

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. 522, will be available for inspection and copying in the Commission's Public Reference Room in Washington, D.C. Copies of such filing will also be available for inspection and copying at the principal office of the Amex. All submissions should refer to File No. SR-AMEX-0039 and should be submitted by September 13, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43157; File No. SR-NASD-99-67]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by NASD Regulation, Inc. Relating to its Membership Rules

August 15, 2000.

On November 2, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary NASD Regulation, Inc. ("NASD Regulation"), submitted to the Securities and Exchange Commission ("SEC" or "Commission") pursuant to section 19(b)(1)<sup>1</sup> of the Securities Exchange Act of 1934 ("Act") and rule 19b-4<sup>2</sup> thereunder, a proposed rule change amending NASD Rule 1010 Series, which contains the provisions relating to the admission to membership. On May 1, 2000, NASD Regulation submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as amended by

Amendment No. 1, was published for comment in the **Federal Register** on June 12, 2000.<sup>4</sup> The Commission received no comments on the proposal. On August 11, 2000, NASD Regulation submitted Amendment No. 2 to the proposed rule change.<sup>5</sup> This order approves the proposal.

## II. Description of the Proposal

NASD Regulation proposes to amend its Rule 1010 Series, which governs admission to NASD membership.

### A. Proposed Rule 1010—Definitions

In addition to clarifying and conforming changes to certain current definitions, NASD Regulation has proposed the following new definitions.

#### 1. "Material Change in Business Operations"

NASD Regulation has proposed to define the phrase "material change in business operations" in proposed Rule 1011(i). As proposed, a "material change in business operations" shall include, but not be limited to, removing or modifying a membership agreement restriction; market making, underwriting, or acting as a dealer for the first time; or adding business activities that require a higher minimum net capital. This proposed definition is significant because it will require a member to apply to its district office for approval of a material change in business operations pursuant to proposed Rule 1017.

In conjunction with the proposed definition, NASD Regulation has proposed Interpretative Material 1011-1 (IM-1011-1) to create a safe harbor for certain business expansions that will not be presumed to be material, and therefore will not require a member to submit an application for approval of the proposed expansion pursuant to proposed Rule 1017. The safe harbor would not be available to members that have a disciplinary history, which is proposed to be defined as a finding of a violation by the member or a principal of the member in the past five years by the SEC, a self-regulatory organization, or a foreign regulatory authority of one or more of the following provisions (or comparable foreign provisions) or rules or regulations thereunder: Sections

15(b)(4)(E)<sup>6</sup> and 15(c)<sup>7</sup> of the Act (failure to supervise; fraud and manipulation); section 17(a)<sup>8</sup> of the Securities Act of 1933 (fraudulent interstate transactions); Exchange Act Rule 10b-5<sup>9</sup> (fraud and manipulation); Exchange Act Rules 15g-1 through 15g-9<sup>10</sup> (penny stock rules); NASD Rules 2110 (just and equitable principles of trade), 2120 (fraud and manipulation), 2310 (suitability), 2330 (protection of customer securities and funds), 2440 (fair prices and commissions), 3010 (failure to supervise), 3310 (manipulative and deceptive quotations), 3330 (payments to influence market prices); and MSRB Rules G-19 (suitability), G-30 (prices and commissions), and G-37 (b) and (c) (political contributions).

Further, because NASD Regulation cannot predict and draft an exhaustive definition of all changes that may in fact be material, if a change in a member's business falls outside of the definition, or the safe harbor (e.g., because the change exceeds the safe harbor limits or because the member has a disciplinary history), members may contact their NASD district office to inquire as to whether the district would deem the change to be material. A member is not required, however, to contact the district office if the member believes that a change would not be considered material. If the staff later determines that a change is indeed material, then the member could potentially be subject to disciplinary action for failure to file an application under proposed Rule 1017.

#### 2. "Principal Place of Business"

NASD Regulation has proposed to define the phrase "principal place of business" for purposes of clarifying where an Applicant's<sup>11</sup> application will be processed, in proposed Rule 1011(l). As proposed, an Applicant's principal place of business shall be the location where the officers, partners, or managers direct and control the activities of the Applicant, unless NASD Regulation staff designates a different location, which may be where the largest number of associated persons are located or

<sup>6</sup> 15 U.S.C. 78o(b)(4)(E).

