

National Adjudicatory Council, the NASD Board, or the Commission.

(i) Request for Review; Final Action  
An Applicant may file a written request for review of the Department's decision with the National Adjudicatory Council pursuant to Rule 1015. The procedures set forth in Rule 1015 shall apply to such review, and the National Adjudicatory Council's decision shall be subject to discretionary review by the NASD Board pursuant to Rule 1016. If the Applicant does not file a request for review, the Department's decision shall constitute final action by NASD [the Association].

(j)–(k) No Change.

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

In its filing with the Commission, NASD 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. NASD 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**

The membership application and membership continuation processes have played an important role in investor protection by helping to ensure that new members and members that make a material change to their business comply or continue to comply with rigorous standards. Rule 1014, which sets forth the standards used when reviewing new member and continuing member applications, specifically requires NASD to consider the public interest and protection of investors when reviewing applications.

Recently, there has been an increase in company restructurings, including the selling of company assets. Asset transfer applications filed pursuant to Rule 1017 are often time-sensitive and may be the first step in a member's withdrawal from the securities business. While asset transfers often serve legitimate business purposes, they also can raise customer protection issues. NASD has encountered several instances where the effect of a member attempting to restructure by transferring assets is to insulate the member and its

owners from responsibility for payment of pending or unpaid arbitrations. Some firms may choose to transfer their assets without a corresponding transfer of their liabilities. Because the corporate format used by many firms insulates the owners from liabilities of the firm, a customer with an award or judgment against the firm may only be able to be paid from the firm's assets. Thus an asset transfer may transform the firm from an operating business that can generate value over time to a shell holding the firm's liquidated value, leaving behind customers with arbitration claims pending against, or arbitration awards unsatisfied by, a firm.

In light of the customer protection concerns raised in the application process, NASD is proposing a rule change that would clarify and expand NASD's authority to identify and respond to changes in a firm that may not account for pending arbitrations and customer claims.

#### **1. Review of Material Transfer of Member's Assets**

Applications submitted pursuant to Rule 1017 provide NASD with the opportunity to review member transactions that can materially adversely affect current and former customers. Rule 1017(a)(3) requires a member to submit an application upon the acquisition of substantially all of the member's assets. However, this may potentially eliminate from NASD's review a member's piecemeal sale of its assets that, while not "substantially all" in amount, may nevertheless have a material impact on the operations or profitability of the selling member.

The proposed rule change would clarify that Rule 1017(a)(3) applies to transfers as well as to sales of a firm's assets, including sales and transfers of assets to an affiliated entity. The proposed rule change also would broaden the scope of Rule 1017(a)(3). In Notice to Members 02–54 (August 2002), which NASD issued to solicit comment on the proposed membership application rules, the proposal set forth in the Notice required members to submit applications prior to the transfer of a material amount of the member's assets or prior to the transfer of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings. Based on the comments received in response to the Notice, as discussed further in Item II C, below, NASD has revised the proposed rule change to include a more objective standard based on the percentage of assets transferred. The revised proposed rule change would require members to

submit applications prior to the sale or transfer of 25% or more of the member's assets or any asset, business or line of operation that generates revenues of 25% or greater of the selling member's earnings over a rolling 36-month period. The 36-month period would be measured backwards from the date that the member initially notifies NASD of its intent to sell or transfer assets by submitting an application pursuant to Rule 1017.<sup>6</sup>

#### **2. Clarification of Members Required to Submit Applications**

Because of concerns that a selling member's customers may be left unprotected following an asset transfer, the seller's situation should be reviewed in connection with all such transactions. Rule 1017(a) currently exempts selling members from the requirement to submit applications if the acquiring firm is a member of the NYSE. The proposed rule change would require all non-NYSE selling members to submit an application regardless of whether the acquiring firm is a NYSE member. The proposed rule change is not intended to put applicants through duplicative approval processes where the transaction is otherwise subject to adequate customer protection safeguards. Rather, in requiring an application regardless of whether the acquirer is a member of the NYSE, NASD will be assured of receiving notice and will be in a position to target particular aspects of the transaction for additional review, if necessary.

#### **3. Consideration of Arbitrations in Application Process**

To encourage compliance with the terms of arbitration and other adjudicated customer awards, the proposed rule change would amend Rule 1014(a)(3) to include as specific factors in the consideration of both new and continuing member applications unpaid arbitration awards, other adjudicated customer awards against an applicant and other persons that may have significant control or influence over the applicant, including its controlling persons, principals, registered representatives, other Associated Persons, any lender of 5% or more of the applicant's net capital, and any other member with respect to which these persons were a controlling person or a 5% lender of its net capital. Currently, NASD Rule 2110 would apply to efforts by a firm and its owners to unfairly prejudice customers seeking

<sup>6</sup>In situations where NASD does not receive notice, the 36-month period will be measured from the date when notice was due. See Rule 1017(c)(1).