

## *NASD Adds Obstacles to Brokerage Firm Asset Transfers*

In an effort to protect customers, the regulators have changed the rules for brokerage firm reorganizations when those reorganizations involve the transfer of assets from one firm to another or to a new entity. That is good news for customers; it also is good news for reps with arbitration awards against them.

Why? While the NASD recognizes that asset transfers may be a legitimate means by which to transfer ownership and control, the NASD expressed to the SEC (in SR-NASD-2003-07) that it was concerned with the recent increase in company restructurings. Indeed, the NASD noted that it had encountered “several instances” where the effect of the asset transfer was to insulate the brokerage firm and its owners from arbitration awards. Where does that leave the rep who has been named in an arbitration claim or arbitration award? Holding the bag, unable to obtain such insulation!

The problem for customers, in the eyes of the regulators, and reps, is more pronounced when brokerage firms and their owners choose to transfer only the assets and not the liabilities. According to the NASD, this action “may transform the firm from an operating business that can generate value over time to a shell holding the firm’s liquidated value, leaving customers with arbitration claims pending against, or arbitration awards unsatisfied, by a firm.” Accordingly, the NASD rule changes are designed to make the brokerage firm and its owners “account for pending arbitrations and customer claims.”

The NASD’s rule changes, approved by the SEC in Litigation Release 34-48969, affect three rules: Rule 1011, Rule 1014 and Rule 1017. Let’s examine the changes in each of these rules to explore what obstacles lie ahead for firms and owners seeking to transfer assets.

The NASD made three changes to Rule 1017, which requires regulatory approval of certain changes in ownership, control or business operations. First, the rule did not apply to transfers of assets, just to acquisitions. That has been changed to include asset transfers. Second, the approval requirement did not apply unless the acquisition involved “substantially all” of the firm’s assets. The new rule reduces that amount, requiring regulatory approval when “25% of more in the aggregate of the member’s assets or any asset, business or line of operation that generates revenues comprising 25% or more in the aggregate of the member’s earnings measured on a rolling 36-month basis.” The third change to Rule 1017 eliminates the exemption from regulatory approval when the acquiring brokerage firm is a member of the New York Stock Exchange.

The NASD also amended Rule 1014, which delineates the factors that the NASD will consider in approving or denying a membership application. Before the rule changes, the NASD could consider pending and past regulatory actions. The new rule “allows the NASD to consider pending arbitrations or civil actions against the applicant, as well as unpaid arbitration awards, or other adjudicated customer awards against the

applicant and other persons who may have significant control or influence over the applicant.” Those who have significant control or influence would include registered reps. Specifically, the NASD considers those with significant control or influence to include “the applicant’s controlling persons, principals, registered representatives, other Associated Persons, any lender or 5% or more of the applicant’s net capital, and any other member with respect to which these persons were a controlling person or a 5% lender of the applicant’s net capital.”

Furthermore, there will be a “rebuttable presumption” that a membership application should be denied when the applicant has committed the “negative events” enumerated in Rule 1014(a)(3)(A), (C), (D) and (E). These negative events include unpaid arbitration awards and settlements as well as adjudicated customer awards. These negative events also include registered reps who have been terminated for cause or permitted to resign after an alleged violation of securities laws regulations, rules, industry standards or conduct.

Third, Rule 1011 has been altered to include, for membership purposes, non-natural persons (that is, corporate entities) as coming within the definition of “Associated Person.” In its release approving the NASD rule changes, the SEC commented that the inclusion of such “persons” should permit the NASD to “examine a broader range of entities that potentially control an applicant, and thereby ensure that its ability to assess the applicant and the applicant’s business history are not unnecessarily restricted.”

In all, these changes not only will help the NASD “strengthen its ability to protect investors with pending claims, awards or judgments against NASD members” but otherwise to “detect and prevent misconduct.” Customers, and reps with claims and awards against them, should be pleased!