<sup>7</sup> 15 U.S.C. 78o(c).

<sup>8</sup> 15 U.S.C. 78q(a).

<sup>9</sup> 17 CFR 240.10b-5.

<sup>10</sup> 17 CFR 240.15g-1 through 15g-9.

<sup>11</sup> The term Applicant is defined as a person that applies for membership in the Association under Rule 1013 or a member that files an application for approval of a change in ownership, control, or business operations under Rule 1017. See Rule 1011(a).

<sup>4</sup> Securities Exchange Act Release No. 42885 (June 1, 2000), 65 FR 36860.

<sup>5</sup> See letter from Alden S. Adkins, General Counsel and Senior Vice President, NASD Regulation, to Katherine England, Assistant Director, Division of Market Regulation, SEC, dated August 9, 2000 ("Amendment No. 2"). In Amendment No. 2, NASD Regulation corrected a typographical error and deleted proposed Rule 1018 in its entirety.

<sup>8</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See letter from Alden S. Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine England, Assistant Director, Division of Market Regulation, SEC, dated April 28, 2000 ("Amendment No. 1").

where the books and records of the member are kept.

### 3. "Sales Practice Event"

NASD Regulation has proposed to change the phrase "sales practice violations" to "sales practice event" and to amend the current definition in proposed rule 1011(m). As amended, the phrase sales practice event will include not only proven violations, but also unproven allegations.<sup>12</sup> The proposed definition will include any customer complaint, arbitration, or civil litigation that has been or is required to be reported to the Central Registration Depository ("CRD") or otherwise required to be reported to the Association (e.g., NASD Rule 3070).

### B. Proposed Rule 1012—Filing by Applicant or Service by the Association

NASD Regulation has proposed to amend the service and filing requirements to permit additional methods of delivery and to standardize how deadlines will be calculated. Specifically, the term "commercial courier" has been replaced with the term "overnight courier" to clarify that Applicants and NASD Regulation may use the overnight delivery service offered by the United States Post Office, as well as any entity that regularly provides overnight delivery services, such as Federal Express or DHL. The use of the term overnight courier, however, does not imply that only actual overnight delivery may be used under the rule. Overnight delivery should be used if it is available, but if it is not available for a particular location, and Applicant or staff of the Department of Member Regulation of NASD Regulation ("Department") may use the most rapid delivery option available from the overnight courier to comply with the rule.

NASD Regulation has proposed to standardize the use of the terms "file" and "serve" to clarify their definitions. Specifically, the term "file" will refer to submissions by an Applicant, while the term "serve" will refer to delivery of requests, decisions, and the like by the Association.

Proposed Rule 1012(b) contains the lapse of application provisions, which NASD Regulation has proposed to consolidate from current Rules 1013(b), 1017(c), and 1018(d). The lapse provisions permit the Department staff to discontinue processing an application if an Applicant does not provide requested documents or information in

a timely manner. In addition to consolidating the lapse provisions, NASD Regulation also has proposed to permit the Department staff and the Applicant to agree on a submission date for the membership agreement, rather than requiring all agreements to be submitted within 25 days. Finally, NASD Regulation has proposed to clarify that fees are not refunded for applications that are lapsed.

### C. Proposed Rule 1013—New Member Application and Interview

NASD Regulation has proposed to amend the procedures for filing a new member application so that the entire application will be filed in one location—the district office in the district where an Applicant intends to have its principal place of business.<sup>13</sup> Once filed, the Department staff will review the entire application to determine if it is substantially complete and if so, the Department staff will forward the appropriate documents to the CRD.

In addition, NASD Regulation has proposed a new rule, proposed Rule 1013(a)(4), setting forth procedures for applications that are not substantially complete at the time of submission. As proposed, if an application is so deficient upon submission that the Department staff cannot begin processing (e.g., it is missing major components of the application, such as written supervisory procedures or a business plan), the Department staff may reject the application. The Department staff must reject the application within 30 days of the submission of the application and must provide reasons for the rejection in writing. If an application is rejected, NASD Regulation will assess a \$350 processing fee, which shall be deducted from the application fee.

