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Dated at Rockville, Maryland, this 23rd day of December 1998.

For the Nuclear Regulatory Commission.

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*Acting Director, Division of Reactor Projects—III/IV, Office of Nuclear Reactor Regulation.*  
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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40826; File No. SR-NASD-98-80]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to the Issuance of Temporary Cease and Desist Orders

December 22, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 28, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its regulatory subsidiary, NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Association amended the proposal on December 15 and 16, 1998.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> The first amendment to the proposal included changes to the evidentiary standard and the tenure of a temporary cease and desist order. See Letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated December 15, 1998. On December 16, 1998, the NASD made further non-substantive changes to the proposed rule language at a meeting between Peter Geraghty, Assistant General Counsel, NASD Regulation, and Mandy S. Cohen, Special Counsel, and Anitra T. Cassas, Attorney, Division, Commission. See Memorandum entitled: Meeting with Staff of NASD regulation, dated December 17, 1998. The NASD also agreed to extend the public comment period to sixty days by letter dated December 21, 1998. See Letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD, to Katherine A. England, Assistant Director, Divisions, Commission.

### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Association is proposing to create the Rule 9800 Series and to amend certain existing NASD Rules of the Association to establish procedures to enable the Association to issue temporary cease and desist orders. The proposed rule change also would grant the NASD authority to initiate non-summary proceedings when temporary or permanent cease and desist orders are violated. The text of the proposed rule change follows. Additions are *italicized*; deletions are [bracketed].<sup>4</sup>

#### 8300. Sanctions

##### 8301. Sanctions for Violation of the Rules

(a) Imposition of Sanctions  
After compliance with the Rule 9000 Series, the Association may impose one or more of the following sanctions on a member or person associated with a member for each violation of the federal securities laws, rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or Rules of the Association, or may impose one or more of the following sanctions on a member or person associated with a member for any neglect or refusal to comply with an order, direction, or decision issued under the Rules of the Association:

- (5) suspend or bar a member or person associated with a member from association with all members; [or]
- (6) [impose any other fitting sanction.] *impose a temporary or permanent cease and desist order against a member or a person associated with a member; or*
- (7) *impose any other fitting sanction.*

\* \* \* \* \*

#### IM-8310-2. Release of Disciplinary Information

\* \* \* \* \*

(d)(1) The Association shall release to the public information with respect to any disciplinary decision issued pursuant to the Rule 9000 Series imposing a suspension, cancellation or expulsion of a member; or suspension or revocation of the registration of a person associated with a member; or barring of a member or person associated with a member from association with all members; or imposition of monetary sanctions of \$10,000 or more upon a member or person associated with a member; or containing an allegation of a violation of a Designated Rule; and may also release such information with respect to any disciplinary decision or group of decisions that involve a

<sup>4</sup> Language in proposed rules IM-8310-2, 9360, 9500, 9510, 9511, and 9513 includes changes proposed in File No. SR-NASD-98-56. See Securities Exchange Act Release No. 34-40378 (August 27, 1998), 63 FR 47058 (September 3, 1998). Language in proposed rule 9120 includes changes proposed in File No. SR-NASD-98-90. See Securities Exchange Act Release No. 34-40755 (December 7, 1998), 63 FR 68814 (December 14, 1998). For purposes of this notice, the proposed rule language in File Nos. SR-NASD-98-56 and 98-90 is treated as approved.

significant policy or enforcement determination where the release of information is deemed by the President of NASD Regulation, Inc. to be in the public interest. The Association also may release to the public information with respect to any disciplinary decision issued pursuant to the Rule 8220 Series imposing a suspension or cancellation of the member or a suspension of the association of a person with a member, unless the National Adjudicatory Council determines otherwise. The National Adjudicatory Council may, in its discretion, determine to waive the requirement to release information with respect to a disciplinary decision under those extraordinary circumstances where the release of such information would violate fundamental notions of fairness or work an injustice. *The Association also shall release to the public information with respect to any temporary cease and desist order issued pursuant to the Rule 9800 Series.*

\* \* \* \* \*

(h) If a final decision of the Association is not appealed to the Commission, the sanctions specified in the decision (other than bars, [and] expulsions, *permanent cease and desist orders, and temporary cease and desist orders*) shall become effective on a date established by the Association but not before the expiration of 30 days after the date of the decision. Bars, [and] expulsions, *permanent cease and desist orders, and temporary cease and desist orders*, however, shall become effective upon issuance of the decision, unless the decision specifies otherwise. *An appeal to the Commission of a decision that imposes a permanent cease and desist order or a temporary cease and desist order shall not stay the effectiveness of such orders, unless the Commission specifies otherwise.*

#### 9000. CODE OF PROCEDURE

##### 9100. Application and Purpose

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##### 9120. Definitions

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###### (x) "Party"

With respect to a particular proceeding, the term "Party" means:

(1) in the Rule 9200 Series, [and] the Rule 9300 Series, *and the Rule 9800 Series*, the Department of Enforcement or a Respondent;

\* \* \* \* \*

#### 9200. DISCIPLINARY PROCEEDINGS

\* \* \* \* \*

##### 9240. Pre-Hearing Conference and Submission

##### 9241. Pre-Hearing Conference

\* \* \* \* \*

###### (c) Subjects to be Discussed

At a pre-hearing conference, the Hearing Officer *shall schedule an expedited proceeding if required by Rule 9290, and may consider and take action with respect to any or all of the following:*

