after such date.¹⁵⁴

If the NBCC fails to issue its decision within fifteen days after the expiration of the call for review period, the applicant may petition the NASD Board in writing to direct the NBCC to issue its decision.¹⁵⁵ Within seven days of receiving such a request, the NASD Board will instruct the NBCC to serve its written decision immediately or show good cause for an extension of time. If the NBCC establishes good cause for an extension of time, the NASD Board may grant the NBCC an extension of no more than fifteen days.

The Commission believes these detailed procedures will help ensure that applications will be processed in a timely manner. Centralizing the new member review process at the NASD's headquarters, however, is not necessary to facilitate the process. Each step in the application process contains a discrete time frame within which the NASD must act. In addition, the NASD has represented that significant initiatives are already underway to ensure national uniformity and consistency in the treatment of membership applications.¹⁵⁶

¹⁴⁸ Proposed Rule 1014(d)(3).

¹⁴⁹ Proposed Rule 1015(a).

¹⁵⁰ Proposed Rule 1015(f).

¹⁵¹ Proposed Rule 1015(h).

¹⁵² Proposed Rule 1015(i)(3). The NASD anticipates that the NBCC will provide the Boards with its proposed decision at the next applicable Board meeting after receiving the subcommittee's recommendation.

¹⁵³ Proposed Rule 1015(i)(3).

¹⁵⁴ Proposed Rule 1015(i)(3).

¹⁵⁵ Proposed Rule 1015(i)(4).

¹⁵⁶ For example, the NASD noted that training sessions focusing on the proposed rules have been

Continued

¹⁴⁰ SEC Order, *supra* note 10; see also Undertaking 5, *supra* note 15.

¹⁴¹ 21(a) Report, *supra* note 10, at 41, A-74.

¹⁴² Specifically, the first part of the application must contain an original, signed, and notarized Form BD, with applicable schedules; an original, signed Form U-4 for each associated person who is required to be registered under the rules of the NASD; an original NASD-approved fingerprint card for each associated person who will be subject to SEC Rule 17f-2; a new member assessment report; a new member firm contact questionnaire; and a check for the appropriate fee. Proposed Rule 1013(a)(1).

¹⁴³ The second part of the application must include, among others: a monthly projection of income and expenses, with supporting rationale, for the first 12 months of operations; 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; and a description of the nature and source of applicant's capital, 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. Proposed Rule 1013(a)(2).

¹⁴⁴ Proposed Rule 1013(a)(4).

¹⁴⁵ Proposed Rule 1013(c)(3).

¹⁴⁶ Proposed Rule 1014(d)(1).

¹⁴⁷ Proposed Rule 1014(d)(3).

It is also reasonable for the application for membership to require applicants to provide the information set forth in proposed Rule 1013(a). The required information is reasonably necessary to facilitate the NASD's ability to review an application and determine if an applicant will be able to comply with all of the applicable standards. In particular, it is appropriate to require applicants to project income and expenses for the first twelve months of operations, to describe the nature and source of the applicant's capital, and to submit copies of Forms U-4 and U-5 as part of their application.

Specifically, it is reasonable to require applicants to furnish a monthly projection of income and expenses for the first twelve months of operations because this information enhances the NASD's ability to determine whether an applicant has a reasonable expectation of being able to comply with the net capital rule once an applicant commences business. It should not be overly burdensome for applicants to provide this information because most new firms already project the revenues necessary to help meet fixed and other expenses for business reasons.

Similarly, it is appropriate for applicants to provide a description of the nature and source of an applicant's capital.¹⁵⁷ This information will assist the NASD in determining whether the applicant will have difficulty in maintaining required net capital. Moreover, it enhances the NASD's ability to correctly identify the true owners of a firm and thus ensure that improper parties (e.g., parties that are barred from the industry) are not involved.

It is also reasonable to require applicants to submit copies of Forms BD, U-4, and U-5 as part of their application. Presenting the NASD with all of the relevant information in one package, including these forms, should help expedite the processing of applications.

Finally, the proposal adequately addresses a commenter's concern that the tolling provisions may prolong the

conducted for supervisors and assistant directors, a comprehensive training program is being finalized for District Office examiners, and a staff steering committee chaired by an NASD Regulation vice president and staffed by senior District Office staff members is finalizing detailed procedures for District Offices to follow to help ensure uniformity and consistency.

¹⁵⁷ The NASD has represented, as described previously, that it has taken steps to ensure an appropriate degree of consistency and uniformity will exist. For example, the NASD indicated that it will require memoranda or public offering documents as information describing the risk to the applicant's capital.

application process.¹⁵⁸ Although these provisions allow the maximum time limits to begin from the date of the Department's last request for information, the proposal also allows an applicant to demand that the Department issue its written decision within 180 days after it was received by the NASD, notwithstanding any of the tolling provisions. This should prevent the Department's requests for information from unduly delaying the application procedure.¹⁵⁹

2. Membership Standards

In the 21(a) Report, the Commission found that the NASD applied criteria not enumerated in the NASD's rules to some applicants.¹⁶⁰ Currently, the NASD's rules do not contain explicit standards that an applicant must meet; they only contain general topics that the membership interview will cover.¹⁶¹ In addition, the current rules only require that the NASD provide the general rationale for its decision.

In contrast, the proposed rule change sets forth thirteen standards that the NASD must consider.¹⁶² Moreover, if the NASD denies an application, the proposed rules explicitly require that the Department, as part of the decision explaining the reason for the denial, reference the applicable standard(s).

The proposed standards are objective in nature but, at the same time, are flexible enough to allow the NASD the discretion it needs to properly assess

¹⁵⁸ Colish Letter, *supra* note 9, at 4.

¹⁵⁹ Proposed Rule 1014(d)(3).

¹⁶⁰ SEC Order, *supra* note 10. For example, the NASD considered adopting a guideline to deny membership to:

Owners, control persons, or principal officers who have been recently employed by a known SOES activist and who have indicated an interest in being a SOES activist themselves. This interest would be evidenced by conducting business predominately on a retail agency basis and the request to have pieces of equipment with SOES capabilities that is close in number to the registered representatives that the firm intends to employ.

Although not adopted as an official policy of the NASD, the supervisor of the PMI section of District 10 applied this particular SOES-related guideline to new applicants along with other guidelines in identifying issues for the PMI Subcommittee to consider. 21(a) Report, *supra* note 10, at A-72.

¹⁶¹ Current Rule 1011(c)(1)-(6).

¹⁶² Proposed Rule 1014(a)(1)-(13). One commenter opined that the standards contained in proposed Rule 1014(a)(8) and proposed Rule 1014(a)(9) are redundant. Although the subject area for both standards is similar, the source for comparison differs. Proposed Rule 1014(a)(8) requires the NASD to compare an applicant's compliance, supervisory, operational, and internal control practices and standards to those practices and standards employed by other firms in the securities industry. Proposed Rule 1014(a)(9), on the other hand, requires the NASD to evaluate these practices and standards in light of the requirements of the federal securities laws, the rules and regulations thereunder, and the rules of the NASD.

membership matters. By identifying the proper criteria for admission, the new rules should help ensure that applicants are not required to satisfy criteria not enumerated in the NASD's rules. In addition, these objective standards will facilitate the Commission's ability to evaluate NASD decisions appealed to it.