To eliminate duplicative submissions, NASD Regulation has proposed to eliminate the requirement for Applicants to submit information that has already been submitted to CRD in proposed Rule 1013(a)(2)(L). Further, an Applicant will continue to submit only its initial Forms BD and U-4 in paper form along with the rest of the application. Thereafter, upon approval of an Applicant's Web CRD entitlement request form, pursuant to proposed Rule 1013(a)(3), an Applicant will be required to make all subsequent form filings and amendments electronically via Web CRD.<sup>14</sup> In addition, the initial

Member Contact Questionnaire and user access request form also will be submitted in paper form, which thereafter may be updated electronically.

As part of its application, an Applicant will be required to provide a description of the communications and operational systems that it will employ to ensure business continuity, including information about its systems' capacity, contingency plans, disaster recovery plans, and the like, pursuant to proposed Rule 1013(a)(2)(F)(xii). In addition, an Applicant will be required to provide NASD Regulation with its disclosures that will be provided to customers who use its systems as well as supervisory or customer protection measures that may apply to customer use of or access to its systems. Pursuant to proposed Rule 1014(a)(6), an Applicant's communications and operational systems must be adequate and provide reasonably for business continuity before an application for membership may be granted. NASD Regulation will not be required to investigate the adequacy of an Applicant's systems, rather the Applicant will be required to certify that its systems, plans, and procedures are adequate for the Applicant's business. The Applicant may either self-certify or may rely on a third party (e.g., a vendor of such a system) to provide the certification.

NASD Regulation has clarified that the Applicant and the Department staff may agree to hold the membership interview that is required pursuant to Rule 1013(b)(4) at the Applicant's place of business. Finally, NASD Regulation has proposed to amend Rule 1013(b)(5) to require an Applicant to provide updated financial information at the time of its membership interview.

### D. Proposed Rule 1014—Department Decision<sup>15</sup>

Proposed Rule 1014 sets forth the standards for admission to membership. In addition to the proposed new business continuity standard, as

amendments thereto). In addition, NASD Regulation has proposed conforming changes to Rule 1140.

<sup>15</sup> The Commission notes that the **Federal Register** notice contained an incorrect subsection reference. Subsection (a)(4) should read as follows: "The Applicant has established all contractual or other arrangements and business relationships with banks, clearing corporations, service bureaus, or others necessary to: (A) Initiate the operations described in the Applicant's business plan, considering the nature and scope of operations and the number of personnel; and (B) comply with federal securities laws, the rules and regulations thereunder, and the Rules of the Association." In addition, subsection (5) should have its further subsections labeled as (A) and (B).

<sup>12</sup> NASD Regulation noted that it was not proposing any change to the definition of "sales practice violation" as that phrase is used on the Form U-4.

<sup>13</sup> See proposed Rule 1011(1).

<sup>14</sup> See Securities Exchange Act Release No. 41594 (July 2, 1999), 64 FR 37586 (July 12, 1999) (regarding SEC requirements for submitting BD and

discussed above, NASD Regulation has proposed that an Applicant's supervisory procedures specifically include procedures to ensure that the firm obtains proper registrations for its associated persons.

Proposed Rule 1014(d), which concerns the submission of membership agreements, has been amended so that the requirement that any member with a membership agreement obtain approval from NASD Regulation of any change in its business that would be outside of the terms of agreement has been deleted.<sup>16</sup> In addition, upon approval of this proposed rule change, NASD Regulation will permit members that are eligible for the safe harbor, IM-1011-01, to use it even if their membership agreement includes a general requirement to obtain approval from NASD Regulation of any change in business outside the terms of the agreement.

#### *E. Proposed Rule 1015—Review by National Adjudicatory Council*

NASD Regulation has proposed to delete the provision whereby the National Adjudicatory Council ("NAC") or a Review Subcommittee may call for the review of a decision on a membership application made by the Department staff, even if the Applicant does not appeal the decision. In addition, new paragraph (h) regarding dismissing appeals that have been abandoned by an Applicant has been proposed. Pursuant to proposed Rule 1015(h), if an Applicant fails to specify the grounds for its request for review, appear at a hearing, or file information or briefs as directed, the NAC or Review Subcommittee may dismiss the request for review as abandoned.

#### *F. Proposed Rule 1017—Application for Approval of Change in Ownership, Control, or Business Operations*

Proposed Rule 1017 will contain provisions regarding applications for removal or modification of a business restriction, as well as, provisions regarding applications for approval of changes in ownership, control, or operations.