\* \* \* \* \*

**9290. Expedited Disciplinary Proceedings**

*For any disciplinary proceeding, the subject matter of which also is subject to a temporary cease and desist proceeding initiated pursuant to Rule 9810 or a temporary cease and desist order, hearings shall be held and decisions shall be rendered at the earliest possible time. An expedited hearing schedule shall be determined at a pre-hearing conference held in accordance with Rule 9241.*

**9300. REVIEW OF DISCIPLINARY PROCEEDING BY NATIONAL ADJUDICATORY COUNCIL AND NASD BOARD; APPLICATION FOR COMMISSION REVIEW**

9310. Appeal to or Review by National Adjudicatory Council

9311. Appeal by Any Party; Cross-Appeal

\* \* \* \* \*

(b) Effect

An appeal to the national Adjudicatory Council from a decision issued pursuant to Rule 9268 or Rule 9269 shall operate as a stay of that decision until the National Adjudicatory Council issues a decision pursuant to Rule 9349 or, in cases called for discretionary review by the NASD Board, until a decision is issued pursuant to Rule 9351. *Any such appeal, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order.*

\* \* \* \* \*

9312. Review Proceeding Initiated By National Adjudicatory Council

\* \* \* \* \*

(b) Effect

Institution of review by a member of the National Adjudicatory Council on his or her own motion, a member of the Review Subcommittee on his or her own motion, or the General Counsel, on his or her own motion, shall operate as a stay of a final decision issued pursuant to Rule 9268 or Rule 9269 as to all Parties subject to the notice of review, until the National Adjudicatory Council issues a decision pursuant to Rule 9349, or, in cases called for discretionary review by the NASD Board, until a decision is issued pursuant to Rule 9351. *Institution of any such review, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order.*

9360. Effectiveness of Sanctions

Unless otherwise provided in the decision issued under Rule 9349 or Rule 9351, a sanction (other than a bar, [or] an expulsion, or a permanent cease and desist order) specified in a decision constituting final disciplinary action of the Association for purposes of SEC Rule 19d-1(c)(1) shall become effective 30 days after the date of service of the decision constituting final disciplinary action. A bar, [or] an expulsion, or a permanent cease and desist order shall become effective upon service of the decision constituting final disciplinary action of the Association for purposes of SEC Rule 19d-1(c)(1), unless otherwise specified therein. The Association shall take reasonable steps

to obtain personal service of a Respondent when the sanction is a bar or an expulsion.

**9500. OTHER PROCEEDINGS**

9510. Summary and Non-Summary Proceedings

9511. Purpose and Computation of Time

(a) Purpose

The Rule 9510 Series sets forth procedures for: (1) summary proceedings authorized by Section 15A(h)(3) of the Act; and (2) non-summary proceedings to impose (A) a suspension or cancellation for failure to comply with an arbitration award or a settlement agreement related to an arbitration or mediation pursuant to Article VI, Section 3 of the NASD By-Laws; (B) a suspension or cancellation of a member, or a limitation or prohibition on any member, associated person, or other person with respect to access to services offered by the Association or a member thereof, if the Association determines that such member or person does not meet the qualification requirements or other prerequisites for such access or such member or person cannot be permitted to continue to have such access with safety to investors, creditors, members, or the Association; [or] (C) an advertising pre-use filing requirement; or (D) a suspension or cancellation of the membership of a member or the registration of a person for failure to comply with a permanent cease and desist order entered pursuant to a decision issued under the Rule 9200 Series or Rule 9300 Series or a temporary cease and desist order entered pursuant to a decision issued under the Rule 9800 Series.

\* \* \* \* \*

9513. Initiation of Non-Summary Proceeding

(a) Notice

Association staff may initiate a proceeding authorized under Rule 9511(a)(2)(A) or (B), by issuing a written notice to the member, associated person, or other person. Association staff may initiate a proceeding authorized under Rule 9511(a)(2)(D), after receiving written authorization from the President or Chief Operating Officer of the Association, by issuing a written notice to the member or associated person. The notice shall specify the grounds for and effective date of the cancellation, suspension, bar, limitation, or prohibition and shall state that the member, associated person, or other person may file a written request for a hearing under Rule 9514. *In addition, if the proceeding is authorized under Rule 9511(a)(2)(D), the notice shall specifically identify the provision of the permanent or temporary cease and desist order that is alleged to have been violated, and shall contain a statement of facts specifying the alleged violation.* The notice shall be served by facsimile or overnight commercial courier.

(b) Effective Date

For any cancellation or suspension pursuant to Rule 9511(a)(2)(A), the effective date shall be at least 15 days after service of the notice on the member or associated person. For any action taken pursuant to Rule 9511(a)(2)(B) or (D), the effective date shall be at least seven days after service of the notice on the member or person, except that

the effective date for a notice of a limitation or prohibition on access to services offered by the Association or a member thereof with respect to services to which the member, associated person, or other person does not have access shall be upon receipt of the notice.

