

# Notices

## Regulatory Notices

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**Note:** FINRA's Disciplinary Actions no longer are included along with monthly *Notices*. FINRA will continue to publish Disciplinary Actions on its Web site at [www.finra.org/notices](http://www.finra.org/notices) and [www.finra.org/disciplinaryactions](http://www.finra.org/disciplinaryactions).

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## Origination and Circulation of Rumors

### FINRA Requests Comment on Proposed FINRA Rule Addressing the Origination and Circulation of Rumors

Comment Period Expires: July 16, 2009

#### Executive Summary

As part of the process of developing a new, consolidated rulebook (the Consolidated FINRA Rulebook), FINRA is requesting comment on proposed FINRA Rule 2030 relating to the origination and circulation of rumors.<sup>1</sup> FINRA initially sought comment on the proposed rule, which is based on FINRA Rule 6140 and Incorporated NYSE Rule 435(5), in *Regulatory Notice 08-68*. In response to the comments received, FINRA is proposing substantial changes to proposed FINRA Rule 2030. The proposed changes include amendments to the general prohibition in Rule 2030 and the proposed reporting requirement, as well as adopting Supplementary Material to Rule 2030 that will address exceptions for certain communications, the definition of the term “rumor,” additional rules of which member firms should be aware, and a firm’s obligation to adopt written policies and procedures concerning rumors. FINRA is requesting comment on the proposed revisions to Rule 2030.

The text of the proposed rule is set forth in Attachment A.

Questions concerning this *Notice* should be directed to Brant Brown, Associate General Counsel, Office of General Counsel, at (202) 728-6927.

#### June 2009

#### Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

#### Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management

#### Key Topic(s)

- Rumors

#### Referenced Rules & Notices

- Regulatory Notice 08-68
- FINRA Rule 6140
- Incorporated NYSE Rule 435(5)

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by July 16, 2009.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to *pubcom@finra.org*; or
- ▶ Mailing comments in hard copy to:

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.<sup>2</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.<sup>3</sup>

## Background & Discussion

In *Regulatory Notice 08-68*, FINRA requested comment on proposed Rule 2030 addressing the origination and circulation of rumors. FINRA received numerous comments on the proposed rule and, in response to those comments, is proposing substantial changes to Rule 2030.<sup>4</sup> The proposed changes to the rule are discussed below.

- ▶ **Amending the general prohibition.** As originally proposed, Rule 2030 prohibited a member firm from originating or circulating a rumor that “the member knows or has reasonable grounds for believing is false or misleading or would improperly influence the market price of a security.” This formulation was based largely on the existing prohibition in FINRA Rule 6140(e). In contrast, NYSE Rule 435(5) prohibits the circulation of rumors of a sensational character “which might reasonably be expected to affect market conditions on the [NYSE].” As amended, proposed Rule 2030 applies to a rumor that a member knows or has reasonable grounds for believing is false or misleading and is likely to influence the market price of a security.

- **Retaining an amended reporting requirement.** As originally proposed, Rule 2030 required a firm to report to FINRA “any circumstance which reasonably would lead the member to believe that any [rumor covered by the rule] might have been originated or circulated.” FINRA received several comments addressing the breadth and scope of the proposed reporting requirement, ranging from suggestions to reduce the scope of the requirement to suggestions that the rule not include any reporting requirement. FINRA continues to believe that the reporting of rumors will enhance FINRA’s efforts to ensure the integrity of the market. However, FINRA is proposing a revised reporting requirement that would require firms to promptly report rumors that the firm learns of and knows, or has reasonable grounds for believing, were originated or circulated for the purpose of improperly influencing the market price of a security. FINRA believes that a more focused reporting requirement will increase FINRA’s efficiency in dealing with reports and enhance FINRA’s ability to respond rapidly and appropriately to those rumors that are most likely to affect the market and harm investors.

In addition to the proposed changes to the language in Rule 2030, FINRA is proposing Supplementary Material to Rule 2030 to address several concerns raised by commenters.

- **Definition of the term “rumor.”** FINRA is proposing Supplementary Material that defines the term “rumor” for purposes of Rule 2030. Under the proposed definition, a “rumor” is defined as “a false or misleading statement or a statement without a reasonable basis.” In addition, the proposed Supplementary Material clarifies that “[a] statement will not be considered a ‘rumor’ if it is clearly an expression of an individual’s or firm’s opinion, such as an analyst’s view of the prospects of a company.”
- **Permissible communications.** The proposed Supplementary Material to Rule 2030 also includes three limited exceptions to the general prohibitions in Rule 2030. The first exception to the rule is based on the existing exception in NYSE Rule 435(5) for rumors that have been published by widely circulated public media provided the source of the rumor and its unsubstantiated nature are disclosed. Second, FINRA is proposing to except discussions of rumors among market participants when necessary to explain market or trading conditions and one’s view of the validity of the information, provided the communication is not intended to influence the price movement of a security and the information is communicated in a responsible way (*i.e.*, sourcing the information where possible, not embellishing the information, and presenting the information in as neutral and balanced a way as practicable under the circumstances). The final exception FINRA is proposing is an exception for internal firm discussions undertaken solely for the purpose of verifying, or inquiring into the truthfulness or accuracy of, a rumor, provided the unsubstantiated nature of the information and, where possible, the source of the information are disclosed.

- ▶ **Market manipulation.** Because FINRA is proposing to include several exceptions to the general prohibitions in Rule 2030, FINRA is also proposing Supplementary Material that highlights the fact that knowingly originating or circulating false or misleading information with the intent to cause an impact on the price movement of a security is unlawful and violates FINRA rules as well as provisions of the federal securities laws and rules of the SEC. This provision emphasizes the fact that engaging in a discussion of potentially false or misleading information could violate FINRA or SEC rules or provisions of the federal securities laws even if the conduct does not violate Rule 2030.
  
- ▶ **Written policies and procedures.** Finally, FINRA is proposing Supplementary Material that specifically addresses a firm's obligation to adopt written policies and procedures concerning rumors. The Supplementary Material also notes a firm's obligation to develop and document appropriate training policies and programs that are reasonably designed to ensure that associated persons of the member firm comply with their responsibilities and obligations surrounding the origination and circulation of rumors.<sup>5</sup>

## Endnotes

- 1 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *FINRA Information Notice 03/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *NASD Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 4 The comments received in response to *Regulatory Notice 08-68* are available on FINRA's Web site at [www.finra.org/notices/08-68](http://www.finra.org/notices/08-68)
- 5 The Supplementary Material concerning training policies and programs is modeled on NASD Rule 2821(e), which governs member firms' responsibilities regarding deferred variable annuities. Specifically, Rule 2821(e) requires member firms to "develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of [the] Rule and that they understand the material features of deferred variable annuities."

## Attachment A

Below is the text of proposed FINRA Rule 2030.

### 2030. Origination or Circulation of Rumors

No member shall originate or circulate in any manner a rumor concerning any security that the member knows or has reasonable grounds for believing is false or misleading and is likely to influence the market price of such security. If a member learns of a rumor that the member knows or has reasonable grounds for believing was originated or circulated for the purpose of improperly influencing the market price of a security, the member must promptly report the rumor to FINRA.

• • • **Supplementary Material:** — — — — —

**.01 Definition of “Rumor.”** A “rumor” is a false or misleading statement or a statement without a reasonable basis. A statement will not be considered a “rumor” if it is clearly an expression of an individual’s or firm’s opinion, such as an analyst’s view of the prospects of a company.

**.02 Permissible Communications.**

(a) Discussion of a rumor that is published by widely circulated public media is not prohibited provided its source and unsubstantiated nature are disclosed.

(b) This Rule does not prohibit the discussion of rumors among market participants when necessary to explain market or trading conditions. In that context, and with due regard that no member or associated person of a member is intending to influence price movement by discussing the information, it is appropriate to comment and present one’s view of the validity of such information in a responsible way (i.e., sourcing the origin of the information where possible; not embellishing the information; and presenting the information in as neutral and balanced a way as practicable under the circumstances).

(c) Associated persons of a member are permitted to discuss a rumor with other associated persons of the member if the discussion is undertaken solely for the purpose of verifying, or inquiring into the truthfulness or accuracy of, the rumor. In these situations, the member or associated person of the member must disclose the unsubstantiated nature of the information and, where possible, the source of the information.

**.03 Market Manipulation.** Knowingly originating or circulating false or misleading information with the intent to cause an impact on the price movement of one or more securities is unlawful and is in violation of FINRA rules (including but not limited to Rule 2010, just and equitable principles of trade, Rule 2020, and Rule 2030), as well as the antifraud and antimanipulation provisions of the federal securities laws (including but not limited to Sections 9 and 10 of the Exchange Act and the rules and regulations promulgated thereunder).

**.04 Written Policies and Procedures.** Members must maintain adequate written policies and supervisory procedures reasonably designed to identify and address the circulation of rumors. Members must also develop and document appropriate training policies and programs reasonably designed to ensure that associated persons of the member comply with their responsibilities and obligations surrounding the origination and circulation of rumors. Members must clearly identify who is responsible for issuing guidance when responding to rumors, including pertinent escalation procedures, and reporting obligations.

## Credit Default Swaps

### SEC Approves Rule Establishing an Interim Pilot Program on Margin Requirements for Transactions in Credit Default Swaps

Effective Date: June 3, 2009

#### Executive Summary

The Securities and Exchange Commission (SEC) has approved new FINRA Rule 4240, which establishes an interim pilot program (the Interim Pilot Program) with respect to margin requirements for certain transactions in credit default swaps (CDS) and addresses related risk monitoring procedures and guidelines. The Interim Pilot Program's requirements extend to any transactions in CDS executed by a member (regardless of the type of account in which the transaction is booked), including those in which the offsetting matching hedging transactions are effected by the member in CDS contracts that are cleared through the central counterparty clearing services of the Chicago Mercantile Exchange (CME). The Interim Pilot Program expires on September 25, 2009.

The text of FINRA Rule 4240 is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- Rudolph Verra, Managing Director, Risk Oversight and Operational Regulation, at (646) 315-8811;
- Glen Garofalo, Director, Credit Regulation, at (646) 315-8464;
- Steve Yannolo, Principal Credit Specialist, Credit Regulation, at (646) 315-8621; or
- Adam H. Arkel, Assistant General Counsel, Office of General Counsel, at (202) 728-6961.

#### June 2009

##### Notice Type

- New Rule

##### Suggested Routing

- Compliance
- Legal
- Margin
- Operations
- Regulatory Reporting
- Risk Management
- Senior Management

##### Key Topic(s)

- Credit Default Swaps
- Interim Pilot Program
- Maintenance Margin Requirements
- Net Capital
- Risk Monitoring Procedures and Guidelines

##### Referenced Rules & Notices

- FINRA Rule 4240
- Incorporated NYSE Rule 431
- NASD Rule 2520
- Securities Act Rule 239T

## Background & Discussion

Regulatory authorities are adopting measures to address concerns arising from systemic risk posed by CDS, including risks to the financial system arising from the lack of a central clearing counterparty to clear and settle CDS. Historically, in the absence of a central clearing counterparty, CDS transactions have not been booked in the member, but rather in affiliated entities. In light of the rapid growth of the CDS market, and the potential inability of parties to meet their obligations as counterparties, the lack of a central clearing counterparty poses risks not only to the two parties to a CDS transaction, but also to the financial system overall because of the resulting chain of significant economic loss when one or more parties default on their obligations under a CDS transaction.

Recently, the SEC enacted interim final temporary rules, effective until September 25, 2009, that provide enumerated exemptions under the federal securities laws for certain CDS to facilitate the operation of one or more central clearing counterparties in such CDS.<sup>1</sup> Designed to be implemented concurrently with the SEC's action, FINRA is adopting FINRA Rule 4240, which establishes the Interim Pilot Program for margin requirements for CDS transactions and addresses related risk monitoring procedures and guidelines.<sup>2</sup> The Interim Pilot Program expires on September 25, 2009.

### Scope of the Interim Pilot Program

FINRA Rule 4240 applies to margin requirements for any transactions in CDS executed by a member (regardless of the type of account in which the transaction is booked),<sup>3</sup> including those in which the offsetting matching hedging transactions (referred to as matching transactions) are effected by the member in contracts that are cleared through the central clearing counterparty clearing services of the CME.

For purposes of the new FINRA rule, the term "CDS" is defined to include any "eligible credit default swap," as defined in Securities Act Rule 239T(d), as well as any other CDS that would otherwise meet that definition but for being subject to individual negotiation.<sup>4</sup> In addition, the new FINRA rule provides that the term "transaction" includes any open (ongoing) CDS position.

## Central Counterparty Clearing Arrangements

FINRA Rule 4240(b) provides that any member, prior to establishing any clearing arrangement with respect to CDS transactions that makes use of any central counterparty clearing services provided by any clearing agency, pursuant to Securities Act Rule 239T(a)(1), must notify FINRA in advance in writing. FINRA notes that it intends to review the monitoring procedures and controls established by members surrounding these transactions prior to the commencement of business. Accordingly, members must submit all relevant documentation to their FINRA Regulatory Coordinator. Such documentation should include:

- the member's procedures and controls for:
  - obtaining and reviewing the required account documentation and financial information necessary for assessing the amount of credit to be extended to customers and broker-dealers;
  - assessing the determination, review and approval of credit limits to each customer and broker-dealer, and across all customers and broker-dealers, engaging in CDS transactions;
  - monitoring credit risk exposure to the member from CDS, including the type, scope and frequency of reporting to senior management;
  - the use of stress testing of accounts containing CDS contracts in order to monitor market risk exposure from individual accounts and in the aggregate;
  - managing the impact of credit extended related to CDS contracts on the member's overall risk exposure;
  - determining the need to collect additional margin from a particular customer or broker-dealer, including whether that determination was based upon the creditworthiness of the customer or broker-dealer and/or the risk of the specific contracts;
  - monitoring the credit exposure resulting from concentrated positions within both individual accounts and across all accounts containing CDS contracts;
  - maintaining sufficient margin in each customer and broker-dealer account to protect against the default of the largest individual exposure in the account as measured by computing the largest maximum possible loss;
- copies of exception reports that will be provided to senior management to monitor broker-dealer and customer exposure to open CDS contracts; and
- an organization chart identifying those persons primarily responsible for CDS risk management and operations and the persons to whom they report.

