

NASD

National Association of Securities Dealers, Inc.
1735 K St., N.W. • Washington, D.C. 20006 • (202) 728-8000

notice to members 88-1

January 4, 1988

IMPORTANT MAIL VOTE
OFFICERS, PARTNERS, PROPRIETORS

TO: All NASD Members

RE: Proposed Amendments to NASD By-Laws and Rules of Fair Practice, and
Proposed New Government Securities Rules

LAST VOTING DATE IS FEBRUARY 4, 1988.

EXECUTIVE SUMMARY

NASD members are invited to vote on proposed amendments to the NASD By-Laws and Rules of Fair Practice, and on proposed new government securities rules designed to permit the NASD to carry out its regulatory responsibilities under the Government Securities Act of 1986.

The Government Securities Act of 1986 provides for the regulation of government securities activities by brokers and dealers. This legislation created a new section 15C of the Securities Exchange Act of 1934, which requires SEC registration and either NASD or exchange membership for government securities brokers and dealers.

The texts of the proposed amendments are attached.

BACKGROUND

Public Law 99-571 (the "Government Securities Act of 1986"), enacted by Congress in October of 1986, amended the Securities Exchange Act of 1934 (1934 Act) by adding a new Section 15C that requires registration of government securities brokers and dealers and provides for adoption of rules for such brokers and dealers by the Treasury Department. In addition, the Government Securities Act amended Section 15A(f) of the 1934 Act to provide the NASD with the authority to adopt and implement rules applicable to its members; to enforce compliance with the provisions of the Government Securities Act and rules and regulations adopted thereunder; to discipline members for violations of the Government Securities Act and rules; to examine members' books and records; and to implement the provisions of the 1934 Act relating to denial of membership, or association with members, of persons or entities subject to statutory disqualifications.

In addition, the Government Securities Act provided the NASD with the authority to adopt rules to prohibit fraudulent, misleading, deceptive, and false advertising of government securities. A proposed amendment to Article III, Section 35 of the NASD Rules of Fair Practice, relating to advertising, was circulated for member comment in Notice to Members 87-24, dated April 14, 1987.

The remainder of the rule proposals relating to government securities activities of NASD member firms was circulated for member comment in Notice to Members 87-53, dated August 12, 1987. The proposed rules incorporate the comments received from both notices.

SUMMARY OF PROPOSED AMENDMENTS

The proposed amendments and new rules are designed to provide the NASD with the ability to carry out its responsibilities under the Government Securities Act. These proposals are divided into four parts:

- Amendments to the NASD By-Laws;
 - Amendments to Schedule C to the NASD By-Laws regarding registration of individuals;
 - An amendment to Article I, Section 5 of the NASD Rules of Fair Practice; and
 - A rule package designated as "Government Securities Rules."
- NASD By-Laws

These amendments incorporate into existing By-Law provisions appropriate references to government securities brokers and dealers or to the rules of the Treasury Department.

Substantive changes to the By-Laws include a new Section 8 to Article VII that allows the Board of Governors to adopt government securities rules subject to member vote and a new Section 6 to Article XVI that applies to limitations of

powers. New Section 6 states that the By-Law provisions governing qualifications of members and rulemaking authority conferred upon the NASD shall not be inconsistent with the Government Securities Act. This provision is similar to an existing provision in the By-Laws relating to municipal securities brokers and dealers.

The amendments also contain changes to Article II, Section 4 of the By-Laws that define the term "disqualification." These changes conform the NASD definition to the definition in the 1934 Act.

- Schedule C to the NASD By-Laws

The proposed amendments to Schedule C to the By-Laws add a new Part X. This section defines government securities principals and representatives. It also requires registration of government securities principals and representatives and exempts from registration persons serving in an exclusively clerical or ministerial capacity. The definitions of the categories of individuals required to be registered either as principals or representatives track the provisions of Section 400.3(c) of the Treasury regulations. Such registration is required to provide the NASD with the information needed to make a determination of potential statutory disqualification and identify a firm's principals for purposes of contact with and examination of the firm. Member vote on these amendments is not required; the amendments are included for information purposes only.

- NASD Rules of Fair Practice

The amendment to Article I, Section 5 of the Rules of Fair Practice is intended to clarify that the applicable Rules of Fair Practice do not apply to members that are registered with the SEC under Section 15C as sole government securities brokers or dealers. The provisions of the Rules of Fair Practice will, of course, remain fully applicable to members registered under Section 15(b) of the 1934 Act.

- Government Securities Rules

The remaining provisions of the proposed rule package are designated as "Government Securities Rules." These rules are substantially parallel to the NASD Rules of Fair Practice in areas in which the NASD believes that such rules are consistent with NASD obligations under the provisions of Section 15A(f) of the 1934 Act.

The proposed rules include provisions relating to the maintenance of books and records, supervisory procedures, and regulation of activities of members that are experiencing financial or operational difficulties or that are changing their exemptive status under the customer protection provisions applicable to government securities brokers and dealers. In addition, these rules contain a government securities advertising rule. The rules also provide the framework for the NASD to bring disciplinary actions pursuant to the NASD Code of Procedure.

SUMMARY OF COMMENTS

The NASD received five comments in response to Notice to Members 87-53. A number of the comments were technical or grammatical in nature. The NASD

Board believes that these technical amendments should be made, and this has been done in the redraft of the text that accompanies this notice. A summary of the significant aspects of the comments and the Board's responses follows.

By-Laws

Article II, Section 2(a)

Two commentators believe that the last sentence of the paragraph that states that qualification standards should not extend to government securities brokers or dealers should be deleted since the general language in Article XVI, Section 6 accomplishes the same result. The Board concurred with this change.

Article II, Section 2(b)

One commentator suggested adding the words "if applicable" to the reference to qualification requirements. The Board concurred with this suggestion.

