

Special Notice to Members

JUNE 23, 2003

SUGGESTED ROUTING

Legal & Compliance
Senior Management

INFORMATIONAL

Temporary Cease and Desist Orders

SEC Approves NASD Rule Change Giving NASD Authority to Issue and Enforce Temporary Cease and Desist Orders

KEY TOPICS

Cease and Desist Proceedings and Orders

Executive Summary

On May 23, 2003, the Securities and Exchange Commission (SEC) approved an NASD proposed rule change that gives NASD the authority to impose and enforce temporary cease and desist orders for alleged violations of specified securities laws and NASD rules.¹ The rule change also makes explicit NASD's authority to impose and enforce permanent cease and desist orders as a remedy in disciplinary cases. The SEC approved the rule change on a trial basis for a two-year period.² The new rule text is contained in Attachment A and is effective as of the date of this *Notice to Members (Notice)*.

Questions/Further Information

Questions regarding this *Notice* may be directed to James S. Wrona, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8270.

Background

In the past, NASD rules did not provide NASD staff with the means to respond rapidly to curtail certain types of serious misconduct by NASD members and associated persons. NASD's only means of addressing such situations was to prosecute a normal disciplinary action, a process that could take months to complete. In some instances, members or associated persons continued to engage in misconduct during the interim. In others, the members' or associated persons' financial condition significantly deteriorated.

In either case, there was a significant risk that the investing public could be further harmed while the disciplinary action was adjudicated.

The rule change described in this *Notice* will allow NASD to address such situations quickly and effectively. It establishes procedures that enable NASD to issue temporary cease and desist orders and makes explicit NASD's ability to impose permanent cease and desist orders as a remedy in disciplinary cases. The rule change also gives NASD authority to initiate non-summary proceedings when respondents violate temporary or permanent cease and desist orders. The rule change will expire in two years from the date of this *Notice* unless it is renewed by NASD with SEC approval.

The rule change includes a number of procedural checks and safeguards to ensure that cease and desist proceedings are used prudently, sparingly, and fairly. NASD, for instance, may institute such proceedings only with the written authorization of the President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs. This provision ensures that such decisions are made at the highest NASD staff levels. In addition, NASD may initiate temporary cease and desist proceedings only for alleged violations of specified securities laws and NASD rules.³

After the President or Executive Vice President authorizes the initiation of a temporary cease and desist proceeding, NASD's prosecuting staff must file a notice with NASD's Office of Hearing Officers (OHO) and serve it on the respondent. The notice must set forth the rule or law that NASD staff alleges the respondent has violated (or is violating),

contain a declaration of facts that specifies the acts or omissions that constitute the alleged violation, and include a proposed order that contains the required elements of a temporary cease and desist order. In addition, if NASD staff has not already issued a complaint under NASD Rule 9211 against the respondent relating to the subject matter of the temporary cease and desist proceeding, NASD staff must serve the complaint with the notice initiating the temporary cease and desist proceeding.

Respondents also are entitled to a hearing before an OHO hearing panel prior to the issuance of a cease and desist order. Moreover, before a hearing panel can issue such an order, it must find, by a preponderance of the evidence, that the respondent committed the alleged violation and that the violative conduct, or its continuation, is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the disciplinary proceeding under the Rule 9200 and 9300 Series.

If the hearing panel issues a temporary cease and desist order, the order will generally remain in effect until the conclusion of the underlying disciplinary proceeding. Furthermore, in any disciplinary proceeding for which a temporary cease and desist order has been issued, the hearing in the companion disciplinary matter will be held and the decision issued at the earliest possible time. If a respondent believes the companion disciplinary proceeding is not being conducted on an expedited basis, the respondent may petition the hearing panel to have the order modified, set aside, limited, or suspended. In addition, the respondent

may seek to challenge a temporary cease and desist order by filing an application for review with the SEC pursuant to Section 19 of the Securities Exchange Act of 1934.⁴

The rule change also provides hearing panels the explicit authority to issue permanent cease and desist orders as a remedy in disciplinary proceedings. In addition, the rule change provides NASD with a mechanism to enforce both temporary and permanent cease and desist orders. NASD may suspend or cancel a respondent's membership or association if, after a non-summary proceeding under the Rule 9510 Series, an OHO hearing panel determines that the respondent violated the cease and desist order.⁵

In sum, this rule change provides NASD with a mechanism to take appropriate remedial action against a member or an associated person that has engaged (or is engaging) in violative conduct that could cause continuing harm to the investing public if not addressed expeditiously. At the same time, the rule change contains numerous procedural protections for respondents to ensure that the proceedings are fair.