### **Margin Requirements: CDS Cleared on the CME**

FINRA Rule 4240(c)(1) addresses customer or broker-dealer<sup>5</sup> transactions in CDS with a member in which the member executes a matching transaction that makes use of the central counterparty clearing facilities of the CME. The rule provides that members must require as a minimum for computing customer or broker-dealer margin with respect to such customer or broker-dealer transactions the applicable margin pursuant to CME rules.<sup>6</sup> Rule 4240(c)(1) requires that members must, based on the risk monitoring procedures and guidelines set forth in paragraph (d) of the rule, determine whether the applicable CME requirements are adequate with respect to their customer and broker-dealer accounts and the positions in those accounts and, where appropriate, increase such margin in excess of the minimum margin. (For this purpose, members are permitted to use the margin requirements that are set forth in the rule's Supplementary Material, FINRA Rule 4240.01.) The aggregate amount of margin the member collects from customers and broker-dealers for transactions in CDS must equal or exceed the aggregate amount of margin the member is required to post at CME with respect to those customer and broker-dealer transactions.

### **Margin Requirements: CDS Cleared on Facilities Other Than CME or Settled Over the Counter (OTC)**

With respect to any CDS transaction that makes use of a central counterparty clearing facility other than the CME or that settles OTC, the new rule requires members to apply the minimum margin as set forth in FINRA Rule 4240.01 regardless of the type of account in which the transaction is booked. However, members must, based on the risk monitoring procedures and guidelines that are set forth in FINRA Rule 4240(d), determine whether such margin is adequate with respect to their customer and broker-dealer accounts and, where appropriate, increase the requirements.

### **Risk Monitoring Procedures and Guidelines**

FINRA Rule 4240(d) requires members to monitor the risk of any customer or broker-dealer accounts with exposure to CDS and to maintain a comprehensive written risk analysis methodology for assessing the potential risk to the member's capital over a specified range of possible market movements over a specified time period. Members must employ the risk monitoring procedures and guidelines that are set forth in paragraphs (d)(1) through (8) of the rule. Further, the rule requires members to review, in accordance with their written procedures, at reasonable periodic intervals, their credit extension activities for consistency with the rule's risk monitoring procedures and guidelines. Members must determine whether the data necessary to apply the risk monitoring procedures and guidelines is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data (i.e., the data relevant for purposes of the risk monitoring procedures and guidelines as set forth in FINRA Rule 4240(d)(1) through (8)).

## Concentrations

FINRA Rule 4240(e) addresses concentrated positions. In sum, where the current and potential future exposure with respect to the largest single name unhedged short CDS across all accounts exceeds the member's tentative net capital, the member must take a capital charge equal to the aggregate margin requirement for such accounts on the positions in such single name CDS that result in a margin deficiency after applying the margin set forth in FINRA Rule 4240.01. This additional requirement for concentrated positions reflects FINRA's concern for the possibility of a sudden default in the largest single name CDS across all accounts in respect of which a member has current or potential exposure.

### FINRA Rule 4240.01 (Supplementary Material)

FINRA Rule 4240.01 sets forth the customer and broker-dealer margin requirements that apply with respect to CDS, as appropriate, pursuant to FINRA Rule 4240(c). The term "applicable FINRA margin rules" as used in paragraph (c) of the Supplementary Material refers to requirements pursuant to NASD Rule 2520 or Incorporated NYSE Rule 431, as applicable to the member.<sup>7</sup> FINRA plans to address NASD Rule 2520 and Incorporated NYSE Rule 431 later as part of the rulebook consolidation process, and, accordingly, will amend FINRA Rule 4240.01(c) as appropriate to refer to the new, consolidated FINRA margin rule.<sup>8</sup>

## Endnotes

- 1 See Securities Act Release No. 8999 (January 14, 2009), 74 FR 3967 (January 22, 2009) (Temporary Exemptions for Eligible Credit Default Swaps To Facilitate Operation of Central Counterparties To Clear and Settle Credit Default Swaps). Generally, as noted by the SEC, a CDS is a bilateral contract between two parties, known as counterparties. The value of this contract is based on underlying obligations of a single entity or on a particular security or other debt obligation, or an index of several such entities, securities, or obligations. The obligation of a seller to make payments under a CDS contract is triggered by a default or other credit event as to such entity or entities or such security or securities.
- 2 See Securities Exchange Act Release No. 34-59955 (May 22, 2009), 74 FR 25586 (May 28, 2009) (Order Granting Accelerated Approval of Proposed Rule Change; File No. SR-FINRA-2009-012). See also Securities Exchange Act Release No. 59578 (March 13, 2009), 74 FR 11781 (March 19, 2009) (Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With Request of Chicago Mercantile Exchange Inc. and Citadel Investment Group, L.L.C.).
- 3 CDS transactions must be booked in either a securities or futures account within the broker-dealer.
- 4 FINRA notes that, because Rule 239T(d) excludes contracts that are “subject to individual negotiation,” the proposed FINRA rule would reach CDS contracts, subject to the other criteria set forth in Rule 239T(d), without regard to whether they are individually negotiated.
- 5 NASD Rule 0120(g) states that the term “customer” shall not include a broker or dealer. For purposes of the new rule, the terms “customer or broker-dealer” and “customer and broker-dealer” are intended to include any party with which a member executes a CDS transaction.
- 6 FINRA notes that the matching transactions that are cleared through the CME as the central clearing counterparty are subject to margin requirements pursuant to CME rules (sometimes referred to in such rules as a performance bond).
- 7 The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms.
- 8 For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).

## Attachment A

Below is the text of new FINRA Rule 4240.

\* \* \* \* \*

### 4000. FINANCIAL AND OPERATIONAL RULES

\* \* \* \* \*

### 4200. MARGIN

\* \* \* \* \*

### 4240. Margin Requirements for Credit Default Swaps

#### (a) Effective Period of Interim Pilot Program

This Rule establishes an interim pilot program (“Interim Pilot Program”) with respect to margin requirements for any transactions in credit default swaps executed by a member (regardless of the type of account in which the transaction is booked), including those in which the offsetting matching hedging transactions (“matching transactions”) are effected by the member in contracts that are cleared through the central counterparty clearing services of the Chicago Mercantile Exchange (“CME”). The Interim Pilot Program shall automatically expire on September 25, 2009. For purposes of this Rule, the term “credit default swap” (“CDS”) shall mean any “eligible credit default swap” as defined in Securities Act Rule 239T(d), as well as any other CDS that would otherwise meet such definition but for being subject to individual negotiation, and the term “transaction” shall include any ongoing CDS position.

#### (b) Central Counterparty Clearing Arrangements

Any member, prior to establishing any clearing arrangement with respect to CDS transactions that makes use of any central counterparty clearing services provided by any clearing agency, pursuant to Securities Act Rule 239T(a)(1), must notify FINRA in advance in writing, in such manner as may be specified by FINRA in a Regulatory Notice.

**(c) Margin Requirements****(1) CDS Cleared on the Chicago Mercantile Exchange**

Members shall require as a minimum for computing customer or broker-dealer margin, with respect to any customer or broker-dealer transaction in CDS with a member in which the member executes a matching transaction that makes use of the central counterparty clearing facilities of the CME (“CME matching customer-side transaction”), the applicable margin pursuant to CME rules (sometimes referred to in such rules as a “performance bond”) regardless of the type of account in which the transaction in CDS is booked. Members shall, based on the risk monitoring procedures and guidelines set forth in paragraph (d) of this Rule, determine whether the applicable CME requirements are adequate with respect to their customer and broker-dealer accounts and the positions in those accounts and, where appropriate, increase such margin in excess of such minimum margin. For this purpose, members are permitted to use the margin requirements set forth in Supplementary Material .01 of this Rule.

The aggregate amount of margin the member collects from customers and broker-dealers for transactions in CDS must equal or exceed the aggregate amount of margin the member is required to post at CME with respect to those customer and broker-dealer transactions.

CME matching customer-side transactions are not subject to the provisions of paragraph (c)(2) of this Rule.

**(2) CDS That Are Cleared on Central Counterparty Clearing Facilities Other Than the CME or That Settle Over-the-Counter (“OTC”)**

Members shall require, with respect to any transaction in CDS that makes use of central counterparty clearing facilities other than the CME or that settle OTC, the applicable minimum margin as set forth in Supplementary Material .01 of this Rule regardless of the type of account in which the transaction in CDS is booked. However, members shall, based on the risk monitoring procedures and guidelines set forth in paragraph (d) of this Rule, determine whether such margin is adequate with respect to their customer and broker-dealer accounts and, where appropriate, increase such requirements.

**(d) Risk Monitoring Procedures and Guidelines**

Members shall monitor the risk of any customer or broker-dealer accounts with exposure to CDS and shall maintain a comprehensive written risk analysis methodology for assessing the potential risk to the member's capital over a specified range of possible market movements over a specified time period. For purposes of this Rule, members must employ the risk monitoring procedures and guidelines set forth in paragraphs (d)(1) through (8) of this Rule. The member must review, in accordance with the member's written procedures, at reasonable periodic intervals, the member's credit extension activities for consistency with the risk monitoring procedures and guidelines set forth in this Rule, and must determine whether the data necessary to apply the risk monitoring procedures and guidelines is accessible on a timely basis and information systems are available to adequately capture, monitor, analyze and report relevant data, including:

- (1) obtaining and reviewing the required account documentation and financial information necessary for assessing the amount of credit to be extended to customers and broker-dealers;
- (2) assessing the determination, review and approval of credit limits to each customer and broker-dealer, and across all customers and broker-dealers, engaging in CDS transactions;
- (3) monitoring credit risk exposure to the member from CDS, including the type, scope and frequency of reporting to senior management;
- (4) the use of stress testing of accounts containing CDS contracts in order to monitor market risk exposure from individual accounts and in the aggregate;
- (5) managing the impact of credit extended related to CDS contracts on the member's overall risk exposure;
- (6) determining the need to collect additional margin from a particular customer or broker-dealer, including whether that determination was based upon the creditworthiness of the customer or broker-dealer and/or the risk of the specific contracts;

(7) monitoring the credit exposure resulting from concentrated positions within both individual accounts and across all accounts containing CDS contracts; and

(8) maintaining sufficient margin in each customer and broker-dealer account to protect against the default of the largest individual exposure in the account as measured by computing the largest maximum possible loss.

**(e) Concentrations**

Where the maximum current and potential exposure with respect to the largest single name CDS across all accounts exceeds the member's tentative net capital, the member must take a capital charge equal to the aggregate margin requirement for such accounts on the positions in such single name CDS in accordance with the tables set forth in Supplementary Material .01 of this Rule. This capital charge may be reduced by the amount of excess margin held in all customer and broker-dealer accounts.

**• • • Supplementary Material: -----**

**.01 Margin Requirements for CDS.** The following customer and broker-dealer margin requirements shall apply, as appropriate, pursuant to paragraph (c) of this Rule.

**(a) Customer and Broker-Dealer Accounts That Are Short a CDS**

The following table shall be used to determine the margin that a member must collect from a customer or broker-dealer that is short a single name debt security CDS contract (sold protection). The margin is to be collected based upon the basis point spread over LIBOR of the CDS contract as well as the maturity of that contract as a percentage of the notional amount, shall be as follows:

Basis Point Spread	Length of Time to Maturity of CDS Contract			
	1 year	3 years	5 years	7 years & longer
0-100	1%	2%	4%	7%
100-300	2%	5%	7%	10%
300-500	5%	10%	15%	20%
500-700	10%	15%	20%	25%
700 and above	15%	20%	25%	30%

For those CDS contracts where the underlying obligation is a debt index, rather than a single name bond, the margin requirement as a percentage of the notional amount shall be as follows:

Index	Length of Time to Maturity of CDS Contract				
	1 year	3 years	5 years	7 years	10 years
CDX.IG	1%	1%	2%	4%	5%
CDX.HY	3%	5%	10%	12%	15%
CDX.HVOL	2%	3%	4%	5%	7%

**(b) Accounts That Are Long a CDS**

For customer or broker-dealer accounts that are long the CDS contracts (purchased protection), the margin to be collected shall be 50% of the above amounts.

**(c) Accounts That Maintain Both Long and Short CDS**

In instances where the customer or broker-dealer maintains both long and short CDS, the member may elect to collect 50% of the above margin requirements on the greater of the long or short position within the same Bloomberg CDS sector, provided those long and short positions are in the same spread and maturity bucket.

If a customer or broker-dealer is long the bond and long a CDS contract on the same underlying obligor, margin needs to be collected only on the long bond position, provided that bond can be delivered against the long CDS contract, as prescribed pursuant to applicable FINRA margin rules.

In instances where the customer or broker-dealer is short the bond and short the CDS on the same underlying obligor, margin need only be collected on the short bond, as prescribed pursuant to applicable FINRA margin rules.

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## Non-Traditional ETFs

### FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds

#### Executive Summary

Exchange-traded funds (ETFs) that offer leverage or that are designed to perform inversely to the index or benchmark they track—or both—are growing in number and popularity. While such products may be useful in some sophisticated trading strategies, they are highly complex financial instruments that are typically designed to achieve their stated objectives on a daily basis. Due to the effects of compounding, their performance over longer periods of time can differ significantly from their stated daily objective. Therefore, inverse and leveraged ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets.<sup>1</sup>

This *Notice* reminds firms of their sales practice obligations in connection with leveraged and inverse ETFs. In particular, recommendations to customers must be suitable and based on a full understanding of the terms and features of the product recommended; sales materials related to leveraged and inverse ETFs must be fair and accurate; and firms must have adequate supervisory procedures in place to ensure that these obligations are met.<sup>2</sup>

Questions concerning this *Notice* should be directed to the Office of Emerging Regulatory Issues at (202) 728-8472.

June 2009

#### Notice Type

- Guidance

#### Suggested Routing

- Compliance
- Legal
- Retail
- Senior Management

#### Key Topics

- Communications With the Public
- ETFs
- Leveraged and Inverse ETFs
- Suitability
- Supervision
- Training

#### Referenced Rules and Notices

- IM 2310-2(e)
- NASD Rule 2210
- NASD Rule 2310
- NASD Rule 3010
- NTM 05-26

## Background and Discussion

ETFs are typically registered unit investment trusts (UITs) or open-end investment companies whose shares represent an interest in a portfolio of securities that track an underlying benchmark or index.<sup>3</sup> However, some ETFs that invest in commodities, currencies, or commodity- or currency-based instruments are not registered as investment companies. Unlike traditional UITs or mutual funds, shares of ETFs typically trade throughout the day on an exchange at prices established by the market.

