

Notices

Regulatory Notices

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Information Notice

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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 and www.finra.org/disciplinaryactions.

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Arbitration Time Limits

SEC Approves an Amendment to the Tolling Provision in the Arbitration Codes for Customer and Industry Disputes

Effective Date: August 10, 2009

Executive Summary

An amendment to the Arbitration Codes for Customer and Industry Disputes that clarifies that the rules toll—*i.e.*, temporarily suspend—the applicable statutes of limitation when a person files an arbitration claim with FINRA¹ becomes effective August 10, 2009, and will apply to claims filed on or after that date.

The text of the amendments is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- ▶ Kenneth L. Andrichik, Senior Vice President, Chief Counsel and Director of Mediation and Business Strategy, Dispute Resolution, at (212) 858-3915 or ken.andrichik@finra.org; or
- ▶ Mignon McLemore, Assistant Chief Counsel, Dispute Resolution, at (202) 728-8151 or mignon.mclemore@finra.org.

July 2009

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topic(s)

- ▶ Arbitration
- ▶ Code of Arbitration Procedure
- ▶ Dispute Resolution
- ▶ Tolling

Referenced Rules & Notices

- ▶ Rules 12206(c)
- ▶ Rules 13206(c)

Background and Discussion

Currently, Rule 12206(a) of the Code of Arbitration Procedure for Customer Disputes (Customer Code) and Rule 13206(a) of the Code of Arbitration Procedure for Industry Disputes (Industry Code) (referred to as the “eligibility rules”) provide that, “no claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim.” The current eligibility rule does not extend applicable statutes of limitation, but does provide that, “where permitted by applicable law, when a claimant files a statement of claim in arbitration, any time limits for the filing of the claim in court will be tolled while FINRA retains jurisdiction of the claim.”² This means that, where permitted by applicable law, statutes of limitation will be tolled (*i.e.*, temporarily suspended) when a person files an arbitration claim with FINRA.

FINRA has interpreted the tolling provision of the current eligibility rule to mean that any applicable statutes of limitation would be tolled in all cases when a person files an arbitration claim with FINRA. However, one state court found that the phrase “where permitted by applicable law,” means that state law must permit tolling expressly, or the statutes of limitation period will not be tolled.³ In its analysis, the court determined that the eligibility rule did not toll the statute of limitations, unless applicable law permitted such tolling expressly.⁴ Further, the court also determined that there were no federal or state statutes that expressly permitted tolling of the applicable statute of limitations and, as a result, the customer’s case was dismissed.⁵

FINRA is concerned that courts may begin citing this interpretation as a reason to dismiss those customer claims that are filed in court because their arbitration claims were dismissed on eligibility grounds from FINRA’s arbitration forum.⁶ In these instances, FINRA believes that the court’s interpretation of the phrase “where permitted by applicable law” could limit or foreclose customers’ access to other judicial forums to address their disputes, which would be an unfair result. Therefore, FINRA is deleting the phrase “where permitted by applicable law” from Rules 12206(c) and 13206(c). The amendment would leave the parties in the same position in court as they were at the start of the arbitration with regard to any statutes of limitation: The time period before the claim was filed in arbitration would not be extended, but applicable statutes of limitation would not run while the matter was in arbitration.

Effective Date Provisions

The amendment becomes effective on August 10, 2009, and will apply to claims filed on or after August 10, 2009.

Endnotes

- 1 Exchange Act Release No. 59906 (May 12, 2009), 74 Federal Register 23462 (May 19, 2009) (File No. SR-FINRA-2009-013).
- 2 See Rules 12206(c) and 13206(c) of the Codes.
- 3 See *Friedman v. Wheat First Securities, Inc.*, 64 F. Supp. 2d 338 (S.D.N.Y. 1999). See also *Individual Securities v. Ross*, 1998 U.S. App. Lexis 12618, and *Rampersad v. Deutsche Bank Securities, Inc.*, 2004 U.S. Dist. Lexis 5031 (finding the phrase “where permitted by law” did not toll the applicable statute to limitation, but deciding the case on other grounds).
- 4 *Id.*
- 5 *Id.*
- 6 Rules 12206(b) and 13206(b) of the Codes state that “dismissal of a claim under this rule does not prohibit a party from pursuing the claim in court. By filing a motion to dismiss a claim under this rule, the moving party agrees that if the panel dismisses a claim under this rule, the non-moving party may withdraw any remaining related claims without prejudice and may pursue all of the claims in court.”

ATTACHMENT A

Deleted language is in brackets.

Code of Arbitration Procedure for Customer Disputes and Code of Arbitration Procedure for Industry Disputes

* * * * *

Customer Code

12206. Time Limits

(a) – (b) No change.

(c) Effect of Rule on Time Limits for Filing Claim in Court

The rule does not extend applicable statutes of limitations; nor shall the six-year time limit on the submission of claims apply to any claim that is directed to arbitration by a court of competent jurisdiction upon request of a member or associated person. However, [where permitted by applicable law,] when a claimant files a statement of claim in arbitration, any time limits for the filing of the claim in court will be tolled while FINRA retains jurisdiction of the claim.

(d) No change.

* * * * *

Industry Code

13206. Time Limits

(a) – (b) No change.

(c) Effect of Rule on Time Limits for Filing Claim in Court

The rule does not extend applicable statutes of limitations; nor shall the six-year time limit on the submission of claims apply to any claim that is directed to arbitration by a court of competent jurisdiction upon request of a member or associated person. However, [where permitted by applicable law,] when a claimant files a statement of claim in arbitration, any time limits for the filing of the claim in court will be tolled while FINRA retains jurisdiction of the claim.

(d) No change.

* * * * *

Trading in Motors Liquidation Company (Formerly Known as General Motors Corporation)

Executive Summary

On July 10, 2009, FINRA halted over-the-counter trading in Motors Liquidation Company (formerly known as General Motors Corporation) because it believed the trading volume in the security represented a potential widespread misunderstanding that this security may be related to interests in the new General Motors Company, as opposed to Motors Liquidation Company. Commencing July 15, 2009, trading in Motors Liquidation Company common stock will resume and the security will begin trading under the symbol MTLQO. The former common stock symbol, GMGMO, will be deleted and should only be used for the limited purpose of reporting as-of reports, corrections or cancellations of trades effected on or prior to July 10, 2009, as described in this *Notice*.