**9800. TEMPORARY CEASE AND DESIST ORDERS**

9810. Initiation of Proceeding

(a) Department of Enforcement

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

(b) Contents of Notice

*The notice shall set forth the rule or statutory provision that the Respondent is alleged to have violated and that the Department of Enforcement is seeking to have the Respondent ordered to cease violating. The notice also shall state whether the Department of Enforcement is requesting the Respondent to be required to take action or to refrain from taking action. The notice shall be accompanied by:*

- (1) a declaration of facts, signed by a person with knowledge of the facts contained therein, that specifies the acts or omissions that constitute the alleged violation; and
- (2) a proposed order that contains the required elements of a temporary cease and desist order (except the date and hour of the orders issuance), which are set forth in Rule 9840(b).

(c) Filing of Underlying Complaint

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

9820. Appointment of Hearing Officer and Hearing Panel

*(a) As soon as practicable after the Department of Enforcement files a copy of the notice initiating a temporary cease and*

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

(b) If at any time a Hearing Officer or Hearing Panelist determines that he or she has a conflict of interest or bias or circumstances otherwise exist where his or her fairness might reasonably be questioned, or if a Party files a motion to disqualify a Hearing Officer or Hearing Panelist, the recusal and disqualification proceeding shall be conducted in accordance with Rules 9233 and 9234, except that:

(1) a motion seeking disqualification of a Hearing Officer or Hearing Panelist must be filed no later than 5 days after the later of the events described in paragraph (b) of Rules 9233 and 9234; and

(2) the Chief Hearing Officer shall appoint a replacement Panelist using the criteria set forth in paragraph (a) of this Rule.

#### 9830. Hearing

##### (a) When Held

The hearing shall be held not later than 15 days after service of the notice initiating the temporary cease and desist proceeding, unless a Hearing Officer or Hearing Panelist is recused or disqualified, in which case the hearing shall be held not later than five days after a replacement Hearing Officer or Hearing Panelist is appointed.

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

The Hearing Officer shall serve a notice of date, time, and place of the hearing on the Department of Enforcement and the Respondent not later than four days before the hearing, unless otherwise ordered by the Hearing Officer. Service shall be made by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Hearing Officer shall send an additional copy of the notice by overnight commercial courier. The notice shall be effective upon service.

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

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

##### (d) Witnesses

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

##### (e) Additional Information

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

##### (f) Transcript

The hearing shall be recorded by a court reporter and a written transcript thereof shall be prepared. A transcript of the hearing shall be available to the Parties for purchase from

the court reporter as prescribed rates. A witness may purchase a copy of the transcript of his or her own testimony from the court reporter as prescribed rates. Proposed corrections to the transcript may be submitted by affidavit to the Hearing Panel within a reasonable time determined by the Hearing Panel. Upon notice to all the Parties to the proceeding, the Hearing Panel may order corrections to the transcript as requested or sua sponte.

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

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

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

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

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

##### (a) Basis for Issuance

The Hearing Panel shall issue a written decision stating whether a temporary cease and desist order shall be imposed. The Hearing Panel shall issue the decision not later than ten days after receipt of the hearing transcript. A temporary cease and desist order shall be imposed if the Hearing Panel finds:

(1) by a preponderance of the evidence that the alleged violation specified in the notice has occurred; and

(2) that the violative conduct or continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding under the Rule 9200 and 9300 Series.

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

A temporary cease and desist order shall:

(1) be limited to ordering a Respondent to cease and desist from violating a specific rule or statutory provision, and, where applicable, to ordering a Respondent to cease and desist from dissipating or covering assets or causing other harm to investors;

(2) set forth the alleged violation and the significant dissipation or conversion of assets or other significant harm to investors that is likely to result without the issuance of an order;

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

(4) include the date and hour of its service.

##### (c) Duration of Order

A temporary cease and desist order shall remain effective and enforceable until the issuance of a decision under Rule 9268 or Rule 9269.

##### (d) Service

The Hearing Officer shall serve the Hearing Panel's decision and any temporary cease and desist order by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Hearing Officer shall send an additional copy of the Hearing Panel's decision and any temporary cease and desist order by overnight commercial courier. The temporary cease and desist order shall be effective upon service.

#### 9850. Review by Hearing Panel

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

#### 9860. Violation of TCDO

A Respondent who violates a temporary cease and desist order imposed under this Rule Series may have its association or membership suspended or canceled under the Rule 9510 Series. The President or Chief Operating Officer of NASD Regulation, Inc., must authorize the initiation of any such proceeding in writing.

#### 9870. Application to Commission for Review

Temporary cease and desist orders issued pursuant to this Rule Series constitute final and immediately effective disciplinary sanctions imposed by the Association. The right to have any action under this Rule Series reviewed by the Commission is governed by Section 19 of the Act. The filing of an application for review shall not stay the effectiveness of temporary cease and desist order, unless the Commission otherwise orders.

\* \* \* \* \*

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

In its filing with the Commission, the Association included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The

Association has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

(i) Background

In 1997, the Commission approved a proposed rule change filed by the Association that, among other things, removed from the NASD's rules the provision that granted the NASD the authority to conduct Expedited Remedial Proceedings.<sup>5</sup> These rules were intended to provide the Association with a mechanism to take appropriate remedial action against an NASD member or an associated person if the member or associated person had engaged and there was a reasonable likelihood that the member or person would again engage in securities law violations.<sup>6</sup> Unfortunately, the rules did not serve their intended purpose. In the proposed rule change removing these rules, the NASD stated that it would file a proposed rule change in the future that would propose a different approach to expedited remedial proceedings.<sup>7</sup> This proposal contains the alternative approach.

