

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 50513 / October 12, 2004

Admin. Proc. File No. 3-11405

In the Matter of the Application of

ALLEN DOUGLAS SECURITIES, INC.
c/o Law Offices of Allan M. Lerner
2888 East Oakland Park Blvd.
Ft. Lauderdale, FL 33306

For Review of Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION - REVIEW OF ASSOCIATION
ACTION

Jurisdiction to Review Action of Association

Member firm of registered securities association sought Commission review of association's determination to disapprove certain proposed subordinated loan agreements. Held, the matter is not subject to Commission review because association's determination does not constitute any of the actions subject to review under Section 19(d) of the Securities Exchange Act of 1934. Application for review is therefore dismissed.

APPEARANCES:

Allan M. Lerner, for Allen Douglas Securities, Inc.

Marc Menchel, Alan Lawhead, and Michael J. Garawski, for NASD.

Appeal filed: February 18, 2004
Last brief received: June 9, 2004

I.

Allen Douglas Securities, Inc. ("Allen Douglas" or the "Firm"), an NASD member firm, seeks review of a January 2004 NASD decision to disapprove, pursuant to NASD's authority under Appendix D to the net capital rule ("Appendix D"), 1/ certain subordinated loan agreements ("SLAs"). Allen Douglas proposed to

execute the SLAs with customers and other creditors (the "Claimants") as a method of dealing with the Firm's liabilities in connection with the settlement of several arbitration and other actions that the Claimants had brought against Allen Douglas between 2000 and 2003 (collectively, the "Proceedings"). Allen Douglas hoped that, by executing the SLAs, it would eliminate a net capital deficiency identified by the Commission's staff during an inspection of the Firm in late 2003. NASD contends that Allen Douglas's appeal should be dismissed for lack of jurisdiction. Our findings are based on an independent review of the record.

II.

Background. In November 2003, members of the Commission's staff performed an inspection of the Firm. In the course of that inspection, the staff informed Allen Douglas that, based on the staff's calculations, the Firm had a net capital deficiency of at least \$485,000. 2/ The cause of that deficiency appears to have been, in significant part, liabilities the Firm incurred as a result of its settlement of the Proceedings. As part of the settlement agreements, the Claimants agreed to relinquish their claims against Allen Douglas and look solely to its parent corporation, American Trading and Brokerage, Inc. ("ATB"), for payment. According to Allen Douglas, the Commission's staff took the position that the settlement liabilities should be treated as debt and subtracted from the Firm's assets in calculating net capital, notwithstanding that the Firm had sought to transfer the liabilities to ATB. 3/

1/ 17 C.F.R. § 240.15c3-1d.

2/ The amount of the net capital deficiency found by the Commission staff is not entirely clear from the record. In its Rule 17a-11 filing, discussed below, Allen Douglas stated that its net capital deficiency was \$586,868. In its briefs and other filings in this appeal, Allen Douglas states that its net capital deficiency was approximately \$485,000. Allen Douglas submitted with its petition for review a barely legible copy of a fax transmission of a spreadsheet from the Commission staff. This document appears to show a finding of a negative "net capital" of approximately \$485,000, a "required net capital" amount of approximately \$58,000, and a negative "excess net capital" of approximately \$544,000. For purposes of this appeal, we need not determine the precise amount of the Commission staff's net capital deficiency calculation.

3/ The facsimile transmission discussed in note 2, supra, is the sole item in the record sent by the Commission's staff to Allen Douglas in connection with the staff's inspection of the Firm. It contains no explanation of the basis for

According to Allen Douglas, "the staff indicated that it based its determination" of net capital deficiency on a July 2003 Commission staff interpretative letter (the "Interpretative Letter"). The Interpretative Letter stated, in relevant part, that a broker-dealer must record an expense as its own liability for net capital purposes, even though a third party has agreed to accept responsibility for that expense, unless the broker-dealer demonstrates that the third party has adequate resources independent of the broker-dealer to pay the liability. 4/ Although the Claimants had agreed to look solely to Allen Douglas's parent corporation for payment under the settlement agreements, 5/ ATB (whose sole source of revenue was the compensation it received under a management agreement with Allen Douglas) did not have adequate resources independent of Allen Douglas to pay the settlement liabilities.