Amendments to Schedule C

All commentators suggested certain changes to the proposed provisions of Schedule C. One suggestion was that the definition of "principal" should include persons engaged in the management or supervision of training. The Board determined that, since the definitions of "representative" and "principal" directly follow those contained in the Treasury regulations, no such change should be made.

One commentator indicated that the proposed rules define the class of persons required to be registered beyond what is necessary. Further, the definition should exclude persons whose primary function is to supply analysis and research to a government securities dealer and persons supervising or administering such activities. Since these activities are specifically included in the Treasury Regulations, the Board believes it appropriate to leave them in the NASD rules.

The commentator also suggested that the definition of "principal" should be limited only to senior managers and supervisors and not to personnel supervising small functional units. The Board does not believe such a distinction can be made in practice. However, the Board noted a suggestion that information relating to the limiting of principal functions to senior management may have been given to firms orally and that a grace period for conversion of registration without further fees might be appropriate. Consequently, a grace period of 90 days will be allowed for this purpose.

A commentator suggested that two additional classes of individuals be exempted from registration under Part X, Section 3. These individuals should include persons not actively engaged in the member's investment banking or securities business and those persons whose functions relate solely and exclusively to the member's need for nominal corporate officers or capital participation. Since the Treasury Department regulations define "registered persons" as only those individuals who actually participate in the member's government securities business, the Board does not believe that an exclusion is necessary in the NASD rules.

Government Securities Rules

Section 4

One commentator questioned whether the authority given the NASD under Section 15A(f)(2) of the 1934 Act supports the provisions of proposed Section 4, which the commentator believes imposes recordkeeping obligations beyond those required under Section 17 of the 1934 Act. Another suggested that it would be appropriate to expand the requirement under Section 4 to include pertinent information related to corporate-type accounts, since these are primarily the accounts in which government securities are held.

The Board believes that the categories of information contained in proposed Section 4 are appropriate and consistent with the purposes of the Government Securities Act. The Board does not believe, however, that the specific additional information suggested should be included in the provisions of Section 4. The Board believes that obtaining such information would constitute good business practice but it is not appropriate to add this information in the government securities rules alone.

Section 5

One commentator also suggested that it was inappropriate under the "supervision" rule to impose an obligation to adopt and enforce written procedures to ensure compliance with "all" sections of the 1934 Act. The provision should be limited to compliance with the Government Securities Act and the rules promulgated thereunder. The Board concurs with this view, and proposed Section 5 has been amended to reflect this change.

Section 6

Several comments were received relating to the applicability of Section 6 of the proposed government securities rules to activities of members experiencing financial or operational difficulty. The provision generally parallels the provision of Article III, Section 38 of the NASD Rules of Fair Practice. While the government securities rules are applicable to all broker-dealers, the references in the rule to the concept of "liquid capital," in effect, limit its applicability to firms registered under Section 15C. It was suggested that the NASD clarify that Section 15(b) firms would be subject instead to the provisions of Section 38. The Board concurs with this view, and Section 6 has been appropriately amended.

Some commentators believed that the terminology in Section 6 was somewhat unclear. Section 6 has also been amended to address these concerns.

Two commentators also suggested that it might be appropriate to apply certain provisions of Section 6 to introducing firms, which, as currently structured, are excluded from the applicability of the rule. The Board believes that since introducing firms are excluded from the applicability of Section 38, similar treatment should be accorded to government securities firms.

Section 7

A commentator suggested that members acting in good faith that are unaware that a change in their method of doing business caused a change in

exemptive status should be excluded from the provisions of Section 7. The Board believes that a member's good faith would serve as mitigation of any rule violation but should not be viewed as an exclusion from the applicability of the rule.

Section 8

Six comments were received on the proposed government securities advertising rule circulated in Notice to Members 87-24. As proposed, the rule would require government securities advertisements to be filed with the NASD Advertising Department within 10 days of first use or publication. Also, existing filing requirements and standards would be applicable to government securities communications.

Four comment letters favored the rule; two suggested substantial modifications. Among the areas of comment were:

- The advertising rule should not be an amendment to Article III, Section 35 of the NASD Rules of Fair Practice, but rather, should be a separate government securities rule. The Board concurs with this view and has incorporated the advertising provision into the proposed government securities rules.
- Commentators believed that neither the post-use filing requirement for all government securities advertising nor application of a pre-use filing requirement for new NASD members is necessary.
- The proposed rule goes beyond what is necessary to address the legislatively perceived problems in GNMA advertising. The Board believes, however, that the approach taken is a reasonable one and that the filing requirements are the only method under which the NASD can assess the degree of problems that exist in government securities advertising.
- It would be appropriate to allow dual NASD/exchange members to be governed by the rules of those exchanges rather than by the rules of the NASD. The exchanges do not have and do not intend to implement the government securities advertising rules and, therefore, the Board believes that no such deference is appropriate.

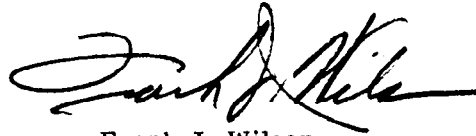
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The Board of Governors believes that the proposed amendments to the NASD By-Laws and Rules of Fair Practice, and the adoption of the government securities rules are necessary and appropriate and recommends that members vote their approval.

Please mark the attached ballot according to your convictions and return it in the enclosed, stamped envelope to "The Corporation Trust Company." Ballots must be postmarked no later than February 4, 1988.

Questions concerning this notice may be directed to T. Grant Callery,
NASD Associate General Counsel, at (202) 728-8285.

Sincerely,

A handwritten signature in black ink, appearing to read "Frank J. Wilson". The signature is fluid and cursive, with a large initial "F" and "W".