Questions regarding this *Notice* should be directed to:

- FINRA Operations at (866) 776-0800; or
- FINRA Office of General Counsel at (202) 728-8071.

Background & Discussion

On July 10, 2009, pursuant to authority under Rule 6460(a)(3), FINRA halted over-the-counter trading in Motors Liquidation Company (formerly known as General Motors Corporation) because it believed the trading volume in the security represented a potential widespread misunderstanding that this security may be related to interests in the new General Motors Company post-bankruptcy (the new GM), as opposed to Motors Liquidation Company.¹ As stated on the Web sites of both Motors Liquidation Company and the new GM, the new GM currently has no publicly traded securities and none of Motors Liquidation Company's publicly owned stocks or bonds are or will become securities of new GM; Motors Liquidation Company is independent from, and unaffiliated with, the new GM.²

July 2009

Notice Type

- Alert

Suggested Routing

- Compliance
- Institutional
- Legal
- Operations
- Registered Representatives
- Senior Management
- Trading

Key Topic(s)

- Bankruptcy
- Suitability
- Symbol Change
- Trading Halt

Referenced Rules & Notices

- FINRA Rule 2114
- FINRA Rule 6460
- NASD Rule 2310

Further, management of Motors Liquidation Company has stated the following:

Management continues to remind investors of its strong belief that there will be no value for the common stockholders in the bankruptcy liquidation process, even under the most optimistic of scenarios. Stockholders of a company in chapter 11 generally receive value only if all claims of the company's secured and unsecured creditors are fully satisfied. In this case, management strongly believes all such claims will not be fully satisfied, leading to its conclusion that the common stock will have no value.³

Commencing July 15, 2009, trading in Motors Liquidation Company will resume and the security will begin trading under the new symbol, MTLQO.⁴ The former common stock symbol, GMGMO, will be deleted and should only be used for the limited purpose of reporting of as-of transactions, corrections or cancellations of trades effected on or prior to July 10, 2009.

Member firms are reminded that the suitability requirements of NASD Rule 2310 (Recommendations to Customers (Suitability)) apply to the recommendation of any security and that firms must have reasonable grounds for believing that a security recommended to a customer is suitable for that customer. Further, FINRA Rule 2114 (Recommendations to Customers in OTC Equity Securities) applies specifically to unlisted securities, such as Motors Liquidation Company,⁵ and supplements existing FINRA rules and the federal securities law, including suitability obligations, for these securities. The rule requires that firms, at a minimum, conduct a due diligence review of an issuer's current financial statements and material business information, and make a determination that such information, and any other information available, provides a reasonable basis under the circumstances for making the recommendation.

Firms and other interested parties that have operational questions concerning the FINRA trading halt or the symbol change should contact FINRA Operations at (866) 776-0800. Questions concerning Motors Liquidation Company or the new GM should be directed to those companies directly.

Endnotes

- 1 Rule 6460(a)(3) provides that FINRA may direct member firms to halt trading and quotations in OTC equity securities if FINRA determines, among other things, that an extraordinary event has occurred or is ongoing that has had a material effect on the market for the OTC equity security. As provided in Supplementary Material .02 to Rule 6460, FINRA considered among the factors in making its determination that questions from brokers and dealers and the trading volume in GMGMQ indicated a potential widespread misunderstanding that these securities represented interests in new GM, which in fact, is not the case
- 2 See the Motors Liquidation Company Web site at www.motorsliquidation.com and the new GM at www.gm.com/corporate/investor_information.
- 3 See the Motors Liquidation Company Web site at www.motorsliquidation.com.
- 4 See the Uniform Practice Code Advisory at www.finra.org/upc/023-09.
- 5 Certain limited exemptions apply. See Rule 2114(e).

FDIC Guaranteed Debt

Guidance on the Net Capital and Reserve Formula Treatment of Senior Unsecured Debt Securities Issued Under the Debt Guarantee Program Component of the FDIC's Temporary Liquidity Guarantee Program

Effective Date: July 15, 2009

Executive Summary

FINRA is issuing this *Notice* to advise firms of the Net Capital and Reserve Formula treatment of senior unsecured debt securities issued under the Debt Guarantee Program component of the Federal Deposit Insurance Corporation's (FDIC) Temporary Liquidity Guarantee Program. Terms of the guidance are detailed in a July 15, 2009, letter to the Securities and Exchange Commission (SEC), included as Attachment A to this *Notice*.

Questions concerning this *Notice* should be directed to:

- Yui Chan, Managing Director, Risk Oversight and Operational Regulation (ROOR), at (646) 315-8426;
- Joanne Li, Director, ROOR, at (646) 315-8403; or
- Kathryn Mahoney, Director, ROOR, at (646) 315-8428.

Background & Discussion

In November 2008, the Board of Directors of the FDIC adopted a final rule regarding the Temporary Liquidity Guarantee Program (TLGP). The TLGP was announced by the FDIC as an initiative to counter the system-wide credit crisis in the nation's financial sector.

To assist firms in proper treatment of senior unsecured debt securities issued pursuant to the Debt Guarantee Program component of the FDIC's TLGP (the Program) under Rules 15c3-1 (Net Capital) and 15c3-3 (Reserve Formula) of the Securities Exchange Act of 1934, the SEC's Division of Trading and Markets staff has provided guidance to FINRA. The guidance is detailed in Attachment A of this *Notice*.

July 2009

Notice Type

- Guidance

Suggested Routing

- Compliance
- Finance
- Legal
- Operations
- Regulatory Reporting
- Senior Management

Key Topic(s)

- Customer Protection
- FDIC Guaranteed Debt
- Net Capital

Referenced Rules & Notices

- SEA Rule 15c3-1
- SEA Rule 15c3-3

As prescribed in the FDIC's final rule regarding the Program, the FDIC will fully and unconditionally guarantee senior unsecured debt securities issued by participating entities pursuant to the Program between October 14, 2008, and June 30, 2009, through the earlier of

- the maturity of such debt;
- the mandatory conversion date of any mandatory convertible debt; or
- June 30, 2012.

In addition, as prescribed in the FDIC's subsequent rule amendment regarding the Program, the FDIC will fully and unconditionally guarantee senior unsecured debt securities issued by participating entities pursuant to the Program between April 1, 2009, and October 31, 2009, through the earlier of

- the maturity of such debt;
- the mandatory conversion date of any mandatory convertible debt; or
- December 31, 2012.