While Allen Douglas disputes the reasoning of the Interpretative Letter, it does not dispute that, based on the Interpretative Letter, it had the net capital deficiency that the staff identified. 6/ Following the staff's deficiency determination and at the staff's direction, Allen Douglas gave notice to the Commission of its net capital deficiency, 7/ and

the staff's determination of a net capital deficiency or details explaining Allen Douglas's financial situation at the time.

- 4/ NASD informed its membership of the position taken in the Interpretative Letter in NASD Notice to Members 03-63, which was issued in October 2003.
- 5/ According to an exhibit filed by Allen Douglas with its petition for review, the total amount of these settlement agreements was originally approximately \$743,150. The Commission staff's facsimile transmission discussed above shows a staff finding, under the heading "Arbitrations Payable," of approximately \$588,000, indicating that the Firm had paid off a portion of its liabilities under the settlement agreements by the time of the staff's inspection.
- 6/ According to Allen Douglas, "Without the shift [of the liabilities to ATB], it was clear that the settled claims had no chance of being paid, and the Applicant would have to close its doors." Allen Douglas sought, in other words, to remove the claims from its books so that it could avoid a net capital deficiency and, thus, continue operating.
- 7/ Rule 17a-11 under the Securities Exchange Act of 1934 requires that a broker-dealer that has been notified by the Commission staff of a finding of net capital deficiency provide notice of such deficiency. 17 C.F.R. § 240.17a-11. The Rule permits the broker-dealer to include in its notice its reasons, if any, for disagreeing with the examining

ceased operations.

NASD Proceedings. In an effort to address the staff's deficiency determination and to resume operations, Allen Douglas then proposed to enter into a series of SLAs with the Claimants. 8/ Under a provision of the net capital rule, 9/ indebtedness subordinated to the claims of other creditors pursuant to SLAs approved under Appendix D 10/ is not included in the calculation of a firm's aggregate indebtedness for net capital purposes. Allen Douglas prepared draft SLAs, which it asserts the Claimants were prepared to execute. On January 6, 2004, it submitted these draft SLAs to NASD for its review under Appendix D. 11/ Later that month, NASD notified Allen Douglas that it found the draft SLAs unacceptable. 12/

authority's finding of a net capital deficiency. Allen Douglas noted its objections to the staff's determination in its Rule 17a-11 filing, but ceased operations.

- 8/ According to Allen Douglas, during a December 2003 meeting with Commission staff to discuss the net capital deficiency, Allen Douglas's counsel "suggested that the Registrant might attempt to subordinate the settled claims, and the Staff concurred that was a possibility."
- 9/ 17 C.F.R. § 240.15c3-1(a)(9)(c)(x).
- 10/ Under Appendix D, NASD, as the Firm's Examining Authority, must find SLAs the Firm seeks to enter to be acceptable before the SLAs may become effective. 17 C.F.R. § 240.15c3-1d(i)(6)(i).
- 11/ In an exhibit filed with its petition for review, Allen Douglas states that, as of January 6, 2004, when the SLAs were submitted to NASD for review, the outstanding amount due under the proposed SLAs was approximately \$560,000.
- 12/ Although NASD provided no explanation for its disapproval in its January 30, 2004, disapproval letter, NASD states in its brief that the determination was made because the SLAs were "non-additive subordinated loans" that, according to NASD, would have resulted in no new inflow of capital to the Firm, but rather would have merely restructured the priority of existing obligations. Allen Douglas argues that NASD's decision to disapprove the SLAs was "arbitrary and capricious" because NASD has approved non-additive subordination agreements on other occasions.

III.

Our authority to review an action of a self-regulatory organization ("SRO"), including NASD, is governed by Section 19 of the Exchange Act. 13/ That provision authorizes Commission review of an SRO action that:

- i) imposes any final disciplinary sanction on any member or person associated with a member;
- ii) denies membership or participation to any applicant;
- iii) prohibits or limits any person in respect to access to services offered by such organization or member thereof; or
- iv) bars any person from becoming associated with a member.