3. Business Restrictions

In the 21(a) Report, the Commission found that the NASD had, in certain instances, placed improper restrictions on certain members' activities as a condition of membership¹⁶³ and prevented certain members from seeking modifications to their restriction agreements.¹⁶⁴ The NASD's current rules regarding the modification or removal of business restrictions are very open-ended. They simply state that members may file a written request that will be reviewed by a subcommittee designated by the District Committee for the District in which the member currently has its principal place of business. There are no set time frames within which the NASD must act. In addition, the subcommittee is only required to consider the circumstances that gave rise to the imposition of the restrictions, the operations of the member since the imposition of the restrictions, and any new evidence submitted in connection with the member's request.

In contrast, the proposal sets forth a detailed procedure for applying for the removal or modification of a business restriction: it grants applicants seeking to modify or remove previously imposed business restrictions the same procedural rights accorded applicants seeking membership.¹⁶⁵ In addition, the NASD will apply the same standards used for evaluating new membership

¹⁶³ For example, the PMI Subcommittee curtailed the ability of certain firms to use the SOES system. The NASD expressly conditioned membership on certain firms' acceptance of substantial limitations on their SOES trading activity. These restrictions included, in certain circumstances, outright prohibitions on the use of SOES, limitations on the number of SOES terminals available to a firm, and restatement of the order splitting and professional trading account rules in the membership agreement. 21(a) Report, *supra* note 10, at A-74.

¹⁶⁴ The Commission noted in the 21(a) Report that the NASD had applied an informal policy of preventing firms from seeking modifications of any restrictions by conditioning membership on the requirement that the firm forbear from seeking modifications for six months to one year, notwithstanding that the NASD's rules permitted a firm to seek a modification at any time. 21(a) Report, *supra* note 10, at A-75.

¹⁶⁵ For example, the Department must respond to requests for modification or removal of business restrictions within certain time frames. See *supra* Section IV.A.1 for a general discussion of the time frames and appellate procedure. See also proposed Rule 1017 (setting forth the procedure for seeking a modification or removal of a business restriction).

applications to such requests.¹⁶⁶ Finally, the proposed rule change contains a provision that requires the Department to modify or remove a restriction on its own initiative if the Department determines such action is appropriate.¹⁶⁷

The Commission believes the detailed procedures contained in the proposed rule change will provide both applicants and the NASD greater guidance with regard to processing requests to modify or remove business restrictions. The establishment of uniform standards by which such requests will be evaluated, combined with the NASD's new training procedures and establishment of a staff steering committee, will help ensure national uniformity and consistency in the treatment of such applications.

B. Changes to the Investigations and Sanctions Rules

For the reasons discussed below, the Commission believes the proposed change to the Rule 8000 Series regarding investigations and sanctions should provide fair and efficient procedures. The Commission also believes that the proposed change is consistent with Section 15A of the Act, and in particular, with Sections 15A(b)(6)¹⁶⁸ and 15A(b)(9)¹⁶⁹ of the Act. Further, the Commission believes the proposed change to the procedures governing investigations and sanctions is reasonably taken in furtherance of and is consistent with the Undertakings.

Undertaking 4 requires the NASD "[t]o provide[] for the autonomy and independence of the regulatory staff of the NASD and its subsidiaries such that the staff, subject only to the supervision of the Board of Governors of the NASD and the Boards of Directors of NASDR and Nasdaq * * * has sole discretion as to what matters to investigate. * * *" ¹⁷⁰ In addition, Undertaking 5 requires that the NASD "promulgate and apply on a consistent basis uniform standards for regulatory and other access issues * * * and institute safeguards to ensure fair and evenhanded access to all services and facilities of the NASD." ¹⁷¹

¹⁶⁶ Proposed Rule 1017(e)(1)(A) (requiring the NASD to utilize the standards set forth in proposed Rule 1014 when evaluating a request to modify or remove a business restriction).

¹⁶⁷ Proposed Rule 1017(h). The Commission noted in the 21(a) Report certain instances where the NASD retained Professional Trading Account restrictions in membership agreements as much as 18 months after those rules were repealed. 21(a) Report, *supra* note 10, at n.203.

¹⁶⁸ 15 U.S.C. § 78o-3(b)(6).

¹⁶⁹ 15 U.S.C. § 78o-3(b)(9).

¹⁷⁰ Undertakings, *supra* note 15.

¹⁷¹ Undertakings, *supra* note 15.

The Rule 8100 Series currently governs complaints against NASD members. Authority permitting the NASD to investigate a member's books and to require a member or associated person to provide information in connection with an investigation or proceeding conducted by the NASD is presently provided by the Rule 8200 Series. The Rule 8200 Series also currently gives the NASD the authority to suspend members or associated persons who do not comply with the Rule 8200 Series. Finally, the Rule 8300 Series provides for sanctions against members and persons associated with members for violations of NASD Rules.

The NASD proposes to amend the Rule 8000 Series to reflect the proposed changes to the Rule 9000 Series, discussed in detail below,¹⁷² and to clarify and enhance the certain provisions. The Commission finds that these clarifying changes and procedural enhancements to the Rule 8000 Series are appropriate and reasonable. In the Commission's view, these changes should improve the current Rule 8000 Series, and provide fair and efficient procedures for investigation and sanction proceedings. For example, the Commission believes that the inclusion of a provision in the proposed Rule 8000 Series that requires that any decision to impose a suspension under the series must state the grounds for the suspension and the conditions for terminating the suspension will promote uniformity.

In addition, the NASD has also proposed changes to the Rule 8100 Series, eliminating the ability of any person who believes he or she has been aggrieved by any act of any member or associated person to initiate formal disciplinary proceedings pursuant to current Rule 8120. The Commission notes that, as discussed below, the NASD has proposed substantial enhancements to the disciplinary process.¹⁷³ For example, the NASD has proposed to implement staff-initiated disciplinary proceedings, to enhance the arbitration process, and to institute an expanded and independent NASD internal review function, including an Ombudsman Office.

As a result of these changes to the NASD's disciplinary process, the Commission believes it is no longer necessary to permit "aggrieved persons" the right to invoke NASD processes to institute formal disciplinary actions. The Commission notes that the NASD

¹⁷² See *infra* discussion of the disciplinary proceedings in Section IV.C.1.

¹⁷³ See *infra* discussion of the disciplinary proceedings in Section IV.C.1.

has acknowledged its responsibility as an SRO to give due consideration to complaints by members, associated persons, or members of the public who bring forth information suggesting wrongdoing. Further, the NASD has stated it recognizes its duty to investigate and to determine whether its disciplinary process should be invoked. In addition, the Commission notes that the NASD has proposed to add a provision to the Delegation Plan requiring NASD Regulation to establish internal procedures for considering complaints by members, associated persons, and members of the public who request an investigation or disciplinary action by the NASD.¹⁷⁴ The procedures established under this provision would involve regular oversight by NASD Internal Review. Finally, the Commission notes that no other SRO has a similar rule permitting "aggrieved persons" to institute disciplinary proceedings.