Leveraged ETFs seek to deliver multiples of the performance of the index or benchmark they track. Some leveraged ETFs are “inverse” or “short” funds, meaning that they seek to deliver the opposite of the performance of the index or benchmark they track. Like traditional ETFs, some inverse ETFs track broad indices, some are sector-specific, and still others are linked to commodities or currencies. Inverse ETFs are often marketed as a way for investors to profit from, or at least hedge their exposure to, downward-moving markets. Some funds are both short and leveraged, meaning that they seek to achieve a return that is a multiple of the inverse performance of the underlying index. An inverse ETF that tracks the S&P 500, for example, seeks to deliver the inverse of the performance of the S&P 500, while a 2x leveraged inverse S&P 500 ETF seeks to deliver twice the opposite of that index’s performance. To accomplish their objectives, leveraged and inverse ETFs pursue a range of investment strategies through the use of swaps, futures contracts and other derivative instruments.

Most leveraged and inverse ETFs “reset” daily, meaning that they are designed to achieve their stated objectives on a daily basis.<sup>4</sup> Due to the effect of compounding, their performance over longer periods of time can differ significantly from the performance (or inverse of the performance) of their underlying index or benchmark during the same period of time. For example, between December 1, 2008, and April 30, 2009:

- ▶ The Dow Jones U.S. Oil & Gas Index gained 2 percent, while an ETF seeking to deliver twice the index's daily return fell 6 percent and the related ETF seeking to deliver twice the inverse of the index's daily return fell 26 percent.
- ▶ An ETF seeking to deliver three times the daily return of the Russell 1000 Financial Services Index fell 53 percent while the index actually gained around 8 percent. The related ETF seeking to deliver three times the inverse of the index's daily return declined by 90 percent over the same period.

This effect can be magnified in volatile markets. Using a two-day example, if the index goes from 100 to close at 101 on the first day and back down to close at 100 on the next day, the two-day return of an inverse ETF will be different than if the index had moved up to close at 110 the first day but then back down to close at 100 on the next day. In the first case with low volatility, the inverse ETF loses 0.02 percent; but in the more volatile scenario the inverse ETF loses 1.82 percent. The effects of mathematical compounding can grow significantly over time, leading to scenarios such as those noted above.

## Suitability

NASD Rule 2310 requires that, before recommending the purchase, sale or exchange of a security, a firm must have a reasonable basis for believing that the transaction is suitable for the customer to whom the recommendation is made. This analysis has two components. The first is determining whether the product is suitable for any customer, an analysis that requires firms and associated persons to fully understand the products and transactions they recommend. With respect to leveraged and inverse ETFs, this means that a firm must understand the terms and features of the funds, including how they are designed to perform, how they achieve that objective, and the impact that market volatility, the ETF's use of leverage, and the customer's intended holding period will have on their performance.

Once a determination is made that a product is generally suitable for at least some investors, a firm must also determine that the product is suitable for the specific customers to whom it is recommended. This analysis includes making reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives and "such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."<sup>5</sup> While the customer-specific suitability analysis depends on the investor's particular circumstances, inverse and leveraged ETFs typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets.

FINRA reminds firms that, as new complex and non-traditional ETFs are introduced to the market, firms should also keep in mind IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products), which states that "[a]s new products are introduced from time to time, it is important that members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding the products." Firms recommending or selling new ETFs may also find it helpful to refer to *Notice to Members 05-26*, which highlights best practices for vetting new products.

## Communications With the Public

NASD Rule 2210 prohibits firms and registered representatives from making false, exaggerated, unwarranted or misleading statements or claims in communications with the public. Therefore, all sales materials and oral presentations used by firms regarding leveraged and inverse ETFs must present a fair and balanced picture of both the risks and benefits of the funds, and may not omit any material fact or qualification that would cause such a communication to be misleading. For example, an advertisement for a leveraged or inverse ETF that is designed to achieve its investment objective on a daily basis may not omit that fact and must specifically disclose that the fund is not designed to, and will not necessarily, track the underlying index or benchmark over a longer period of time. Firms are further reminded that providing risk disclosure in a prospectus or product description does not cure otherwise deficient disclosure in sales material, even if the sales material is accompanied or preceded by the prospectus or product description.

## Supervision

In accordance with NASD Rule 3010, firms should establish an appropriate supervisory system to ensure that their associated persons comply with all applicable FINRA and SEC rules when recommending any product, including leveraged and inverse ETFs. Among other things, if a firm promotes or allows its registered representatives to recommend such funds, the firm must ensure that its written supervisory procedures require that:

- the appropriate reasonable-basis suitability analysis is completed;
- associated persons perform appropriate customer-specific suitability analysis;
- all promotional materials are accurate and balanced; and
- all FINRA and SEC rules are followed.

In addition to establishing written procedures, such firms must document the steps they have taken to ensure adherence to these procedures.

## Training

Firms must train registered persons about the terms, features and risks of all ETFs that they sell, as well as the factors that would make such products either suitable or unsuitable for certain investors. In the case of leveraged and inverse ETFs, that training should emphasize the need to understand and consider the risks associated with such products, including the investor's time horizons, and the impact of time and volatility on the fund's performance. Training for all persons should emphasize that, due to the complexity and structure of these funds, they may not perform over time in direct or inverse correlation to their underlying index. This is particularly important as many investors may be turning to these funds as part of a long-term strategy to weather current market conditions.

## Endnotes

- 1 There also are mutual funds that are designed to provide inverse and leveraged performance relative to their benchmarks. These mutual funds may reset on a daily basis as well, and thus raise many of the issues discussed in this Notice on ETFs.
- 2 This *Notice* is being issued concurrently with an Investment Industry Regulatory Organization of Canada Notice on the same topic.
- 3 In 2008, the Securities and Exchange Commission began issuing exemptive orders that allow certain ETFs to be actively managed and thus not track an underlying benchmark or index. See SEC Rel. No. 33-8901 (Mar. 11, 2008), 73 Fed. Reg. 14618, 14620 n. 20 (Mar. 18, 2008).
- 4 At least one ETF sponsor has filed registration statements for leveraged and inverse ETFs that would seek to track the underlying performance of the index or benchmark for a period longer than a trading day, such as a month.
- 5 See NASD Rule 2310.

## Deferred Variable Annuities

### SEC Approves Amendments to NASD Rule 2821 Governing Purchases and Exchanges of Deferred Variable Annuities

Effective Date: February 8, 2010

#### Executive Summary

On April 15, 2009, the SEC approved amendments to NASD Rule 2821 governing purchases and exchanges of deferred variable annuities.<sup>1</sup> Among other things, the amendments:

- ▶ limit the rule's application to recommended transactions;
- ▶ change the triggering event that begins the principal review period; and
- ▶ clarify various other issues through new supplementary material to the rule.

The rule text is set forth in Attachment A and is effective February 8, 2010.

Questions regarding this *Notice* should be directed to:

- ▶ James S. Wrona, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270; or
- ▶ Lawrence N. Kosciulek, Director, Investment Companies Regulation, at (240) 386-4535.

June 2009

#### Notice Type

- ▶ Rule Amendment

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

#### Key Topic(s)

- ▶ Deferred Variable Annuities
- ▶ Principal Review
- ▶ Sales Practices
- ▶ Suitability
- ▶ Supervision

#### Referenced Rules & Notices

- ▶ NASD Rule 2310
- ▶ NASD Rule 2330
- ▶ NASD Rule 2820
- ▶ NASD Rule 2821
- ▶ SEA Rule 15c3-1
- ▶ SEA Rule 15c3-3
- ▶ Regulatory Notice 07-53

## Background & Discussion

NASD Rule 2821 establishes sales practice standards regarding purchases and exchanges of deferred variable annuities.<sup>2</sup> The rule addresses four main areas of concern. First, the rule has requirements governing broker recommendations, including suitability and disclosure obligations. Second, it includes various principal review and approval obligations. Third, the rule requires member firms to establish and maintain supervisory procedures reasonably designed to achieve compliance with the standards set forth in the rule. Fourth, the rule has a training component.

The recommendation and training sections currently are effective.<sup>3</sup> The effective dates of the principal review and supervisory procedures sections were stayed to give the SEC time to consider amendments that FINRA filed after careful consideration of public comments.<sup>4</sup> On April 15, 2009, the SEC approved those amendments, which become effective on **February 8, 2010**.<sup>5</sup> As described in more detail below, the amendments, among other things, limit the rule's application to recommended transactions, change the triggering event that begins the principal review period, and clarify various other issues through new supplementary material to the rule.

### Limiting Application of the Rule to Recommended Transactions

Prior to the amendments, paragraph (c) of NASD Rule 2821 would have required principals to treat "all transactions as if they have been recommended for purposes of this principal review." After carefully considering the public comments, FINRA proposed, and the SEC approved, limiting the rule's application to recommended transactions. This approach is consistent with that taken by FINRA's general suitability rule, NASD Rule 2310.<sup>6</sup> Moreover, because the vast majority of purchases and exchanges of deferred variable annuities are recommended by brokers, the rule will cover most transactions. FINRA emphasizes that firms must implement reasonable measures to detect and correct instances of recommended transactions that brokers mischaracterize as non-recommended. Where the transaction truly is initiated by the customer and not recommended by the broker, there generally is less concern regarding potential or actual conflicts of interest and less need for heightened sales-practice requirements. This change also promotes competition by allowing a wide variety of business models to exist, including those premised on keeping costs low by, in part, eliminating the need for a sales force and large numbers of principals.

### Modifying the Starting Point for the Seven-Business-Day Review Period

Under the earlier version of paragraph (c) of NASD Rule 2821, principals were required to review and determine whether to reject or approve a deferred variable annuity transaction no later than seven business days after the customer signed the

application. Based on the public comments, FINRA proposed, and the SEC approved, modifying the beginning of the period within which the principal must review and determine whether to approve or reject the application. Pursuant to the amendments, the period will begin to run not from the date of the customer's signature but from the date when a firm's office of supervisory jurisdiction (OSJ) receives a complete and correct copy of an application.<sup>7</sup> To help ensure that the process remains efficient from the beginning, the amendments also require the associated person who recommended the annuity to promptly transmit the complete and correct application package to the OSJ.<sup>8</sup> FINRA emphasizes, however, that the time begins to run when *any* OSJ at the firm receives the complete and correct application. A firm does not get to pick which OSJ starts the clock.

### Clarifying Issues Through Supplementary Material

The supplementary material examines issues that were raised by multiple groups and that potentially could have a significant impact on how firms sell or process deferred variable annuities. The supplementary material makes clear, for instance, that firms generally allowed to handle and carry customer funds under SEA Rules 15c3-1 and 15c3-3 are not prohibited by NASD Rule 2821 from depositing funds for a deferred variable annuity prior to principal approval.

FINRA also reconsidered the question of whether firms could forward funds to insurance companies for deposit in the companies' "suspense accounts" prior to principal approval. FINRA has modified its earlier position rejecting such a process, discussed in *Regulatory Notice 07-53* (Nov. 2007), and now will allow such action under certain conditions, including, *inter alia*, that the insurance company segregate the funds in a manner equivalent to that required of a member firm under SEA Rule 15c3-3.

In addition, the supplementary material discusses:

- customers' lump-sum payments for the purchase of deferred variable annuities and other products;
- the forwarding of customer checks or funds to an IRA custodian prior to principal approval;
- the timing of "transmittal" of the application where an insurance company and its affiliated broker-dealer share office space and/or employees;
- consideration of what constitutes a "reasonable effort" to determine whether a customer has had a recent exchange at another broker-dealer; and
- the permissibility of using information required for principal review in the contract issuance process.

## Endnotes

- 1 See Exchange Act Release No. 59772 (April 15, 2009), 74 FR 18419 (April 22, 2009) (Order Approving File No. SR-FINRA-2008-019) (Approval Order).
- 2 In general, a variable annuity is a contract between an investor and an insurance company, whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products (June 2004) (Joint Report), available at [www.sec.gov/news/studies/secnasdvip.pdf](http://www.sec.gov/news/studies/secnasdvip.pdf).
- 3 Paragraphs (a), (b), and (e) of NASD Rule 2821, as approved in SR-NASD-2004-183, became effective on May 5, 2008.
- 4 On April 17, 2008, FINRA filed a proposed rule change, which became effective upon filing, to delay the effective date of paragraphs (c) and (d) of NASD Rule 2821 until after the SEC's approval or disapproval of a substantive proposed rule change. See Exchange Act Release No. 57769 (May 2, 2008), 73 FR 26176 (May 8, 2008) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2008-015).
- 5 See Approval Order, *supra* note 1.
- 6 FINRA has proposed to adopt a modified version of NASD Rule 2310 as FINRA Rule 2111 in the Consolidated FINRA Rulebook. See *Regulatory Notice 09-25* (May 2009).
- 7 As FINRA and the SEC previously have noted, "Many broker-dealers are subject to lower net capital requirements under SEA Rule 15c3-1 and are exempt from the requirement to establish and fund a customer reserve account under SEA Rule 15c3-3 because they do not carry customer funds or securities." See Exchange Act Release No. 56376 (Sept. 7, 2007), 72 FR 52400 (Sept. 13, 2007) (Order Granting Exemption to Broker-Dealers from Requirements in SEA Rules 15c3-1 and 15c3-3 to Promptly Transmit Customer Checks).  
  
Although some of these firms receive checks from customers made payable to third parties, the SEC does not deem a firm to be carrying customer funds if it "promptly transmits" the checks to third parties. The SEC has interpreted "promptly transmits" to mean that "such transmission or delivery is made no later than noon of the next business day after receipt of such funds or securities." *Id.* at 52400. In conjunction with its approval of Rule 2821, the SEC provided an exemption to the "promptly transmits" requirement as long as, among other things, the "principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days in accordance with the rule." *Id.* at 52401. In its order approving the recent amendments, the SEC explained that the exemption order continues to apply, notwithstanding the new starting point for the principal review period under NASD Rule 2821. See Approval Order, *supra* note 1, at 18422 n.37.