Although we have not previously considered the question of whether we can review NASD action disapproving proposed SLAs, we have considered the extent of Commission jurisdiction to hear appeals from other types of SRO actions. Based on those earlier rulings, we conclude that Allen Douglas's appeal does not fall within the categories identified in Section 19(d). 14/

A. Imposition of Disciplinary Sanction. Section 19(d) authorizes Commission review when an SRO, through its disciplinary process, determines to impose a final disciplinary sanction on a member, or on a person associated with a member.

13/ 15 U.S.C. § 78s(d).

14/ Allen Douglas argues that, even if we determine that we lack jurisdiction under Section 19(d), we nevertheless should consider the Firm's appeal because of "its significant import, both as to the actions taken by the NASD, as well as the staff." The cases Allen Douglas cites do not support its argument. Frank R. Rubba, 53 S.E.C. 670 (1998) (finding jurisdiction because NASD action had effect of barring persons from association with member firm); Exchange Services Inc., 48 S.E.C. 210 (1985) (same); David L. Turnipseed, 48 S.E.C. 689 (1987) (finding jurisdiction to review case in which respondent had been censured and suspended for thirty days from association with NASD member firms). While Allen Douglas claims that "extraordinary circumstances . . . justify accepting its application," we have previously rejected an applicant's claim of "compelling reasons" as a basis for review where the appeal did not satisfy the jurisdictional requirements set forth in Section 19(d). Joseph Dillon & Co., Inc., Exchange Act Rel. No. 43523 (Nov. 6, 2000), 73 SEC Docket 2256, 2258 n.5. We see no basis for departing from that precedent here.

That did not happen here. In finding the SLAs unacceptable, NASD did not employ its disciplinary procedures, did not make a determination that Allen Douglas had violated a statute or rule, and did not impose a final disciplinary sanction. 15/ Instead, NASD merely responded to Allen Douglas's request to evaluate the SLAs to determine whether they were acceptable under Appendix D.

In Morgan Stanley & Co., we declined to review an NASD exemption denial involving operation of Municipal Securities Rulemaking Board Rule G-37 because we found, among other things, that the exemption denial did not constitute a "disciplinary sanction." 16/ Although the effect of the exemption denial was that the appealing firm was prohibited from engaging in certain municipal securities business for two years, we concluded that NASD's action was not disciplinary in nature because it did not involve a "determination of wrongdoing." 17/

Similarly, in Joseph Dillon, we declined to find jurisdiction to consider the appeal of a firm that had requested an exemption from NASD Conduct Rule 3010(b)(2) because, among other reasons, NASD's action was not disciplinary in nature. 18/

15/ See Tague Securities Corporation, 47 S.E.C. 743, 745 (1982) (finding no Commission jurisdiction to review Philadelphia Stock Exchange action requiring member firm to make adjustments in certain options trades, in part due to the fact that Exchange did not impose disciplinary sanctions on member firm).

16/ Morgan Stanley & Co., 53 S.E.C. 379, 383 (1997). Rule G-37 prohibits a firm from engaging in certain "municipal securities business" with an issuer for two years following any contribution to an official of such issuer by any municipal finance professional associated with the firm.

17/ Id.

18/ Joseph Dillon, see n.14, supra.

Rule 3010(b)(2) requires any NASD member firm that employs a specified number of registered persons who were, within a specified period, associated with any "disciplined firm" to establish and enforce special telemarketing supervisory procedures, including the taping of customer calls.