Endnotes

- 1 Exchange Act Release No. 47925 (May 23, 2003) (File No. SR-NASD-98-80), 68 Federal Register 33548 (June 4, 2003). The rule change authorizes NASD to initiate cease and desist proceedings for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder; Rules 15c-1 through 15c-9 under the Exchange Act; or NASD Rules 2110, 2120 or 2330. With regard to alleged violations of NASD rules, the rule change is further limited. For NASD Rule 2110, governing standards of commercial honor and just and equitable principles of trade, the alleged violations are limited to violations of Section 17(a) of the Securities Act of 1933 or circumstances involving unauthorized trading or misuse or conversion of customer assets. For NASD Rule 2330, governing members' use of customers' securities or funds, the alleged violations are limited to circumstances involving misuse or conversion of customer assets.
- 2 The temporary cease and desist order pilot will expire two years after the effective date indicated in this *Notice to Members* unless NASD seeks and obtains SEC approval to extend or permanently adopt the proposal.
- 3 See *supra* note 1.
- 4 A respondent's application to challenge an order, however, will not stay the effectiveness of the order, unless the SEC orders otherwise.
- 5 The President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs must provide written authorization before NASD prosecuting staff can institute a proceeding to suspend or cancel a respondent's association or membership for violating an order.

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ATTACHMENT A

New language is underlined and deletions are in brackets.

Text of Rule Change

Sanctions

8310. Sanctions for Violation of the Rules

(a) Imposition of Sanction

After compliance with the Rule 9000 Series, the Association may impose one or more of the following sanctions on a member or person associated with a member for each violation of the federal securities laws, rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or Rules of the Association, or may impose one or more of the following sanctions on a member or person associated with a member for any neglect or refusal to comply with an order, direction, or decision issued under the Rules of the Association:

(1) through (4) No Change.

(5) suspend or bar a member or person associated with a member from association with all members; [or]

(6) [impose any other fitting sanction.] impose a temporary or permanent cease and desist order against a member or a person associated with a member; or

(7) impose any other fitting sanction.

(b) No Change.

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IM-8310-2. Release of Disciplinary Information

(a) through (c) No Change.

(d) (1) The Association shall release to the public information with respect to any disciplinary decision issued pursuant to the Rule 9000 Series imposing a suspension, cancellation or expulsion of a member; or suspension or revocation of the registration of a person associated with a member; or suspension or barring of a member or person associated with a member from association with all members; or imposition of monetary sanctions of \$10,000 or more upon a member or person associated with a member; or containing an allegation of a violation of a Designated Rule; and may also release such information with respect to any disciplinary decision or group of decisions that involve a significant policy or enforcement determination where the release of information is deemed by the President of NASD Regulation, Inc. to be in the public interest. The Association also may release to the public information with respect to any disciplinary decision issued pursuant to the Rule 8220 Series imposing a suspension or cancellation of the member or a suspension of the association of a person with a member, unless the National Adjudicatory Council determines otherwise. The National Adjudicatory Council may, in its discretion, determine to waive the requirement to release information with respect to a disciplinary decision under those extraordinary circumstances where the release of such information would violate fundamental notions of fairness or work an injustice. The Association also shall release to the public information with respect to any temporary cease and desist order issued pursuant to the Rule 9800 Series. The Association may release to the public information on any other final, litigated, disciplinary decision issued pursuant to the Rule 8220 Series or Rule 9000 Series, not specifically enumerated in this paragraph, regardless of sanctions imposed, so long as the names of the parties and other identifying information is redacted.

(A) through (B) No Change.

(2) No Change.

(e) through (l) No Change.

* * * * *

9120. Definitions

(a) through (w) No Change.

(x) "Party"

With respect to a particular proceeding, the term "Party" means:

in the Rule 9200 Series, [and] the Rule 9300 Series, and the Rule 9800 Series, the Department of Enforcement or the Department of Market Regulation or a Respondent;

(2) No Change.

(y) through (cc) No Change.

* * * * *

9240. Pre-Hearing Conference and Submission

9241. Pre-Hearing Conference

(a) through (b) No Change.

(c) Subjects to be Discussed

At a pre-hearing conference, the Hearing Officer shall schedule an expedited proceeding as required by Rule 9290, and may consider and take action with respect to any or all of the following:

(1) through (10) No Change.

(d) through (f) No Change.

* * * * *

9290. Expedited Disciplinary Proceedings

For any disciplinary proceeding, the subject matter of which also is subject to a temporary cease and desist proceeding initiated pursuant to Rule 9810 or a temporary cease and desist order, hearings shall be held and decisions shall be rendered at the earliest possible time. An expedited hearing schedule shall be determined at a pre-hearing conference held in accordance with Rule 9241.