The Commission also believes that the proposal to delete Rule 8130, which currently authorizes the DBCCs to file complaints, is in furtherance of Undertaking 4. As noted in the discussion of the disciplinary process below,¹⁷⁵ pursuant to Undertaking 4, the DBCCs will no longer have authority to issue complaints. The Commission believes that the proposed deletion of current Rule 8130 is a reasonable means to address the findings of the Commission's 21(a) Report and is consistent with the Undertakings, particularly with Undertaking 4.

As discussed above, one commenter noted that proposed Rule 8210 did not differentiate between requests for information to parties, as opposed to non-parties. The NASD declined to modify Rule 8210 in response to this comment. The Commission notes that parties and non-parties subject to Rule 8210 requests are NASD members or associated persons, and therefore have submitted themselves to the jurisdiction of the NASD. Therefore, the Commission believes it is reasonable for the NASD not to differentiate in Rule 8210 between requests to parties and requests to non-parties. The Commission also believes that the NASD's interpretation of proposed Rule

¹⁷⁴ NASD Regulation currently logs, tracks, and investigates all customer complaints through the NASD's long-standing customer complaint program. The NASD has proposed to amend Section II.A.1.f. of the Delegation Plan to specify that NASD Regulation will establish procedures to consider requests by members, associated person, and members of the public that NASD Regulation initiate formal disciplinary action. See Securities Exchange Act Release No. 38909 (Aug. 7, 1997).

¹⁷⁵ See *infra* discussion of the disciplinary proceedings in Section IV.C.1.

9146, which permits a hearing officer to issue a protective order upon the motion of a party or other person, is a reasonable means to enable parties and non-parties to limit the use of materials submitted in a disciplinary proceeding.

Further, the commenter requested that reference to the existence of payment plans available to members for the payment of fines, sanctions or costs be included in the Code of Procedure. The Commission notes that although neither Rule 8320 nor the Code of Procedure specifically address the availability of payment plans, the NASD has confirmed that it will inform its members of the existence of payment plans through the inclusion of information regarding installment plans in the NASD's Sanctions Guidelines, which are publicly available.

In conclusion, the Commission finds that proposed Rule 8000 Series is consistent with the Act, and should enhance both the fair and efficient operation of the NASD's disciplinary proceedings and the dispassionate application of the rules and fairness in the NASD's disciplinary process, as well as other regulatory activities.

C. Changes to the Code of Procedure

1. Disciplinary Proceedings

For the reasons discussed below, the Commission believes that the proposed changes regarding the disciplinary proceedings are consistent with the Act, improve the current system, and should provide fair and efficient procedures to address disciplinary matters. The Commission also believes that the proposed rule change is consistent with Section 15A of the Act, and in particular, with Sections 15A(b)(6)¹⁷⁶ and 15A(b)(8)¹⁷⁷ of the Act.

(a) *How disciplinary proceedings are initiated.* The Commission believes that the proposed rule change, which removes the authority to authorize and issue a complaint from the District Committees, the Market Regulation Committee, and the NBCC, and places it solely on the Department of Enforcement of NASD Regulation, is reasonably taken in furtherance of and is consistent with Undertaking 4 in the SEC Order.¹⁷⁸

Pursuant to the NASD's Undertakings in the SEC Order, the NASD has agreed to "provide for the autonomy and independence of the regulatory staff of the NASD and its subsidiaries such that the staff * * * has sole discretion as to what matters to investigate and prosecute, * * *, [] and is generally

insulated from the commercial interests of its members and the Nasdaq market."¹⁷⁹ In particular, under the proposed rules, only the Department of Enforcement of NASD Regulation will be permitted to authorize and issue complaints. In addition, the Department of Enforcement may be directed to authorize and issue a complaint by the NASD Regulation Board or the NASD Board.

To further provide the desired level of autonomy to its regulatory staff, and to address the Commission's conclusion in the 21(a) Report that District Committees were granted overly-broad discretionary authority, the NASD proposes to eliminate the District Committees' involvement in the disciplinary process. Under the revised procedures, the District Committees will no longer have the authority to initiate disciplinary proceedings or to authorize the NASD's staff recommendation to initiate a disciplinary proceeding, nor will they have the ability to veto NASD staff enforcement recommendations. Even more significant, the District Committees will no longer serve as adjudicative bodies, which historically have provided certain segments of the NASD membership with a disproportionate role in the self-regulatory process.¹⁸⁰ They will no longer serve as evidentiary hearing panels for disciplinary proceedings, issue final decisions, or review or approve final decisions. The District Committees' only disciplinary role will be to serve as a pool of persons from which two of the three hearing panelists are selected.

Moreover, the NASD's proposed changes to the Market Regulation Committee's responsibilities and duties in the disciplinary process address the Commission's conclusion in the 21(a) Report that the Market Surveillance Committee (now the Market Regulation Committee) inappropriately performs a grand jury function with respect to disciplinary actions proposed by the NASD's Market Surveillance Department.¹⁸¹ Under the proposed changes, like the District Committees, the only disciplinary role for the Market Regulation Committee will be to serve as a pool of panelists to serve on a hearing panel or, if applicable, an extended hearing panel. A person who currently serves or who has previously served (not earlier than four years before the date the complaint was served upon the respondent) on the Market

Regulation Committee who is associated with an NASD member, or retired therefrom may be chosen to serve as one of the panelists on a hearing panel or an extended hearing panel when the complaint alleges at least one cause of action involving a violation of a statute or a rule within the scope of proposed Rule 9120(r).¹⁸²

One commenter expresses concern that the Department of Enforcement may be able to "pre-select" panelists from the Market Regulation Committee (current or former members) by alleging at least one violation set forth in proposed Rule 9120(r), thereby affecting the selection process.¹⁸³ The Commission agrees with the NASD's view that proposed Rule 9120(r) does not intend to place all federal and state securities laws, rules, and regulations under the advisory jurisdiction of the Market Regulation Committee. A current or former member of the Market Regulation Committee will serve on a panel only when the matter relates to certain subjects, including: quotations of securities; execution of transactions; reporting of transactions; and trading practices.

In the Commission's view, by limiting the role of the District Committees and Market Regulation Committee, while providing the Department of Enforcement with the autonomy and independence to authorize and issue complaints, the professional staff of NASD Regulation should be able to implement a vigorous and evenhanded enforcement program. Moreover, the Commission believes that this shift of authority in the complaint process should ensure that member participation and peer review is preserved, while eliminating problematic aspects of the disciplinary process identified in the 21(a) Report.

(b) *The role of the Hearing Officer and Hearing Panel.* The Commission also believes the proposed change allowing the recently established Office of Hearing Officers to preside over all formal NASD disciplinary proceedings is reasonably taken in furtherance of and is consistent with the Undertaking 3 in the SEC Order. Specifically, in Undertaking 3 in the SEC Order, the NASD agreed to "institute the participation of professional hearing officers (who shall be attorneys with appropriate experience and training) to preside over disciplinary proceedings."¹⁸⁴

¹⁷⁶ 15 U.S.C. § 78o-3(b)(6).