The debt securities issued pursuant to the Program, which include commercial paper, non-convertible debt securities and mandatory convertible debt securities, may be:

1. **full-term guaranteed by the FDIC:** any debt securities issued pursuant to the Program that have a maturity date that ends, or a mandatory conversion date that is effective, on or before the aforementioned Program end-dates, such that the debt securities are guaranteed by the FDIC for the entire term from the date they are issued until their maturity date or mandatory conversion date;
2. **partial-term guaranteed by the FDIC:** any debt securities, except mandatory convertible debt securities, issued pursuant to the Program that have a maturity date that ends after the aforementioned Program end-dates, such that the debt securities are guaranteed by the FDIC for the entire period from the date they are issued until the Program's end-date, but are not guaranteed by the FDIC for any remaining period beyond the Program's end-date through their maturity date; or
3. **non-guaranteed by the FDIC:** any debt securities issued pursuant to the Program that are not guaranteed by the FDIC for any period from the date they are issued until their maturity date.

Based on the above, the SEC's Division of Trading and Markets staff has advised that FINRA firms may apply the Net Capital and Reserve Formula treatment on the debt securities issued pursuant to the Program as detailed in FINRA's July 15, 2009, letter to the SEC (see Attachment A of this *Notice*).

Attachment A

July 15, 2009

Michael A. Macchiaroli, Esq.
Associate Director
Securities and Exchange Commission
Division of Trading and Markets
100 F Street, NE
Washington, DC 20549

Dear Mr. Macchiaroli,

FINRA has requested guidance from the Division of Trading and Markets staff of the Securities and Exchange Commission as to the treatment of senior unsecured debt securities issued pursuant to the Debt Guarantee Program component of the Federal Deposit Insurance Corporation's (FDIC) Temporary Liquidity Guarantee Program (the Program), under Rules 15c3-1 (Net Capital) and 15c3-3 (Reserve Formula) of the Securities Exchange Act of 1934.

As prescribed in the FDIC's final rule regarding the Program, and confirmed through discussions with FDIC staff, the FDIC will fully and unconditionally guarantee senior unsecured debt securities issued by participating entities pursuant to the Program between October 14, 2008, and June 30, 2009, through the earlier of the maturity of such debt, the mandatory conversion date of any mandatory convertible debt or June 30, 2012. In addition, as prescribed in the FDIC's subsequent rule amendment regarding the Program, the FDIC will fully and unconditionally guarantee senior unsecured debt securities issued by participating entities pursuant to the Program between April 1, 2009, and October 31, 2009, through the earlier of the maturity of such debt, the mandatory conversion date of any mandatory convertible debt or December 31, 2012.

The debt securities issued pursuant to the Program, which include commercial paper, non-convertible debt securities and mandatory convertible debt securities, may be:

1. full-term guaranteed by the FDIC: any debt securities issued pursuant to the Program that have a maturity date that ends, or a mandatory conversion date that is effective, on or before the aforementioned Program end-dates, such that the debt securities are guaranteed by the FDIC for the entire term from the date they are issued until their maturity date or mandatory conversion date;

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2. partial-term guaranteed by the FDIC: any debt securities, except mandatory convertible debt securities, issued pursuant to the Program that have a maturity date that ends after the aforementioned Program end-dates, such that the debt securities are guaranteed by the FDIC for the entire period from the date they are issued until the Program's end-date, but are not guaranteed by the FDIC for any remaining period beyond the Program's end-date through their maturity date; or
3. non-guaranteed by the FDIC: any debt securities issued pursuant to the Program that are not guaranteed by the FDIC for any period from the date they are issued until their maturity date.

Based on the foregoing and our subsequent discussions with you, it is our understanding that the SEC's Division of Trading and Markets staff is in agreement with FINRA staff that FINRA firms may apply the following Net Capital and Reserve Formula treatment on the debt securities issued pursuant to the aforementioned Program:

SEA Rule 15c3-1 - Net Capital Treatment

Proprietary positions in full-term guaranteed commercial paper and non-convertible debt securities issued by an unaffiliated entity shall be subject to the haircut deductions under SEA Rule 15c3-1(c)(2)(vi)(A) (Government Securities).

Proprietary positions in partial-term guaranteed and non-guaranteed commercial paper issued by an unaffiliated entity shall be subject to the haircut deductions under SEA Rule 15c3-1(c)(2)(vi)(E) (Commercial Paper), if such securities meet all the required provisions thereunder. Otherwise, the applicable haircut deductions of SEA Rule 15c3-1(c)(2)(vii) and the interpretations thereunder shall be applied on such debt securities.

Proprietary positions in partial-term guaranteed and non-guaranteed non-convertible debt securities issued by an unaffiliated entity shall be subject to the haircut deductions under SEA Rule 15c3-1(c)(2)(vi)(F) (Non-Convertible Debt Securities), if such securities meet all the required provisions thereunder. Otherwise, the applicable haircut deductions of SEA Rule 15c3-1(c)(2)(vii) and the interpretations thereunder shall be applied on such debt securities.

Proprietary positions in any mandatory convertible debt securities issued by an unaffiliated entity shall be subject to the haircut deductions under SEA Rule 15c3-1(c)(2)(vi)(G) (Convertible Debt Securities), pursuant to the prescribed provisions thereunder.

Mr. Michael Macchiaroli, Esq.
July 15, 2009
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Proprietary positions in any commercial paper or non-convertible debt securities issued by an affiliated entity shall be treated as a non-allowable asset, unless the broker-dealer can satisfy the requirements prescribed under interpretation /061 of SEA Rule 15c3-1(c)(2)(vi).

Proprietary positions in any mandatory convertible debt securities issued by an affiliated entity shall be treated as a non-allowable asset.

Broker-dealers that are allocated any debt securities issued by an affiliated entity pursuant to the Program, as part of a pool of collateral to a reverse repurchase transaction pursuant to the FICC General Collateral Financing Repo Program, need not apply a deduction to net capital on the reverse repurchase contract if the allocated collateral is returned the next morning. The foregoing applies irrespective of the duration of the reverse repurchase contract (*i.e.*, overnight or term). Broker-dealers must apply a charge to their net capital for the computed deficit, if any, on such reverse repurchase contracts pursuant to SEA Rule 15c3-1(c)(2)(iv)(F)(2). In addition, where the underlying collateral received from the FICC allocation includes the aforementioned debt securities issued by an affiliated entity, broker-dealers must maintain records to evidence that the reverse repurchase contracts were effected pursuant to the FICC General Collateral Financing Repo Program.