Allen Douglas seeks to distinguish its application from cases involving SRO denials of exemptions from the operation of certain rules. See, e.g. Morgan Stanley; Joseph Dillon; Whitehall Wellington Investments, Inc., Exchange Act Rel. No. 44367 (May 30, 2001), 75 SEC Docket 314 (finding no authority for Commission review of NASD denial of taping requirement exemption). Characterizing NASD's action in disapproving the SLAs as, in effect, a determination that Allen Douglas had violated the net capital rule, Allen

As in Morgan Stanley, NASD had made no finding of wrongdoing and did not "employ its disciplinary procedures in reaching its conclusion." 19/

We believe that our decisions in Morgan Stanley and Joseph Dillon govern here. As in those other cases, it was Allen Douglas, not NASD, that initiated the NASD action at issue (review of the SLAs) as a means of addressing a perceived regulatory deficiency and, thereby, a way to continue operating as a broker-dealer without running afoul of regulatory requirements. 20/ In disapproving the SLAs, NASD made no finding of wrongdoing and did not employ its disciplinary procedures, but "merely exercis[ed] the discretionary authority granted it under" Appendix D. 21/

Allen Douglas asserts that we have jurisdiction to consider its appeal because NASD's action was, in its view, "tantamount to a disciplinary sanction." According to Allen Douglas, NASD made it clear that, if the firm resumed operations, Allen Douglas would be subject to disciplinary proceedings for net capital violations. 22/ The possibility, however likely, of Allen

Douglas argues that such SRO action is more serious than a mere denial of an exemption. Allen Douglas contends that NASD's disapproval involved, "either directly or indirectly, the employment of disciplinary procedures and is thus more deserving of review than a mere denial of an exemption." However, as discussed above, NASD never made a determination that Allen Douglas had violated the net capital rule. NASD merely found that the SLAs Allen Douglas proposed to use to address its net capital deficiency were unacceptable under Appendix D.

19/ Joseph Dillon, 73 SEC Docket at 2259 (citations omitted).

20/ We note that the applicants in Morgan Stanley and Joseph Dillon did not dispute that the rules and requirements at issue in those cases applied to them. Allen Douglas, on the other hand, disputes that it was in violation of the net capital rule under the existing settlement agreements with the Claimants, regardless of NASD's disapproval of the SLAs. This distinction between those earlier cases and this proceeding is not determinative with respect to the issue of jurisdiction.

21/ Morgan Stanley, 53 S.E.C. at 382.

22/ The basis for Allen Douglas's claim of NASD's "threat" of disciplinary proceedings is NASD Notice to Members 03-63, which warns that a member firm "may be subject to severe disciplinary sanctions" as a consequence of attempting to move to a third party any unsatisfied arbitration award against the firm in a manner inconsistent with the Interpretative Letter. While the question of whether a firm can shift liability, for net capital purposes, to a third

Douglas becoming subject to disciplinary proceedings does not, by itself, give rise to a right of review under Section 19(d). 23/ In contrast, if Allen Douglas had proceeded with the execution of the SLAs notwithstanding NASD's disapproval, operated as a broker-dealer despite an apparent net capital deficiency, and became subject to an NASD disciplinary sanction as a result, the

party arose in connection with the Commission staff's inspection of Allen Douglas, it does not appear to be relevant to NASD's determination to disapprove the SLAs. 23/ Allen Douglas supports its argument that its appeal implicates the first prong of Section 19(d) by citing our decision in Tower Trading, L.P., Exchange Act Rel. No. 47537 (Mar. 19, 2003), 79 SEC Docket 3189, where we set aside a determination by the Chicago Board Options Exchange ("CBOE") to terminate a member firm's designation as a "Designated Primary Market-Maker" and reallocate its option classes based on a failure to meet performance standards.

Although we based jurisdiction there on a finding that the CBOE's action constituted a denial of access to services - the third prong under Section 19(d) - we expressly declined to find jurisdiction on the basis that the CBOE's determination constituted a disciplinary action. Noting that "we have interpreted the term 'disciplinary' to refer to action responding to an alleged violation . . . or action 'in which a punishment or sanction is sought or intended,'" we concluded that the applicant in that case had not been subject to a disciplinary action because the CBOE's decision was based on performance, not violative activity, and did not result in the imposition of a sanction. 79 SEC Docket at 3195 (citations omitted). Similarly, the NASD action at issue here did not involve any allegation of a violation and did not result in a sanction.