Frank J. Wilson
Executive Vice President
and General Counsel

Attachment

PROPOSED AMENDMENTS TO NASD BY-LAWS*

ARTICLE I

Definitions

When used in these By-Laws, and any rules of the Corporation, unless the context otherwise requires, the term:

(a) "Act" means the Securities Exchange Act of 1934 as amended;

(b) "bank" means (1) a banking institution organized under the laws of the United States, (2) a member bank of the Federal Reserve System, (3) any other banking institution, whether incorporated or not, doing business under the laws of any state or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks and which is supervised and examined by a State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of the Act, and (4) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (1), (2) or (3) of this subsection;

(c) "branch office" means an office located in the United States which is owned or controlled by a member, and which is engaged in the investment banking or securities business;

(d) "broker" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank;

(e) "Commission" means the Securities and Exchange Commission;

(f) "Corporation" means the National Association of Securities Dealers, Inc.;

(g) "dealer" means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business;

(h) "investment banking or securities business" means the business, carried on by a broker, dealer, [or] municipal securities dealer (other than a bank or department or division of a bank), or government securities broker or dealer of underwriting or distributing issues of securities, or of purchasing securities and

* New language is underlined; deleted language is in brackets.

offering the same for sale as a dealer, or of purchasing and selling securities upon the order and for the account of others;

(i) "member" means any broker or dealer admitted to membership in the Corporation;

(j) "municipal securities" means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond as defined by Section 3(a)(29) of the Act;

(k) "municipal securities dealer" means any person, except a bank or department or division of a bank, engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise, but does not include any person insofar as he buys or sells securities for his own account either individually or in some fiduciary capacity but not as a part of a regular business;

(l) "municipal securities broker" means a broker, except a bank or department or division of a bank, engaged in the business of effecting transactions in municipal securities for the account of others;

(m) "person associated with a member" or "associated person of a member" means every sole proprietor, partner, officer, director, or branch manager of any member, or any natural person occupying a similar status or performing similar functions, or any natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by such member, whether or not any such person is registered or exempt from registration with the Corporation pursuant to these By-Laws;

(n) "registered broker, dealer, [or] municipal securities broker or dealer, or government securities broker or dealer" means any broker, dealer, [or] municipal securities broker or dealer, or government securities broker or dealer which is registered with the Commission under the Act;

(o) "rules of the Corporation" means all rules of the Corporation including the Certificate of Incorporation, By-Laws, Rules of Fair Practice, Government Securities Rules, Code of Procedure, Uniform Practice Code, and any Interpretations thereunder.

(p) "government securities broker" shall have the same meaning as in Section 3(a)(43) of the Act except that it shall not include financial institutions as defined in Section 3(a)(46) of the Act.

(q) "government securities dealer" shall have the same meaning as in Section 3(a)(44) of the Act except that it shall not include financial institutions as defined in Section 3(a)(46) of the Act.

ARTICLE II

Qualifications of Members and Associated Persons

Persons Eligible to Become Members and Associated Persons of Members

Sec. 1. (a) Any registered broker, dealer, [or] municipal securities broker or dealer, or government securities broker or dealer authorized to transact, and whose regular course of business consists in actually transacting, any branch of the investment banking or securities business in the United States, under the laws of the United States, shall be eligible for membership in the Corporation, except such registered brokers, dealers, [or] municipal securities brokers or dealers, or government securities brokers or dealers which are excluded under the provisions of Sections 3(a) or (b) of this Article.

(b) Any person shall be eligible to become an associated person of a member, except such persons who are excluded under the provisions of Section 3(b) of this Article.

Authority of Board to Adopt Qualification Requirement

Sec. 2. (a) The Board of Governors shall have authority to adopt rules and regulations applicable to applicants for membership, members and persons associated with applicants or members establishing specified and appropriate standards with respect to the training, experience, competence and such other qualifications as the Board of Governors finds necessary or desirable, and in the case of an applicant for membership or a member, standards of financial responsibility or operational capability.

(b) In establishing and applying such standards, the Board of Governors may classify members and persons associated with such members, taking into account relevant matters, including the nature, extent and type of business being conducted and of securities sold, dealt in, or otherwise handled. The Board of Governors may specify that all or any portion of such standards shall be applicable to any such class and may require the persons in any such class to be registered with the Corporation.

(c) The Board of Governors may from time to time make changes in such rules, regulations and standards as it deems necessary or appropriate. Neither the adoption nor any change in such standards need be submitted to the membership for approval and such rules, regulations and standards as adopted or amended shall become effective at such time as the Board of Governors may prescribe.

Ineligibility of Certain Persons for Membership or Association

Sec. 3. (a) No registered broker, dealer, [or] municipal securities broker or dealer, or government securities broker or dealer shall be admitted to membership, and no member shall be continued in membership, if such broker, dealer, [or] municipal securities broker or dealer or government securities broker or dealer, or member fails or ceases to satisfy the qualification requirements under Section 2 of this Article, if applicable, or if such broker, dealer, municipal securities broker or dealer or government securities broker or dealer, or member is or becomes subject to a disqualification under Section 4 of this Article.

(b) No person shall become associated with a member, or continue to be associated with a member, or transfer association to another member, if such person fails or ceases to satisfy the qualification requirements under Section 2 of this Article if applicable, or if such person is or becomes subject to a disqualification under Section 4 of this Article; and no broker, dealer, [or] municipal securities broker or dealer, or government securities broker or dealer shall be admitted to membership, and no member shall be continued in membership if any person associated with it is ineligible to be an associated person under this subsection.

(c) If it deems it appropriate, the Board of Governors, upon notice and opportunity for a hearing, may cancel the membership of a member if it becomes ineligible for continuance in membership under subsection (a) hereof, may suspend or bar a person from continuing to be associated with any member if such person is or becomes ineligible for association under subsection (b) hereof, and may cancel the membership of any member who continues to be associated with any such ineligible person.