NASD rules also could have conflicted with the seven-business-day period. NASD Rule 2330, for instance, generally prohibits improper use of customer funds, and NASD Rule 2820 specifically requires firms to “transmit promptly” the application and purchase payment for a variable annuity contract to the issuing insurance company. Because of this potential conflict, FINRA provided an exemption similar to that provided by the SEC. FINRA stated that a firm may hold an application for a deferred variable annuity and a customer’s non-negotiated check payable to an insurance company for up to seven business days without violating either NASD Rule 2330 or 2820 if the reason for the hold is to allow completion of principal review of the transaction pursuant to NASD Rule 2821. As with the SEC’s exemption order, FINRA’s exemption continues to apply even though the triggering event for the principal review period has changed via the recently approved amendments. (FINRA has proposed to adopt NASD Rule 2330 as FINRA Rule 2150 in the Consolidated FINRA Rulebook—see SR-FINRA-2009-014 (filed March 24, 2009)—and to adopt NASD Rule 2820 as FINRA Rule 2320 in the consolidated FINRA rulebook—see Exchange Act Release No. 59762 (April 14, 2009), 74 FR 18269 (April 21, 2009) (Notice of Filing File No. SR-FINRA-2009-023)).

- 8 However, the provision, amended paragraph (b)(3) of NASD Rule 2821, would not preclude the customer from transmitting the complete and correct application package to the OSJ. For instance, there may be occasions where the application package is technically complete and correct but the customer wants to review the purchase or exchange further at home and then send the application to the OSJ. Proceeding in such a manner is not inconsistent with the proposed provision.

## Attachment A

### Text of Amended Rule

New language is underlined; deletions are in brackets.

*(Paragraphs (a), (b), and (e) of Rule 2821 currently are effective. New paragraphs (c) and (d) and the supplementary material, as well as amendments to paragraphs (a), (b), and (e), are effective February 8, 2010.)*

\* \* \* \* \*

### 2821. Members' Responsibilities Regarding Deferred Variable Annuities

#### (a) General Considerations

##### (1) Application

This Rule applies to recommended [the] purchases [or] and exchanges of [a] deferred variable annuity[y]ies and recommended initial [the] subaccount allocations. This Rule does not apply to reallocations among [of] subaccounts made or to funds paid after the initial purchase or exchange of a deferred variable annuity. This Rule also does not apply to deferred variable annuity transactions made in connection with any tax-qualified, employer-sponsored retirement or benefit plan that either is defined as a "qualified plan" under Section 3(a)(12)(C) of the [Securities] Exchange Act [of 1934] or meets the requirements of Internal Revenue Code Sections 403(b), 457(b), or 457(f), unless, in the case of any such plan, a member or person associated with a member makes recommendations to an individual plan participant regarding a deferred variable annuity, in which case the Rule would apply as to the individual plan participant to whom the member or person associated with the member makes such recommendations.

##### (2) Creation, Storage, and Transmission of Documents

For purposes of this Rule, documents may be created, stored, and transmitted in electronic or paper form, and signatures may be evidenced in electronic or other written form.

##### (3) Definitions

For purposes of this Rule, the term "registered principal" shall mean a person registered as a General Securities Sales Supervisor (Series 9/10), a General Securities Principal (Series 24) or an Investment Company Products/Variable Contracts Principal (Series 26), as applicable.

**(b) Recommendation Requirements**

(1) No member or person associated with a member shall recommend to any customer the purchase or exchange of a deferred variable annuity unless such member or person associated with a member has a reasonable basis to believe

(A) that the transaction is suitable in accordance with Rule 2310 and, in particular, that there is a reasonable basis to believe that

(i) the customer has been informed, in general terms, of various features of deferred variable annuities, such as the potential surrender period and surrender charge; potential tax penalty if customers sell or redeem deferred variable annuities before reaching the age of 59½; mortality and expense fees; investment advisory fees; potential charges for and features of riders; the insurance and investment components of deferred variable annuities; and market risk;

(ii) the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit; and

(iii) the particular deferred variable annuity as a whole, the underlying subaccounts to which funds are allocated at the time of the purchase or exchange of the deferred variable annuity, and riders and similar product enhancements, if any, are suitable (and, in the case of an exchange, the transaction as a whole also is suitable) for the particular customer based on the information required by [sub]paragraph (b)(2) of this Rule; and

(B) in the case of an exchange of a deferred variable annuity, the exchange also is consistent with the suitability determination required by [sub]paragraph (b)(1)(A) of this Rule, taking into consideration whether

(i) the customer would incur a surrender charge, be subject to the commencement of a new surrender period, lose existing benefits (such as death, living, or other contractual benefits), or be subject to increased fees or charges (such as mortality and expense fees, investment advisory fees, or charges for riders and similar product enhancements);

(ii) the customer would benefit from product enhancements and improvements; and

(iii) the customer[’s account] has had another deferred variable annuity exchange within the preceding 36 months.

The determinations required by this paragraph shall be documented and signed by the associated person recommending the transaction.

(2) Prior to recommending the purchase or exchange of a deferred variable annuity, a member or person associated with a member shall make reasonable efforts to obtain, at a minimum, information concerning the customer’s age, annual income, financial situation and needs, investment experience, investment objectives, intended use of the deferred variable annuity, investment time horizon, existing assets (including investment and life insurance holdings), liquidity needs, liquid net worth, risk tolerance, tax status, and such other information used or considered to be reasonable by the member or person associated with the member in making recommendations to customers.

(3) Promptly after receiving information necessary to prepare a complete and correct application package for a deferred variable annuity, a person associated with a member who recommends the deferred variable annuity shall transmit the complete and correct application package to an office of supervisory jurisdiction of the member.

#### **(c) Principal Review and Approval**

Prior to transmitting a customer’s application for a deferred variable annuity to the issuing insurance company for processing, but no later than seven business days after an office of supervisory jurisdiction of the member receives a complete and correct application package, a registered principal shall review and determine whether he or she approves of the recommended purchase or exchange of the deferred variable annuity.

A registered principal shall approve the recommended transaction only if he or she has determined that there is a reasonable basis to believe that the transaction would be suitable based on the factors delineated in paragraph (b) of this Rule.

The determinations required by this paragraph shall be documented and signed by the registered principal who reviewed and then approved or rejected the transaction.

**(d) Supervisory Procedures**

In addition to the general supervisory and recordkeeping requirements of Rules 3010, 3012, 3013, and 3110, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable NASD rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

**(e) Training**

Members shall develop and document specific training policies or programs reasonably designed to ensure that associated persons who effect and registered principals who review transactions in deferred variable annuities comply with the requirements of this Rule and that they understand the material features of deferred variable annuities, including those described in [sub]paragraph (b)(1)(A)(i) of this Rule.

**••• Supplementary Material: -----**

.01 Under Rule 2821, a member that is permitted to maintain customer funds under SEA Rules 15c3-1 and 15c3-3 may, prior to the member's principal approval of the deferred variable annuity, deposit and maintain customer funds for a deferred variable annuity in an account that meets the requirements of SEA Rule 15c3-3.

.02 If a customer provides a member that is permitted to hold customer funds with a lump sum or single check made payable to the member (as opposed to being made payable to the insurance company) and requests that a portion of the funds be applied to the purchase of a deferred variable annuity and the rest of the funds be applied to other types of products, Rule 2821 would not prohibit the member from promptly applying those portions designated for purchasing products other than a deferred variable annuity to such use. A member that is not permitted to hold customer funds can comply with such requests only through its clearing firm that will maintain customer funds for the intended deferred variable annuity purchase in an account that meets the requirements of SEA Rule 15c3-3. In such circumstances, the checks would need to be made payable to the clearing firm.

.03 Rule 2821 does not prohibit a member from forwarding a check made payable to the insurance company or, if the member is fully subject to SEA Rule 15c3-3, transferring funds for the purchase of a deferred variable annuity to the insurance company prior to the member's principal approval of the deferred variable annuity, as long as the member fulfills the following requirements: (a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and (b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member's principal approval and is provided with the application or is notified of the member's principal rejection, it will (1) segregate the member's customers' funds in a bank in an account equivalent to the deposit of those funds by a member into a "Special Account for the Exclusive Benefit of Customers" (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers' funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers, (2) not issue the variable annuity contract prior to the member's principal approval, and (3) promptly return the funds to each customer at the customer's request prior to the member's principal approval or upon the member's rejection of the application.

.04 A member is not prohibited from forwarding a check provided by the customer for the purpose of purchasing a deferred variable annuity and made payable to an IRA custodian for the benefit of the customer (or, if the member is fully subject to SEA Rule 15c3-3, funds) to the IRA custodian prior to the member's principal approval of the deferred variable annuity transaction, as long as the member enters into a written agreement with the IRA custodian under which the IRA custodian agrees (a) to forward the funds to the insurance company to complete the purchase of the deferred variable annuity contract only after it has been informed that the member's principal has approved the transaction and (b), if the principal rejects the transaction, to inform the customer, seek immediate instructions from the customer regarding alternative disposition of the funds (e.g., asking whether the customer wants to transfer the funds to another IRA custodian, purchase a different investment, or provide other instructions), and promptly implement the customer's instructions.

.05 Rule 2821 requires that the member or person associated with a member consider whether the customer has had another deferred variable annuity exchange within the preceding 36 months. Under this provision, a member or person associated with a member must determine whether the customer has had such an exchange at the member and must make reasonable efforts to ascertain whether the customer has had an exchange at any other broker-dealer within the preceding 36 months. An inquiry to the customer as to whether the customer has had an exchange at another broker-dealer within 36 months would constitute a "reasonable effort" in this context. Members shall document in writing both the nature of the inquiry and the response from the customer.

.06 Rule 2821 requires principal review and approval "[p]rior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing...." In circumstances where an insurance company and its affiliated broker-dealer share office space and/or employees who carry out both the principal review and the issuance process, FINRA will consider the application "transmitted" to the insurance company only when the broker-dealer's principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

.07 Rule 2821 does not prohibit using the information required for principal review and approval in the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer. For instance, the rule does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, i.e., paper or electronic) that the insurance company uses for the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

\* \* \* \* \*

## SEC Approves New Consolidated FINRA Rules

### SEC Approval and Effective Date for New Consolidated FINRA Rules

Effective Date: August 17, 2009

#### Executive Summary

Following the consolidation of NASD and the member regulation, enforcement and arbitration functions of NYSE Regulation into FINRA, FINRA established a process to develop a new consolidated rulebook (Consolidated FINRA Rulebook), which FINRA has discussed in previous *Information Notices*.<sup>1</sup> FINRA is proposing new consolidated rules in phases for approval by the SEC as part of the Consolidated FINRA Rulebook.<sup>2</sup> In April and May 2009, the SEC approved eight new consolidated FINRA Rules, which will take effect on August 17, 2009.

Questions regarding this *Notice* should be directed to:

- Erika L. Lazar, Senior Attorney, Office of General Counsel (OGC), at (646) 315-8512 (regarding FINRA Rule 2267);
- Stan Macel, Assistant General Counsel, OGC, at (202) 728-8056 (regarding FINRA Rules 2080, 2266, 2310, 2342, 3250 and 4551); or
- Matthew E. Vitek, Counsel, OGC, at (202) 728-8156 (regarding FINRA Rule 1122).

#### June 2009

##### Notice Type

- Rule Approvals
- Consolidated Rulebook

##### Suggested Routing

- Compliance
- Legal
- Mutual Fund
- Operations
- Registration
- Senior Management
- Trading

##### Key Topic(s)

- Alternative Trading Systems
- CRD System
- Designation of Accounts
- Direct Participation Programs
- Effective Dates of Consolidated Rules
- FINRA Manual
- Investment Company Securities
- Investor Education
- Investor Protection
- Membership
- Registration
- Rulebook Consolidation
- Security Futures
- SIPC

##### Referenced Rules & Notices

- FINRA Rule 1122
- FINRA Rule 2080
- FINRA Rule 2266
- FINRA Rule 2267
- FINRA Rule 2310
- FINRA Rule 2342
- FINRA Rule 3250
- FINRA Rule 4551
- Information Notice 03/12/08
- Information Notice 10/06/08
- Regulatory Notice 08-57

## Discussion

In April and May 2009, the SEC approved eight FINRA Rules as part of the Consolidated FINRA Rulebook:

- ▶ Rule 1122 (Filing of Misleading Information as to Membership or Registration);<sup>3</sup>
- ▶ Rule 2080 (Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System);<sup>4</sup>
- ▶ Rule 2266 (SIPC Information);<sup>5</sup>
- ▶ Rule 2267 (Investor Education and Protection);<sup>6</sup>
- ▶ Rule 2310 (Direct Participation Programs);<sup>7</sup>
- ▶ Rule 2342 (“Breakpoint” Sales);<sup>8</sup>
- ▶ Rule 3250 (Designation of Accounts);<sup>9</sup> and
- ▶ Rule 4551 (Requirements for Alternative Trading Systems to Record and Transmit Order and Execution Information for Security Futures).<sup>10</sup>

The attachment to this *Notice* sets forth additional information regarding these new consolidated rules and includes a hyperlink to each related rule filing. The filings provide, among other things, FINRA’s statement of the purpose of the rule changes and an exhibit showing the changes between the new rule text and the text of the NASD and/or Incorporated NYSE Rules as they exist in the Transitional Rulebook. Also, the text of each new FINRA Rule is available in the online *FINRA Manual* at [www.finra.org/finramanual](http://www.finra.org/finramanual).<sup>11</sup>

## Rule Conversion Chart

As discussed in additional detail in *Information Notice 10/06/08* and *Regulatory Notice 08-57*, FINRA has posted a Rule Conversion Chart on its Web site to help firms become familiar with the new rules and show how the new rules relate to the NASD and/or Incorporated NYSE Rules in the Transitional Rulebook that they will replace.

Firms should be aware that the chart is intended as a reference aid only. FINRA reminds firms that the chart does not in any way serve as a substitute for diligent review of the relevant new rule language. The Rule Conversion Chart is located at [www.finra.org/ruleconversionchart](http://www.finra.org/ruleconversionchart).