Any reverse repurchase contracts that are not transacted pursuant to the FICC General Collateral Financing Repo Program, where the underlying collateral received consists of debt securities issued by an affiliated entity pursuant to the Program, shall be treated as a non-allowable asset.

SEA Rule 15c3-3 Reserve Formula Treatment

Full-term guaranteed commercial paper and non-convertible debt securities issued by an unaffiliated entity pursuant to the Program, either held in inventory by a broker-dealer or obtained through a reverse repurchase contract, may be deemed a “qualified security” under SEA Rule 15c3-3(a)(6) for deposit into a Reserve Bank Account under the following conditions:

1. The total amount of all unaffiliated full-term guaranteed commercial paper and non-convertible debt securities deposited into a Reserve Bank Account may not exceed 25 percent of the broker-dealer’s aggregate SEA Rule 15c3-3 Reserve Bank Account deposit(s) (Customer and PAIB); and

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2. The total amount of all unaffiliated full-term guaranteed commercial paper and non-convertible debt securities of any single issuer deposited into a Reserve Bank Account may not exceed 10 percent of the broker-dealer's aggregate SEA Rule 15c3-3 Reserve Bank Account deposit(s) (Customer and PAIB).

The foregoing limitations have been established in view of the 20 percent risk weighting applied by federal banking agencies to debt that is guaranteed by the FDIC under the Program, which is also consistent with such agencies' capital treatment of FDIC-insured deposits.

All other commercial paper, non-convertible debt and mandatory convertible debt securities issued by either an unaffiliated or affiliated entity pursuant to the Program, may not be deemed a "qualified security" under SEA Rule 15c3-3(a)(6) for deposit into a Reserve Bank Account.

We understand that the foregoing represents a SEC staff position with respect to the Net Capital and Reserve Formula treatment of debt securities issued pursuant to the Program. Furthermore, this guidance may be withdrawn or modified if your staff determines that such action is necessary in the public interest, for the protection of investors, or otherwise in furtherance of the purpose of the securities laws.

Very truly yours,

Krisoula Dailey
Vice President
FINRA

FINRA Regulation Board Composition

SEC Approves Changes to the FINRA Regulation Board Composition and Conforming Changes to the FINRA Regulation By-Laws

Effective Date: August 20, 2009

Executive Summary

Effective August 20, 2009, the Board composition of FINRA Regulation, Inc. (a subsidiary of FINRA) will more closely parallel the composition and governance structure of the FINRA Inc. Board of Governors (FINRA Board).¹ The revisions to the FINRA Regulation, Inc. By-Laws (By-Laws) also reflect current business and legal practices concerning the administration of FINRA Regulation. In addition, the revisions make non-substantive or conforming changes to the By-Laws, including updates to reflect the corporate name change. The revised By-Laws are available at www.finra.org/finramanual/bylaws.

Questions concerning this *Notice* should be directed to Stacy Paxson Chittick, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8375.

Background & Discussion

On July 30, 2007, NASD and the New York Stock Exchange consolidated their member firm regulation, enforcement and arbitration functions and became FINRA. As part of the consolidation transaction, the Securities and Commission (SEC) approved amendments to the NASD By-Laws to implement governance and related changes,² including a FINRA Board governance structure that balanced public and industry representation.

July 2009

Notice Type

- Rule Amendment

Suggested Routing

- Executive Representative
- Senior Management

Key Topic(s)

- By-Laws
- FINRA Regulation Board Composition

Referenced Rules & Notices

- FINRA Regulation By-Laws

FINRA Regulation is a subsidiary of FINRA. FINRA Regulation's By-Laws were not amended at the time of the consolidation, other than in a few sections where those By-Laws conflicted with the new FINRA By-Laws.

On November 6, 2008, the SEC approved amendments to the FINRA Regulation By-Laws that:

- ▶ restructured the industry representation on the National Adjudicatory Council (NAC)³ to parallel the firm-size criteria for industry representation on the FINRA Board;
- ▶ modified the nomination process for certain industry member seats on the NAC by using the FINRA Nominating Committee and by discontinuing the Regional Nominating Committees; and
- ▶ adopted conforming changes to reflect the corporate name change and similar matters.⁴

The SEC approved the current changes to the FINRA Regulation By-Laws on May 21, 2009.⁵ These changes complete the process of updating the FINRA Regulation By-Laws to reflect the consolidation transaction and harmonizing them with the FINRA By-Laws. The effective date for these changes is August 20, 2009.

Revisions to FINRA Regulation By-Laws

The FINRA By-Laws provide that the FINRA Board of Governors must consist of:

- ▶ the Chief Executive Officer of FINRA;
- ▶ the Chief Executive Officer of NYSE Regulation;
- ▶ eleven Public Governors; and
- ▶ ten Industry Governors, including the following:
 - ▶ a Floor Member Governor;
 - ▶ an Independent Dealer/Insurance Affiliate Governor;
 - ▶ an Investment Company Affiliate Governor;
 - ▶ three Small Firm Governors;
 - ▶ one Mid-Size Firm Governor; and
 - ▶ three Large-Firm Governors.⁶

The Small Firm Governors, Mid-Size Firm Governor and Large-Firm Governors are elected by FINRA member firms according to their classification as a Small Firm, Mid-Size Firm, or Large Firm.⁷

Under the revised By-Laws, the FINRA Regulation Board will continue to consist of between five and 15 members.⁸ The FINRA Regulation Board members will be drawn exclusively from, and elected by, the FINRA Board. In addition, the revised By-Laws require the FINRA Regulation Board, like the FINRA Board, to have a greater number of Public Directors than Industry Directors.⁹ To foster industry representation on the FINRA Regulation Board, the revised By-Laws also require that at least two, and not less than 20 percent, of the FINRA Regulation Board Directors be Small, Mid-Size or Large Firm Governors.¹⁰

The revised By-Laws provide that FINRA Regulation's stockholder, FINRA, has the authority to remove FINRA Regulation Directors and select the Chair of the FINRA Regulation Board. The revised By-Laws reflect other current business and legal practices concerning the administration of FINRA Regulation and its capital stock.