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9310. Appeal to or Review by National Adjudicatory Council

9311. Appeal by Any Party; Cross-Appeal

(a) No Change.

(b) Effect

An appeal to the National Adjudicatory Council from a decision issued pursuant to Rule 9268 or Rule 9269 shall operate as a stay of that decision until the National Adjudicatory Council issues a decision pursuant to Rule 9349 or, in cases called for discretionary review by the NASD Board, until a decision is issued pursuant to Rule 9351. Any such appeal, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order.

(c) through (f) No Change.

9312. Review Proceeding Initiated By National Adjudicatory Council

(a) No Change.

(b) Effect

Institution of review by a member of the National Adjudicatory Council on his or her own motion, a member of the Review Subcommittee on his or her own motion, or the General Counsel, on his or her own motion, shall operate as a stay of a final decision issued pursuant to Rule 9268 or Rule 9269 as to all Parties subject to the notice of review, until the National Adjudicatory Council issues a decision pursuant to Rule 9349, or, in cases called for discretionary review by the NASD Board, until a decision is issued pursuant to Rule 9351. Institution of any such review, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order.

(c) through (d) No Change.

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9360. Effectiveness of Sanctions

Unless otherwise provided in the decision issued under Rule 9349 or Rule 9351, a sanction (other than a bar, [or] an expulsion, or a permanent cease and desist order) specified in a decision constituting final disciplinary action of the Association for purposes of SEC Rule 19d-1(c)(1) shall become effective on a date to be determined by Association staff. A bar, [or] an expulsion, or a permanent cease and desist order shall become effective upon service of the decision constituting final disciplinary action of the Association, unless otherwise specified therein. The Association shall serve the decision on a Respondent by courier, facsimile or other means reasonably likely to obtain prompt service when the sanction is a bar, [or] an expulsion, or a permanent cease and desist order.

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9511. Purpose and Computation of Time

(a) Purpose

The Rule 9510 Series sets forth procedures for: (1) summary proceedings authorized by Section 15A(h)(3) of the Act; and (2) non-summary proceedings to impose (A) a suspension or cancellation for failure to comply with an arbitration award or a settlement agreement related to an arbitration or mediation pursuant to Article VI, Section 3 of the NASD By-Laws; (B) a suspension or cancellation of a member, or a limitation or prohibition on any member, associated person, or other person with respect to access to services offered by the Association or a member thereof, if the Association determines that such member or person does not meet the qualification requirements or other prerequisites for such access or such member or person cannot be permitted to continue to have such access with safety to investors, creditors, members, or the Association; [or] (C) an advertising pre-use filing requirement; or (D) a suspension or cancellation of the membership of a member or the registration of a person for failure to comply with a permanent cease and desist order entered pursuant to a decision issued under the Rule 9200 Series or Rule 9300 Series or a temporary cease and desist order entered pursuant to a decision issued under the Rule 9800 Series.

(b) No Change.

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9513. Initiation of Non-Summary Proceeding

(a) Notice

Association staff may initiate a proceeding authorized under Rule 9511(a)(2)(A) or (B), by issuing a written notice to the member, associated person, or other person. Association staff may initiate a proceeding authorized under Rule 9511(a)(2)(D), after receiving written authorization from the President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs, by issuing a written notice to the member or associated person. The notice shall specify the grounds for and effective date of the cancellation, suspension, bar, limitation, or prohibition and shall state that the member, associated person, or other person may file a written request for a hearing under Rule 9514. In addition, if the proceeding is authorized under Rule 9511(a)(2)(D), the notice shall specifically identify the provision of the permanent or temporary cease and desist order that is alleged to have been violated, and shall contain a statement of facts specifying the alleged violation. The notice shall be served by facsimile or overnight commercial courier.

(b) Effective Date

For any cancellation or suspension pursuant to Rule 9511(a)(2)(A), the effective date shall be at least 15 days after service of the notice on the member or associated person. For any action pursuant to Rule 9511(a)(2)(B) or (D), the effective date shall be at least seven days after service of the notice on the member or person, except that the effective date for a notice of a limitation or prohibition on access to services offered by the Association or a member thereof with respect to services to which the member, associated person, or other person does not have access shall be upon receipt of the notice.

(c) No Change.

