

customer and the registered person are both registered persons of the same firm; the lending arrangement is based on a personal relationship outside of the broker-customer relationship; or the lending arrangement is based on a business relationship outside of the broker-customer relationship.

NASD believes that the solicitation of loans from customers by registered persons is an area of legitimate NASD interest because of the potential for misconduct. NASD has brought disciplinary action against registered persons who have violated just and equitable principles of trade by taking unfair advantage of their customers by inducing them to lend money in disregard of the customers' best interests, or by borrowing funds from, but not repaying, customers. The potential for misconduct also exists when a registered person lends money to a customer.

The proposed rule change establishes a regulatory framework that would give members greater control over, and more specific supervisory responsibilities for, lending arrangements between registered persons and their customers. Members could choose to permit their registered persons to borrow from or lend to customers consistent with the requirements of the rule or prohibit the practice in whole or in part. If members choose to permit their registered persons to engage in lending arrangements with customers, the proposed rule change would require members to have written procedures in place to monitor such lending arrangements. The notice and approval requirements of the proposed change would enhance members' ability to supervise the activities of registered personnel. Members would be able to evaluate, before granting approval, whether the lending arrangement falls within one of the five types of permissible arrangements. Members would be permitted to approve loans only if the loan falls within one of the five types of permissible lending arrangements. In addition, the notice requirement would place an affirmative obligation on registered persons that could be separately charged in a disciplinary action if not followed.

The proposed rule change also would enhance NASD's ability to monitor loans between registered persons and their customers. Currently, under controlling Commission decisions, to bring a disciplinary action against a registered person who has entered into an unethical lending arrangement with a customer, NASD generally must prove that the arrangement is inconsistent with just and equitable principles of

trade under NASD Rule 2110 because the registered person has acted in bad faith or unethically. This can be difficult to prove in cases in which the customer is unable or unavailable to testify, or refuses to testify because he or she is relying on the registered person for financial advice. The proposed rule change would better enable NASD to monitor such loans, since members would be required to maintain written records of the loans as evidence of compliance. NASD also believes that the proposed rule change would be an effective deterrent to potential misconduct because members would require their registered persons to give prior notice of the loan and get approval from the member before engaging in the transaction, and the lending arrangement must fall within one of the five types of permissible arrangements. Members that do not wish to engage in this review and approval process could prohibit the practice altogether.

It is important to note that this proposal does not change the application of Regulation T³ to lending activities by associated persons. Specifically, the definition of "creditor" under Regulation T extends to associated persons of broker/dealers and therefore, certain loans to customers by associated persons may require compliance with the provisions of Regulation T.⁴

(2) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of section 15A(b)(6) of the Act,⁵ which requires, among other things, that NASD's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change is designed to accomplish these ends by establishing a regulatory framework that will give members greater control over lending arrangements by permitting members to prohibit such arrangements altogether or, in the alternative, permit such arrangements only if they fall within one of five types of permissible arrangements. Members that permit such arrangements would be required to keep written procedures. Providing the member permits such loans, registered persons would be required to give their firms prior notice of the loan, and the member will be required to pre-approve the loan in writing. These procedures

would enable both members and NASD to proscribe customer-broker loans and monitor those that have been approved.

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

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

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

Written comments were neither solicited nor received for this rule proposal. Previously, in NASD Notice to Members 94-93 (December 1994), NASD requested comment on a more limited proposal regarding the adoption of a rule that would require registered persons to provide prior notification to, and obtain prior approval from, their employing member firm when personally borrowing funds or securities from customers. NASD has not included a discussion of the comments received on that proposal because the current rule proposal differs significantly in that it specifies the permissible types of lending arrangements and requires members to have written procedures that permit only those lending arrangements consistent with the rule.

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

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

(A) By order approve such proposed rule change; or

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

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule

³ 12 CFR 220.

⁴ 12 CFR 220.2.

⁵ 15 U.S.C. 78o-3(b)(6).