¹⁷⁷ 15 U.S.C. § 78o-3(b)(8).

¹⁷⁸ Undertakings, *supra* note 15.

¹⁷⁹ Undertakings, *supra* note 15.

¹⁸⁰ 21(a) Report, *supra* note 10, at 35 n.91 and accompanying text.

¹⁸¹ 21(a) Report, *supra* note 10, at 35 n.91.

¹⁸² See *supra* note 23.

¹⁸³ ABA Letter, *supra* note 9, at 75.

¹⁸⁴ SEC Order, *supra* note 10. See also Undertakings, *supra* note 15.

This undertaking was made in response to the Commission's conclusions in the 21(a) Report that the NASD did not adequately guard against the influence of particular segments of its membership over its regulatory functions and processes. For example, the Commission concluded in the 21(a) Report that market makers had exerted substantial influence over the administration of the NASD's disciplinary process. The Commission concluded that market makers' influence over the NASD, which constituted a majority of the District Committees and the former Market Surveillance Committee, resulted in heightened enforcement of SOES activity, and lax enforcement of the firm quote obligations, trade reporting rules, and excused withdrawal rules.¹⁸⁵

NASD Regulation has responded to the Commission's concerns by establishing the Office of Hearing Officers as an independent office within NASD Regulation. All litigated disciplinary proceedings will be decided by a panel composed of one hearing officer and two panelists, *i.e.*, the two securities industry representatives. Hearing panel decisions are not subject to review by the District Committees or the Market Regulation Committee. Once a hearing panel has ruled, the decision is subject to review by the NBCC, and the Boards of the NASD Regulation and NASD.

The hearing officer, who is assigned to a disciplinary proceeding by the chief hearing officer, presides over all matters relating to the proceeding. The hearing officer, among other things, considers all procedural and evidentiary matters, discovery requests, and other non-dispositive matters. The hearing officer presiding over a particular disciplinary proceeding also has the authority to impose discretionary sanctions for violations of an order issued by the hearing officer, hearing panel or, if applicable, extended hearing panel, or for other contemptuous conduct during any stage of the disciplinary proceeding.

One commenter believes that to avoid the perception of unfairness and bias, the Office of Hearing Officers should report to the President of the NASD, rather than to the President of NASD Regulation.¹⁸⁶ The Commission believes, however, that the NASD has reasonably addressed the commenter's concern by implementing various measures, as highlighted above, to assure the independence of the chief

hearing officer and the hearing officers.¹⁸⁷

The Commission believes the establishment of an office of professional hearing officers, with the appropriate legal training, should enhance the dispassionate application of the rules and fairness in the disciplinary process. Moreover, the Commission believes that because industry representatives will continue to be represented on each hearing panel, their market expertise will continue to provide a central role in the disciplinary process.¹⁸⁸

(c) *Ex parte communications prohibited.* Proposed Rule 9143 defines and prohibits *ex parte* communications between the disciplinary panels and the Parties or their representatives. In the Commission's view, it is reasonable for the NASD to prohibit *ex parte* communications between the disciplinary panels and the parties or their representatives during the disciplinary proceedings. The Commission also believes that the boundaries set by the NASD in the *ex parte* communication rule should help to ensure that no party can unfairly advance his or her position in a disciplinary proceeding through discussions outside of the proceeding's forum.

In addition, the Commission believes the parties subject to the prohibition on *ex parte* communications include those who reasonably would be expected to participate in a disciplinary proceeding. Specifically, the parties defined in Rule 9120(v), persons identified with such parties,¹⁸⁹ an adjudicator, as defined in Rule 9120(a), and persons identified with such adjudicator, are subject to the *ex parte* communication rule.¹⁹⁰

¹⁸⁷ NASD Response, *supra* note 6.

¹⁸⁸ One commenter recommends that at least one person serving as a panelist on a hearing panel or extended hearing panel "be engaged in similar activities within the securities industry as the respondent." ABA Letter, *supra* note 9, at 67. The Commission agrees with the NASD's view that in order to avoid selecting a panelist with a conflict of interest or bias, "expertise" should not be considered as the only factor in the selection process.

¹⁸⁹ Each group consists of at least a party, and his or her counsel or representative. In disciplinary proceedings, the relevant group includes the respondent or the several respondents (each a member firm or an associated person), and counsel or representatives. The Department of Enforcement, and Interested Association Staff, as defined in Rule 9120(q) is subject to the *ex parte* prohibition.

¹⁹⁰ The adjudicatory group that is prohibited from making or receiving prohibited communications includes the adjudicator and any person, such as a law clerk or other person, who is engaged in advising the adjudicator, including a Governor, a Director or an adjudicator who is participating in a decision with respect to that proceeding, or [to] an NASD employee who is participating or advising

The Commission also believes it is reasonable to establish an objectively determinable point in time when the prohibition of *ex parte* communications commences. Specifically, the prohibition applies upon "the authorization of a complaint * * * unless the person responsible for the communication has knowledge that the complaint will be authorized, in which case the prohibitions shall apply beginning at the time of his or her acquisition of such knowledge." ¹⁹¹ The proposed rule also indicates that in no case shall the prohibition begin to apply later than the time at which a proceeding is noticed for hearing. The Commission recognizes the importance of providing parties and adjudicators and those associated with each group with an identifiable point in time that the prohibition begins. Accordingly, the Commission believes that the NASD's proposed standard reasonably provides those relevant groups with adequate notice of their obligations under this rule.

In the Commission's view, it is also reasonable for a respondent (or potential respondent) to be deemed to have waived his or her protections under the *ex parte* communications prohibition if: (1) a respondent submits an offer of settlement; or (2) a member or a person associated with a member executes an AWC or a MRV. This waiver should help to ensure that the disciplinary process operates efficiently by providing all persons involved in the settlement process or the pre-complaint resolution process with the flexibility to attempt to dispose of a disciplinary matter.

(d) *Motions practice, discovery, and pre-hearing procedures.* The Commission believes it is reasonable for the NASD to establish a formal motions practice in the Code of Procedure. The general provisions governing motions practice are set forth in proposed Rule 9146. The Commission notes that the establishment of a formal motions practice in NASD disciplinary proceedings provides a framework for parties to move for various forms of relief including, but not limited to, a more definite statement; summary disposition; recusal or disqualification of an adjudicator; and leave to introduce additional evidence. The Commission believes the establishment of a formal motion practice should enhance the fair and efficient operation of the disciplinary proceedings.

The Commission also believes that the NASD's proposed discovery provisions

in the decision of a Governor, a Director, or an adjudicator with respect to that proceeding.

¹⁹¹ Proposed Rule 9143.

¹⁸⁵ 21(a) Report, *supra* note 10, at 35-39.

¹⁸⁶ ABA Letter, *supra* note 9, at 39-40.

reasonably address the need for respondents subject to a disciplinary proceeding to have broader documentary discovery rights.¹⁹² Specifically, proposed Rules 9251 through 9253 provide for the discovery of non-privileged and otherwise unprotected documents by respondents in a disciplinary proceeding. Under the proposed rules, a respondent has a right to obtain certain documents and the right to insist upon their production based upon a schedule set forth in the rules.¹⁹³ The Commission notes that the proposed discovery rules should help to ensure that a respondent will receive nonprivileged and otherwise unprotected documents in advance of the initial hearing (or soon thereafter if the Department of Enforcement received the requested document after the commencement of the hearing).