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9800. TEMPORARY CEASE AND DESIST ORDERS

(The entire Rule 9800 Series, and related amendments adopted by SR-NASD-98-80 to Rule 8310, IM-8310-2(d)(1), 9120(x), 9241(c), 9290, 9311(b), 9312(b), 9360, 9511(a), 9513(a) and 9513(b) shall expire on June 23, 2005, unless extended or permanently adopted by the Association pursuant to SEC approval at or before such date.)

9810. Initiation of Proceeding

(a) Department of Enforcement or Department of Market Regulation

With the prior written authorization of the President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs, the Department of Enforcement or the Department of Market Regulation may initiate a temporary cease and desist proceeding with respect to alleged violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder; SEC Rules 15g-1 through 15g-9; NASD Rule 2110 (if the alleged violation is unauthorized trading, or misuse or conversion of customer assets, or based on violations of Section 17(a) of the Securities Act of 1933); NASD Rule 2120; or NASD Rule 2330 (if the alleged violation is misuse or conversion of customer assets). The Department of Enforcement or the Department of Market Regulation shall initiate the proceeding by serving a notice on a member or associated person (hereinafter "Respondent") and filing a copy thereof with the Office of Hearing Officers. The Department of Enforcement or the Department of Market Regulation shall serve the notice by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Department of Enforcement or the Department of Market Regulation shall send an additional copy of the notice by overnight commercial courier. The notice shall be effective upon service.

(b) Contents of Notice

The notice shall set forth the rule or statutory provision that the Respondent is alleged to have violated and that the Department of Enforcement or the Department of Market Regulation is seeking to have the Respondent ordered to cease violating. The notice also shall state whether the Department of Enforcement or the Department of Market Regulation is requesting the Respondent to be required to take action or to refrain from taking action. The notice shall be accompanied by:

(1) a declaration of facts, signed by a person with knowledge of the facts contained therein, that specifies the acts or omissions that constitute the alleged violation; and

(2) a proposed order that contains the required elements of a temporary cease and desist order (except the date and hour of the order's issuance), which are set forth in Rule 9840(b).

(c) Filing of Underlying Complaint

If the Department of Enforcement or the Department of Market Regulation has not issued a complaint under Rule 9211 against the Respondent relating to the subject matter of the temporary cease and desist proceeding and alleging violations of the rule or statutory provision specified in the notice described in paragraph (b), the Department of Enforcement or the Department of Market Regulation shall serve and file such a complaint with the notice initiating the temporary cease and desist proceeding.

9820. Appointment of Hearing Officer and Hearing Panel

(a) As soon as practicable after the Department of Enforcement or the Department of Market Regulation files a copy of the notice initiating a temporary cease and desist proceeding with the Office of Hearing Officers, the Chief Hearing Officer shall assign a Hearing Officer to preside over the temporary cease and desist proceeding. The Chief Hearing Officer shall appoint two Panelists to serve on a Hearing Panel with the Hearing Officer. The Panelists shall be current or former Governors, Directors, or National Adjudicatory Council members, and at least one Panelist shall be an associated person.

(b) If at any time a Hearing Officer or Hearing Panelist determines that he or she has a conflict of interest or bias or circumstances otherwise exist where his or her fairness might reasonably be questioned, or if a Party files a motion to disqualify a Hearing Officer or Hearing Panelist, the recusal and disqualification proceeding shall be conducted in accordance with Rules 9233 and 9234, except that:

(1) a motion seeking disqualification of a Hearing Officer or Hearing Panelist must be filed no later than 5 days after the later of the events described in paragraph (b) of Rules 9233 and 9234; and

(2) the Chief Hearing Officer shall appoint a replacement Panelist using the criteria set forth in paragraph (a) of this Rule.

9830. Hearing

(a) When Held

The hearing shall be held not later than 15 days after service of the notice and filing initiating the temporary cease and desist proceeding, unless otherwise extended by the Hearing Officer with the consent of the Parties for good cause shown. If a Hearing Officer or Hearing Panelist is recused or disqualified, the hearing shall be held not later than five days after a replacement Hearing Officer or Hearing Panelist is appointed.

(b) Service of Notice of Hearing

The Office of Hearing Officers shall serve a notice of date, time, and place of the hearing on the Department of Enforcement or the Department of Market Regulation and the Respondent not later than seven days before the hearing, unless otherwise ordered by the Hearing Officer. Service shall be made by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Office of Hearing Officers shall send an additional copy of the notice by overnight commercial courier. The notice shall be effective upon service.

(c) Authority of Hearing Officer

The Hearing Officer shall have authority to do all things necessary and appropriate to discharge his or her duties as set forth under Rule 9235.

(d) Witnesses

A person who is subject to the jurisdiction of the Association shall testify under oath or affirmation. The oath or affirmation shall be administered by a court reporter or a notary public.