## Endnotes

- 1 See *Information Notice 10/06/08* (Rulebook Consolidation Process: Effective Dates of New Consolidated Rules; Introduction of Rule Conversion Chart); see also *Information Notice 03/12/08* (Rulebook Consolidation Process).
- 2 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The new FINRA Rules apply to all member firms, unless such rules have a more limited application by their terms. As the Consolidated FINRA Rulebook expands with the SEC's approval and with the new FINRA Rules taking effect, the rules in the Transitional Rulebook that address the same subject matter of regulation will be eliminated. When the Consolidated FINRA Rulebook is completed, the Transitional Rulebook will have been eliminated in its entirety.
- 3 See Exchange Act Release No. 59789 (April 20, 2009), 74 FR 18767 (April 24, 2009) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-009).
- 4 See Exchange Act Release No. 59987 (May 27, 2009), 74 FR 26902 (June 4, 2009) (Order Approving Proposed Rule Change as Amended; File No. SR-FINRA-2009-016).
- 5 See *id.*
- 6 See Exchange Act Release No. 60012 (May 29, 2009), 74 FR 27214 (June 8, 2009) (Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1; File No. SR-FINRA-2008-062).
- 7 See *supra* note 4.
- 8 See Exchange Act Release No. 59961 (May 21, 2009), 74 FR 25795 (May 29, 2009) (Order Granting Approval of Proposed Rule Change; File No. SR-FINRA-2009-018).
- 9 See Exchange Act Release No. 59947 (May 20, 2009), 74 FR 25293 (May 27, 2009) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-017).
- 10 See *supra* note 4.
- 11 FINRA updates the rule text on its online *Manual* within two business days of SEC approval of changes to the rule text.

## Attachment A

### List of Approved FINRA Rules (and Related Rule Filings)

The SEC approved the following new FINRA Rules in April and May 2009. The effective date of these rules is August 17, 2009.

#### FINRA Rule Filing SR-FINRA-2008-062

[www.finra.org/rulefilings/2008-062](http://www.finra.org/rulefilings/2008-062)

The rule change adopts FINRA Rule 2267 based on NASD Rule 2280 (Investor Education and Protection).

FINRA Rule 2267 requires member firms, except a firm that does not have customers or is an introducing firm that is party to a carrying agreement where the carrying firm member complies with the requirements of the rule, to provide customers with FINRA's Web site address and information regarding FINRA's BrokerCheck® program at least once every calendar year. Member firms that conduct a limited business in which contact with customers is limited to introducing customer accounts to be held directly at an entity other than a FINRA member, and thereafter do not carry customer accounts or hold customer funds and securities (*e.g.*, do not provide account statements or trade confirmations) may furnish a customer with the information required by the rule at or prior to the time of the customer's initial purchase, in lieu of once every calendar year. The rule also clarifies that the information required under the rule may be provided electronically to customers.

Any firm subject to NASD Rule 2280 that complies with its annual (calendar year) mailing requirement on or after January 1, 2009 but prior to the August 17, 2009 effective date of FINRA Rule 2267 will be deemed to have complied with FINRA Rule 2267 for the 2009 calendar year.

<b>RULE/SERIES NO.</b>	<b>RULE TITLE</b>
Rule 2200 Series	COMMUNICATIONS AND DISCLOSURES
Rule 2260 Series	Disclosures
Rule 2267	Investor Education and Protection

## FINRA Rule Filing SR-FINRA-2009-009

[www.finra.org/rulefilings/2009-009](http://www.finra.org/rulefilings/2009-009)

The rule change adopts, with certain modifications, NASD Interpretive Material (IM) 1000-1 (Filing of Misleading Information as to Membership or Registration) as FINRA Rule 1122.

NASD IM-1000-1 provides that the filing of membership or registration information as a Registered Representative with FINRA which is incomplete or inaccurate so as to be misleading, or which could in any way tend to mislead, or the failure to correct such filing after notice thereof, may be deemed conduct inconsistent with just and equitable principles of trade and may be subject to disciplinary action.

The rule change transfers NASD IM-1000-1 into the Consolidated FINRA Rulebook as FINRA Rule 1122, and clarifies its applicability to members and persons associated with members by specifying that “no member or person associated with a member” shall file incomplete or misleading membership or registration information. Additionally, the rule change eliminates the reference to the filing of registration information “as to Registered Representative” to clarify that the rule applies to the filing of registration information regarding any category of registration. Finally, the rule change deletes the reference that the prohibited conduct may be deemed inconsistent with just and equitable principles of trade and subject to disciplinary action as unnecessary and to better reflect the adoption of the NASD IM as a stand-alone rule.

<b>RULE/SERIES NO.</b>	<b>RULE TITLE</b>
<b>Rule 1000 Series</b>	<b>MEMBER APPLICATION AND ASSOCIATED PERSON REGISTRATION</b>
<b>Rule 1100 Series</b>	<b>MEMBER APPLICATION</b>
<b>Rule 1120 Series</b>	<b>Member Application Process</b>
Rule 1122	Filing of Misleading Information as to Membership or Registration

## FINRA Rule Filing SR-FINRA-2009-016

[www.finra.org/rulefilings/2009-016](http://www.finra.org/rulefilings/2009-016)

The rule change adopts, without material change:

- ▶ NASD Rule 2130 (Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD System)) as FINRA Rule 2080;
- ▶ NASD Rule 2810 (Direct Participation Programs) as FINRA Rule 2310;
- ▶ NASD Rule 3115 (Requirements for Alternative Trading Systems to Record and Transmit Order and Execution Information for Security Futures) as FINRA Rule 4551; and
- ▶ NASD Rule 2342 (SIPC Information) as FINRA Rule 2266, and deletes comparable Incorporated NYSE Rule 409A (SIPC Disclosures).

FINRA Rule 2080 addresses the expungement of customer dispute information from the Central Registration Depository (CRD<sup>®</sup>) system. The rule requires that a court of competent jurisdiction order or confirm all expungement directives before FINRA will expunge customer dispute information from the CRD system. It also requires that FINRA members or associated persons name FINRA as an additional party in any court proceeding in which they seek an order to expunge customer dispute information or request confirmation of an award containing an order of expungement. Upon request, however, FINRA may waive the requirement to be named as a party in certain specified circumstances.

FINRA Rule 2310 requires, among other things, that members participating in a public offering of direct participation programs and unlisted real estate investment trusts (collectively, Investment Programs) (1) meet certain requirements regarding underwriting compensation, fees and expenses; (2) perform due diligence on the Investment Programs; (3) follow specific guidelines on suitability; and (4) adhere to limits on non-cash compensation.

FINRA Rule 4551 requires alternative trading systems (ATs) that accept orders for security futures to record and report to FINRA certain information regarding those orders, including the date and time the order was received, the security future product name and symbol, the details of the order, and the date and time that the order was executed. The rule provides FINRA with an audit trail of orders for security futures placed on an ATS.

FINRA Rule 2266 requires all FINRA members, except those members (1) that are excluded from membership in the Securities Investor Protection Corporation (SIPC) and are not SIPC members; or (2) whose business consists exclusively of the sale of investments that are ineligible for SIPC protection, to advise all new customers, in writing, at the opening of an account, that they may obtain information about SIPC, including the SIPC brochure, by contacting SIPC. Such members also must provide SIPC's Web site address and telephone number. In addition, such members must provide all customers with the same information, in writing, at least once each year.

<b>RULE/SERIES NO.</b>	<b>RULE TITLE</b>
<b>Rule 2000 Series</b>	<b>DUTIES AND CONFLICTS</b>
Rule 2080	Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD) System
<b>Rule 2200 Series</b>	<b>COMMUNICATIONS AND DISCLOSURES</b>
<b>Rule 2260 Series</b>	<b>Disclosures</b>
Rule 2266	SIPC Information
<b>Rule 2300 Series</b>	<b>SPECIAL PRODUCTS</b>
Rule 2310	Direct Participation Programs
<b>Rule 4500 Series</b>	<b>BOOKS, RECORDS AND REPORTS</b>
<b>Rule 4550 Series</b>	<b>ATS Reporting</b>
Rule 4551	Requirements for Alternative Trading Systems to Record and Transmit Order and Execution Information for Security Futures

**FINRA Rule Filing SR-FINRA-2009-017**

[www.finra.org/rulefilings/2009-017](http://www.finra.org/rulefilings/2009-017)

The rule change adopts, with certain modifications, Incorporated NYSE Rule 406 (Designation of Accounts) as FINRA Rule 3250.

FINRA Rule 3250 provides that no member shall carry an account on its books in the name of a person other than that of the customer, except that an account may be designated by a number or symbol, provided the member has on file a written statement signed by the customer attesting the ownership of such account.

In effect, the rule provides that a member must hold each customer account in the customer's name, except that a member may identify a customer's account with a number or symbol, as long as the member maintains documentation identifying the customer. Formerly, Incorporated NYSE Rule 406 applied only to Dual Members; FINRA Rule 3250 applies to all FINRA member firms.

<b>RULE/SERIES NO.</b>	<b>RULE TITLE</b>
Rule 3000 Series	SUPERVISION AND RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS
Rule 3200 Series	RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS
Rule 3250	Designation of Accounts

### FINRA Rule Filing SR-FINRA-2009-018

[www.finra.org/rulefilings/2009-018](http://www.finra.org/rulefilings/2009-018)

The rule change adopts, with certain modifications, NASD Interpretive Material (IM) 2830-1 (“Breakpoint” Sales) as FINRA Rule 2342.

FINRA Rule 2342 prohibits sales of mutual fund shares in amounts below a “breakpoint” if such sales are made “so as to share in the higher sales charges.” In the context of mutual fund sales, a “breakpoint” is that point at which the sales charge is reduced for quantity purchases of fund shares. The rule change eliminates the references to “just and equitable principles of trade,” makes other minor changes to the text to reflect that it is a stand-alone rule and eliminates certain redundant text that is inconsistent with a more rules-based format.

<b>RULE/SERIES NO.</b>	<b>RULE TITLE</b>
Rule 2300 Series	SPECIAL PRODUCTS
Rule 2340 Series	Investment Companies
Rule 2342	“Breakpoint” Sales

## Investment Company Securities

### FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Investment Company Securities

Comment Period Expires: August 3, 2009

#### Executive Summary

As part of the process to develop a new consolidated rulebook (the Consolidated FINRA Rulebook),<sup>1</sup> FINRA is requesting comment on a proposed FINRA rule regarding the distribution and sale of investment company securities. The proposal is based on NASD Rule 2830, subject to certain changes, including proposed new requirements regarding disclosure of cash compensation.

The text of the proposed rule is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- ▶ Joe Savage, Vice President and Counsel, Investment Companies Regulation, at (240) 386-4534; or
- ▶ Stan Macel, Assistant General Counsel, Office of General Counsel, at (202) 728-8056.

#### June 2009

#### Notice Type

- ▶ Request for Comment
- ▶ Consolidated FINRA Rulebook

#### Suggested Routing

- ▶ Compliance
- ▶ Executive Representatives
- ▶ Investment Companies
- ▶ Legal
- ▶ Mutual Fund
- ▶ Registered Representative
- ▶ Senior Management

#### Key Topics

- ▶ Cash Compensation
- ▶ Exchange-Traded Funds
- ▶ Investment Companies
- ▶ Non-Cash Compensation
- ▶ Revenue Sharing

#### Referenced Rules & Notices

- ▶ FINRA Rule 5110
- ▶ NASD Rule 2830
- ▶ NASD Rule 2810
- ▶ NTM 03-54
- ▶ NTM 99-55

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by August 3, 2009.

Member firms and other interested parties can submit their comments using the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

## Important Notes

The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.<sup>2</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.<sup>3</sup>

## Discussion

FINRA is proposing to adopt FINRA Rule 2341 regarding the regulation of members' activities in connection with the sale and distribution of registered investment company securities. Proposed FINRA Rule 2341 is based largely on NASD Rule 2830, with some significant changes, discussed below.<sup>4</sup>

## NASD Rule 2830

NASD Rule 2830 regulates member firms' activities in connection with the distribution and sale of investment company securities. Proposed FINRA Rule 2341 revises the provisions of NASD Rule 2830 in four areas. It:

- ▶ requires firms to make new disclosures to investors regarding the receipt of cash compensation;
- ▶ makes a minor change to the recordkeeping requirements for non-cash compensation;
- ▶ eliminates a condition regarding discounted sales of investment company securities to dealers; and
- ▶ codifies past FINRA staff interpretations regarding the purchases and sales of exchange-traded funds (ETFs).

These proposed changes are discussed in more detail below.

## Proposed Changes to the Cash Compensation Provisions

NASD Rule 2830(l) governs the payment and acceptance of cash and non-cash compensation in connection with the sale of investment company securities. Among other things, NASD Rule 2830(l)(4) prohibits member firms from accepting cash compensation from an "offeror" (generally an investment company and its affiliates), unless the compensation is described in the fund's current prospectus. If a member firm enters into a "special cash compensation" arrangement with an offeror, and the offeror does not make the arrangement available on the same terms to all member firms that sell the fund's shares, the member firm's name and the details of the arrangement must be disclosed in the prospectus.<sup>5</sup>

FINRA proposes to modify the disclosure requirements for cash compensation arrangements in several respects.<sup>6</sup> First, the proposal requires that standard "sales charges and service fees" (rather than all cash compensation) be described in the prospectus.<sup>7</sup> Second, the proposal eliminates the term "special cash compensation" and instead requires prospectus disclosure where a member firm received greater (or special) sales charges or service fees than are ordinarily paid in connection with sales of fund shares. Other types of cash compensation, such as revenue-sharing payments,<sup>8</sup> would not require prospectus disclosure. Like the current rule, the proposal requires the names of the firms that have entered into arrangements to receive special sales charges or service fees and the details of these arrangements to be disclosed in the prospectus or SAI.

Third, the proposal requires a member firm that receives cash payments in addition to the standard sales charges and service fees paid in connection with the sale of fund shares to make certain disclosures to its customers at the time the account is opened.<sup>9</sup> These additional cash payments could take the form of higher sales commissions or service fees, or revenue sharing payments made by offerors to firms. If a member firm receives additional cash compensation from an offeror, it would have to:

- (1) disclose that information about a fund's fees and expenses may be found in the fund's prospectus;
- (2) if applicable, disclose the following:
  - that the firm receives cash payments from offerors in addition to the standard sales charges and service fees disclosed in the prospectus;
  - the nature of such payments received in the last 12 months; and
  - a list of offerors making such payments listed in descending order of payments received; and
- (3) provide a reference to a Web page or toll-free number containing updated information, which must be updated at least every six months. Alternatively, if the firm elects not to maintain a Web page or toll-free number, it must disclose updated information to customers every six months.

FINRA seeks comment on how this information should be disclosed to investors, particularly given the availability of the Internet. Should firms be permitted to deliver initial disclosure information (*i.e.*, information described in items 1 and 2 above) to customers electronically, unless a customer specifically requests paper-based disclosure? Alternatively, should the rule allow firms to provide generalized disclosure (in either paper or electronic format) to an investor when an account is opened regarding the receipt of cash compensation that refers the investor to a Web site address or toll-free number that provides the information described in items 1 and 2 above?