The proposed rules are based upon and closely mirror the SEC rules pertaining to temporary cease and desist orders,<sup>8</sup> but with increased procedural protections in some respects. For example, the SEC rules permit a temporary cease and desist order to be entered against a person without prior notice and an opportunity for a hearing. Such ex parte proceedings are not permitted under the rules proposed by the NASD. In addition, under the rules the NASD is proposing, a temporary cease and desist proceeding can be initiated only with respect to alleged violations of certain sections of the securities laws and certain NASD rules. The SEC rules have no such limitation.

(ii) NASD Notice to Members 98-42

The NASD issued a Notice to Members in June 1998 to solicit comment on proposed temporary cease and desist rules that differed in a

number of respects from the proposal contained in this filing.<sup>9</sup> The comment period closed on July 31, 1998. The Association received 13 comment letters in response.<sup>10</sup> While three commentators expressed support for the Association's overall goal of effective regulation of the securities markets, none of the commentators voiced support for the proposal. The commentators generally stated that the Association has not justified the need for the rules and, if adopted, the rules lacked sufficient procedural protections for proposed respondents (hereinafter referred to as "Respondents"). One commentator questioned whether the Act provides self-regulatory organizations with the authority to issue temporary cease and desist orders. As discussed in greater detail later, the Association believes that the Act does provide it with the authority, and that the proposed rules are both necessary and fair. The staff has carefully reviewed all comments and, as a result, modified the proposal in many significant respects. These changes will:

- Limit markup violations for which temporary cease and desist orders can be pursued to those violations involving fraudulent markups;
- Require that a hearing panel find by a preponderance of the evidence that a violation occurred;
- Require that the disciplinary action underlying a temporary cease and desist order be conducted on an expedited basis;
- Limit the duration of a temporary cease and desist order;
- Require that a member or associated person being charged with violating a temporary or permanent cease and desist order be notified of the specific provision of the order alleged to have been violated and that the notification be accompanied by specific facts supporting the alleged violation; and
- Specify that temporary cease and desist orders are final and immediately effective decisions of the NASD that can

be appealed to the SEC under Section 19 of the Exchange Act.

(iii) Need for Temporary Cease and Desist Authority

The Association believes there is a clear need for an additional tool to stop members' or associated persons' misconduct that causes significant dissipation of or conversion of assets or other significant harm to investors while a disciplinary action is pending. While NASD Regulation litigates disciplinary actions involving limited capitalization, or microcap, securities, for example, investors may continue to lose substantial sums.<sup>11</sup> Without a temporary cease and desist rule, the Association has no immediate means to order cessation of egregious, ongoing violative conduct.

Several commentators believe that the Association's regular disciplinary proceedings provide sufficient measures to combat the violative conduct that concerns the NASD. The Association disagrees. Temporary cease and desist orders would be pursued in cases where the Association believes significant dissipation or conversion of assets or other significant harm to investors is likely to occur before a disciplinary proceeding under the Rules of the Association is concluded. In addition, under the NASD's current rules, it takes a minimum of four months to complete a disciplinary proceeding. This scenario assumes that the action is not settled and that each aspect of the proceeding occurs without delay. The Association's experience with microcap fraud is that investor losses tend to occur quickly, over very short periods of time.

One commentator suggested that the Association could use its summary suspension authority to address egregious cases of fraud, while another commentator suggested that the NASD could use its non-summary suspension authority in such circumstances. The NASD believes that it, and any other self-regulatory organization, can summarily suspend a member or associated person only in the limited situations that are described in Section 15A(h)(3) of the Act, which do not include the types of situations the Association is attempting to address with the temporary cease and desist rules. The NASD's non-summary suspension rules<sup>12</sup> also can be used only in limited situations that do not include the types of situations that the

<sup>9</sup> See NASD Notice to Members 98-42 (June 1998) ("NTM-98-42").

<sup>10</sup> See Letters from PIM Financial Services, Inc. (June 18, 1998); Choice Investments (June 19, 1998); Dan Jamieson (June 19, 1998); Cunner & Company (June 24, 1998); Wulff, Hansen & Co. (June 22, 1998); Combined Research & Trading, Inc. (June 22, 1998); A.G. Edwards & Sons, Inc. (June 26, 1998); Dortch Securities & Investments, Inc. (July 10, 1998); Whale Securities Co., L.P. (July 17, 1998); Orrick, Herrington & Sutcliffe LLP (July 17, 1998); Securities Industry Association, Compliance and Legal Division (August 5, 1998); Securities Industry Association, Federal Regulation Committee and Self-Regulation and Supervisory Practices Committee (August 17, 1998); and American Bar Association, Section of Litigation and Business Law (August 18, 1998).

<sup>5</sup> See Securities Act Release No. 38908 (August 7, 1997), 62 FR 43387 (August 13, 1997) (File No. SR-NASD-97-28).

<sup>6</sup> Under these rules, the NASD was authorized to suspend, limit, or condition a broker-dealer's membership or suspend, limit, or condition a person's association with a broker-dealer.