Finally, the revised By-Laws are updated by using the FINRA name throughout and by making several non-substantive or conforming changes, such as making the provision on communicating views about contested elections or nominations consistent with the FINRA By-Laws.

Endnotes

- 1 See Exchange Act Release No. 59962 (May 21, 2009), 74 FR 25792 (May 29, 2009) (SEC Order Approving SR-FINRA-2009-020).
- 2 See Exchange Act Release No. 56145 (July 26, 2007), 72 FR 42169 (August 1, 2007), as amended by Exchange Act Release No. 56145A (May 30, 2008), 73 FR 32377 (June 6, 2008) (File No. SR-NASD-2007-023).
- 3 The NAC is appointed by the FINRA Board of Governors to review all disciplinary decisions issued by FINRA hearing panels and presides over disciplinary matters that have been appealed to or called for review by the NAC. The NAC also reviews statutory disqualification matters and considers appeals of membership proceedings and exemption requests.
- 4 See Exchange Act Release No. 58909 (November 6, 2008), 73 FR 68467 (Nov. 18, 2008) (SEC Order Approving SR-FINRA-2008-046).
- 5 See Exchange Act Release No. 59962 (May 21, 2009), 74 FR 25792 (May 29, 2009) (SEC Order Approving SR-FINRA-2009-020).
- 6 See FINRA By-Laws, Article VII, Section 4 and Article XXII, Section 2(a).
- 7 See FINRA By-Laws, Article I(z), (dd) & (xx) (defining Small Firm Governor, Mid-Size Firm Governor, and Large-Firm Governor), and Article VII, Section 4(a).
- 8 See FINRA Regulation By-Laws, Article IV, Section 4.2 (Number of Directors).
- 9 See FINRA Regulation By-Laws, Article IV, Section 4.3(a) (Qualifications).
- 10 See *id.*

SEC Approves New Consolidated FINRA Rules

SEC Approval and Effective Dates for New Consolidated FINRA Rules on Electronic Filing Requirements for Uniform Forms and Arbitration Disclosures

Effective Date (FINRA Rule 1010): July 27, 2009

Effective Date (FINRA Rule 2263): September 25, 2009

Executive Summary

The SEC recently approved the adoption of NASD Rule 1140, subject to certain amendments, as new FINRA Rule 1010 (Electronic Filing Requirements for Uniform Forms). FINRA Rule 1010 supports the information reported by firms to Web CRD and, among other things, permits a firm to file amendments to Form U4 disclosure information without obtaining the associated person's manual signature, subject to specified conditions (the mandatory signature exception).¹ The effective date of FINRA Rule 1010 is July 27, 2009.²

The SEC also approved the adoption of NASD Rule 3080, subject to minor amendments, as new FINRA Rule 2263 (Arbitration Disclosure to Associated Persons Signing or Acknowledging Form U4). FINRA Rule 2263 requires firms to provide each associated person with arbitration disclosures whenever the firm asks an associated person, pursuant to FINRA Rule 1010, to manually sign a new or amended Form U4, or to otherwise provide written acknowledgment of an amendment to the Form U4. The effective date of FINRA Rule 2263 is September 25, 2009, to provide firms with additional time to make the necessary changes to forms and any related systems to reflect the slightly revised disclosure language.

The text of the rule amendments are set forth in Attachment A.

July 2009

Notice Type

- Rule Approvals
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management
- Training

Key Topics

- Arbitration Disclosures
- Central Registration Depository (CRD®)
- Electronic Filing Requirements
- Form U4
- Form U5
- Regulatory Disclosure Questions

Referenced Rules & Notices

- FINRA Rule 1010
- FINRA Rule 2263
- NASD Rule 1140
- NASD Rule 3080
- NTM 99-63
- Regulatory Notice 09-16
- Regulatory Notice 09-23
- SEA Rule 17a-4

Questions concerning this *Notice* should be directed to:

- ▶ Richard E. Pullano, Associate Vice President and Chief Counsel, Registration and Disclosure, at (240) 386-4821; or
- ▶ Patricia Albrecht, Assistant General Counsel, Office of General Counsel, at (202) 728-8026.

Background

Web CRD is an interactive, Web-based registration system that maintains the qualification, employment and disclosure information of more than half a million registered persons, and it facilitates the processing of fingerprint submissions, registration fees and renewal fees.³ The SEC recently approved the adoption of NASD Rule 1140, subject to certain amendments, as new FINRA Rule 1010 (Electronic Filing Requirements for Uniform Forms). FINRA Rule 1010 supports the information reported by firms to Web CRD.

The SEC also approved the adoption of NASD Rule 3080, subject to minor amendments, as new FINRA Rule 2263 (Arbitration Disclosure to Associated Persons Signing or Acknowledging Form U4). FINRA Rule 2263 requires firms to provide each associated person with arbitration disclosures whenever the firm asks an associated person, pursuant to FINRA Rule 1010, to manually sign a new or amended Form U4, or to otherwise provide written acknowledgment of an amendment to the Form U4.

Discussion

FINRA Rule 1010

Uniform Form Filing and Signature Requirements

FINRA Rule 1010(a) retains, without substantive changes, the requirement in NASD Rule 1140 that each firm file Forms U4, U5, BR, BDW and BD amendments (collectively, the Uniform Forms) electronically (or via another process that FINRA may prescribe) to Web CRD. In addition, FINRA Rule 1010(c) retains the requirement in NASD Rule 1140 that an initial and transfer electronic Form U4 be based on a signed Form U4,⁴ and codifies FINRA's position that such electronic documents be based on an original, manually signed Form U4 provided to the firm by the person on whose behalf the Form U4 is being filed.⁵ FINRA believes it is important to have clear evidence of the associated person's execution of the initial and transfer Forms U4, including his or her agreement to the attestations set forth in the form.