In addition, the Commission believes it is reasonable for the Department of Enforcement to withhold a document that is privileged, constitutes attorney work product, is an examination or inspection report, is an internal memorandum or writing prepared by NASD staff that will not be offered in evidence, or is correspondence between the NASD and state, federal, or foreign regulatory authority or an SRO.¹⁹⁴ Under such circumstances, the hearing

officer may require the Department of Enforcement to submit a list of the documents withheld,¹⁹⁵ and may conduct an *in camera* inspection of any such documents to determine whether they should be produced.

The Commission also believes that the proposed rules regarding pre-hearing procedures should help to ensure that disciplinary proceedings run fairly and efficiently, and should improve the overall quality of the hearing. Specifically, the proposed rules grant the hearing officer discretionary authority to require the parties to participate in pre-hearing conferences or to file a variety of informational materials in advance of the hearing. According to the NASD, these conferences are intended, among other things, to: expedite the disposition of the proceeding; establish procedures to manage the proceeding efficiently; and improve the quality of the hearing through more thorough preparation. In the Commission's view, effective planning and increased control over the proceeding by the hearing officer during the pre-hearing phase should provide for a more fair and efficient disciplinary process.

(e) *Pro se respondents.* The Commission recognizes that the enhanced procedural requirements and protections set forth in the disciplinary procedures should improve the fairness and efficiency of a disciplinary proceeding, but could disadvantage some *pro se* respondents. In response to the Commission's concerns, the NASD has represented that, through the NASD Regulation's Office of Dispute Resolution and the chief hearing officer, it is committed to providing a fair forum for all parties. Accordingly, the chief hearing officer and all hearing officers will adopt as a practice the flexible approach of state and federal judicial proceedings. *Pro se* respondents will be granted waivers from certain procedural

requirements¹⁹⁶ or otherwise be excused from fully or partially complying with certain procedural or technical rules to the extent that the adjudicator may allow, while continuing to: (i) Provide fair notice to other parties of the issues before the adjudicator; (ii) provide the parties an opportunity to respond to the issues; and (iii) establish and maintain a record for any appeal of the matter. The Commission believes that this approach should provide a fair method in which to promote the efficient administration of disciplinary proceedings with respect to *pro se* respondents.

(f) *Offers of settlement, AWCs, MRVs.* The Commission believes that the NASD has proposed a reasonable framework in governing the settlement of cases prior to the filing of a complaint, and the settlement procedures after a complaint has been filed. Specifically, an AWC is a letter that a person or a member agrees to execute to resolve a potential disciplinary matter in a pre-complaint environment. An MRV is a letter that a person or a member agrees to execute to resolve a potential disciplinary matter prior to the issuance of a complaint.¹⁹⁷ Finally, an offer of settlement is an offer made by a respondent in order to resolve the matter prior to the issuance of a decision on the merits. The Commission notes that current provisions governing each of these proceedings have been substantially incorporated into the proposed Code of Procedure.

Because AWCs, MRVs, and offers of settlement are executed voluntarily by a respondent, or a person about to be named as a respondent, the NASD also proposes to require, before going forward with such procedures, a party (or a potential party) to agree to waive the protections offered against *ex parte* communications and the separation of functions provisions in proposed Rule 9144. As noted above, the Commission recognizes that this waiver should help to ensure that the disciplinary process operates efficiently by providing all persons involved in the settlement process or the pre-complaint resolution process with the flexibility to attempt to dispose of a disciplinary matter. The Commission notes, however, that if the AWC, MRV, or offer of settlement is not accepted by the final adjudicator, the

¹⁹² One commenter suggests that Federal Rule of Evidence 501 (for privilege issues) and Federal Rule of Civil Procedure 26(b)(3) (for work-product immunity issues) should be used as a model. ABA Letter, *supra* note 9, at 89-90. The Commission believes that it is reasonable for the NASD to decide not to incorporate these rules into the Code of Procedure. The Commission agrees with the NASD's view that it must provide a fair process but is not limited by the specific evidentiary rules relating to privilege in the Federal Rules of Evidence and the Federal Rules of Civil Procedure.

The commenter also suggests that the right to an interlocutory appeal should be available to contest any ruling denying a claim of attorney-client privilege or work-product privilege. ABA Letter, *supra* note 9, at 46-48. The Commission agrees with the NASD's view that privilege issues are very important, but to grant interlocutory review as a right regarding every contested privilege issue would impede the effective operation of the SRO adjudicatory process.

¹⁹³ One commenter believes that the proposed discovery rule should not include a standard regarding materiality and relevance in the post-complaint time frame. ABA Letter, *supra* note 9, at 85. The Commission believes that it is reasonable for the NASD to subject a secondary production of documents to a material relevance standard so that the Department of Enforcement is not forced to turn over documents that are not relevant to the proceeding initiated and may relate to a potential, but yet-to-be named respondent as part of the same investigation file.

¹⁹⁴ One commenter believes that the only documents that the staff should be able to withhold are privileged documents or documents constituting attorney work product. ABA Letter, *supra* note 9, at 89-90. The Commission believes that the NASD's proposed discovery provisions should both protect a respondent's discovery rights, while ensuring that the NASD's enforcement efforts are not impaired.

¹⁹⁵ One commenter believes that the enforcement staff should be required to provide a list of all documents it obtains to the respondent, and the hearing officer, not the enforcement staff, should make determinations of relevance. ABA Letter, *supra* note 9, at 85. The Commission agrees with the NASD's view that it would be inappropriate to mandate a withheld document list in every case because it might enable a reader to trace the course of an investigation, forcing improper disclosure about the investigation and the investigatory process in circumstances that could impede a continuing investigation of another member or associated person. Moreover, the Commission believes that the NASD has proposed a reasonable standard in proposed Rule 9251(c) under which a respondent may move to require the Department of Enforcement to produce a list of documents withheld if the motion is based upon "some reason to believe that a document is being withheld in violation of the Code." Amendment No. 3, *supra* note 6.

¹⁹⁶ For example, the NASD states that in certain circumstances it would be appropriate to excuse a *pro se* respondent from complying with certain requirements in Rule 9146 regarding motions practice.

¹⁹⁷ Proposed Rule IM-9216 (listing those specific types of violations appropriate for disposition under the minor rule violations plan).

rejected document does not constitute a part of the record in any proceeding. In addition, the NASD proposes to allow the NBCC to delegate authority to the General Counsel of NASD Regulation to accept or refer to the NBCC for its consideration AWCs, MRVs, and uncontested offers of settlement. Further, the NASD proposes to allow the NBCC to delegate to the Chair and the Vice Chair of the NBCC the authority to accept or reject such AWCs, MRVs, and offers of settlement. A contested offer of settlement and order of acceptance may be accepted or rejected only by either the full NBCC or the Chair and Vice Chair, as provided in proposed Rule 9270(f)(2). The Commission believes that these delegation provisions should help to allow the NBCC to concentrate on contested disciplinary matters and those matters raising policy questions.