Fourth, the staff proposes to add supplementary material that clarifies provisions regarding the disclosure of cash compensation and that would supersede all prior guidance with respect to these provisions. Among other things, the supplementary material provides that:

- (1) cash compensation includes revenue sharing paid in connection with the sale and distribution of investment company securities (and therefore member firms would be required to disclose revenue sharing arrangements pursuant to the rule); and
- (2) a special sales charge or service fee arrangement includes any arrangement under which a member firm receives greater sales charges or service fees than other member firms selling the same investment company securities, even if an offeror would have made the same arrangement available to other member firms had they requested it.

### Proposed Changes to the Non-Cash Compensation Provisions

NASD Rule 2830(l)(5) generally prohibits member firms and their associated persons from accepting or making payments of non-cash compensation in connection with the sale of investment company securities, subject to certain exceptions. These exceptions allow gifts of under \$100, entertainment that does not raise questions of propriety, certain training or education meetings, and sales contests that do not favor particular products.

NASD Rule 2830(l)(3) requires member firms to keep records of all compensation received by the member firm or its associated persons from offerors, other than small gifts and entertainment permitted by the rule. Currently, this provision requires the records to include the nature of and, "if known," the value of any non-cash compensation received. FINRA proposes to modify this requirement by deleting the phrase "if known" regarding the value of non-cash compensation. This change would make the provision more consistent with the non-cash compensation recordkeeping requirements in other FINRA rules.<sup>10</sup> Firms would be permitted to estimate in good faith the actual value of non-cash compensation received for which a receipt (or similar documentation) assigning a value is not available.<sup>11</sup>

## Proposed Changes Regarding Conditions for Discounts to Dealers

NASD Rule 2830(c) currently prohibits investment company underwriters from selling the fund's securities to a retail broker-dealer at a price other than the public offering price unless they meet two requirements:

- ▶ the sale must be in conformance with NASD Rule 2420 (Dealing with Non-Members); and
- ▶ for certain investment company securities, a sales agreement must be in place that sets forth the concessions paid to the retail firm.

The requirement that the sale be in conformance with NASD Rule 2420 is based on historical concerns that both underwriters and dealers of investment company securities be members. Since the time this provision was adopted, the laws governing broker-dealers have changed, and today virtually all broker-dealers doing business with the public are FINRA members. As a result of this change, FINRA proposes eliminating the requirement that the sale be in conformance with Rule 2420.

## Proposed Changes Regarding Sales of ETFs

In recent years, member firms have bought and sold shares of ETFs, which are open-end investment companies or unit investment trusts (UITs) that differ from traditional mutual funds and UITs, since their shares typically are traded on securities exchanges. Because ETF shares are sometimes traded at prices that differ from the fund's current net asset value, ETFs can raise issues both under the Investment Company Act and NASD Rule 2830. For example, Section 22(d) of the Investment Company Act requires dealers to sell shares of an open-end investment company at the current public offering price described in its prospectus (*i.e.*, the fund's net asset value plus any applicable sales load). Similarly, NASD Rule 2830(i) generally prohibits member firms from purchasing fund shares at a price lower than the bid price next quoted by or for the issuer (for traditional mutual funds, this price is the fund's current net asset value).

To address these issues, the SEC has issued a series of exemptive orders that allow ETFs to trade on exchanges at prices that differ from the fund's public offering price. The SEC also has proposed a rule that would codify the exemptive relief provided by its orders.<sup>12</sup> Similarly, FINRA staff has issued letters interpreting NASD Rule 2830 that allow member firms to purchase and sell shares of ETFs at prices other than the current net asset value consistent with SEC exemptive orders.<sup>13</sup> As proposed, the new FINRA rule would add a provision, FINRA Rule 2341(o), to codify earlier FINRA staff interpretive letters that permit the trading of ETF shares at prices other than the current net asset value consistent with applicable SEC rules or exemptive orders.

## Endnotes

- 1 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 03/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See SEA Section 19 and rules thereunder.
- 4 As with NASD Rule 2830, FINRA Rule 2341 would not regulate member firms' activities in connection with variable insurance contracts, which are regulated by NASD Rule 2820. The SEC recently approved FINRA's proposal to adopt NASD Rule 2820 with minor changes as FINRA Rule 2320 in the Consolidated FINRA Rulebook. See Exchange Act Release No. 60086 (June 10, 2009) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-023).
- 5 FINRA staff has interpreted this provision as permitting disclosure in a fund's statement of additional information (SAI) rather than in its statutory (printed) prospectus. See *Notice to Members 99-55* (July 1999), Question #18.
- 6 FINRA previously proposed similar changes to the cash compensation provisions of Rule 2830 in 2003. See *Notice to Members 03-54* (Sept. 2003).
- 7 The terms "sales charge" and "service fees" are defined in NASD Rule 2830 and would retain the same definitions in FINRA Rule 2341. "Sales charge" means "all charges or fees that are paid to finance sales or sales promotion expenses, including front-end, deferred and asset-based sales charges, excluding charges and fees for ministerial, recordkeeping or administrative activities and investment management fees." NASD Rule 2830(b)(8). "Service fees" include "payments by an investment company for personal service and/or the maintenance of shareholder accounts." NASD Rule 2830(b)(9).
- 8 Revenue-sharing payments can take many different forms. For example, a fund company may pay a firm additional amounts at year-end based on the amount a firm's customers currently hold in the offeror's funds, or based on the firm's total sales of the offeror's funds in the previous year. They can also take the form of other cash payments, such as an offeror helping to pay the costs of a firm's annual sales meeting. See, e.g., Securities Act Release No. 8358 (Jan. 24, 2004), 69 FR 6438 (Feb. 10, 2004), at 6441 n.17.
- 9 If the customer does not open an account with the broker-dealer or its clearing firm, such as when the customer has an account with a mutual fund transfer agent, this disclosure would have to be made before the initial shares are purchased.

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## Endnotes (continued)

- 10 *See, e.g.*, recordkeeping requirements for non-cash compensation regarding public offerings of securities in FINRA Rule 5110(i)(2) and direct participation programs in NASD Rule 2810(c)(2). The SEC recently approved FINRA's proposal to adopt NASD Rule 2810 without material change as FINRA Rule 2310 in the Consolidated FINRA Rulebook. *See* Exchange Act Release No. 59987 (May 27, 2009), 74 FR 26909 (June 4, 2009) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-016).
- 11 The SEC recently approved FINRA's proposal to make a similar change to the recordkeeping requirements for non-cash compensation received in connection with the offer or sale of variable insurance products pursuant to current NASD Rule 2820 (which will become FINRA Rule 2320). *See supra* note 4.
- 12 Securities Act Release No. 8901 (Mar. 11, 2008), 73 FR 14618 (Mar. 18, 2008).
- 13 *See, e.g.*, Letter from Joseph P. Savage, Counsel, Investment Companies Regulation, NASD, to Kathleen H. Moriarty, Carter, Ledyard & Milburn (Oct. 30, 2002).

## Attachment A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

\* \* \* \* \*

### Text of Proposed New FINRA Rule (Marked to Show Changes from NASD Rule 2830; NASD Rule 2830 to be Deleted in its Entirety from the Transitional Rulebook)

\* \* \* \* \*

#### 2000. DUTIES AND CONFLICTS

\* \* \* \* \*

#### 2300. SPECIAL PRODUCTS

\* \* \* \* \*

#### 2340. Investment Companies

\* \* \* \* \*

#### [2830]2341. Investment Company Securities

##### (a) Application

This Rule shall apply exclusively to the activities of members in connection with the securities of companies registered under the Investment Company Act[ of 1940 (“the 1940 Act”)]; provided, however, that Rule 2320[2820]1 shall apply, in lieu of this Rule, to members’ activities in connection with “variable contracts” as defined therein.

##### (b) Definitions

(1) The terms “affiliated member,” “compensation,” “cash compensation,” “non-cash compensation” and “offeror” as used in paragraph (l) of this Rule shall have the following meanings:

(A) “Affiliated Member” shall mean a member which, directly or indirectly, controls, is controlled by, or is under common control with a non-member company.

(B) “Compensation” shall mean cash compensation and non-cash compensation.

(C) “Cash compensation” shall mean any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override or cash employee benefit received in connection with the sale and distribution of investment company securities.

(D) “Non-cash compensation” shall mean any form of compensation received in connection with the sale and distribution of investment company securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging.

(E) “Offeror” shall mean an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company [1940] Act) of such entities.

(2) “Brokerage commissions,” as used in paragraph (k), shall not be limited to commissions on agency transactions but shall include underwriting discounts or concessions and fees paid to members in connection with tender offers.

(3) “Covered account,” as used in paragraph (k), shall mean (A) any other investment company or other account managed by the investment adviser of such investment company, or (B) any other account from which brokerage commissions are received or expected as a result of the request or direction of any principal underwriter of such investment company or of any affiliated person (as defined in the Investment Company [1940] Act) of such investment company or of such underwriter, or of any affiliated person of an affiliated person of such investment company.

(4) “Person” shall mean “person” as defined in the Investment Company [1940] Act.

(5) “Prime rate,” as used in paragraph (d), shall mean the most preferential interest rate on corporate loans at large U.S. money center commercial banks.

(6) “Public offering price” shall mean a public offering price as set forth in the prospectus of the issuing company.

(7) “Rights of accumulation” as used in paragraph (d), shall mean a scale of reducing sales charges in which the sales charge applicable to the securities being purchased is based upon the aggregate quantity of securities previously purchased or acquired and then owned plus the securities being purchased. The quantity of securities owned shall be based upon:

(A) The current value of such securities (measured by either net asset value or maximum offering price); or

(B) Total purchases of such securities at actual offering prices; or

(C) The higher of the current value or the total purchases of such securities.

The quantity of securities owned may also include redeemable securities of other registered investment companies having the same principal underwriter.

(8) “Sales charge” and “sales charges,” as used in paragraph (d) and paragraph (l)(4), shall mean all charges or fees that are paid to finance sales or sales promotion expenses, including front-end, deferred and asset-based sales charges, excluding charges and fees for ministerial, recordkeeping or administrative activities and investment management fees. For purposes of this Rule, members may rely on the sales-related fees and charges disclosed in the prospectus of an investment company.

(A) An “asset-based sales charge” is a sales charge that is deducted from the net assets of an investment company and does not include a service fee.

(B) A “deferred sales charge” is any amount properly chargeable to sales or promotional expenses that is paid by a shareholder after purchase but before or upon redemption.

(C) A “front-end sales charge” is a sales charge that is included in the public offering price of the shares of an investment company.

(9) “Service fees,” as used in paragraph (d) and paragraph (l)(4), shall mean payments by an investment company for personal service and/or the maintenance of shareholder accounts.

(10) The terms “underwriter,” “principal underwriter,” “redeemable security,” “periodic payment plan,” “open-end management investment company,” and unit investment trust,” shall have the same definitions used in the Investment Company [1940] Act.

(11) A “fund of funds” is an investment company that acquires securities issued by any other investment company registered under the Investment Company [1940] Act in excess of the amounts permitted under paragraph (A) of Section 12(d)(1) of the Investment Company [1940] Act. An “acquiring company” in a fund of funds is the investment company that purchases or otherwise acquires the securities of another investment company, and an “acquired company” is the investment company whose securities are acquired.

(12) “Investment companies in a single complex” are any two or more companies that hold themselves out to investors as related companies for purposes of investment and investor services.

**(c) Conditions for Discounts to Dealers**

No member who is an underwriter of the securities of an investment company shall sell any [such security to any dealer or broker at any price other than a public offering price unless such sale is in conformance with Rule 2420 and, if the] security that is issued by an open-end management company or by a unit investment trust which invests primarily in securities issued by other investment companies[,] to any dealer or broker at any price other than a public offering price unless a sales agreement is in effect between the parties as of the date of the transaction, which agreement shall set forth the concessions to be received by the dealer or broker.

**(d) Sales Charge**

No member shall offer or sell the shares of any open-end investment company, any closed-end investment company that makes periodic repurchase offers pursuant to Rule 23c-3(b) under the Investment Company [1940] Act and offers its shares on a continuous basis pursuant to Rule 415(a)(1)(xi) under the Securities Act[ of 1933], or any “single payment” investment plan issued by a unit investment trust (collectively “investment companies”) registered under the Investment Company [1940] Act if the sales charges described in the prospectus are excessive. Aggregate sales charges shall be deemed excessive if they do not conform to the following provisions:

**(1) Investment Companies Without an Asset-Based Sales Charge**

(A) Aggregate front-end and deferred sales charges described in the prospectus which may be imposed by an investment company without an asset-based sales charge shall not exceed 8.5% of the offering price.

(B) (i) Rights of accumulation (cumulative quantity discounts) may be made available to any person in accordance with one of the alternative quantity discount schedules provided in subparagraph (C)(i) below, as in effect on the date the right is exercised.

(ii) If rights of accumulation are not made available on terms at least as favorable as those specified in subparagraph (C)(i) the maximum aggregate sales charge shall not exceed 8.0% of the offering price.

(C) (i) Quantity discounts, if offered, shall be made available on single purchases by any person in accordance with one of the following two alternatives:

a. A maximum aggregate sales charge of 7.75% on purchases of \$10,000 or more and a maximum aggregate sales charge of 6.25% on purchases of \$25,000 or more; or

b. A maximum aggregate sales charge of 7.50% on purchases of \$15,000 or more and a maximum aggregate sales charge of 6.25% on purchases of \$25,000 or more.

(ii) If quantity discounts are not made available on terms at least as favorable as those specified in subparagraph (C)(i) the maximum aggregate sales charge shall not exceed:

a. 7.75% of offering price if the provisions of subparagraphs (B) are met.

b. 7.25% of offering price if the provisions of subparagraph (B) are not met.

(D) If an investment company without an asset-based sales charge pays a service fee, the maximum aggregate sales charge shall not exceed 7.25% of the offering price.

## **(2) Investment Companies with an Asset-Based Sales Charge**

(A) Except as provided in subparagraphs (C) and (D), the aggregate asset-based, front-end and deferred sales charges described in the prospectus which may be imposed by an investment company with an asset-based sales charge, if the investment company has adopted a plan under which service fees are paid, shall not exceed 6.25% of total new gross sales (excluding sales from the reinvestment of distributions and exchanges of shares between investment companies in a single complex, between classes of an investment company with multiple classes of shares or between series of a series investment company) plus interest charges on such amount equal to the prime rate plus one percent per annum. The maximum front-end or deferred sales charge resulting from any transaction shall be 6.25% of the amount invested.

