

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52692; File No. SR-NASD-2005-064)

October 28, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Granting Approval of Proposed Rule Change as Amended by Amendment No. 1 Relating to the Publication of Decisions Issued by the National Adjudicatory Council Pursuant to NASD Rule 1015

I. Introduction

On May 12, 2005, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend NASD Interpretive Material 8310-2, “Release of Disciplinary and Other Information Through the Public Disclosure Program” (“IM-8310-2”) to authorize the NASD to release to the public information with respect to any decision issued by the National Adjudicatory Council (“NAC”) pursuant to NASD Rule 1015, “Review of National Adjudicatory Council.”³ The proposed rule change was published for notice and comment in the Federal Register on June 13, 2005 (“Notice”).⁴ The Commission received two comment letters on the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ NASD Rule 1015 is part of the NASD Rule 1010 Series governing membership proceedings. These proceedings involve both the review of new member applications (NASD Rule 1014) and continuing membership applications seeking approval of a change in ownership, control, or business operations (NASD Rule 1017). See infra notes 15-17 and accompanying text.

⁴ See Securities Exchange Act Release No. 51786 (June 6, 2005), 70 FR 34170.

proposal.⁵ On July 26, 2005, the NASD filed a response to comments.⁶ On October 6, 2005, the NASD filed Amendment No. 1 to the proposed rule change.⁷ This order approves the proposed rule change, as amended.

II. Summary of Comments

The Commission received two comment letters on the proposed rule change.⁸ Both commenters opposed the proposed rule change on the general basis that publication of NAC decisions issued under NASD Rule 1015 would infringe on personal rights of privacy and confidentiality by permitting NASD to reveal to the public details concerning private transactions between private individuals. The following is a summary of the major concerns that the commenters raised.

A. Details Concerning Private Transactions Between Private Individuals Will Be Released for Anyone to View

One commenter believes that the proposal to disclose NAC decisions has “crossed the line” where personal rights to privacy would be diminished.⁹ The commenter believes the NASD should not be allowed to publicly reveal private transactions between private individuals and expresses concern that persons appearing before the NAC would have less privacy and

⁵ See letters from James Antosh, Chief Operating Officer and Chief Financial Officer of a privately owned broker-dealer (“Antosh”) dated June 30, 2005 and Joseph W. Mays, Jr., President, Securities Consulting Group, Inc. (“Mays”) dated July 5, 2005, both of which were addressed to Jonathan G. Katz, Secretary, Commission.

⁶ See July 26, 2005 letter from Shirley H. Weiss, Associate General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC (“NASD Response Letter”).

⁷ In Amendment No. 1, NASD made non-substantive changes to clarify the form of the NAC decisions authorized to be released to the public. It is a technical amendment and is not subject to notice and comment.

⁸ See supra note 5.

⁹ See Antosh at 1.

confidentiality than would be afforded in a civil court.¹⁰ The commenter agrees that the public has a right to information when it entrusts its assets to others, but believes that the release of NAC decisions would publicly disclose sensitive details of business transactions, trade secrets, or financial information.¹¹ As a result, the commenter views the consideration for the public's right to information as embodied in this proposal to have "crossed the line."¹²

B. The Release of NAC Decisions Regarding "Associated Persons," as Defined in the NASD Rules, Violates Constitutional Rights to Confidentiality and Privacy

Another commenter expresses disapproval of the proposal because he believes it will result in the disclosure of shareholders of broker-dealers, who are included in the definition of "Associated Person" under the NASD Rules.¹³ The commenter states that the definition of Associated Person has been adjusted by the NASD and the SEC to apply, among others, to

¹⁰ Id.

¹¹ Id.

¹² Id.

¹³ See Mays at 1. The term "Associated Person" means: (1) a natural person registered under NASD Rules; or (2) a sole proprietor, or any partner, officer, director, branch manager of the Applicant, or any person occupying a similar status or performing similar functions; (3) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the Applicant; (4) any employee of the Applicant, except any person whose functions are solely clerical or ministerial; (5) any person directly or indirectly controlling the Applicant whether or not such person is registered or exempt from registration under NASD By-laws or NASD Rules; (6) any person engaged in investment banking or securities business controlled directly or indirectly by the Applicant whether such person is registered or exempt from registration under NASD By-laws or NASD Rules; or (7) any person who will be or is anticipated to be a person described in (1) through (6) above. See NASD Rule 1011(b).

The term "Applicant" means a person that applies for membership in the Association under NASD Rule 1013 or a member that files an application for approval of a change in ownership, control, or business operations under NASD Rule 1017. See NASD Rule 1011(a).