"disciplinary action would be reviewable," 24/ as would relevant issues including the proper calculation of Allen Douglas's net capital. Moreover, although NASD's determination to disapprove the SLAs undoubtedly made it more difficult for Allen Douglas to resume operations as a broker-dealer, we have held that "SRO action is not reviewable merely because it adversely affects the applicant." 25/

B. Other Bases of Jurisdiction. We also conclude that NASD's action does not constitute a denial of membership or participation. NASD's disapproval of the SLAs has no bearing on the Firm's NASD membership status, which is unaffected by NASD's consideration of the SLAs. Allen Douglas asserts that NASD's action in disapproving the SLAs "had the ultimate impact of precluding the participation of the Firm in the business of a securities dealer and a fortiori, participation as a member of

24/ Morgan Stanley, 53 S.E.C. at 383-84.

Allen Douglas argues that it should not be required to risk its license and thus its ability to conduct future business by "playing chicken" with NASD regarding interpretations of the net capital rule. While we are not unsympathetic to Allen Douglas's position, we nevertheless observe that our oversight of SROs is governed by the statutory scheme established by the Exchange Act, and does not extend beyond the authority granted therein. Cf. Tower Trading, 79 SEC Docket at 3194 (noting that, prior to the adoption of Section 19(d), which was enacted as part of the Securities Acts Amendments of 1975, "the Commission did not have authority to review disciplinary or other actions of exchanges").

25/ Joseph Dillon, 73 SEC Docket at 2260 (citations omitted). See also Morgan Stanley, 53 S.E.C. at 383; Lance E. Van Alstyne, 53 S.E.C. 1093, 1098 (1998).

We also observe in this connection that Allen Douglas has been, in certain respects, far less adversely affected by the NASD action at issue than was the applicant firm in Morgan Stanley. The applicant firm's sole means of avoiding the impact of the municipal securities bar at issue in that earlier case was the exemption NASD had denied it and which was the subject of the appeal. Here, by contrast, approval of the SLAs under Appendix D was presumably one of several options available to Allen Douglas to return to net capital compliance and, thereby, resume operations. For example, while Allen Douglas claims that the SLAs constituted the "only alternative open to" the Firm, it appears that the Firm always had (and still has) the option of eliminating any net capital deficiency through a capital contribution or a subordinated loan of cash to the Firm.

the NASD." We disagree.

NASD did not impose any condition or restriction on Allen Douglas's NASD membership or its ability to participate as an NASD member, but merely disapproved a means Allen Douglas had proposed to satisfy its net capital requirement, a requirement imposed by federal law. 26/ Notwithstanding NASD's determination regarding the SLAs, Allen Douglas remains free to participate in NASD as an NASD member and can resume operations as a broker-dealer so long as it, like every other NASD member, is in regulatory compliance.

NASD's action in disapproving the proposed SLAs does not constitute a denial of access to services offered by NASD because it has no impact on Allen Douglas's access to any such service. Allen Douglas argues that the NASD service it was denied was "access to the use of a reasonable subordinated loan agreement as proposed by the Applicant." Under Appendix D, however, NASD is required only to review proposed SLAs, a service that it clearly provided to Allen Douglas in this case.

Decisions in which we have found jurisdiction based on this third prong of Section 19(d) have emphasized the impact that SRO decisions have on members' access to fundamentally important services provided by the SRO. 27/ For example, in Tower Trading and Scattered Corporation, 28/ we held that the termination by an SRO of the member firm's status as a market-maker and the determination not to process a member firm's application for

26/ See, e.g., Morgan Stanley, 53 S.E.C. at 384 (rejecting assertion of jurisdiction under this second prong of Section 19(d) because applicant was "seeking relief from the operation of the rule, not from any condition imposed on its membership by the NASD").

We note that, in Joseph Dillon, we rejected the applicant firm's argument that, in denying its exemption request, NASD had conditioned its membership on the firm's ability to comply with the taping requirement at issue, which the firm claimed it was unable financially to do. Conceding that the costs of compliance might be high, we held there that "[t]he membership of every NASD member is conditioned on the member's continued compliance with NASD rules." 73 SEC Docket at 2261. Similarly, Allen Douglas's ability to function as a broker-dealer is dependent on its ability to satisfy its regulatory requirements; that the costs of doing so may be significant does not alter our conclusion regarding jurisdiction.