(e) Additional Information

At any time during its consideration, the Hearing Panel may direct a Party to submit additional information. Any additional information submitted shall be provided to all Parties at least one day before the Hearing Panel renders its decision.

(f) Transcript

The hearing shall be recorded by a court reporter and a written transcript thereof shall be prepared. A transcript of the hearing shall be available to the Parties for purchase from the court reporter at prescribed rates. A witness may purchase a copy of the transcript of his or her own testimony from the court reporter at prescribed rates. Proposed corrections to the

transcript may be submitted by affidavit to the Hearing Panel within a reasonable time determined by the Hearing Panel. Upon notice to all the Parties to the proceeding, the Hearing Panel may order corrections to the transcript as requested or sua sponte.

(g) Record and Evidence Not Admitted

The record shall consist of the notice initiating the proceeding, the declaration, and the proposed order described in Rule 9810(b); the transcript of the hearing; all evidence considered by the Hearing Panel; and any other document or item accepted into the record by the Hearing Officer or the Hearing Panel. The Office of Hearing Officers shall be the custodian of the record. Proffered evidence that is not accepted into the record by the Hearing Panel shall be retained by the custodian of the record until the date when the NASD's decision becomes final or, if applicable, upon the conclusion of any review by the Commission or the federal courts.

(h) Failure to Appear at Hearing

If a Respondent fails to appear at a hearing for which it has notice, the allegations in the notice and accompanying declaration may be deemed admitted, and the Hearing Panel may issue a temporary cease and desist order without further proceedings. If the Department of Enforcement or Department of Market Regulation fails to appear at a hearing for which it has notice, the Hearing Panel may order that the temporary cease and desist proceeding be dismissed.

9840. Issuance of Temporary Cease and Desist Order by Hearing Panel

(a) Basis for Issuance

The Hearing Panel shall issue a written decision stating whether a temporary cease and desist order shall be imposed. The Hearing Panel shall issue the decision not later than ten days after receipt of the hearing transcript, unless otherwise extended by the Hearing Officer with the consent of the Parties for good cause shown. A temporary cease and desist order shall be imposed if the Hearing Panel finds:

(1) by a preponderance of the evidence that the alleged violation specified in the notice has occurred; and

(2) that the violative conduct or continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding under the Rule 9200 and 9300 Series.

(b) Content, Scope, and Form of Order

A temporary cease and desist order shall:

(1) be limited to ordering a Respondent to cease and desist from violating a specific rule or statutory provision, and, where applicable, to ordering a Respondent to cease and desist from dissipating or converting assets or causing other harm to investors;

(2) set forth the alleged violation and the significant dissipation or conversion of assets or other significant harm to investors that is likely to result without the issuance of an order;

(3) describe in reasonable detail the act or acts the Respondent is to take or refrain from taking; and

(4) include the date and hour of its issuance.

(c) Duration of Order

A temporary cease and desist order shall remain effective and enforceable until the issuance of a decision under Rule 9268 or Rule 9269.

(d) Service

The Office of Hearing Officers shall serve the Hearing Panel's decision and any temporary cease and desist order by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Office of Hearing Officers shall send an additional copy of the Hearing Panel's decision and any temporary cease and desist order by overnight commercial courier. The temporary cease and desist order shall be effective upon service.

9850. Review by Hearing Panel

At any time after the Office of Hearing Officers serves the Respondent with a temporary cease and desist order, a Party may apply to the Hearing Panel to have the order modified, set aside, limited, or suspended. The application shall set forth with specificity the facts that support the request. The Hearing Panel shall respond to the request in writing within ten days after receipt of the request, unless otherwise extended by the Hearing Officer with the consent of the Parties for good cause shown. The Hearing Panel's response shall be served on the Respondent via personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Office of Hearing Officers shall send an additional copy of the temporary cease and desist order by overnight commercial courier. The filing of an application under this Rule shall not stay the effectiveness of the temporary cease and desist order.

9860. Violation of Temporary Cease and Desist Orders

A Respondent who violates a temporary cease and desist order imposed under this Rule Series may have its association or membership suspended or canceled under the Rule 9510 Series. The President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs must authorize the initiation of any such proceeding in writing.

9870. Application to Commission for Review

Temporary cease and desist orders issued pursuant to this Rule Series constitute final and immediately effective disciplinary sanctions imposed by the Association. The right to have any action under this Rule Series reviewed by the Commission is governed by Section 19 of the Exchange Act. The filing of an application for review shall not stay the effectiveness of the temporary cease and desist order, unless the Commission otherwise orders.