<sup>7</sup> See Release No. 34-38908.

<sup>8</sup> See 17 CFR 201.500-201.514.

<sup>11</sup> While the need for temporary cease and desist authority is often expressed in the context of microcap fraud, it is not necessarily so limited. Temporary cease and desist orders could be used to address fraudulent conduct in many contexts.

<sup>12</sup> NASD Rules 9511(a)(2) and 9513.

Association is attempting to address. For example, the NASD, after notice and opportunity for a hearing, may suspend or cancel the membership of a member or the registration of a person for failure to pay fees, dues, assessments or other charges, or for failure to comply with an arbitration award or settlement agreement. In addition, the non-summary suspension rules and temporary cease and desist rules are designed for different purposes. Non-summary suspension proceedings are designed to limit or stop a member's or associated person's ability to conduct business, whereas temporary cease and desist orders are designed to stop ongoing, violative conduct while an underlying disciplinary proceeding is being litigated.

In addition, some commentators believe that the NASD could refer cases to the SEC or a state regulatory authority for prosecution where an emergency exists. The Association's experience demonstrates that this is not a viable alternative to the proposed rule. Even though the NASD, the SEC and other regulators have made great strides in coordinating their respective enforcement efforts, this is not a substitute for temporary cease and desist authority. There are situations where the Association is in the best position to take immediate action, based on its preexisting investigation and access to case-specific information. In such situations, the need to refer the case to another regulatory authority might result in unacceptable delay and would not be an efficient use of the Association's or other regulators' resources.

#### (iv) Authority for Issuing Temporary Cease and Desist Orders

The Association believes that relevant provisions of the Act provide self regulatory organizations with the authority to issue temporary cease and desist orders. Section 15A(b)(2) of the Act, among other things, requires that an association of brokers and dealers have the capacity to be able to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the Act, the rules and regulations thereunder, and the rules of the Association. In addition, Section 15A(b)(6) requires that the rules of an association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. Section 15A(b)(7) permits an association to sanction its members and persons associated with members in many

different ways, including through the imposition of any "fitting sanction," and Section 15A(b)(8), among other things, requires that the rules of an association, in general, provide a fair procedure for disciplining members and persons associated with members. The proposed rules are consistent with the Association's obligations under Sections 15A(b)(2), (6), (7), and (8) because temporary cease and desist orders are fitting sanctions designed to stop violative conduct that is likely to cause significant dissipation or conversion of assets or other significant harm to investors, subject to the specific procedures contained in the rules.

#### (v) Due Process Protections

The Association recognizes that temporary cease and desist orders are powerful measures that should be used very cautiously. Consequently, the rules have been designed to ensure that the proceedings are used to address only the most serious types of misconduct and that the interests of Respondents are protected. For example, to ensure that temporary cease and desist proceedings are used appropriately and that the decision to initiate a proceeding is made only at the highest staff levels, the proposed rules require the President or Chief Operating Officer of NASD Regulation to issue written authorization before NASD Regulation's Department of Enforcement can institute a temporary cease and desist proceeding. Two commentators stated that the President or Chief Operating Officer should be required to follow specific guidelines or meet a specific standard before authorizing temporary cease and desist proceeding. The Association believes that such guidelines or standards already exist. The Association believes it is implicit that the President or Chief Operating Officer must be convinced by a preponderance of the evidence that the alleged violation has occurred, and the violative conduct or the continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to completion of the disciplinary proceeding under the Rule 9200 and 9300 Series. This is the same standard that guides the hearing panel in determining whether to issue a temporary cease and desist order.

In addition, the NASD proposes limiting use of this tool to only the most serious offenses. A temporary cease and desist proceeding can be initiated only with respect to alleged violations of certain sections of the securities laws

and certain NASD rules.<sup>13</sup> In addition, the alleged violations of NASD rules for which a temporary cease and desist proceeding can be initiated are further limited to circumstances involving fraud, unauthorized trading, misuse or conversion of customer assets, or markups.

In the NTM-98-42, the Association proposed pursuing temporary cease and desist orders in cases in which the Department of Enforcement alleged that the markups were excessive and in violation of Rule 2110. Two commentators believed it would be inappropriate to pursue a temporary cease and desist order for excessive markups because of the degree of uncertainty involved in determining appropriate markups. In response to the comments, the Association has modified the proposal to permit temporary cease and desist orders only in cases in which it is alleged that the markups are fraudulent under Section 10(b) of the Exchange Act, SEC Rule 10b-5 thereunder, or NASD Rule 2120.

The proposed rules are based upon the rules that govern NASD disciplinary proceedings, with certain modifications made to reflect that temporary cease and desist proceedings are expedited proceedings. The proposed rules therefore provide Respondents with many procedural protections.