(g) *NBCC and NASD Regulation/NASD Board Review.* In the Commission's view, the call for review and appellate process set forth in the proposed Rule 9300 Series provide a reasonable interim system for reviewing lower-level decisions. As noted above, the NASD Board has recently approved a subsequent corporate restructuring, which will, in part, eliminate the additional NASD Regulation Board layer of review. The NASD proposed rules provide the NBCC the authority to review any disciplinary proceeding for which a first or "trial-level" decision has been rendered. Also, a respondent or the Department of Enforcement may appeal to the NBCC any "trial-level" decision, including a default decision.¹⁹⁸ The Commission believes that it is appropriate for the Department of Enforcement staff to determine whether an appeal should be filed.

In addition, the NBCC's decision whether to call a case for review rests with an NBCC Review Subcommittee. The two to four person Review Subcommittee must be composed of current members of the NBCC, and must include a balance of non-industry Directors and industry Directors, or, if not balanced, shall include a majority of non-industry Directors. Also, the General Counsel of NASD Regulation, by delegation of the authority of the NBCC, may determine if a default decision issued pursuant to Rule 9269 should be reviewed by the NBCC.

The NBCC subcommittees and extended proceeding committees act as the appeal forum and recommend decisions to the full NBCC in writing not later than seven days before the meeting of the NBCC at which the disciplinary proceeding is considered. At the same time, all other Directors who sit on the NASD Regulation Board also receive the written recommended decision. After considering all matters presented in the appeal or review, the written recommended decision of the subcommittee (or, if applicable, the extended proceeding committee), and after reaching its conclusions on the issues, the NBCC prepares a proposed written decision.¹⁹⁹ The proposed written decision of the NBCC may be called for review by, respectively, any Director of the NASD Regulation Board, and any Governor of the NASD Board. The opportunity for a Director or Governor to call a case for review occurs sequentially. In the Commission's view, these procedures should provide an efficient, fair, and balanced framework for reviewing lower-level decisions.

(h) *Recusal or disqualification.* The Commission believes that the NASD has proposed a reasonable standard under which an adjudicator must recuse him or herself or may be disqualified by motion. Specifically, the standard (as set forth in proposed Rules 9160, 9233, 9234, and 9332) is "a conflict of interest or bias, or circumstances otherwise exist where the * * * [Adjudicator's] fairness might reasonably be questioned." The NASD sets forth in the rules the various persons or groups that may act as an adjudicator and therefore would be subject to disqualification or recusal procedures. Specifically, Governors, Directors, members of the NBCC and certain subcommittees, panelists of hearing panels or extended hearing panels, hearing officers, and members of the staff of the Department of Member Regulation are subject to possible disqualification under the standard set forth above.

¹⁹⁹ Specifically, the decision must include:

- (1) a statement describing the investigative or other origin of the disciplinary proceeding;
- (2) the specific statutory or rule provisions that were alleged to have been violated;
- (3) a statement setting forth the findings of fact with respect to any act or practice the respondent was alleged to have committed or omitted;
- (4) the conclusions as to whether the respondent violated any provision alleged in the complaint;
- (5) a statement in support of the disposition of the principal issues raised in the proceeding; and
- (6) a statement describing any sanction imposed, the reasons therefore, and, pursuant to Rule 9360, the date upon which such sanction shall become effective.

Proposed Rule 9349(b) (1)-(6).

One commenter recommends that proposed Rule 9160 regarding recusal or disqualification set forth procedural steps that must be followed in seeking disqualification of Governors, Directors, NBCC Committee members, and certain NASD Regulation staff when serving an adjudicatory role.²⁰⁰ The Commission agrees with the NASD's view that additional procedures are unnecessary because an adjudicator will recuse him or herself when he or she has a conflict of interest or a bias, and other members of a board or committee have the ability to suggest recusal or seek disqualification if the member does not act promptly to recuse him or herself.

The same commenter also proposes that the right to an interlocutory appeal should be available to contest any situation in which a panelist refuses to recuse him or herself. The Commission agrees with the NASD's view that the right of an interlocutory appeal is unnecessary because (1) a party may challenge the panelist through a disqualification motion; and (2) persons other than parties may inform the chief hearing officer or hearing officer of disqualifying factors, providing another avenue to remove a panelist from a hearing panel.²⁰¹

The Commission also notes that clarity in this area is highly desirable because the proposed rule allows the Chairs and Vice Chairs of the NBCC, and the respective Chairs of the NASD and NASD Regulation Boards to order the disqualification of their competitors sitting on the applicable boards, committees, and subcommittees. The Commission believes the standard set forth in the rules should provide a reasonable framework in which to make such determinations.

(i) *Contemptuous conduct.* The Commission believes that it is appropriate for the NASD to allow for sanctions for conduct that violates orders of a hearing officer, a hearing panel or, if applicable, an extended hearing panel, and for other contemptuous conduct during a hearing. Specifically, the hearing officer, hearing panel or, if applicable, an extended hearing panel, can sanction contemptuous conduct by ruling, among other things, that: the subject matter of the violated order or any other designated facts be taken as established for purposes of the proceeding; the violator or contemptuous party be precluded from supporting or opposing certain claims or defenses, or precluded from introducing evidence on certain

¹⁹⁸ A respondent may not "appeal" any final action contained in an AWC, an MRV or an offer of settlement that has been accepted by any of the General Counsel of NASD Regulation, the Chair and the Vice Chair of the National Business Conduct Committee, or the National Business Conduct Committee (proposed Rules 9216 (a) and (b), and 9270).

²⁰⁰ ABA Letter, *supra* note 9, at 52.

²⁰¹ NASD Response, *supra* note 6, at 10.

matters; and particular pleadings or parts thereof be stricken.

Proposed Rule 9280(b)(2) provides for the imposition of sanctions for a party's unjustified refusal to make disclosures required by the proposed Rule 9240 and 9250 Series, or otherwise required by order of a hearing officer, hearing panel, or, if applicable, an extended hearing panel. Unless the failure to make disclosures is harmless, the recalcitrant party is precluded from using any of the information withheld or the testimony of the witness that was not disclosed as evidence at the hearing, or otherwise relying on such information or testimony. This sanction may be imposed in addition to, or in lieu of, the various restrictions on the conduct of the case authorized by proposed Rule 9280(b)(1). Further, under proposed Rule 9280(c), absent reasonable basis, a party's failure to admit the genuineness of a document that is later found to be genuine may also be subject to the sanctions listed in proposed Rule 9280(b)(1).