Pursuant to proposed Rule 1011(i), a material change in business operations

includes the removal or modification of a business restriction. In addition, all material changes in business operations will trigger the requirement for a review under proposed Rule 1017. NASD Regulation noted that a restriction contained in a membership agreement is specifically labeled as such and is accompanied by a decision issued by NASD Regulation setting forth the rationale for the restriction. A restriction is distinct from other limitations that may be set forth in a member's business plan and may be recited in the "Business Activities" section of the membership agreement. These limitations are not considered "restrictions" under the rules because NASD Regulation does not impose them. Therefore, a member may expand beyond those limitations to the extent permitted in the safe harbor set forth in IM-1011-1 without having to apply to NASD Regulation for approval.

In contrast, NASD Regulation may impose specific restrictions in a membership agreement. If a member wishes to modify such restrictions, it must seek NASD Regulation approval pursuant to proposed Rule 1017, and thus will not be able to utilize the safe harbor found in IM-1011-1.

In addition, NASD Regulation has proposed to discontinue its review of certain changes, such as mergers and acquisitions by members that are reviewed by the New York Stock Exchange ("NYSE"). Proposed Rule 1017 also sets forth the type of information to be included in an application and the content of the Department staff's decision regarding an application. Further, proposed Rule 1017 clarifies when an application should be filed and what changes can be effected prior to obtaining NASD Regulation's approval.

Proposed Rule 1017(k) clarifies the procedures to be followed in the event that a change in ownership application lapses or is denied. In such instances, an Applicant has a fixed period of time to submit a new application;<sup>17</sup> unwind the transaction, or file a Form BDW. The Department may shorten the 60-day period for the protection of investors or lengthen it upon good cause shown by the Applicant. During the 60-day period, the Department may continue to place interim restrictions on the member.

### **III. Discussion**

Upon careful review, 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.<sup>18</sup> Specifically, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6),<sup>19</sup> which requires, among other things, 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 Commission believes that the changes proposed by NASD Regulation relating to the admission of members to be consistent with the Act because they clarify the process by which persons may apply for membership and the process by which current members may change the terms of their membership. For example, NASD Regulation has proposed to specifically define the phrase material change in business operations to enable members to determine when changes to their business structure require the prior approval of NASD Regulation, pursuant to proposed Rule 1017. As defined, a material change in business operations includes removing or modifying a membership agreement restriction; market marking, underwriting or acting as a dealer for the first time; or adding business activities that require a higher minimum net capital. Each of these examples of material changes in business operations has significant investor protection considerations. For example, in granting membership, NASD Regulation may determine to limit the activities of a member, which is set forth as a restriction in the membership agreement. These restrictions are based upon findings made by NASD Regulation that it believes are necessary for the member to engage in business consistent with the Act. Thus, the Commission believes that it is reasonable for NASD Regulation to review any change to the restriction.

Further, engaging in market making, underwriting, or acting as a dealer involves many complex regulatory issues, including ensuring that the public interest is protected. Moreover, activities that would lead to an increase in a member's net capital requirements would also raise investor protection concerns. The Commission believes that it is in the public interest for NASD Regulation to review these changes in its members' business structure. NASD Regulation has regulatory

<sup>16</sup> NASD Regulation noted that many members have been admitted without executing a membership agreement because NASD Regulation only began requiring all members to execute membership agreements in 1997. See Securities Exchange Act Release No. 38908 (August 7, 1997), 62 FR 43385 (August 13, 1997). Therefore, according to NASD Regulation, members with a membership agreement may be at a disadvantage when seeking to change their business compared to members that have been admitted without a membership agreement.

<sup>17</sup> A lapsed Applicant may propose the same owners; a denied Applicant must propose new owners.

<sup>18</sup> In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>19</sup> 15 U.S.C. 78o-3(b)(6).

responsibilities over its members and it must ensure that its members' businesses operate in a manner that is consistent with the requirements of the Act. Further, the Commission believes that NASD Regulation should review its members with respect to these issues to prevent members from expanding beyond their capabilities to the detriment of the markets and investors.

In conjunction with the new definition of material change in business operations, NASD Regulation has also proposed a safe harbor for certain types of changes in business operations. Specifically, a member can increase the number of associated persons involved in sales or increase the number of offices it operates or increase the number of markets made by the member without having to submit an application pursuant to proposed Rule 1017 so long as the increases fall within the specified limits. The Commission believes that the safe harbor should increase NASD Regulation's, as well as its members', operational efficiency without sacrificing regulatory interests.