(d) Any broker, dealer, [or] municipal securities dealer, or government securities broker or dealer which is ineligible for admission into membership, or any member which is ineligible for continuance in membership, may file with the Board of Governors an application requesting relief from the ineligibility, pursuant to procedures adopted by the Board of Governors and contained in the Corporation's Code of Procedure. The Board of Governors may, in its discretion, approve the admission or continuance of an applicant or member, or the association of any person, if the Board determines that such approval is consistent with the public interest and the protection of investors. Any approval hereunder may be granted unconditionally or on such terms and conditions as the Board considers necessary or appropriate. In the exercise of the authority granted hereunder, the Board of Governors may:

(1) conduct such inquiry or investigation into the relevant facts and circumstances as it, in its discretion, considers necessary to its determination, which, in addition to the background and circumstances giving rise to the failure to qualify or disqualification may include the proposed or present business of an applicant for membership or of a member and the conditions of association of any prospective or presently associated person, among other matters;

(2) permit, in limited types of situations, a membership or association with a member pending completion of its inquiry or investigation, and its final determination, based upon a consideration of relevant factors, and may classify situations taking into account the status of brokers, dealers, [and] municipal securities brokers and dealers and government securities brokers and dealers as applicants or existing members and of persons as prospective or presently associated persons of members; the type of disqualification or failure to qualify; whether a member or associated person has been the subject of a previous approval and the terms and conditions thereof; and any other relevant factors; and

(3) delegate any of its functions and authority under this subsection (d) to appropriate committees of the Corporation or to Corporation staff members.

(e) An application filed under subsection (d) hereof shall not foreclose any action which the Board of Governors is authorized to take under subsection (c) hereof until approval has been granted.

(f) Approval by the Board of Governors of an application made under subsection (d) shall be subject to whatever further action the Commission may take pursuant to authority granted to the Commission under the Act.

Definition of Disqualification

Sec. 4. A person is subject to a "disqualification" with respect to membership, or association with a member, if such person:

Commission and Self-Regulatory Organization Disciplinary Sanctions

(a) has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization[;], contract market designated pursuant to Section 5 of the Commodity Exchange Act, or futures association, registered under Section 17 of such Act, or has been denied trading privileges on any such contract market.

(b) is subject to an order of the Commission or other appropriate regulatory agency denying, suspending for a period not exceeding twelve months, or revoking its registration as a broker, dealer, [or] municipal securities dealer (including a bank or department or division of a bank), or government securities broker or dealer, or barring or suspending him from being associated with a broker, dealer, [or] municipal securities dealer (including a bank or department or division of a bank), or government securities broker or dealer[;], or is subject to an order of the Commodity Futures Trading Commission denying, suspending, or revoking his registration under the Commodity Exchange Act;

(c) by his conduct while associated with a broker, dealer, [or] municipal securities dealer (including a bank or department or division of a bank), or government securities broker or dealer, or while associated with an entity or person required to be registered under the Commodity Exchange Act has been found to be a cause of any effective suspension, expulsion or order of the character described in subsections (a) or (b) of this Section.

(d) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person described in subsections (a), (b), or (c) of this Section.

Misstatements

(e) has willfully made or caused to be made in any application for membership in [the Corporation] a self-regulatory organization or to become associated with a member of [the Corporation] a self-regulatory organization, or in any report required to be filed with [the Corporation] a self-regulatory organization, or in any proceeding before [the Corporation] a self-regulatory organization, any statement which was at the time, and in light of the circumstances under which it was made, false, or misleading with respect to any material fact, or has omitted to state in any such application, report or proceeding any material fact which is required to be stated therein;

Convictions

(f) has been convicted within ten years preceding the filing of any application for membership in the Corporation, or to become associated with a

member of the Corporation, or at any time thereafter, of any felony or misdemeanor which;

(1) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any such offense;

(2) arises out of the conduct of the business of a broker, dealer, municipal securities dealer or government securities broker or dealer, investment adviser, bank insurance company, [or] fiduciary, or any entity or person required to be registered under the Commodity Exchange Act;

(3) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; or

(4) involves the violation of Sections 152, 1341, 1342, or 1343 or Chapters 25 or 47 of Title 18, United States Code; or

Injunctions

(g) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, [or] entity or person required to be registered under the Commodity Exchange Act, municipal securities dealer (including a bank or department or division of a bank) or government securities broker or dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

ARTICLE III

Membership

Application for Membership

Sec. 1. (a) Application for membership in the Corporation, properly signed by the applicant, shall be made to the Corporation, on the form to be prescribed by the Corporation, and shall contain:

(1) an acceptance of and an agreement to abide by, comply with, and adhere to, all the provisions, conditions, and covenants of the Certificate of Incorporation, the By-Laws, the rules and regulations of the Corporation as they are or may from time to time be adopted, changed or amended, and all rulings, orders, directions and decisions of, and sanctions imposed by, the Board of Governors or any duly authorized committee, the provisions of the federal securities laws, including the rules and regulations adopted thereunder, [and] including the rules of the Municipal Securities Rulemaking Board[,] and the Treasury Department, provided, however, that such an agreement shall not be construed as a waiver by the applicant of any right to appeal as provided in the Act;

(2) an agreement to pay such dues, assessments, and other charges in the manner and amount as shall from time to time be fixed by the Board of Governors pursuant to these By-Laws;

(3) an agreement that neither the Corporation, nor any officer or employee thereof, nor any member of the Board of Governors or of any district or other committee, shall be liable, except for willful malfeasance, to the applicant or to any member of the Corporation or to any other person, for any action taken by such officer or member of the Board of Governors or of any district or other committee, in his official capacity, or by any employee of the Corporation while acting within the scope of his employment or under instruction of any officer, board, or committee of the Corporation, in connection with the administration or enforcement of any of the provisions of the rules of the Corporation as they are or may from time to time be adopted, or amended, or any ruling, order, directive, decision of, or penalty imposed by, the Board of Governors or any duly authorized committee, the provisions of the federal securities laws, including the rules and regulations adopted thereunder, including the rules of the Municipal Securities Rulemaking Board and the Treasury Department; and

(4) such other reasonable information with respect to the applicant as the Board of Governors may require.