FINRA Rule 1010(c), however, modifies the signature requirement with respect to amendments to disclosure information in the Form U4.⁶ Previously, Form U4 disclosure information amendments had to be manually signed by the associated person on whose behalf the filing was being made. FINRA Rule 1010 permits a firm to file amendments to the Form U4 disclosure information without obtaining the registered person's manual signature if the firm uses reasonable efforts to:

- provide the registered person with a copy of the amended disclosure information prior to filing; and
- obtain the registered person's written acknowledgment (which may be electronic) prior to filing that the information has been received and reviewed.⁷

FINRA Rule 1010(c) also requires a firm, as part of its recordkeeping requirements, to retain the written acknowledgment in accordance with SEA Rule 17a-4(e)(1) and make it available promptly upon regulatory request.⁸

FINRA Rule 1010(c) also clarifies a firm's responsibility to submit disclosure information of which it has knowledge in those cases where the firm is not able to obtain an associated person's manual signature or written acknowledgement of the amendment.⁹ This provision codifies the firm's obligation to submit such disclosure information, consistent with the obligation under the FINRA By-Laws that every Form U4 be kept current.¹⁰ Supplementary Material .03 (Filing of Amendments Involving Disclosure Information) sets forth examples of reasons why a firm may not be able to obtain the associated person's manual signature or written acknowledgement. They include, but are not limited to, the associated person:

- refusing to acknowledge the information in writing;
- being on active military duty; or
- otherwise being unavailable during the period provided for filing the amendment.

In such instances, a firm should enter "Representative Refused to Sign/Acknowledge," "Representative Not Available" or a substantially similar entry in the signature box of the electronic form. This instruction is generally consistent with current practice in instances where an associated person is unable or unavailable to sign a disclosure information amendment.¹¹

In addition, FINRA Rule 1010(c) incorporates Web CRD's current practice of permitting Form U4 administrative information to be amended without obtaining the associated person's signature (manual or otherwise).¹² Supplementary Material .04 (Filing of Amendments Involving Disclosure Information) explains that administrative information includes such items as the addition of state or self-regulatory organization registrations, exam scheduling and updates to residential, business and personal history.

Finally, FINRA Rule 1010 incorporates, without substantive change, NASD Rule 1140's provisions regarding the submission of fingerprint information and Form U5 filing requirements, and notes the applicable retention periods for Form U5 under SEA Rule 17a-4.¹³

Supervisory Requirements

FINRA Rule 1010(b) retains NASD Rule 1140's requirement that each firm identify a registered principal(s) or corporate officer(s) who has a position of authority over registration functions to be responsible for supervising the firm's electronic filings pursuant to the rule. Supplementary Material .01 (Delegation of Electronic Filing Functions) permits the registered principal(s) or corporate officer(s) who is responsible for supervising a firm's electronic filings to delegate to another associated person (who need not be registered) the electronic filing of the firm's forms via Web CRD. The Supplementary Material, however, makes clear that the principal(s) or corporate officer(s) may not delegate any of the supervision, review and approval responsibilities and must take reasonable and appropriate action to ensure that all delegated electronic filing functions are properly executed and supervised.

FINRA Rule 1010 also retains as Supplementary Material .02 (Third-Party Agreements), NASD Rule 1140's provision that a firm may use third parties to file forms electronically on behalf of the firm and its associated persons, but makes clear that, notwithstanding the existence of such an arrangement, the firm remains responsible for complying with FINRA Rule 1010.

Effective Date

FINRA Rule 1010 is effective July 27, 2009. Firms may choose to rely on FINRA Rule 1010's mandatory signature exception to comply with recent amendments to Form U4 that, among other things, added new regulatory disclosure information questions (relating to willful violations) to the Form that must be answered by November 14, 2009.¹⁴ These new disclosure questions will require firms to amend (or refile) the Forms U4 that they have submitted on behalf of their registered persons. Firms have represented that this requirement to amend the Forms U4 for their registered persons will place a significant additional administrative burden on firms in completing the amendments. FINRA believes that such burden may be alleviated in part by FINRA Rule 1010's mandatory signature exception.

FINRA Rule 2263

Nearly identical to NASD Rule 3080, FINRA Rule 2263 requires firms to provide each associated person with certain written disclosures regarding the nature and process of arbitration proceedings whenever the firm asks an associated person, pursuant to FINRA Rule 1010, to manually sign a new or amended Form U4, or to otherwise provide written acknowledgment of an amendment to the form. FINRA Rule 2263 makes no significant changes to the required disclosures other than updating the disclosure language to reflect recent amendments to FINRA's Code of Arbitration Procedure for Customer Disputes and Code of Arbitration Procedure for Industry Disputes requiring arbitrators to provide an explained decision to the parties in eligible cases if there is a joint request by all parties at least 20 days before the first scheduled hearing date.¹⁵ The effective date of FINRA Rule 2263 is September 25, 2009, to provide firms with additional time to make the necessary changes to forms and any related systems to reflect the modified disclosure language.

Endnotes

- 1 See Exchange Act Release No. 60348 (July 20, 2009), 74 FR 37077 (July 27, 2009) (SEC Order Approving SR-FINRA-2009-019).
- 2 FINRA notes that it is deviating from the protocol by which FINRA generally announces the effective dates of the new FINRA rules that are being adopted as part of the consolidated rulebook in establishing the effective dates of FINRA Rules 1010 and 2263. See *Information Notice 10/06/08* (Rulebook Consolidation Process: Effective Dates of New Consolidated Rules; Introduction of Rule Conversion Chart). As further discussed in this Notice, FINRA is establishing a July 27, 2009 effective date for FINRA Rule 1010 to, among other things, allow firms to promptly avail themselves of the mandatory signature exception.
- 3 The CRD system, which was developed jointly by FINRA and the North American Securities Administrators Association (NASAA), was first launched in 1981 to centralize the registration process for the securities industry. During the last two decades, FINRA has expanded and modified the system extensively to meet the evolving needs of its constituents. CRD became an interactive, Web-based registration system (Web CRD) on August 16, 1999. See *NTM 99-63* (August 1999) (SEC Approves and Adopts Revised Forms and Electronic Filing Requirement; New Member Applicants Should Continue to File Paper Forms).
- 4 Under the CRD system, the firm submits the electronic Form U4 on behalf of the associated person by typing the person's name into the signature box on the electronic form.
- 5 FINRA Rule 1010(c)(1). In addition, FINRA Rule 1010(c) clarifies that initial and amendments to Forms U4 must be retained until at least three years after the registered person's employment and any other connection with the firm has terminated. See Rule 17a-4(e)(1) under the Securities Exchange Act of 1934 (SEA).
- 6 FINRA Rule 1010(c)(2).
- 7 FINRA Rule 1010(c)(2)(A) and (B).
- 8 FINRA Rule 1010(c)(2)(B). In February 2008, at FINRA's request, the SEC staff issued a no-action letter regarding the ability of FINRA member firms to rely on Web CRD to satisfy their record retention requirements under SEA Rule 17a-4 with respect to certain Forms U4, U5 and BR filed in Web CRD. See Letter from Thomas K. McGowan, Assistant Director, Division of Trading and Markets, SEC, to Richard E. Pullano, Associate Vice President and Chief Counsel, Registration and Disclosure, FINRA, February 19, 2008 (www.sec.gov/divisions/marketreg/mr-noaction/2008/finra021908.pdf).