In addition, once the President or Chief Operating Officer of NASD Regulation has provided written authorization to initiate a temporary cease and desist proceeding, the Department of Enforcement must file a notice with the Office of Hearing Officers and serve the Respondent with a copy of the notice. The notice must set forth the rule or statutory provision the Respondent is alleged to have violated, include a declaration of facts that specifies the acts or omissions that constitute the alleged violation,<sup>14</sup> and

<sup>13</sup>The sections and rules are specified in proposed NASD Rule 9810(a) and are limited to alleged violations of Section 10(b) of the Act and Rule 10b-5 thereunder, Rules 15c-1 through 15c-9 under the Act and NASD Rules 2110, 2120, or 2330. The alleged violations of NASD rules for which a temporary cease and desist proceeding can be initiated are further limited. For NASD Rule 2110, which governs standards of commercial honor and principles of trade, the alleged violations are limited to circumstances involving alleged violations of Section 17(a) of Securities Act of 1933, or circumstances involving unauthorized trading or misuse or conversion of customer assets. For Rule 2330, which governs members' use of customers' securities or funds, the alleged violations for which a temporary cease and desist proceeding can be initiated are limited to circumstances involving misuse or conversion of customer assets.

<sup>14</sup>The declaration of facts must be signed by a person with knowledge of the facts contained in the declaration. Such persons may include the Association staff.

must contain a proposed order that contains the required elements of a temporary cease and desist order.<sup>15</sup> In addition, if the Department of Enforcement has not already issued a complaint under Rule 9211 against the Respondent relating to the subject matter of the temporary cease and desist proceeding and alleging violations of the rule or statutory provisions specified in the notice initiating the temporary cease and desist proceeding, the Department must serve such a complaint with the notice initiating the temporary cease and desist proceeding.

Further, a hearing to determine whether a temporary cease and desist order should be issued must be held within 15 days after service of the notice (unless a Hearing Officer or Hearing Panelist is recused or disqualified),<sup>16</sup> and the Respondent must be served with notice of the date, time, and location of the hearing not later than four days before the hearing,<sup>17</sup> unless the Hearing Officer orders otherwise. One commentator believes that requiring the hearing to be held within 15 days after service of the notice does not provide a Respondent with sufficient time to prepare for the hearing and, by way of comparison, notes that the Securities Act of 1933 and the Act require that hearings in SEC temporary cease and desist proceedings be held no earlier than 30 days nor later than 60 days after service of the notice. The Association believes that conducting the hearing within 15 days after service of the notice is appropriate because its rules would require the notice initiating the proceeding to have sufficient detail of the alleged violation.<sup>18</sup> In addition, these proceedings are designed to occur on an expedited basis so as to stop ongoing violative conduct that is likely to cause significant dissipation or conversion of assets or other significant harm to investors before the underlying disciplinary proceeding is concluded.

Each hearing panel would be appointed by the Chief Hearing Officer of the NASD's Office of Hearing Officers, and would be comprised of a hearing officer and two panelists. The two panelists would be selected from a roster of candidates that is comprised of current or former members of the National Adjudicatory Council, NASD Board of Governors, or the Association Board of Directors, and at least one panelist would have to be an associated

person. A hearing officer, who is an attorney and an employee of the Association, would preside over each proceeding and would have the authority to do all things necessary and appropriate to discharge his or her own duties as set forth in Rule 9235.

One commentator suggested that the same hearing panel that issued the temporary cease and desist order be assigned to hear the disciplinary proceeding. The Association agrees that this is desirable whenever possible. The class of persons eligible to serve on a temporary cease and desist hearing panel, however, is more limited than the class eligible to serve on disciplinary hearing panels, so such dual service may not be possible in all situations. The Association would attempt to use the same panels whenever possible.

The proposed rules also set a specific standard that must be met before a hearing panel can issue such a temporary cease and desist order. A hearing panel must find by a preponderance of the evidence that the alleged violation has occurred, which is the same evidentiary standard used in the underlying disciplinary proceeding. The hearing panel also must find that the violative conduct or the continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to completion of the disciplinary proceeding under the Rule 9200 and 9300 Series. This standard is designed to ensure that a temporary cease and desist order cannot be issued for technical violations of rules, but can be issued only if the violative conduct or the continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors before completion of the underlying disciplinary proceeding.

Several commentators believe that the hearing panels should be required to find a likelihood of success on the merits and irreparable harm to investors, and should explicitly consider the effect of the order on the Respondent. While the Association believes that the "likelihood of success" standard is inappropriate in the context of the other required showings, it does agree that there should be an express evidentiary standard in the rule. Thus, in response to the commentators' concerns, the proposed rules require that there be a preponderance of evidence of a violation of one of the specified rules before an order can be issued. The preponderance of evidence test would be in addition to the requirement that the alleged violative conduct or the continuation thereof be likely to result in significant dissipation

or conversion of assets or other significant harm to investors.

The Association believes that an irreparable harm standard would frustrate its attempt to stop ongoing fraudulent activity. Under such a standard, as long as a member could show that it is solvent and at the time could pay any potential arbitration or mediation awards while the disciplinary action is proceeding, the Association would be unable to stop the ongoing fraudulent activity until the completion of the regular disciplinary proceeding. Too often, the member's financial condition significantly changes after the conclusion of the disciplinary proceeding. Indeed, in a number of recent cases, the member firm filed for bankruptcy or went into the Securities Industry Protection Corporation, known as SIPC, liquidation during or immediately after the completion of a NASD disciplinary action. Finally, the Association believes that once it has been shown that the violative conduct or the continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors, the potential harm to the Respondent if an order is issued is overshadowed by the harm that is likely to occur to investors if the order is not issued.