(b) Any application received by the Corporation shall be referred to the District Committee of the district in which the applicant has his principal place of business, and if a majority of the members of such District Committee determine that the applicant has satisfied all of the admission requirements of the By-Laws, it shall recommend the applicant's admission to membership and promptly notify the Secretary of the Corporation of such recommendation.

(c) If a majority of the members of such District Committee determine that the applicant fails to satisfy all of the admission requirements of the By-Laws, it shall promptly notify the Secretary of the Corporation who shall thereafter take appropriate action as of the date when posted to the membership roll.

(d) Each member shall ensure that its membership application with the Corporation is kept current at all times by supplementary amendments to the original application.

Similarity of Membership

Sec. 2. No change.

Executive Representative

Sec. 3. No change.

Membership Roll

Sec. 4. No change.

Resignation of Members

Sec. 5. No change.

Transfer and Termination of Membership

Sec. 6. No change.

Registration of Branch Offices

Sec. 7. No change.

Vote of Branch Offices

Sec. 8. No change.

District Committees' Right to Classify Branches

Sec. 9. No change.

ARTICLE IV

Registered Representatives and Associated Persons

Qualification Requirements

Sec. 1. No member shall permit any person associated with such member to engage in the investment banking or securities business unless the member determines that such person has complied with the applicable provisions under Article II of the By-Laws.

Application for Registration

Sec. 2. (a) Application by any person for registration with the Corporation, properly signed by the applicant, shall be made to the Corporation, on the form to be prescribed by the Board of Governors and shall contain:

(1) an acceptance of and an agreement to comply with all the provisions of the rules of the Corporation as they are or may from time to time be adopted or amended, all rulings, orders, directions and decisions of, and penalties imposed by, the Board of Governors or any duly authorized committee, the provisions of the federal securities laws, including the rules and regulations adopted thereunder[, and] including the rules of the Municipal Securities Rulemaking Board and the Treasury Department, provided, however, that such an agreement shall not be construed as a waiver by the applicant of any right to appeal as provided in the Act;

(2) an agreement that neither the Corporation, nor any officer or employee thereof, nor any member of the Board of Governors or of any District or other Committee, shall be liable except for willful malfeasance, to the applicant or to any member of the Corporation or to any other person, for any action taken by such officer, member of the Board of Governors or of any District or other Committee in his official capacity, or by any employee of the Corporation while acting within the scope of his employment, or under instruction of any officer, board or committee of the Corporation, in connection with the administration or enforcement of any of the provisions of the By-Laws, any rules of the Corporation as they are or may from time to time be adopted or amended, any ruling, order, direction, decision of, or penalty imposed by, the Board of Governors or any duly authorized committee, the provisions

of the federal securities laws, including the rules and regulations adopted thereunder, [or] including the rules of the Municipal Securities Rulemaking Board and the rules of the Treasury Department; and

(3) such other reasonable information with respect to the applicant as the Corporation may require.

(b) The Corporation shall not approve an application for registration of any person who is not eligible to be an associated person of a member under the provisions of Section 3(b) of Article II of these By-Laws.

(c) Every application for registration filed with the Corporation shall be kept current at all times by supplementary amendments to the original application.

Notification by Member to Corporation of Termination

Sec. 3. Following the termination of the association with a member of a person who is registered with it, such member shall promptly, but in no event later than thirty (30) calendar days after such termination, give written notice to the Association on a form designated by the Board of Governors of the termination of such association. A member who does not submit such notification in writing within the time period prescribed shall be assessed a late filing fee as specified by the Board of Governors. Termination of registration of such person associated with a member shall not take effect so long as any complaint or action is pending against a member and to which complaint or action such person associated with a member is also a respondent, or so long as any complaint or action is pending against such person individually or so long as any examination of the member or person associated with such member is in process. The Corporation, however, may in its discretion declare the termination effective at any time.

Retention of Jurisdiction

Sec. 4. A person whose association with a member has been terminated and is no longer associated with any member of the Corporation shall continue to be subject to the filing of a complaint under the Code of Procedure based upon conduct which commenced prior to the termination, but any such complaint shall be filed within one (1) year after the effective date of termination of registration pursuant to Section 3 above or, in the case of an unregistered person, within one (1) year after the date upon which such person ceased to be associated with the member.

ARTICLE V

Affiliates

No change.

ARTICLE VI

Dues, Assessments and Other Charges

No change.

ARTICLE VII

Board of Governors

Powers and Authority of Board of Governors

Sec. 1. (a) The Board of Governors shall be the governing body of the Corporation and, except as otherwise provided by these By-Laws, shall be vested with all powers necessary for the management and administration of the affairs of the Corporation and the promotion of the Corporation's welfare, objects and purposes. In the exercise of such powers, the Board of Governors shall have the authority to:

(1) adopt for submission to the membership, as hereinafter provided, such By-Laws, Rules of Fair Practice and changes or additions thereto as it deems necessary or appropriate;

(2) make such regulations, issue such orders, resolutions, interpretations, including interpretations of the Rules of Fair Practice, and directions, and make such decisions as it deems necessary or appropriate;

(3) prescribe a code of arbitration procedure providing for the required or voluntary arbitration of controversies between members and between members and customers or others as it shall deem necessary or appropriate and neither the adoption nor any amendments to the code need be submitted to the membership for approval and the code and any amendments thereto shall become effective as the Board of Governors may prescribe;

(4) establish rules and procedures to be followed by members in connection with the distribution of securities issued by members and affiliates thereof, and neither the adoption nor any amendments to such rules and procedures need be submitted to the membership for approval and such rules and procedures and any amendments thereto shall become effective as the Board of Governors may prescribe;