In short, such relief extends to, among other things, Form U4 amendments that do not require the registered person's signature. Because FINRA's request for no-action relief excluded Form U4 amendments that provide or update disclosure information (on the basis that such amendments required the registered person's signature), FINRA sought clarification from SEC staff on the extent of the relief in light of the mandatory signature exception set forth in (then proposed) FINRA Rule 1010. SEC staff has affirmed in a conversation with FINRA staff that the no-action relief provided in the February 19, 2008, letter will extend to Form U4 amendments that provide or update disclosure information that is submitted pursuant to FINRA Rule 1010 without obtaining the registered person's manual signature. Telephone conversation between Thomas K. McGowan, Assistant Director, Division of Trading and Markets, SEC, and Patrice Gliniecki, Senior Vice President & Deputy General Counsel and Richard E. Pullano, Associate Vice President & Chief Counsel, Registration and Disclosure, FINRA, March 5, 2009.

- 9 FINRA Rule 1010(c)(3).
- 10 FINRA By-Laws Article V, Section 2.
- 11 FINRA will consider future enhancements to the CRD system that may include incorporating a “drop down” menu, or some substantially similar method for recording the reason the registered person has not acknowledged the filing, to assist firms in completing the signature section in these circumstances.
- 12 FINRA Rule 1010(c)(4); *see also* Exchange Act Release No. 41575 (June 29, 1999), 64 FR 36728, 36729 n.7 (July 7, 1999) (SEC Order Approving SR-NASD-99-28); Exchange Act Release No. 37439 (July 15, 1996), 61 FR 37950 (July 22, 1996) (SEC Order Approving SR-NASD-96-21).
- 13 *See* FINRA Rule 1010(d) (Fingerprint Information) and (e) (Form U5 Filing Requirements).
- 14 *See* Exchange Act Release No. 60086 (June 10, 2009); 74 FR 28743 (June 17, 2009) (SEC Order Approving SR-FINRA-2009-008); *see also* *Regulatory Notice 09-23* (May 2009).
- 15 *See* Exchange Act Release No. 59358 (Feb. 4, 2009), 74 FR 6928 (Feb. 11, 2009) (Order Approving File No. SR-FINRA-2008-051); *see also* *Regulatory Notice 09-16* (March 2009).

Attachment A

Below is the text of new FINRA Rules 1010 and 2263. New rule language is underlined; deletions are in brackets.

* * * * *

1000. Member Application and Associated Person Registration

[1140] 1010. Electronic Filing [Rules]Requirements for Uniform Forms

(a) Filing Requirement

Except as provided in NASD Rule 1013(a)(2), all forms required to be filed by Article IV, Sections 1, 7, and 8, and Article V, Sections 2 and 3, of the FINRA By-Laws shall be filed through an electronic process or such other process [the Association]FINRA may prescribe to the Central Registration Depository.

(b) Supervisory Requirements

(1) In order to comply with the supervisory procedures requirement in NASD Rule 3010, each member shall identify a [R]registered [P]principal(s) or corporate officer(s) who has a position of authority over registration functions, to be responsible for supervising the electronic filing of appropriate forms pursuant to this Rule.

(2) The [R]registered [P]principal(s) or corporate officer(s) who has or have the responsibility to review and approve the forms filed pursuant to this Rule shall be required to acknowledge, electronically, that he is filing this information on behalf of the member and the member's associated persons.

(c) Form U4 Filing Requirements

(1) Except as provided in paragraphs (c)(2) and (c)(3) below, [E]very initial and transfer electronic Form U4 filing and any amendments to the disclosure information on Form U4 shall be based on a manually signed Form U4 provided to the member or applicant for membership by the person on whose behalf the Form U4 is being filed. As part of the member's recordkeeping requirements, it shall retain the person's manually signed Form U4 or amendments to the disclosure information on Form U4 in accordance with SEA Rule 17a-4(e)(1) and make [it] them available promptly upon regulatory request. An applicant for membership

also [must] shall retain in accordance with SEA Rule 17a-4(e)(1) every manually signed Form U4 it receives during the application process and make them available promptly upon regulatory request.

(2) A member may file electronically amendments to the disclosure information on Form U4 without obtaining the subject associated person's manual signature on the form, provided that the member shall use reasonable efforts to:

(A) provide the associated person with a copy of the amended disclosure information prior to filing; and

(B) obtain the associated person's written acknowledgment (which may be electronic) prior to filing that the information has been received and reviewed. As part of the member's recordkeeping requirements, the member shall retain this acknowledgment in accordance with SEA Rule 17a-4(e)(1) and make it available promptly upon regulatory request.

(3) In the event a member is not able to obtain an associated person's manual signature or written acknowledgement of amended disclosure information on Form U4 prior to filing of such information pursuant to paragraph (c)(1) or (2), the member is obligated to file the disclosure information as to which it has knowledge in accordance with Article V, Section 2 of the FINRA By-Laws. The member shall use reasonable efforts to provide the associated person with a copy of the amended disclosure information that was filed.

(4) A member may file electronically amendments to administrative data on Form U4 without obtaining the subject associated person's signature on the form. The member shall use reasonable efforts to provide the associated person with a copy of the amended administrative information that was filed.