A hearing panel must issue a written decision within ten days of receiving the transcript of the hearing. If a hearing panel decides that a temporary cease and desist order should be issued, the order must direct the Respondent to cease and desist from violating specific rule or statutory provisions and, where applicable, to cease and desist from dissipating or converting assets or causing other harm to investors. The order also must set forth the alleged violation and the significant dissipation or conversion of assets or other significant harm to investors that is likely to result without the issuance of the order, and it must describe in reasonable detail the act or acts the Respondent is to take or refrain from taking.<sup>19</sup> A temporary cease and desist order issued to stop unauthorized trading, for example, would order a Respondent to cease and desist from violating NASD Rule 2110 by directing the Respondent to stop the practice of executing unauthorized trades for customers' accounts. The order would not instruct the Respondent to cease and desist from conducting business with customers.

<sup>19</sup> The order also must include the date and hour of its issuance.

<sup>15</sup> The required elements of a temporary cease and desist order are set forth in proposed Rule 9840(b).

<sup>16</sup> See proposed Rule 9830(a).

<sup>17</sup> The Association believes that a four day notice requirement should provide the Respondent with sufficient notice prior to the initiation of a hearing.

<sup>18</sup> See proposed Rule 9810(b).

## (vi) Publicizing Issuance of a Temporary Cease and Desist Order

If a hearing panel issues a temporary cease and desist order, the Association would publicize the issuance of the order, just as it publicizes the issuance of other final decisions in disciplinary proceedings that result in significant sanctions. Accordingly, the proposed rule change modifies IM-8310-2 to permit the release of this information. When issuance of a temporary cease and desist order is made public, if applicable, a statement would accompany the public release indicating that the decision could still be appealed to the Commission or that the appeal is pending.

## (vii) Duration of Temporary Cease and Desist Orders

Once a temporary cease and desist order has been issued, it will remain in effect until a decision is issued in the underlying disciplinary proceeding.<sup>20</sup> Two commentators suggested that, in any disciplinary proceeding for which a temporary cease and desist order has been issued, the disciplinary proceeding should be conducted on an expedited basis. The NASD agrees with this suggestion and has proposed Rule 9290, which would require that in any disciplinary proceeding for which a temporary cease and desist order has been issued, every hearing shall be held and every decision shall be rendered at the earliest possible time.

In addition, a Respondent is provided the opportunity to challenge a temporary cease and desist order, pursuant to Rule 9850, if it believes the underlying disciplinary proceeding is not being conducted on an expedited basis. If a Respondent can prove by a preponderance of the evidence that the underlying disciplinary proceeding is not being conducted on an expedited basis due to bad faith conduct by the Association, the hearing panel that issued the temporary cease and desist order can modify, set aside, limit, or suspend the order as it believes is appropriate. If a challenge on such a basis is pursued by a Respondent, the hearing panel's consideration would be limited to determining whether the underlying disciplinary proceeding was not being conducted on an expedited basis due to the bad faith conduct of the Association.

<sup>20</sup> The hearing panel issuing the decision in the underlying disciplinary proceeding, however, may issue a permanent cease and desist order as part of the sanctions, if any, imposed pursuant to the underlying disciplinary proceeding. The effectiveness of a permanent cease and desist order would not be stayed if the Respondent appeals the decision in the underlying disciplinary proceeding.

The proposed rules provide Respondents with several opportunities to challenge a temporary cease and desist order. A Respondent may apply to the hearing panel, pursuant to proposed Rule 9850, to have the order modified, set aside, limited, or suspended, or the Respondent may challenge the order by filing an application for review with the SEC pursuant to Section 19 of the Exchange Act.<sup>21</sup> A Respondent challenging an order, however, will not stay the effectiveness of the order, unless otherwise ordered by the Commission.

Two commentators raised a concern about the ability of a Respondent to appeal decisions issuing temporary cease and desist orders to the SEC because it was unclear whether temporary cease and desist orders are final disciplinary decisions of the NASD. The Association believes temporary cease and desist orders should be considered final and immediately effective decisions of the NASD and therefore appealable to the SEC as soon as the orders are issued. A temporary cease and desist order is issued after notice and an opportunity for a hearing and upon a finding by a preponderance of the evidence that a violation of a statutory provision or rule has occurred. The temporary cease and desist order is an "other fitting sanction" under Section 15A(b)(7) of the Act because the order directs a Respondent to cease from violating a rule, to cease specified violative conduct and, as appropriate, to cease and desist from dissipating or converting assets. Further, a temporary cease and desist order is immediately effective and enforceable, and a Respondent that violates the terms of a temporary cease and desist order can have its membership or registration suspended or canceled.

## (viii) Enforcement of Cease and Desist Orders

In order for temporary cease and desist orders, or permanent cease and desist orders issued pursuant to disciplinary proceedings conducted under Rule 9200 Series or Rule 9300 Series, to have their full effect it is necessary to have a mechanism to enforce such orders and to be able to sanction members or associated persons that violate the orders. Consequently, the proposed rule change seeks to provide the Association with the authority to suspend or cancel a Respondent's membership or

<sup>21</sup> Section 19 of the Exchange Act provides for the appeal of final disciplinary sanctions imposed by self-regulatory organizations.

association if it is found, after a proceeding pursuant to Rule 9510 Series,<sup>22</sup> that a Respondent violated a temporary cease and desist order or a permanent cease and desist order. The proposed rule change provides that a proceeding to suspend or cancel a Respondent's association or membership for violating an order cannot be initiated unless it is authorized in writing by the President or Chief Operating Officer of NASD Regulation.<sup>23</sup> This provision ensures that decisions that can have a significant impact on a Respondent are made only at the highest staff level.