(5) require all over-the-counter transactions in securities between members, other than transactions in exempted securities, to be cleared and settled through the facilities of a clearing agency registered with the Commission pursuant to the Act, which clears and settles such over-the-counter transactions in securities;

(6) organize and operate automated systems to provide qualified subscribers with securities information and automated services. The systems may be organized and operated by a division or subsidiary company of the Corporation or by one or more independent firms under contract with the Corporation as the Board of Governors may deem necessary or appropriate. The Board of Governors may adopt rules of such automated systems, establish reasonable qualifications and classifications for members and other subscribers, provide qualification standards for securities included in such systems, require members to report promptly information in connection with securities included in such systems, and establish charges to be collected from subscribers and others. The Board of Governors shall have power to adopt, amend, supplement or modify such rules, qualifications, classifications, standards and charges from time to time without recourse to the membership for approval, and such rules, qualifications, classifications, standards and charges shall become effective as the Board of Governors may prescribe;

(7) engage in any activities or conduct necessary or appropriate to carry out the Corporation's purposes under its Certificate of Incorporation and the federal securities laws; and

(8) (a) adopt for submission to the membership such rules as the Board of Governors deems appropriate to implement the provisions of the Act as amended by the Government Securities Act of 1986 and the rules and regulations promulgated thereunder, and (b) make such regulations, issue such orders, resolutions, interpretations, including interpretations of the rules adopted pursuant to this Section, and directions, and make such decisions as it deems necessary or appropriate.

(b) In the event of the refusal, failure, neglect or inability of any member of the Board of Governors to discharge his duties, or for any cause affecting the best interests of the Corporation the sufficiency of which the Board of Governors shall be the sole judge, the Board shall have the power, by the affirmative vote of two-thirds of the Governors then in office, to remove such member and declare his position vacant and that it shall be filled in accordance with the provisions of Section 6 of this Article.

Authority to Suspend for Failure to Submit Required Information

Sec. 2. No change.

Composition of Board

Sec. 3. No change.

Term of Office of Governors

Sec. 4. No change.

Succession to Office

Sec. 5. No change.

Election of Board Members

Sec. 6. No change.

Filling of Vacancies on Board

Sec. 7. No change.

Meetings of Board

Sec. 8. No change.

Offices of Corporation

Sec. 9. No change.

ARTICLE VIII

District Committees

No change.

ARTICLE IX

Nominating Committees

No change.

ARTICLE X

Officers and Employees

No change.

ARTICLE XI

Committees

No change.

ARTICLE XII

Rules of Fair Practice

No change.

ARTICLE XIII

Disciplinary Proceedings

No change.

ARTICLE XIV

Power of Board to Prescribe Sanctions

The Board of Governors is hereby authorized to prescribe appropriate sanctions applicable to members, including censure, fine, suspension or expulsion from membership, suspension or barring from being associated with all members, limitation of activities, functions and operations of a member, or any other fitting sanction, and to prescribe appropriate sanctions applicable to persons associated with members, including censure, fine, suspension or revocation of registration, if any,

suspension or barring a person associated with a member from being associated with all members, limitation of activities, functions and operations of a person associated with a member, or any other fitting sanction, for:

(a) breach by a member or a person associated with a member of any covenant with the Corporation or its members;

(b) violation by a member or a person associated with a member of any of the terms, conditions, covenants, and provisions of the rules of the Corporation, the federal securities laws, including the rules and regulations adopted thereunder, and including rules of the Municipal Securities Rulemaking Board and the rules of the Treasury Department;

(c) failure by a member or person associated with a member to submit a dispute for arbitration under the Code of Arbitration Procedure ("Code") as required by the Code, or to fail to appear or to produce any document in their possession or control as directed pursuant to provisions of the Code, or to fail to honor an award of arbitrators properly rendered pursuant to the Code where a timely motion has not been made to vacate or modify such award pursuant to applicable law;

(d) refusal by a member or person associated with a member to abide by an official ruling of the Board of Governors or Uniform Practice Committee acting within its appropriate authority, with respect to any transaction which is subject to the Uniform Practice Code; or

(e) failure by a member or a person associated with a member to adhere to any ruling, order, direction or decision of, or to pay any penalty, fine or costs, imposed by, the Board of Governors or any District Business Conduct Committee.

ARTICLE XV

Uniform Practice Code

No change.

ARTICLE XVI

Limitation of Powers

Prohibitions

Sec. 1. Under no circumstances shall the Board of Governors or any officer, employee or member of the Corporation have power to:

(a) make any donation or contribution from the funds of the Corporation or to commit the Corporation for the payment of any donations or contributions for political or charitable purposes; or

(b) use the name or facilities of the Corporation in aid of any political party or candidate for any public office.

Use of Name of Corporation by Members

Sec. 2. No member shall use the name of the Corporation except to the extent that may be authorized by the Board of Governors.

Unauthorized Expenditures

Sec. 3. No officer, employee, member of the Board of Governors or of any District or other Committee, shall have any power to incur or contract any liability on behalf of the Corporation not authorized by the Board of Governors. The Board may delegate to the President of the Corporation, or his delegate, such authority as it deems necessary to contract on behalf of the Corporation or to satisfy unanticipated liabilities during the period between Board meetings.

Conflicts of Interest

Sec. 4. No member of the Board of Governors or of any committee of the Corporation shall directly or indirectly participate in any adjudication of the interests of any party which would at the same time substantially affect his interest or the interests of any person in whom he is directly or indirectly interested. In any such case, the member shall disqualify himself or shall be disqualified by the Chairman of the Board or Committee.

Municipal Securities

Sec. 5. The provisions of the By-Laws conferring rulemaking authority upon the Board of Governors shall not be applicable to the municipal securities activities of members or persons associated with members to the extent that the application of such authority would be inconsistent with Section 15B of the Act.