27/ Morgan Stanley, 53 S.E.C. at 385.

28/ 52 S.E.C. 812 (1996).

registration as a market-maker, respectively, limited the firms' access to member services by preventing the firms from availing themselves of the guaranteed transaction participation that comes with designated market-maker status. In William J. Higgins, 29/ we granted review under the third prong of Section 19(d) where the New York Stock Exchange denied a member firm's request to install a telephone link to permit direct communication between the trading floor and non-member customers, based on the premise that "[t]he operation of a trading floor and access to that floor is the principal service offered by a national securities exchange to its members, and by its members to investors." 30/ NASD's disapproval of the SLAs did not deny Allen Douglas access to any similar NASD member service.

NASD's action in disapproving the proposed SLAs did not bar any person from becoming associated with Allen Douglas. Allen Douglas does not specifically argue that this fourth prong of Section 19(d) provides a basis for a finding of jurisdiction here. However, in another context, the Firm cites our decisions in Rubba and Exchange Services, both of which found jurisdiction based on this fourth prong of Section 19(d). In those cases, we found that SRO denials of requests for exemptions from examination requirements for registered representatives seeking to become associated with member firms had the effect of barring those persons from becoming associated with those firms. NASD's disapproval of the proposed SLAs here had no similar effect on Allen Douglas or any of its associated persons, all of whom remain free to be associated with the Firm. 31/

29/ 48 S.E.C. 713 (1987).

30/ Id. at 718-19.

31/ Allen Douglas further seeks review of the actions of the Commission's staff in connection with its November 2003 inspection of the Firm, which Allen Douglas describes as "part of an unbroken chain of events leading to the demise of Applicant." While that inspection led to Allen Douglas's determination to cease operations, it did not result in the initiation of administrative proceedings against the Firm. It therefore would not be appropriate for us to review those actions in the context of the adjudicatory process.

Nor would it be appropriate in this proceeding for us to review reasoning contained in the Interpretative Letter, which Allen Douglas claims is "at odds with, and beyond the scope of," the net capital rule. As we previously have observed, staff interpretative letters (like the numerous other written and verbal expressions of views offered to the public by the Commission's staff in various contexts) "do not necessarily reflect the views of the Commission [and] do not have the force of law." Marc N. Geman, Exchange Act Rel. No. 43963 (Feb. 14, 2001), 74 SEC Docket 999, 1020-21

Under the circumstances, we have determined to dismiss Allen Douglas's appeal. 32/

An appropriate order will issue. 33/

By the Commission (Chairman DONALDSON and Commissioners GOLDSCHMID, ATKINS and CAMPOS); Commissioner GLASSMAN not participating.

Jonathan G. Katz

Secretary

n.50 (citing Lowell H. Listrom, 50 S.E.C. 883, 886 n.3 (1992), aff'd, 975 F.2d 866 (8th Cir. 1992)), aff'd, 334 F.3d 1183 (10th Cir. 2003). We have further observed that, "[w]here a conclusion is not dictated by the literal terms of a regulation, the fact that a broker-dealer's conduct does not conform to the standards set forth in a staff no-action or interpretative position does not command the conclusion that the conduct violates the regulation." Listrom, 50 S.E.C. at 886 n. 3. We "'may choose to adopt or reject the staff's previously-stated reasoning with respect to the application of the particular regulation at issue.'" Geman at 1020-21 n.50.

32/ Our determination to dismiss Allen Douglas's appeal should not be construed as indicating that we approve or disapprove the net capital determinations at issue in this case. See discussion in n.31, supra.

33/ We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 50513 / October 12, 2004

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In the Matter of the Application of

ALLEN DOUGLAS SECURITIES, INC.
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ORDER DISMISSING APPLICATION FOR REVIEW OF ACTION OF
REGISTERED SECURITIES ASSOCIATION

On the basis of the Commission's opinion issued this day, it
is

ORDERED that Allen Douglas Securities, Inc.'s petition for
review be, and it hereby is, dismissed.

By the Commission.

Jonathan G. Katz
Secretary