Proposed Rule 9280, read in conjunction with proposed Rule 9150, also authorizes a hearing officer, hearing panel, or, if applicable, an extended hearing panel to exclude an offending attorney or person acting in a representative capacity from functioning as such in the particular proceedings. In this regard, proposed Rule 9141(b) also makes clear that the right to representation in a disciplinary proceeding is subject to the power to exclude a party's representative or attorney under proposed Rules 9150 and 9280. Under proposed Rule 9280(c), an attorney or representative who is excluded from participating in a disciplinary proceeding may seek immediate review of the exclusion order by the NBCC by filing a motion to vacate within five days after service of the order. The filing of such a motion operates to stay all aspects of the disciplinary proceeding, pending expedited consideration and a prompt decision by the NBCC. The Commission believes these sanctioning powers provide a reasonable means for these adjudicators to maintain acceptable levels of conduct by the parties and their representatives when participating in a disciplinary proceeding.

2. Members Experiencing Financial or Operating Difficulties; Summary Suspensions; and Procedures for Exemptions From Certain NASD Rules

The Commission believes the proposed changes regarding the Rule 9400, 9500 and 9600 Series improve the current procedures and should provide a fair and efficient means to address: (1)

Limitations of the activities of members experiencing financial or operational difficulties; (2) summary and non-summary suspension, cancellation, bar, limitation or prohibition on access to NASD services; (3) eligibility; and (4) exemptions from specific NASD rules. The Commission believes the proposed rule change is consistent with Sections 15A(b)(6),²⁰² 15A(b)(9),²⁰³ and 15A(h)(3)²⁰⁴ of the Act. The Commission also believes the proposed changes to these procedures are reasonably taken in furtherance of and are consistent with the Undertakings.²⁰⁵

Undertaking 4 requires the NASD "[t]o provide[] for the autonomy and independence of the regulatory staff of the NASD and its subsidiaries such that the staff, subject only to the supervision of the Board of Governors of the NASD and the Boards of Directors of NASDR and Nasdaq * * * has sole discretion as to what matters to investigate * * *."²⁰⁶ In addition, Undertaking 5 requires that the NASD "promulgate and apply on a consistent basis uniform standards for regulatory and other access issues * * * and institute safeguards to ensure fair and evenhanded access to all services and facilities of the NASD."²⁰⁷

In the Commission's view, the proposal should provide an adequate procedural framework for the Rule 9400, 9500, and 9600 Series, enhancing the fair and efficient operation of these rule series. Specifically, the amended proceedings incorporate a great number of procedural improvements that should provide members and persons associated with members clearer, more detailed, and more streamlined procedures for the above-described proceedings.

The Commission notes that, pursuant to proposed Rule 9110, the new Rule 9400 through 9600 Series procedures are governed by the provisions of the Rule 9100 Series, unless a rule specifically provides otherwise. As discussed in detail above in Section IV.C.1, the Rule 9100 Series defines certain terms and addresses notice, service and filing procedures; motions practice; *ex parte* communications; separation of adjudicatory and prosecutorial functions; and disqualification of adjudicators under appropriate circumstances. The Commission believes that it is reasonable for the NASD to establish

these provisions for the Rule 9400, 9500, and 9600 Series, because the provisions should enhance the fair and efficient operation of the procedures governing limitations of the activities of members experiencing financial or operational difficulties; summary and non-summary suspension, cancellation, bar, limitation or prohibition on access to NASD services; eligibility; and exemptions from specific NASD rules.

In addition, the Commission believes the revisions and enhancements to the Rule 9400 through 9600 Series procedures should help ensure that participants in the proceedings are aware of their rights and obligations under the Series, and will improve the overall quality of the procedures and their outcomes. Specifically, the procedures under these Series provide for notice to a member or associated person of the grounds or basis for a notice or limitation; the nature of the sanction or limitation; the effective date of such a notice; the consequences of a failure to comply with a notice or the criteria that must be met to have a notice removed (where appropriate); the member or associated person's rights at a hearing; the definition of the record for each proceeding; and the required components of a written decision under these Series. For example, the Rule 9510 Series, governing summary and non-summary suspension procedures, provides for service of notice of a suspension by facsimile or overnight commercial courier to help ensure that the subject of the suspension has adequate time to respond to such a notice within the time-frames established by the series. In addition, the Rule 9400 and 9500 Series provide for the retention of evidence that is proffered but not accepted into the record until the date when the NASD's decision becomes final or, if applicable, upon the conclusion of any review by the Commission or the federal courts.

Further, the rules provide a mechanism for the member or associated person to request and obtain review of a notice issued pursuant to the Rule 9400 and 9500 Series. Each of the Rule 9400 and 9500 Series procedures also provides for a call for review by the NASD Board (and, in most cases, by the NASD Regulation Board as well), under procedures similar to those for disciplinary proceedings under the Rule 9200 and 9300 Series. In addition, the Rule 9400 and 9500 Series require that adjudicatory and prosecutorial functions remain separated,²⁰⁸ and provide for the disqualification of an adjudicator when there is "a conflict of

²⁰² 15 U.S.C. § 78o-3(b)(6).

²⁰³ 15 U.S.C. § 78o-3(b)(9).

²⁰⁴ 15 U.S.C. § 78o-3(h)(3).

²⁰⁵ SEC Order, *supra* note 10.

²⁰⁶ Undertakings, *supra* note 15.

²⁰⁷ Undertakings, *supra* note 15.

²⁰⁸ Proposed Rule 9144.

interest or bias, or circumstances otherwise exist where the * * * [adjudicator's] fairness might reasonably be questioned."²⁰⁹

The proposed Rule 9600 Series is intended to centralize exemptive authority in NASD Regulation staff that is now, pursuant to current rules, delegated to various standing committees. The proposed Rule 9600 Series governing exemptions for certain NASD rules also contains some of the procedural enhancements present in the Rule 9400 and 9500 Series, including service requirements, components of the decision, procedure to appeal a decision and obtain a hearing, and the opportunity to present oral evidence. The Commission notes that applicants for exemptions have a right of appeal, which will be heard by a sub-committee appointed by the NBCC. The decision then issued by the NBCC constitutes final action of the NASD, and will not be subject to a call for review by the NASD Board. The Commission notes that the authority of the NBCC over exemption decisions pursuant to the Rule 9600 Series is a delegation from the NASD Board, leaving the NASD Board ultimately responsible for the fairness of the exemption proceedings and procedures.²¹⁰

The Commission believes that the NASD's proposal to modify the Rule 9400 through 9600 Series is reasonable, and should improve the procedures for limitations of the activities of members experiencing financial or operational difficulties; summary and non-summary suspension, cancellation, bar, limitation or prohibition on access to NASD services; eligibility; and exemptions from specific NASD rules. The Commission believes that the proposed Rule 9400 through 9600 Series will assist the NASD in promulgating and applying on a consistent basis uniform standards for regulatory and other access issues, as well as instituting safeguards to ensure fair and evenhanded access to all services and facilities of the NASD, consistent with the 21(a) Report and the Undertakings. In conclusion, the Commission finds that proposed Rule 9400, 9500 and 9600 Series are consistent with the Act, and should enhance both the fair and efficient operation of the NASD, and the dispassionate and fair application of the rules in the NASD's regulatory activities.

D. Effectiveness of the Proposed Rules

The NASD has proposed a transition schedule for the procedures approved in this order. In the Commission's view, the schedule proposed by the NASD for implementation as discussed in detail in Section II.D., should help to assist in the transition to the new procedures.