Government Securities

Sec. 6. The provisions of the By-Laws governing qualifications of members and persons associated with members and conferring rulemaking authority upon the Board of Governors shall not be applicable to the government securities activities of members or persons associated with members to the extent that the application of such provisions or authority would be inconsistent with Section 15A(f) of the Act.

ARTICLE XVII

Procedure for Adopting Amendments to By-Laws

No change.

ARTICLE XVIII

Corporate Seal

No change.

ARTICLE XIX

Checks

No change.

ARTICLE XX

Annual Financial Statement

No change.

**PROPOSED AMENDMENTS TO SCHEDULE C
TO THE NASD BY-LAWS**

(New language is underlined.)

V

PERSONS EXEMPT FROM REGISTRATION

(1) The following persons associated with a member are not required to be registered with the Corporation:

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(d) persons associated with a member whose functions are related solely and exclusively to:

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(ii) transactions in exempted securities, except as provided in Part X hereof, or

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(Part X is new.)

X

**REGISTRATION OF GOVERNMENT SECURITIES PRINCIPALS
AND REPRESENTATIVES**

1. **Registration of Principals.** All persons associated with a member who are to function as government securities principals shall be registered as such with the Corporation.

(a) Definition of Government Securities Principal--Persons associated with a member who are:

(1) engaged in the management or supervision of the member's government securities business, including:

- (i) underwriting, trading or sales of government securities;
- (ii) financial advisory or consultant services for issuers in connection with the issuance of government securities;
- (iii) research or investment advice, other than general economic information or advice, with respect to government securities in connection with the activities described in (i) and (ii) above;
- (iv) activities other than those specifically mentioned that involve communication, directly or indirectly, with public investors in government securities in connection with the activities described in (i) and (ii) above; or

(2) are responsible for supervision of:

- (i) the processing and clearance activities with respect to government securities; or
- (ii) the maintenance of records involving any of the activities described in (a)(1) above;

are designated as principals.

(b) Notification of Principal Status--A member shall promptly notify the Corporation of the assumption by an individual of principal status on the form designated by the Board of Governors accompanied by the applicable fees.

2. **Registration of Representatives.** All persons associated with a member who are to function as government securities representatives shall be registered as such with the Corporation.

(a) Definition of Representative--Persons associated with a member, including assistant officers other than principals, who are engaged in the government securities business for the member including:

- (i) underwriting, trading or sales of government securities;
- (ii) financial advisory or consultant services for issuers in connection with the issuance of government securities;
- (iii) research or investment advice, other than general economic information or advice, with respect to government securities in connection with the activities described in paragraphs (i) and (ii) above;

- (iv) activities other than those specifically mentioned that involve communication, directly or indirectly, with public investors in government securities in connection with the activities described in paragraphs (i) and (ii) above;

are designated as representatives.

(b) Notification of Representative Status--A member shall promptly notify the Corporation of the assumption by an individual of representative status on the form designated by the Board of Governors accompanied by the applicable fees.

3. **Persons Exempt From Registration.** Persons associated with a member whose functions are exclusively clerical or ministerial are not required to register with the Corporation.

PROPOSED AMENDMENT TO NASD RULES OF FAIR PRACTICE

(New language is underlined.)

ARTICLE I

Adoption and Application

Applicability

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Sec. 5. (a) These Rules of Fair Practice shall apply to all members and persons associated with a member, other than those members registered with the Securities and Exchange Commission solely under the provisions of Section 15C of the Act and persons associated with such members. Persons associated with a member shall have the same duties and obligations as a member under these Rules of Fair Practice.

(The remainder of Section 5 remains unchanged.)

PROPOSED NEW GOVERNMENT SECURITIES RULES

Adoption of Rules

Sec. 1. The following provisions are adopted pursuant to Article VII, Section 1(a)(8) of the NASD By-Laws.

Applicability

Sec. 2. (a) These rules shall apply to the government securities business of all members and persons associated with a member in order to implement and enforce the provisions of the Securities Exchange Act of 1934 and the rules promulgated thereunder including the rules of the Treasury Department. Unless otherwise indicated herein, the requirements of these rules are in addition to those contained in the Rules of Fair Practice for members that are subject to the provisions of the Rules of Fair Practice. Persons associated with a member shall have the same duties and obligations as a member under these rules.

(b) A member or person associated with a member, who has been expelled, cancelled, or revoked from membership or from registration or who has been barred from being associated with all members, shall cease to have any privileges of membership or registration. A member or person associated with a member who has been suspended from membership or registration shall also cease to have any privileges of membership or registration other than those under the Code of Procedure or insurance programs sponsored by the Corporation. In neither case shall such a member or person associated with a member be entitled to recover any admission fees, dues, assessments, or other charges paid to the Corporation.

(c) A member or person associated with a member who has been suspended from membership or from registration shall have all of the obligations imposed by the By-Laws, these rules, and other regulations of the Corporation.

Definitions in By-Laws and Rules of Fair Practice

Sec. 3. Unless the context otherwise requires, or unless defined in these rules, terms used in the rules and provisions hereby adopted, if defined in the By-Laws or Rules of Fair Practice shall have the meaning as defined therein.

Books and Records

Sec. 4.

Requirements

(a) Each member shall keep and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations, and statements of policy promulgated thereunder and with the rules of this Association.

Information on accounts

(b) Each member shall maintain accounts of customers in such form and manner as to show the following information: name, address, and whether the customer is legally of age; signature of the registered representative introducing the accounts and signature of the member or the partner, officer, or manager accepting the account for the member. If the customer is associated with or employed by another member, this fact must be noted. In discretionary accounts, the member shall also record the age or approximate age and occupation of the customer as well as the signature of each person authorized to exercise discretion in such account.

Record of written complaints

(c) Each member shall keep and preserve either a separate file of all written complaints of customers and action taken by the member, if any, or a separate record of such complaints and a clear reference to the files containing the correspondence connected with such complaint.