(B) Except as provided in subparagraphs (C) and (D), if an investment company with an asset-based sales charge does not pay a service fee, the aggregate asset-based, front-end and deferred sales charges described in the prospectus shall not exceed 7.25% of total new gross sales (excluding sales from the reinvestment of distributions and exchanges of shares between investment companies in a single complex, between classes of an investment company with multiple classes of shares or between series of a series investment company) plus interest charges on such amount equal to the prime rate plus one percent per annum. The maximum front-end or deferred sales charge resulting from any transaction shall be 7.25% of the amount invested.

(C) The maximum aggregate sales charge on total new gross sales set forth in subparagraphs (A) and (B) may be increased by an amount calculated by applying the appropriate percentages of 6.25% or 7.25% to total new gross sales which occurred after an investment company first adopted an asset-based sales charge until July 7, 1993 plus interest charges on such amount equal to the prime rate plus one percent per annum less any front-end, asset-based or deferred sales charges on such sales or net assets resulting from such sales.

(D) The maximum aggregate sales charges of an investment company in a single complex, a class of shares issued by an investment company with multiple classes of shares or a separate series of a series investment company, may be increased to include sales of exchanged shares provided that such increase is deducted from the maximum aggregate sales charges of the investment company, class or series which redeemed the shares for the purpose of such exchanges.

(E) No member shall offer or sell the shares of an investment company with an asset-based sales charge if:

(i) The amount of the asset-based sales charge exceeds .75 of 1% per annum of the average annual net assets of the investment company; or

(ii) Any deferred sales charges deducted from the proceeds of a redemption after the maximum cap described in subparagraphs (A), (B), (C) and (D) hereof, has been attained are not credited to the investment company.

### (3) Fund of Funds

(A) If neither an acquiring company nor an acquired company in a fund of funds structure has an asset-based sales charge, the maximum aggregate front-end and deferred sales charges that may be imposed by the acquiring company, the acquired company and those companies in combination, shall not exceed the rates provided in paragraph (d)(1).

(B) Any acquiring company or acquired company in a fund of funds structure that has an asset-based sales charge shall individually comply with the requirements of paragraph (d)(2), provided:

(i) If the acquiring and acquired companies are in a single complex and the acquired fund has an asset-based sales charge, sales made to the acquiring fund shall be excluded from total gross new sales for purposes of acquired fund's calculations under [sub]paragraphs (d)(2)(A) through (d)(2)(D); and

(ii) If both the acquiring and acquired companies have an asset-based sales charge:

a. the maximum aggregate asset-based sales charge imposed by the acquiring company, the acquired company and those companies in combination, shall not exceed the rate provided in [sub]paragraph (d)(2)(E)(i); and

b. the maximum aggregate front-end or deferred sales charges shall not exceed 7.25% of the amount invested, or 6.25% if either company pays a service fee.

(C) The rates described in [sub]paragraphs (d)(4) and (d)(5) shall apply to the acquiring company, the acquired company and those companies in combination. The limitations of [sub]paragraph (d)(6) shall apply to the acquiring company and the acquired company individually.

(4) No member or person associated with a member shall, either orally or in writing, describe an investment company as being "no load" or as having "no sales charge" if the investment company has a front-end or deferred sales charge or whose total charges against net assets to provide for sales related expenses and/or service fees exceed .25 of 1% of average net assets per annum.

(5) No member or person associated with a member shall offer or sell the securities of an investment company if the service fees paid by the investment company, as disclosed in the prospectus, exceed .25 of 1% of its average annual net assets or if a service fee paid by the investment company, as disclosed in the prospectus, to any person who sells its shares exceeds .25 of 1% of the average annual net asset value of such shares.

(6) No member or person associated with a member shall offer or sell the securities of an investment company if:

(A) The investment company has a deferred sales charge paid upon redemption that declines over the period of a shareholder's investment ("contingent deferred sales load"), unless the contingent deferred sales load is calculated as if the shares or amounts representing shares not subject to the load are redeemed first, and other shares or amounts representing shares are then redeemed in the order purchased, provided that another order of redemption may be used if such order would result in the redeeming shareholder paying a lower contingent deferred sales load; or

(B) The investment company has a front-end or deferred sales charge imposed on shares, or amounts representing shares, that are purchased through the reinvestment of dividends, unless the registration statement registering the investment company's securities under the Securities Act [of 1933] became effective prior to April 1, 2000.

**(e) Selling Dividends**

No member shall, in recommending the purchase of investment company securities, state or imply that the purchase of such securities shortly before an ex-dividend date is advantageous to the purchaser, unless there are specific, clearly described tax or other advantages to the purchaser, and no member shall represent that distributions of long-term capital gains by an investment company are or should be viewed as part of the income yield from an investment in such company's securities.

**(f) Withhold Orders**

No member shall withhold placing customers' orders for any investment company security so as to profit [himself]itself as a result of such withholding.

**(g) Purchase for Existing Orders**

No member shall purchase from an underwriter the securities of any open-end investment company and no member who is an underwriter of such securities shall purchase such securities from the issuer, except (1) for the purpose of covering purchase orders previously received or (2) for its own investment. Nothing herein shall be deemed to prohibit any member from purchasing securities of any investment company specifically designed for short-term investment (e.g., money market fund).

**(h) Refund of Sales Charge**

If any security issued by an open-end management investment company is repurchased by the issuer, or by the underwriter for the account of the issuer, or is tendered for redemption within seven business days after the date of the transaction, (1) the dealer or broker shall forthwith refund to the underwriter the full concession allowed to the dealer or broker on the original sale and (2) the underwriter shall forthwith pay to the issuer the underwriter's share of the sales charge on the original sale by the underwriter and shall also pay to the issuer the refund which [he]it received under subparagraph (1) when [he]it receives it. The dealer or broker shall be notified by the underwriter of such repurchase or redemption within ten days of the date on which the certificate or written request for redemption is delivered to the underwriter or issuer. If the original sale was made directly to the investor by the principal underwriter, the entire sales charge shall be paid to the issuer by the principal underwriter.

**(i) Purchases as Principal**

No member who is a party to a sales agreement referred to in paragraph (c) shall, as principal, purchase any security issued by an open-end management investment company or unit investment trust from a record holder at a price lower than the bid price next quoted by or for the issuer.

**(j) Repurchase from Dealer**

No member who is a principal underwriter of a security issued by an open-end investment company or a closed-end investment company that makes periodic repurchase offers pursuant to Rule 23c-3(b) under the Investment Company [1940] Act and offers its shares on a continuous basis pursuant to Rule 415(a)(1)(xi) under the Securities Act [of 1933] shall repurchase such security, either as principal or as agent for the issuer, from a dealer acting as principal who is not a party to a sales agreement

with a principal underwriter, nor from any investor, unless such dealer or investor is the record owner of the security so tendered for repurchase. No member who is a principal underwriter shall participate in the offering or in the sale of any such security if the issuer voluntarily redeems or repurchases its securities from a dealer acting as principal who is not a party to such a sales agreement nor from any investor, unless such dealer or investor is the record owner of the security so tendered for repurchase. Nothing in this paragraph shall relate to the compulsory redemption of any security upon presentation to the issuer pursuant to the terms of the security.

Nothing in this Rule shall prevent any member, whether or not a party to a sales agreement, from selling any such security for the account of a record owner to the underwriter or issuer at the bid price next quoted by or for the issuer and charging the investor to a reasonable charge for handling the transaction, provided that such member discloses to such record owner that direct redemption of the security can be accomplished by the record owner without incurring such charges.

**(k) Execution of Investment Company Portfolio Transactions**

(1) No member shall, directly or indirectly, favor or disfavor the sale or distribution of shares of any particular investment company or group of investment companies on the basis of brokerage commissions received or expected by such member from any source, including such investment company, or any covered account.

(2) No member shall sell shares of, or act as underwriter for, an investment company, if the member knows or has reason to know that such investment company, or an investment adviser or principal underwriter of the company, has a written or oral agreement or understanding under which the company directs or is expected to direct portfolio securities transactions (or any commission, markup or other remuneration resulting from any such transaction) to a broker or a dealer in consideration for the promotion or sale of shares issued by the company or any other registered investment company.

(3) No member shall, directly or indirectly, demand or require brokerage commissions or solicit a promise of such commissions from any source as a condition to the sale or distribution of shares of an investment company.

(4) No member shall, directly or indirectly, offer or promise to another member, brokerage commissions from any source as a condition to the sale or distribution of shares of an investment company and no member shall request or arrange for the direction to any member of a specific amount or percentage of brokerage commissions conditioned upon that member's sales or promise of sales of shares of an investment company.

(5) No member shall circulate any information regarding the amount or level of brokerage commissions received by the member from any investment company or covered account to other than management personnel who are required, in the overall management of the member's business, to have access to such information.

(6) No member shall, with respect to such member's activities as underwriter of investment company shares, suggest, encourage, or sponsor any incentive campaign or special sales effort of another member with respect to the shares of any investment company which incentive or sales effort is, to the knowledge or understanding of such underwriter-member, to be based upon, or financed by, brokerage commissions directed or arranged by the underwriter-member.

(7) No member shall, with respect to such member's retail sales or distribution of investment company shares:

(A) provide to salesmen, branch managers or other sales personnel any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including such investment companies or any covered account. Included in this prohibition are bonuses, preferred compensation lists, sales incentive campaign or contests, or any other method of compensation which provides an incentive to sales personnel to favor or disfavor any investment company or group of investment companies based on brokerage commissions;

(B) recommend specific investment companies to sales personnel, or establish "recommended," "selected," or "preferred" lists of investment companies, regardless of the existence of any special compensation or incentives to favor or disfavor the shares of such company or companies in sales efforts, if such companies are recommended or selected on the basis of brokerage commissions received or expected from any source;

(C) grant to salesmen, branch managers or other sales personnel any participation in brokerage commissions received by such member from portfolio transactions of an investment company whose shares are sold by such member, or from any covered account, if such commissions are directed by, or identified with, such investment company or any covered account; or

(D) use sales of shares of any investment company as a factor in negotiating the price of, or the amount of brokerage commissions to be paid on, a portfolio transaction of an investment company or of any covered account, whether such transaction is executed in the over-the-counter market or elsewhere.

(8) Provided that the member does not violate any of the specific provisions of this paragraph (k), nothing herein shall be deemed to prohibit:

(A) the execution of portfolio transactions of any investment company or covered account by members who also sell shares of the investment company; or

(B) a member from compensating its salesmen and managers based on total sales of investment company shares attributable to such salesmen or managers, whether by use of overrides, accounting credits, or other compensation methods, provided that such compensation is not designed to favor or disfavor sales of shares of particular investment companies on a basis prohibited by this paragraph (k).

**(l) Member Compensation**

In connection with the sale and distribution of investment company securities:

(1) Except as described below, no associated person of a member shall accept any compensation from anyone other than the member with which the person is associated. This requirement will not prohibit arrangements where a non-member company pays compensation directly to associated persons of the member, provided that:

(A) the arrangement is agreed to by the member;

(B) the member relies on an appropriate rule, regulation, interpretive release, interpretive letter, or “no-action” letter issued by the [Commission] SEC or its staff that applies to the specific fact situation of the arrangement;

(C) the receipt by associated persons of such compensation is treated as compensation received by the member for purposes of FINRA rules [the Rules of the Association]; and

(D) the record[ ]keeping requirement in paragraph (l)(3) is satisfied.

(2) No member or person associated with a member shall accept any compensation from an offeror which is in the form of securities of any kind.

(3) Except for items described in [sub]paragraphs (l)(5)(A) and (B), a member shall maintain records of all compensation received by the member or its associated persons from offerors. The records shall include the names of the offerors, the names of the associated persons, the amount of cash, and the nature and [ , if known, the ] value of non-cash compensation received.

(4) (A) No member shall accept any [cash compensation]sales charges or service fees from an offeror unless such compensation is described in a current prospectus of the investment company. When special [cash compensation]sales charges or service fee arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus. [Prospectus disclosure requirements shall not apply to cash compensation arrangements between:]

[(A) principal underwriters of the same security; and]

[(B) the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment.]

(B) Any member that has within the previous 12 months received from an offeror any form of cash compensation, other than sales charges or service fees disclosed in the prospectus fee table, must:

(i) disclose that information about an investment company's fees and expenses may be found in the fund's prospectus;

(ii) disclose, if applicable, that the member receives cash payments from an offeror, other than sales charges or service fees disclosed in the prospectus fee table, the nature of any such cash payments received in the past 12 months, and the name of each offeror that made such a cash payment, listed in descending order based upon the amount of compensation received from each offeror; and

(iii) provide a reference (or in the case of electronically delivered documents, a hyperlink) to the web page or toll-free telephone number described in subparagraph (D). If the member elects not to maintain a web page or toll-free telephone number as described in subparagraph (D), the member must disclose that updated information described in this subparagraph (B) will be sent to the customer on a semi-annual basis.

(C) The disclosure required by subparagraph (B) must be updated on a semi-annual basis and must be made in written documentation:

(i) at the time that the customer establishes an account with the member or the member's clearing broker;

(ii) if no such account is established, by the time the customer first purchases shares of an investment company; or

(iii) with respect to accounts existing when subparagraph (B) becomes effective, the later of (a) 90 days after the effective date, or (b) the time the customer first purchases shares of an investment company after the effective date (other than purchases through reinvestment of dividends or capital distributions or through automatic investment plans).

(D) Any member that receives cash payments from investment companies and their affiliates, other than sales charges or service fees disclosed in the prospectus fee table must either:

(i) maintain a web page or toll-free telephone number that is available to the public and that provides updated information described in subparagraph (B); or

(ii) send updated information described in subparagraph (B) in written form on a semi-annual basis to its customers who originally received this disclosure.

(E) The requirements of Rule 2341(l)(4)(B) shall not apply to cash compensation in the form of a sales charge or service fee disclosed in the prospectus fee table of the offeror's investment company.

(5) No member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Notwithstanding the provisions of [sub]paragraph (l)(1), the following non-cash compensation arrangements are permitted:

(A) Gifts that do not exceed an annual amount per person fixed periodically by FINRA[the Association]<sup>1</sup> and are not preconditioned on achievement of a sales target.

(B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) the record<sup>2</sup>keeping requirement in paragraph (l)(3) is satisfied;

(ii) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph (l)(5)(D);

(iii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iv) the payment or reimbursement is not applied to the expenses of guests of the associated person; and

(v) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement permitted by paragraph (l)(5)(D).