V. Amendment No. 2

The Commission finds good cause for approving Amendment No. 2 prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. Specifically, Amendment No. 2 sets forth proposed changes to the proposed Rule 9400 and 9500 Series and proposes to seek approval of the proposed Rule 9600 Series. The Commission notes that Amendment No. 2, which amends the proposed Rule 9400, 9500 and 9600 Series, was noticed and published for the full 21-day comment period, and no comments were received. Further, as discussed above, the Commission believes that the proposed Rule 9400, 9500 and 9600 Series are consistent with the Act, and should enhance both the fair and efficient operation of the NASD's disciplinary proceedings and the dispassionate application of the rules and fairness in the NASD's disciplinary process, as well as other regulatory activities. Finally, the acceleration of the effectiveness of Amendment No. 2 will enable the Commission to approve the proposed Rule 9400, 9500 and 9600 Series concurrent with the other major modifications to the NASD's rules as proposed in SR-NASD-97-28. Therefore, the Commission believes granting accelerated approval to Amendment No. 2 is appropriate and consistent with Section 19(b)(2) of the Act.²¹¹

VI. Amendment No. 3

The Commission finds good cause for approving Amendment No. 3 prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. As noted above, the NASD made several modifications to the disciplinary proceeding rules in Amendment No. 3 to the proposed rule change, including expanding the pool of persons eligible to serve as panelists in a disciplinary proceeding, defining the administrative and ministerial role of the Counsel to the NBCC, providing greater flexibility for an attorney to withdraw from a proceeding with good cause without 30 days notice, and eliminating the right of the Department of Enforcement to move for summary

disposition of a disciplinary proceeding. In addition, the proposed changes made to the Rule 8000 Series in Amendment No. 3 were technical, non-substantive amendments. Finally, the NASD made several modifications to the membership application process including adding a requirement that, once approved, a member must return an executed membership agreement within twenty-five days of service of the agreement, inserting language in several sections permitting an applicant and the NASD to modify certain deadlines by agreement, codifying the procedural protections afforded new member applications in the business restrictions section, and certain other clarifying changes.

The Commission believes the NASD's proposed changes in Amendment No. 3 further strengthen and clarify the proposed rule change and raise no new regulatory issues. Further, the Commission believes that Amendment No. 3 does not significantly alter the Original Proposal which was subject to a full notice and comment period. Therefore, the Commission believes that granting accelerated approval to Amendment No. 3 is appropriate and consistent with Section 19(b)(2) of the Act.²¹²

VII. Amendment No. 4

The Commission finds good cause for approving Amendment No. 4 prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. Specifically, Amendment No. 4 makes several technical non-substantive changes to the proposal such as identifying appropriate cross-references and correcting typographical errors in the Rule 9100-9300 Series of the Code of Procedure. The Commission believes that proposed Amendment No. 4 raises no new regulatory issues. Therefore, the Commission believes granting accelerated approval to Amendment No. 4 is appropriate and consistent with Section 19(b)(2) of the Act.²¹³

VIII. Amendment No. 5

The Commission finds good cause for approving Amendment No. 5 prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. Specifically, Amendment No. 5 makes a technical change to the proposal, deleting the requirement for signatures of each member of a hearing panel on a disciplinary decision. Further, as discussed in detail above, Amendment

²⁰⁹ Proposed Rule 9160.

²¹⁰ The Commission understands that the fairness of exemption proceedings will be within the scope of responsibility of the NASD Board's Audit Committee.

²¹¹ 15 U.S.C. § 78s(b)(2).

²¹² 15 U.S.C. § 78s(b)(2).

²¹³ 15 U.S.C. § 78s(b)(2).

No. 5 describes the effective date for each component of the NASD's proposal. The Commission believes that proposed Amendment No. 5 raises no new regulatory issues. Therefore, the Commission believes granting accelerated approval to Amendment No. 5 is appropriate and consistent with Section 19(b)(2) of the Act.²¹⁴

IX. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 3, 4 and 5 to the proposed rule change. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to Amendment Nos. 3, 4 and 5 that are filed with the Commission, and all written communications relating to Amendment Nos. 3, 4 and 5 between the Commission and any persons, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. § 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-97-28 and should be submitted by September 3, 1997.

X. Conclusion

For all of the aforementioned reasons, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²¹⁵ that the proposed rule change (SR-NASD-97-

28) is approved, including Amendment Nos. 2, 3, 4, and 5 on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹⁶

Margaret H. McFarland,

Deputy Secretary.

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OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE

Generalized System of Preferences (GSP); Notice Regarding the 1997 Annual GSP Review and Completion of the Expedited Indonesian Melamine Dinnerware Review

AGENCY: Office of the United States Trade Representative.

ACTION: Notice.

SUMMARY: This notice lists the petitions that were accepted for the Annual Generalized System of Preferences (GSP) review for modifications of GSP product eligibility. The dates for hearings on these product reviews and for the submission of comments will be notified later. The expedited review of the GSP eligibility of melamine dinnerware from Indonesia was completed with the decision that denial of continued GSP eligibility was not warranted.

FOR FURTHER INFORMATION CONTACT: GSP Subcommittee, Office of the United States Trade Representative, 600 17th Street, NW, Room 518, Washington, D.C. 20506. The telephone number is (202) 395-6971.

SUPPLEMENTARY INFORMATION:

I. 1997 GSP Product Review

Pursuant to Title V the Trade Act of 1974, ("Trade Act") (19 U.S.C. 2461 *et seq.*), the GSP program grants duty-free

treatment to designated eligible articles that are imported from designated beneficiary developing countries. In a notice dated May 21, 1997, USTR initiated the 1997 Annual GSP Review provided for in the GSP regulations (15 CFR 2007 *et seq.*) and announced a deadline of July 2, 1997 for the filing of petitions requesting modifications in the list of eligible articles (62 **Federal Register** 27828). Petitions may request that products be added or removed from the list of eligible articles or that a country be granted a waiver of "competitive need limits" (CNLs) for an eligible article pursuant to section 503(c) of the Trade Act (19 U.S.C. 2464(c)).

The GSP Subcommittee of the Trade Policy Staff Committee (TPSC), after reviewing the product petitions submitted, has decided that the petitions listed in the attached annex should be accepted for consideration in the 1997 Annual GSP Review. The annex sets forth the case number, product identification, the change requested and the petitioner for each product included in the 1997 Annual GSP Review.

The opportunities for public comment on the products under review, including the dates for a public hearing and procedures for participating in the hearing, will be published in a subsequent notice.

II. Expedited Review of Melamine Dinnerware Petition

As part of an expedited review of a petition to suspend GSP eligibility for melamine institutional tableware from Indonesia, USTR requested comments on the petition by July 2, 1997 (62 **Federal Register** 2852). As a result of that review, the GSP TPSC Subcommittee had decided that removal of GSP eligibility was not warranted.

Frederick L. Montgomery,
Chairman, Trade Policy Staff Committee.

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²¹⁴ 15 U.S.C. § 78s(b)(2).

²¹⁵ 15 U.S.C. § 78s(b)(2).

²¹⁶ 17 CFR 200.30-3(a)(12).