"Complaint" defined

(d) A "complaint" shall be deemed to mean any written statement of a customer or any person acting on behalf of a customer alleging a grievance involving the activities of those persons under the control of the member in connection with the solicitation or execution of any transaction or the disposition of securities or funds of that customer.

Supervision

Sec. 5.

Written procedures

(a) Each member shall establish, maintain, and enforce written procedures that will enable it to supervise properly the activities of each registered representative and associated person to ensure compliance with the applicable provisions of the Securities Exchange Act of 1934, rules, regulations, and statements of policy promulgated thereunder including the rules of the Treasury Department, and with the applicable rules of this Association.

Responsibility of member

(b) Final responsibility for proper supervision shall rest with the member. The member shall designate a partner, officer, or manager to carry out the written supervisory procedures. A copy of such procedures shall be kept in each office of the member.

Eligibility investigated

(c) Each member shall have the responsibility and the duty to ascertain by investigation the absence of any statutory disqualification as that term is defined under Section 3(a)(39) or 15C(e) of the Securities Exchange Act of 1934 and that any application for registration by an associated person is complete and accurate.

**Regulation of Activities of Members Experiencing
Financial and/or Operational Difficulties**

Sec. 6. (a) Application—For the purposes of this rule, the term "member" shall be limited to any member of the Association registered with the Securities and Exchange Commission pursuant to Section 15C of the Securities Exchange Act of 1934 that is not designated to another self-regulatory organization by the Securities and Exchange Commission for financial responsibility pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17d-1 thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department.

(b) A member, when so directed by the Association, shall not expand its business during any period in which:

(1) Any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:

(A) A firm's liquid capital is less than 150 percent of the total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.

(B) A firm's liquid capital minus total haircuts is less than 150 percent of its minimum dollar capital requirement.

(C) The deduction of capital withdrawal including maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).

(2) The Association restricts the member for any other financial or operational reason.

(c) A member, when so directed by the Association, shall forthwith reduce its business:

(1) To a point enabling its available capital to comply with the standards set forth in subparagraphs (b)(1)(A), (B), or (C) of this rule if any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:

(A) A firm's liquid capital is less than 125 percent of total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.

(B) A firm's liquid capital minus total haircuts is less than 125 percent of its minimum dollar capital requirement.

(C) The deduction of capital withdrawal including maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).

(2) As required by the Association when it restricts a member for any other financial or operational reason.

● ● ● Explanation of the Board of Governors

Restrictions on a Member's Activity

This explanation outlines and discusses some of the financial and operational deficiencies which could initiate actions under the rule. Subparagraphs (b)(2) and (c)(2) of the rule recognize that there are various unstated financial and operational reasons for which the Association may impose restrictions on a member so as to prohibit its expansion or to require a reduction in overall level of business. These provisions are deemed necessary in order to provide for the variety of situations and practices which do arise and, which if allowed to persist, could result in increased exposure to customers and to broker-dealers.

In the opinion of the Board of Governors, it would be impractical and unwise to attempt to identify and list all of the situations and practices that might lead to the imposition of restrictions or the types of remedial actions the Corporation may direct be taken because they are numerous and cannot be totally identified or specified with any degree of precision. The Board believes, however, that it would be helpful to members' understanding to list some of the other bases upon which the Corporation may conclude that a member is in or approaching financial difficulty.

(a) For purposes of subparagraphs (b)(2) and (c)(2) of the rule, a member may be considered to be in or approaching financial or operational difficulty in conducting its operations and therefore subject to restrictions if it is determined by the Corporation that any of the parameters specified therein are exceeded or one or more of the following conditions exist:

(1) The member has experienced significant reduction in excess liquid capital in the preceding month or in the three-month period immediately preceding such computation.

(2) The member has experienced a substantial change in the manner in which it processes its business which, in the view of the Corporation, increases the potential risk of loss to customers and members.

(3) The member's books and records are not maintained in accordance with the provisions of Section 404.2 of the Treasury Department rules.

(4) The member is not in compliance, or is unable to demonstrate compliance, with applicable capital requirements of Section 402 of the Treasury Department rules.

(5) The member is not in compliance, or is unable to demonstrate compliance, with Section 403.4 of the Treasury Department rules (Customer Protection--Reserve and Custody of Securities).

(6) The member is unable to clear and settle transactions promptly.

(7) The member's overall business operations are in such a condition, given the nature and kind of its business that, notwithstanding the

absence of any of the conditions enumerated in subparagraphs (1) through (6), a determination of financial or operational difficulty should be made.

(8) The member is registered as a Futures Commission Merchant and its net capital is less than required by Section 402.1(d) of the Treasury Department rules.

(b) If the Corporation determines that any of the conditions specified in subparagraph (a) of this Explanation exists, it may require that the member take appropriate action by effecting one or more of the following actions until such time as the Corporation determines they are no longer required:

- (1) Promptly pay all free credit balances to customers.
 - (2) Promptly effect delivery to customers of all fully paid securities in the member's possession or control.
 - (3) Introduce all or a portion of its business to another member on a fully disclosed basis.
 - (4) Reduce the size or modify the composition of its inventory.
 - (5) Postpone the opening of new branch offices or require the closing of one or more existing branch offices.
 - (6) Promptly cease making unsecured loans, advances, or other similar receivables, and, as necessary, collect all such loans, advances, or receivables where practicable.
 - (7) Accept no new customer accounts.
 - (8) Undertake an immediate audit by an independent public accountant at the member's expense.
 - (9) Restrict the payment of salaries or other sums to partners, officers, directors, shareholders, or associated persons of the member.
 - (10) Effect liquidating transactions only.
 - (11) Accept unsolicited customer orders only.
 - (12) File special financial and operating reports.
 - (13) Be subject to such other restrictions or take such other actions as the Corporation deems appropriate under the circumstances in the public interest and for the protection of members.
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