NASD Regulation has also proposed changes to Rule 1017 regarding applications for approval of changes in ownership, control or business operations. In its proposal, NASD Regulation clarified the difference between a restriction, which is subject to NASD Regulations' review and approval, and a limitation, which may be set forth in the Business Activities section of a membership agreement and thus not required to be reviewed by NASD Regulation if the safe harbor applies. The Commission finds that this clarifies NASD Regulation's oversight responsibilities with respect to restrictions and limitations and should enhance the ability of its members to operate efficiently within the requirements of NASD Regulation's rules. Further, this clarification should assist members in determining whether they are eligible to utilize the safe harbor for their planned business changes.

In addition, proposed Rule 1017 makes the application process for changes in a member's structure more efficient by discontinuing NASD Regulation's review of certain changes that are already reviewed by the NYSE. This change eliminates duplicative oversight. The Commission believes that the NYSE, as part of its self-regulatory responsibilities, should be able to sufficiently review such transactions to ensure that they comply with the requirements of the Act.

In proposed rule 1014, NASD Regulation proposed to require as a condition for membership that an

Applicant provide supervisory procedures that include procedures that ensure that proper registrations are obtained by the firm. This new requirement should ensure that associated persons are adequately trained and supervised, which should enhance investor protections.

In addition, NASD Regulation has proposed as a condition of admission that firms certify that their systems, plans, and procedures are adequate for the firm's business. Thus, as part of its application, an Applicant will be required to provide a description of its communications and operational systems that will be employed to ensure business continuity, including information about systems' capacity, contingency plans and disaster recovery plans. NASD Regulation will use this information to determine, pursuant to proposed Rule 1014(a)(6), whether an Applicant's communications and operational systems are adequate and provide reasonably for business continuity such that the applicant has met the standard for admission to membership. The Commission finds that this new requirement is consistent with the Act and furthers just and equitable principles of trade and should enhance protections for investors. Today, technology is a driving force in the markets. As never before, many firms utilize and rely on technology to perform many roles, such as accepting and routing of customer orders for execution. Thus, it is more important than ever that the technology used by firms be able to operate and have sufficient capacity to carry out its stated functions. Today, a technology failure can have significant consequences both for the customer and the firm. Thus, the Commission believes that it is imperative that NASD Regulation seek to ensure that its members have the systems capabilities to operate in a fashion that is consistent with the requirements of the Act.

Finally, in proposed Rule 1014(d), NASD Regulation has proposed to delete the requirement that members with membership agreements obtain NASD Regulation's approval of any change outside of the membership agreement. The Commission believes that this provision may have given an unfair advantage to those members that do not have a membership agreement.<sup>20</sup> The Commission believes that the proposed definition of material change in business operations along with the safe harbor should provide members with the ability to expand their business without raising investor protection

concerns. Further, these provisions provide NASD Regulation with sufficient tools to oversee its members' business operations.

In conclusion, the Commission finds that the proposal is consistent with the requirements of the Act. The proposal, in general, clarifies and organizes the rules in a manner that should be beneficial to members and potential members. Further, the proposed changes should enhance the ability of NASD Regulation to implement its regulatory objectives in a fair and efficient manner.

The Commission finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice in the **Federal Register**. In Amendment No. 2, the NASD Regulation deleted proposed Rule 1018. Therefore, this portion of the proposed rule change is no longer subject to Commission review. In addition, NASD Regulation corrected a typographical error. Therefore, because Amendment No. 2 does not raise any regulatory concerns, the Commission finds good cause for accelerating approval of Amendment No. 2 to the proposed rule change.

#### IV. Conclusion

*It Is Therefore Ordered*, pursuant to section 19(b)(2)<sup>21</sup> of the Act, that the proposed rule change (SR-NASD-99-67) is hereby approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>22</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

[FR Doc. 00-21430 Filed 8-22-00; 8:45 am]

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43156; File No. SR-NASD-00-49]

#### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. to Eliminate CAES Transactions Charges for Member Firms that Receive and Execute Orders

August 15, 2000.

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 August

<sup>21</sup> 15 U.S.C. 78s(b)(2).

<sup>22</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>20</sup> See *supra* note 16.