(D) Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:

(i) the member's or non-member's non-cash compensation arrangement, if it includes investment company securities, is based on the total production of associated persons with respect to all investment company securities distributed by the member;

(ii) the non-cash compensation arrangement requires that the credit received for each investment company security is equally weighted;

(iii) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

(iv) the record[]keeping requirement in paragraph (l)(3) is satisfied.

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in paragraph (l)(5)(D).

**(m) Prompt Payment for Investment Company Shares**

(1) Members (including underwriters) that engage in direct retail transactions for investment company shares shall transmit payments received from customers for such shares, which such members have sold to customers, to payees (i.e., underwriters, investment companies or their designated agents) by (A) the end of the third business day following a receipt of a customer's order to purchase such shares or by (B) the end of one business day following receipt of a customer's payment for such shares, whichever is the later date.

(2) Members that are underwriters and that engage in wholesale transactions for investment company shares shall transmit payments for investment company shares, which such members have received from other members, to investment company issuers or their designated agents by the end of two business days following receipt of such payments.

**(n) Disclosure of Deferred Sales Charges**

In addition to the requirements for disclosure on written confirmations of transactions contained in NASD Rule 2230, if the transaction involves the purchase of shares of an investment company that imposes a deferred sales charge on redemption, such written confirmation shall also include the following legend: "On selling your shares, you may pay a sales charge. For the charge and other fees, see the prospectus." The legend shall appear on the front of a confirmation and in, at least, 8-point type.

### (o) Exchange-Traded Funds

Nothing in this Rule shall be deemed to prohibit the trading of an exchange-traded fund on a secondary market or securities exchange at prices other than the exchange-traded fund's current net asset value, provided that such transactions are consistent with applicable SEC rules and orders. For purposes of this paragraph, "exchange-traded fund" means an open-end investment company or unit investment trust registered under the Investment Company Act that either has received an exemptive order from the SEC permitting trading of the investment company's shares at prices other than its current net asset value, or is operating in a manner consistent with SEC rules applicable to registered open-end investment companies or unit investment trusts that trade in the secondary market.

1. The current annual amount fixed by FINRA[the Association] is \$100.

#### • • • Supplementary Material: — — — — —

.01 "Cash Compensation." Paragraph (b)(1)(C) of this Rule defines "cash compensation" to mean "any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override or cash employee benefit received in connection with the sale and distribution of investment company securities." Paragraph (b)(1)(E) defines "offeror" to include the adviser, fund administrator, and underwriter of an investment company, and certain affiliates. For purposes of this Rule, "cash compensation" includes cash payments commonly known as "revenue sharing" which are typically paid by the investment company's adviser or another affiliate of the investment company in connection with the sale and distribution of the investment company's securities. "Cash compensation" includes these payments whether they are based upon the amount of investment company assets that a member's customers hold, the amount of investment company securities that the member has sold, or any other amount if the payment is related to the sale and distribution of the investment company's securities.

This guidance supersedes all prior guidance with respect to the definition of cash compensation under paragraph (b)(1)(C) or any predecessor rule.

.02 Special Sales Charge or Service Fee Arrangements. Paragraph (l)(4)(A) of this Rule prohibits a member from accepting sales charges or service fees from an offeror unless such compensation is described in the current prospectus of the investment company, and requires additional disclosure for special sales charge or service fee arrangements. This provision requires two levels of disclosure. First, the prospectus must disclose the

sales charges and service fees that are paid to the member. Second, if an offeror does not make sales charges and service fees available on the same terms to all members that distribute the investment company's securities, the prospectus must disclose the details of the special sales charge or service fee arrangement with the member and the identity of the member in its prospectus.

For purposes of this provision, "special sales charge or service fee arrangement" means an arrangement under which a member receives greater sales charges or service fees than other members selling the same investment company securities. For example, if a member receives the full gross sales charge imposed on the sale of investment company securities, while other members selling the same securities receive only a portion of the gross sales charge, the member receiving the full gross charge has entered into a special sales charge or service fee arrangement with an offeror that requires prospectus disclosure. Similarly, if a member receives a cash payout in addition to the regular commission paid on the sale of investment company securities, and other members do not receive this additional cash payout, the member has entered into a special sales charge or service fee arrangement. This disclosure requirement applies even if an offeror would have made the same arrangement available to other members had they requested it. Generally a member should assume it has entered into a special sales charge or service fee arrangement if it is receiving sales charges or service fees from an offeror in addition to the standard dealer reallocation or commission described in an investment company's prospectus, unless the prospectus is clear that this additional compensation is being paid to all members that sell the investment company's securities.

This guidance supersedes all prior guidance with respect to the disclosure of cash compensation arrangements under paragraph (l)(4) or any predecessor rule.

\* \* \* \* \*

1 FINRA has proposed to adopt NASD Rule 2820 as FINRA Rule 2320, with minor changes. See Exchange Act Release No. 59762 (Apr. 14, 2009), 74 FR 18269 (Apr. 21, 2009) (Notice of Filing SR-FINRA-2009-023).

## Municipal Securities

### FINRA Recommends Review of Municipal Securities Activities

#### Executive Summary

FINRA recommends that firms engaged in municipal securities business review and, if necessary, modify their policies and procedures in light of changes to the Municipal Securities Rulemaking Board's (MSRB) Electronic Municipal Market Access system (EMMA) that take effect July 1, 2009, and changes to MSRB rules that went into effect June 1, 2009.

FINRA also encourages firms to review the overall adequacy and effectiveness of their current policies and procedures for municipal securities activities generally, particularly those relating to the disclosure of material information, the suitability of recommendations to retail customers and the general supervision of their municipal securities activities.

Questions concerning this *Notice* should be directed to the Member Regulation Fixed Income Group at (202) 728-8085 or (202) 728-8133.

For information about compliance with MSRB rules, including the upcoming amendments to Rule 15c2-12, contact FINRA at the numbers above, or the MSRB at (703) 797-6600.

#### Background and Discussion

##### Municipal Securities Disclosure

Securities Exchange Act Rule 15c2-12 imposes certain obligations on municipal securities dealers in connection with disclosure, with both initial offerings and the secondary market.

#### June 2009

##### Notice Type

- Guidance

##### Suggested Routing

- Compliance
- Legal
- Municipal Securities
- Registered Representatives
- Senior Management

##### Key Topic(s)

- Disclosure
- EMMA
- Municipal Securities
- Suitability
- Supervision

##### Referenced Rules & Notices

- MSRB Rule G-17
- MSRB Rule G-19
- MSRB Rule G-27
- MSRB Rule G-32
- MSRB Rule G-36
- MSRB Notice 2008-47
- MSRB Notice 2009-22
- SEA Rule 15c2-12

With respect to initial offerings, the rule prohibits a municipal securities dealer from acting as a participating underwriter of an offering unless, among other things, the underwriter has reviewed an official statement that the issuer has deemed final as of its date. The participating underwriter also must have reasonably determined that the issuer, or an “obligated person,” has entered into a written agreement (the continuing disclosure agreement) to provide certain disclosure to each of the four nationally recognized municipal securities information repositories (NRMSIRs), as well as the appropriate state information depository (SID), if any. This required disclosure includes certain financial information and “notices of certain enumerated material events.”

The requirement to ensure that such an agreement has been reached is critical because of the importance of these notices and of the required financial information to the municipal securities market. The rule enumerates the following material events:

- Principal and interest payment delinquencies;
- Non-payment related defaults;
- Unscheduled draws on debt service reserves reflecting financial difficulties;
- Unscheduled draws on credit enhancements reflecting financial difficulties;
- Substitution of credit or liquidity providers or their failure to perform;
- Adverse tax opinions or events affecting the tax-exempt status of the security;
- Modifications to rights of security holders;
- Bond calls;
- Defeasances;
- Release, substitution or sale of property securing repayment of the securities; and
- Rating changes.

With respect to the secondary market, Rule 15c2-12(c) prohibits any municipal securities dealer from recommending the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive prompt notice of any material event notice.

### Changes to EMMA

On December 5, 2008, the U.S. Securities and Exchange Commission (SEC) approved amendments to Rule 15c2-12<sup>1</sup> and certain MSRB rules relating to EMMA, the MSRB’s electronic repository of municipal market information. EMMA already provides municipal securities dealers and other market participants with access to official statements filed with the MSRB, as well as advance refunding documents, 529 college savings plan offering documents and real-time and historic trade data for municipal bonds. Beginning July 1, 2009, EMMA will also include continuing disclosures submitted by municipal bond issuers, and will become the sole entity designated by the SEC as a NRMSIR.<sup>2</sup>

These changes may require municipal securities underwriters and dealers to modify current policies and procedures related to compliance with Rule 15c2-12, as well as certain MSRB rules. For example, underwriters will have to reasonably determine that required disclosure is made to the MSRB rather than to the current NRMSIRs as of July 1, 2009.<sup>3</sup> Firms also should review their policies and procedures to make certain they reflect the requirement that material event notices and notices of failure to provide required financial disclosure will be available through EMMA.

The amendments also will affect the small issuer exemption in Rule 15c2-12(d)(2), which may in turn require municipal securities underwriters and dealers to amend their existing policies and procedures with respect to small offerings. The small issuer exemption currently allows for limited or no financial or operating data disclosures if certain requirements are met (including no more than \$10 million in aggregate amount of outstanding municipal securities). For offerings made on or after July 1, 2009, issuers who are eligible for and use the small issuer exemption will need to agree, in writing, to file such financial information or operating data at least annually with the MSRB in an electronic format, as prescribed by the MSRB if such information is customarily prepared and is publicly available.

### **Amendments to MSRB Rule G-32 and G-36**

On May 21, 2009, the SEC also approved amendments to MSRB rules that will consolidate and amend current Rule G-36, relating to the delivery of official statements, and Rule G-32, governing disclosures in connection with new issues. As a result, firms will have to modify their policies and procedures relating to the delivery of official statements in connection with primary offerings of municipal securities.<sup>4</sup> The amendments were effective June 1, 2009, and, in addition to implementing some transitional and recordkeeping requirements, accomplish the following:

- Authorize the MSRB to launch EMMA as its primary municipal market disclosure service;
- Allow the MSRB to implement an “access equals delivery” standard for dissemination of official statements;
- Consolidate the new issue disclosure requirements of MSRB Rule G-32 and the official statement filing requirements of Rule G-36 into new Rule G-32 on disclosures in connection with primary offerings, which requires underwriters to file official statements with the MSRB electronically via EMMA;
- Implement new filing and/or notification requirements when an issue of municipal securities is exempt from Rule 15c2-12; and
- Replace Forms G-36(OS) and G-36(ARD) with new Form G-32.

Firms underwriting or selling primary offerings of municipal securities should familiarize themselves with these rule amendments and review and modify their existing policies and procedures concerning the delivery of official statements accordingly. For additional information, please refer to MSRB Notice 2009-22 ([www.msrb.org/msrb1/whatsnew/2009-22.asp](http://www.msrb.org/msrb1/whatsnew/2009-22.asp)).

### Disclosure, Suitability and Supervision

FINRA urges municipal securities dealers—including those whose business activities are limited to the secondary market—to reassess the adequacy of their current policies and procedures for complying with their obligations under MSRB rules generally, giving particular attention to those relating to:

- ▶ the disclosure of material information;
- ▶ the suitability of recommendations to customers; and
- ▶ the supervision of the firm’s municipal securities activities.

MSRB Rule G-17 provides that, in the conduct of its municipal securities activities, each dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest or unfair practice. The MSRB has interpreted Rule G-17 to require a dealer, in connection with any transaction in municipal securities, to disclose to its customer, at or prior to the sale, all material facts about the transaction known by the dealer, as well as material facts about the security that are reasonably accessible to the market.

In addition, MSRB Rule G-19 requires a dealer that recommends a municipal security to have reasonable grounds for believing that the recommendation is suitable, based upon information available from the issuer of the security, or otherwise, and the facts disclosed by or otherwise known about the customer.<sup>5</sup>

If a firm discovers through its Rule 15c2-12 procedures or otherwise that an issuer has failed to make filings required under its continuing disclosure agreements, the firm must take this information into consideration in meeting its obligations under Rule G-17 and in assessing the suitability of the issuer’s bonds under Rule G-19.

Finally, MSRB G-27 requires firms to supervise their municipal securities business, and to ensure that they have adequate policies and procedures in place for monitoring the effectiveness of their supervisory systems. Specifically, firms must:

- ▶ supervise the conduct of the municipal securities activities of the firm and associated persons to ensure compliance with all MSRB rules, the Exchange Act and the rules thereunder;

- have adequate written supervisory procedures; and
- implement supervisory controls to ensure that their supervisory procedures are adequate.

Beginning July 1, 2009, these procedures should include requiring and training associated persons to access all relevant information from EMMA and other established industry sources before selling or recommending a municipal security, whether in connection with an initial offering or in the secondary market.

The MSRB has published information and guidance about its rules, as well as changes to EMMA, at [www.msrb.org](http://www.msrb.org). The EMMA Web site may be accessed at [www.emma.msrb.org](http://www.emma.msrb.org).

## Endnotes

- 1 See MSRB Notice 2008-47 ([www.msrb.org/MSRB1/whatsnew/2008-47.asp](http://www.msrb.org/MSRB1/whatsnew/2008-47.asp)).
- 2 The amendments also eliminate the requirement that underwriters ensure that the continuing disclosure agreement obligates issuers to file with applicable SIDs; however, issuers may still be required to do so under state law.
- 3 For disclosure prior to July 1, 2009, underwriters would need to look to the NRMSIRs that were then operating rather than EMMA, unless the issuer voluntarily files pre-July 1, 2009, disclosures with EMMA.
- 4 See Exchange Act Release No. 59966 (May 21, 2009).
- 5 Like NASD Rule 2310, MSRB Rule G-19's suitability obligation requires both a "reasonable basis" determination that the recommended security is suitable for at least some investors, and a "customer-specific" analysis that the security is suitable for the specific customer to whom the recommendation is made. To meet the customer-specific prong of the suitability obligation, a dealer must make reasonable efforts to obtain information concerning the customer's financial status, tax status and investment objectives, as well as any other information reasonable and necessary in making the recommendation. See MSRB Reminder of Customer Protection Obligations in Connection With Sales of Municipal Securities (May 30, 2007); and MSRB Interpretation on Customer Protection Obligations Relating to the Marketing of 529 College Savings Plans (August 7, 2006).