In addition, under the proposed rules, in any proceeding initiated pursuant to the Rule 9510 Series to sanction a member or associated person for violating a temporary or permanent cease and desist order, NASD Regulation would be required to specifically identify in the notice initiating the proceeding the provision of the temporary or permanent cease and desist order that is alleged to have been violated, and the notice must contain a statement of facts specifying the alleged violation. These provisions were included in response to a suggestion by a commentator.

## (ix) Report to Board of Directors

The Association recognizes that temporary cease and desist orders are new and powerful enforcement tools. Therefore, the Association staff is required to report to the Board of Directors of the Association ("Board"), within two years after the effective date of the rules (if the rules are approved by the SEC), on the staff's experience with the rules and obtain the Board's authorization to continue to exercise authority under the rules. This report will enable the Board to assess whether the authority is being exercised as it had envisioned.

## 2. Statutory Basis

The Association believes that the proposed rule change is consistent with the provisions of Section 15A(b)(2) of the Act, which requires, among other things, that an association of brokers and dealers have the capacity to be able to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its

<sup>22</sup> The Rule 9510 Series sets forth the procedures for summary and non-summary suspension, cancellation, bar, limitation, or prohibition. Pursuant to the proposed amendment Rule 9511, the sanctions for a violation of a temporary or permanent cease and desist order are limited to suspension of cancellation of the membership of a member of the registration of a person.

<sup>23</sup> See proposed Rule 9860.



members with the Act, the rules and regulations thereunder, and the rules of the Association. In addition, the Association believes the proposed rule change is consistent with the provisions of Section 15A(b)(6), which require that the rules of an association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and, in general, to protect investors and the public interest. The NASD also believes the proposal is consistent with the provisions of Sections 15A(b)(7) and (8). Paragraph (b)(7) permits the sanctioning of members and associated persons by several means, including by imposing fitting sanctions, and paragraph (b)(8) requires that the rules of an association, in general, provide a fair procedure for disciplining members and persons associated with members. The Association believes that the relevant provisions of the Act provide it with authority to issue temporary cease and desist orders. NASD also believes the proposed rules are consistent with the Association's obligations under Sections 15A(b)(2), (6), (7), and (8) because temporary cease and desist orders are fitting sanctions designed to stop violative conduct that is likely to cause significant dissipation or conversion of assets or other significant harm to investors, subject to the specific procedures contained in the rules.

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

The Association does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

The proposed rule change was published for comment in NASD Notice to Members 98-42. Thirteen comments were received in response to NTM-98-48. While three comment letters expressed support for the Association's overall goal of effective regulation of the securities markets, none of the comment letters voiced support for the proposed rule change.

The Board of Directors of NASD Regulation and the National Adjudicatory Council reviewed the Notice of Members and approved its publication. In addition, the Small Firm Advisory Board supported issuing NTM 98-42, although it took no formal position. Finally, a subcommittee of the Legal Advisory Board reviewed and

unanimously supported issuing it as well.

### **III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 35 days of the publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the NASD consents, the Commission will:

- (A) By order approve the proposed rule change, or
- (B) Institute proceedings to determine whether the proposed rule change should be disapproved.

### **IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal is consistent with the Act. In particular, the Commission solicits comments on (A) whether the scope of possible violations should be narrowed; (B) what impact, if any, the issuance of an NASD temporary cease and desist order will have on other laws (i.e., other than the federal securities laws); and (C) whether the NASD has sufficiently justified the need for temporary cease and desist powers. 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 the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at 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. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. File Number SR-NASD-98-80 should be included on the subject line if E-mail is used to submit a comment letter. Electronically submitted comment letters will be posted on the Commission's Internet web site (<http://www.sec.gov>). All submission should refer to File No. SR-NASD-98-80 and should be submitted by March 1, 1999.

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

**Margaret H. McFarland,**

*Deputy Secretary.*

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## **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-40812; File No. SR-NYSE-98-44]

### **Self-Regulatory Organizations; Proposed Rule Change by the New York Stock Exchange, Inc. Relating to an Interpretation With Respect to Rule 344 ("Supervisory Analysts")**

December 21, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on December 3, 1998, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### **I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change**

The proposed rule change consists of an interpretation with respect to the meaning and administration of Exchange Rule 344 ("Supervisory Analysts"). Additions are italicized; deletions are bracketed.

#### **Rule 344**

##### */01 Qualifications*

Supervisory Analyst candidates shall qualify by taking and passing the Supervisory Analyst (Series 16) Examination.

##### *Experience*

Appropriate experience for a candidate for Supervisory Analyst [has been defined as] means having at least three years prior experience [as a securities analyst] *within the immediately preceding six years involving securities or financial analysis.*

Examples of appropriate experience may include the following:

- *Equity or Fixed Income Research Analyst;*
- *Credit Analyst for a securities rating agency;*
- *Supervising preparation of materials prepared by financial/securities analysts;*

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

<sup>2</sup> 17 CFR 240.19b-4.