The term "Association" means, collectively, the NASD, NASD Regulation, Nasdaq, and NASD Dispute Resolution. See NASD Rule 0120(b).

individuals or entities that are non-employee shareholders of an Applicant broker-dealer who do not “supervise, manage or direct the activities of the broker-dealer or are members of the board of directors.”¹⁴ The commenter further explains that because such shareholders are included in the NASD’s formal consideration of a broker-dealer’s application for membership¹⁵ or a broker-dealer’s application for approval of a change in ownership, control, or business operations,¹⁶ the information concerning such shareholders would be incorporated into any NAC decision if such Applicant broker-dealer elects to appeal the NASD decision in accordance with NASD Rule 1015.¹⁷

As a result, the commenter believes that the release of information in NAC decisions, as contemplated by the proposed rule change, would reveal confidential information regarding non-employee shareholders and concludes that release of the information should not be permitted.¹⁸ The commenter argues that, as a consequence of the proposal, such shareholders would be denied their “constitutional rights” to confidentiality and privacy, and the release of information regarding such shareholders would directly violate federal and state law pertaining to the protection of confidentiality and privacy generally afforded to individuals and legal entities.¹⁹

¹⁴ See Mays at 1.

¹⁵ See NASD Rule 1014.

¹⁶ See NASD Rule 1017.

¹⁷ Under NASD Rule 1015, an aggrieved Applicant may file a written request for NAC review of the NASD’s decision issued under NASD Rules 1014 or 1017. See generally NASD Rule 1015.

¹⁸ See Mays at 1. The NAC’s decision will include a description of the NASD’s decision, including its rationale, a description of the principal issues raised, a summary of the evidence, a statement as to whether the NASD’s decision is affirmed, modified, or reversed, and a rationale for the decision that references the applicable standards. See NASD Rule 1015(j).

¹⁹ See Mays at 1.

III. NASD's Response to Comments

On July 26, 2005, the NASD responded to the comments.²⁰ As a general preface, the NASD first notes in its response that disclosure of NAC decisions under the proposed rule change would not involve every application for NASD membership, but would be limited to those applications that culminate in appeal proceedings before the NAC.²¹

Regarding a commenter's concern that the proposed rule change would result in the disclosure of details concerning private transactions between private individuals, the NASD argues that the attendant disclosure of an Applicant's proposed or executed business arrangements or transactions with other persons must be balanced against the public's interest in being able to review the NAC decisions.²² The NASD states that furnishing potential new members and members that are considering a change in ownership, control, or business operations the opportunity to review the NAC decisions issued under NASD Rule 1015 will assist Applicants in understanding the standards that must be met under NASD Rule 1014 or 1017, as the case may be, and the manner in which the NAC applies the standards.²³ Additionally, the NASD believes that public investors will benefit from the availability of information about any limitations placed on members, where the limitations result from proceedings before the NAC.²⁴ As stated in the Notice, the NASD represents that under the proposed rule change, the names of any persons who are not themselves under consideration or review as part of the membership application process will not be disclosed when the NAC

²⁰ See supra note 6.

²¹ See NASD Response Letter at 1.

²² See id.

²³ Id. at 1-2.

²⁴ Id. at 2.

decision is published.²⁵ Finally, the NASD notes that the information contained in NAC decisions is already subject to publication if an Applicant appeals an adverse NAC decision to the SEC, “because the SEC makes its decision in such matters available to the public, including on the SEC’s web site.”²⁶

In response to a commenter’s concern that the NASD should not be permitted to release information about persons who may be non-employee shareholders of a broker-dealer, the NASD notes that it is not aware of any cognizable constitutional or statutory claim that pertains to the violation of protected rights to confidentiality and privacy.²⁷ The NASD acknowledges that as a self-regulatory organization, it must comport with its duty of fairness. The NASD argues that the proposed rule change is consistent with this duty and furthers a “reasonable regulatory purpose.”²⁸

Under this proposed rule change, the NASD explains that the shareholders of broker-dealers who are not otherwise employed by the broker-dealer or engaged in the broker-dealer’s business will be on notice that their names will be subject to release to the public if they meet the definition of Associated Person in NASD Rule 1011(b) and the Applicant appeals an adverse decision to the NAC.²⁹ The NASD states that shareholder status, alone, would not trigger disclosure under the proposed rule change. Rather, an individual or entity who is not registered with the NASD or otherwise engaged in the broker-dealer’s business would meet the definition of Associated Person only if the individual or entity “directly or indirectly controls the

²⁵ Id.

²⁶ Id.

²⁷ Id.

²⁸ Id.

²⁹ Id.

applicant.”³⁰ The NASD states that the definition of Associated Person excludes passive investors who are not control persons of the broker-dealer, such as non-employee shareholders and shareholders who are otherwise not directly engaged in the broker-dealer’s business.³¹

Finally, the NASD argues that information about control persons can be a critical part of its consideration of membership applications and applications in connection with a member’s change of ownership, control or business operations.³² The NASD believes that, in the interest of protecting investors and serving the public interest, when the NAC’s decisions are based on information regarding an Applicant’s control persons, public investors and current members should be allowed to review such information.³³

IV. Discussion and Commission Findings

The Commission has carefully reviewed the proposed rule change, as amended, the comment letters, and the NASD Response Letter, and finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association³⁴ and, in particular, Section 15A(b)(6) of the Act.³⁵ Section 15A(b)(6) requires, among other things, that the rules of a national securities association be

³⁰ Id. See also NASD Rule 1011(b). The Commission notes that a broker-dealer’s information reported on Form BD (Uniform Application for Broker-Dealer Registration), which may include information about a person(s) who directly or indirectly controls the broker-dealer, is publicly available.

³¹ Id. The NASD represents that it would consider certain information concerning lenders of 5% or more of the Applicant’s net capital in determining whether the Applicant meets all standards for admission, a change in ownership or control, or a material change in its business operations. See id.

³² Id.

³³ Id.

³⁴ In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³⁵ 15 U.S.C.78o-3(b)(6).

designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The Commission finds that the proposal to amend IM-8310-2 to give NASD authority to release to the public information with respect to any decision issued by the NAC pursuant to NASD Rule 1015 is consistent with Section 15A(b)(6) of the Act. The Commission believes that the proposal is reasonably designed to (i) allow potential new NASD members and current members considering a change in ownership, control, or business operations to better understand the standards that must be met under NASD Rule 1014 or 1017, as the case may be, and the manner in which such standards are applied; and (ii) afford the general public, including public investors, the opportunity to be better informed of the membership process and the rationale behind the NAC's decision-making, particularly with respect to those instances in which the NAC issues an adverse decision.

Based on the NASD's representations, the Commission believes the proposed rule change will not unreasonably infringe on rights of privacy or confidentiality by permitting the NASD to publish detailed information with respect to decisions issued by the NAC. With regard to a commenter's assertions that the proposal will reveal to the public details concerning private transactions between private persons, the Commission believes that, after weighing the negative impact of public disclosure of such transactions against the positive impact of enhanced knowledge of the NASD standards of NASD Rules 1014 and 1017, the publication of NAC decisions would promote just and equitable principles of trade by allowing current NASD members, potential NASD members, and the general public equal access to, and a better understanding of, the specific application and interpretation of such standards. The Commission believes that public investors will benefit from the availability of information about any adverse

decisions against Applicants and limitations placed on members, where such adverse decisions and limitations are a result of proceedings before the NAC, because the factors that are instrumental in the granting of membership or the expansion of business activities will be articulated in the decisions and made available to the public as a result of the proposed rule change. With respect to NAC decisions involving applications for NASD membership, reviewed pursuant to NASD Rule 1014, or applications for a change in ownership, control, or business operations, reviewed pursuant to NASD Rule 1017, the Commission further notes that access to such decisions would not only benefit future Applicants in the application process, but would also promote efficiency by deterring meritless appeals, and foster consistency by assisting the NASD in its review of such applications and serve as useful precedent for future NAC decisions. Finally, the Commission recognizes that the information contained in the NAC decisions is already subject to publication if an Applicant appeals an adverse NAC decision to the Commission because the Commission makes its decisions in such matters available to the public. The Commission believes that the public availability of such information furthers the goals outlined in Section 15A(b)(6) of the Act by making more transparent NASD's rules and regulations, and promoting the coordination of an unimpeded flow of information that encourages a free and open market for investors and the general public.

Regarding a commenter's assertion that the proposal permits the improper disclosure of non-employee shareholders of a broker-dealer not engaged in the management of such broker-dealer's business because such shareholders would be included within the definition of Associated Person in NASD Rule 1011(b), the Commission believes the NASD has adequately responded to this concern.³⁶ Additionally, as Amendment No. 1 to the proposed rule change

³⁶ See supra notes 30-31 and accompanying text.

clarifies, in the interest of protecting privacy, the NAC decisions will not routinely publish the names of persons who are not themselves under consideration or review as part of the application process.³⁷ Finally, the Commission believes that the proposed rule change furthers a legitimate regulatory purpose and does not implicate constitutional scrutiny or violate any cognizable federal or state statute related to the protection of confidentiality and privacy.

With regard to all other issues raised by the commenters, the Commission is satisfied that the NASD has adequately and accurately addressed the commenters' concerns.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act³⁸, that the proposed rule change (SR-NASD-2005-064) be, and it hereby is, approved, as amended.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁹

Jonathan G. Katz
Secretary

³⁷ See supra note 7.

³⁸ 15 U.S.C. 78s(b)(2).

³⁹ 17 CFR 200.30-3(a)(12).