[(2)](d) Fingerprint [Cards]Information

Upon filing an electronic Form U4 on behalf of a person applying for registration, a member shall promptly submit [a] fingerprint [card]information for that person. [NASD]FINRA may make a registration effective pending receipt of the fingerprint [card]information. If a member fails to submit [a] the fingerprint [card]information within 30 days after [NASD]FINRA receives the electronic Form U4, the person's registration shall be deemed inactive. In such case, [NASD]FINRA shall notify the member that the person must immediately cease all activities requiring registration and is prohibited from performing any duties and functioning in any capacity requiring

registration. [NASD]FINRA shall administratively terminate a registration that is inactive for a period of two years. A person whose registration is administratively terminated may reactivate the registration only by reapplying for registration and meeting the qualification requirements of the applicable provisions of the NASD Rule 1020 Series and the NASD Rule 1030 Series. Upon application and a showing of good cause, FINRA[NASD] may extend the 30-day period.

~~[(d)](e)~~ Form U[-]5 Filing Requirements

Initial filings and amendments of Form U[-]5 shall be submitted electronically. As part of the member's recordkeeping requirements, it shall retain such records for a period of not less than three years, the first two years in an easily accessible place, in accordance with SEA Rule 17a-4, and make such records available promptly upon regulatory request.

[(e) Third Party Filing]

[A member may employ a third party to file the required forms electronically on its behalf.]

• • • Supplementary Material: -----

.01 Delegation of Electronic Filing Functions. The designated registered principal(s) or corporate officer(s) required by paragraph (b)(1) to supervise the member's electronic filings may delegate to an associated person (who need not be registered) the electronic filing of the member's appropriate forms via Web CRD. The registered principal(s) or corporate officer(s) responsible for supervising the member's electronic filings may also delegate to the associated person making the electronic filings the requirement in paragraph (b)(2) to acknowledge, electronically, that he is making the filing on behalf of the member and the member's associated persons. However, the registered principal(s) or corporate officer(s) may not delegate any of the supervision, review, and approval responsibilities mandated in paragraphs (b)(1) and (2) and shall take reasonable and appropriate action to ensure that all delegated electronic filing functions are properly executed and supervised.

.02 Third-Party Agreements. A member may enter into an agreement with a third party pursuant to which the third party agrees to file the required forms electronically on behalf of the member and the member's associated persons. Notwithstanding the existence of such an agreement, the member remains responsible for complying with the requirements of this Rule.

.03 Filing of Amendments Involving Disclosure Information. In the event a member is not able to obtain an associated person’s manual signature or written acknowledgement of amended disclosure information on that person’s Form U4 prior to filing of such amendment reflecting the information pursuant to paragraph (c)(3) (examples of reasons why a member may not be able to obtain the manual signature or written acknowledgement may include, but are not limited to, the associated person refuses to acknowledge such information, is on active military service or otherwise is unavailable during the period provided for filing of such amendments under Article V of the FINRA By-Laws), the member shall enter “Representative Refused to Sign/Acknowledge” or “Representative Not Available” or a substantially similar entry in the electronic Form U4 field for the associated person’s signature.

.04 Filing of Amendments Involving Administrative Information. For purposes of paragraph (c)(4) of the Rule, administrative data includes such items as the addition of state or self-regulatory organization registrations, exam scheduling, and updates to residential, business and personal history.

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2000. Duties and Conflicts

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2200. Communications and Disclosures

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2260. Disclosures

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[3080] 2263. Arbitration Disclosure to Associated Persons [When] Signing or Acknowledging Form U[-]4

A member shall provide an associated person with the following written statement whenever the associated person is asked, pursuant to FINRA Rule 1010, to manually sign an [new] initial or amended Form U4, or to otherwise provide written (which may be electronic) acknowledgement of an amendment to the Form U4[.]:

The Form U4 contains a predispute arbitration clause. It is in item 5 of Section 15A of the Form U4. You should read that clause now. Before signing the Form U4, you should understand the following:

(1) You are agreeing to arbitrate any dispute, claim or controversy that may arise between you and your firm, or a customer, or any other person[,] that is required to be arbitrated under the rules of the self-regulatory organizations with which you are registering. This means you are giving up the right to sue a member, customer, or another associated person in court, including the right to a trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed.

(2) A claim alleging employment discrimination, including a sexual harassment claim, in violation of a statute is not required to be arbitrated under [NASD] FINRA rules. Such a claim may be arbitrated at [the NASD] FINRA only if the parties have agreed to arbitrate it, either before or after the dispute arose. The rules of other arbitration forums may be different.

(3) Arbitration awards are generally final and binding; a party's ability to have a court reverse or modify an arbitration award is very limited.

(4) The ability of the parties to obtain documents, witness statements and other discovery is generally more limited in arbitration than in court proceedings.

(5) The arbitrators do not have to explain the reason(s) for their award unless, in an eligible case, a joint request for an explained decision has been submitted by all parties to the panel at least 20 days prior to the first scheduled hearing date.

(6) The panel of arbitrators may include arbitrators who were or are affiliated with the securities industry or[,] public arbitrators, as provided by the rules of the arbitration forum in which a claim is filed.

(7) The rules of some arbitration forums may impose time limits for bringing a claim in arbitration. In some cases, a claim that is ineligible for arbitration may be brought in court.

* * * * *

Investment Banking Representative

SEC Approves Rule Change Creating New Limited Representative – Investment Banker Registration Category and Series 79 Investment Banking Exam

Effective Date: November 2, 2009

Executive Summary

Effective November 2, 2009, amendments to NASD Rules 1022 and 1032 require individuals whose activities are limited to investment banking and principals who supervise such activities to pass the new Limited Representative – Investment Banking Qualification Examination (Series 79 Exam). Individuals who are registered as a General Securities Representative (Series 7) and engage in the member firm's investment banking business as described in NASD Rule 1032(i) may "opt in" to the new registration category by May 3, 2010 (within six months of the effective date).

Frequently asked questions about registration as an investment banking representative are listed in Attachment A. The text of the rule change is set forth in Attachment B.

Questions concerning this *Notice* should be directed to:

- Philip Shaikun, Associate Vice President and Associate General Counsel, at (202) 728-8451;
- Joe McDonald, Director, Qualifications and Examinations, at (240) 386-5065; or
- Tina Freilicher, Director, Psychometrics and Qualifications, at (646) 315-8752.

July 2009

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Continuing Education
- Investment Banking
- Legal
- Operations
- Registration
- Sales
- Senior Management

Key Topic(s)

- Continuing Education
- Investment Banking
- Qualification Examinations
- Registration
- Supervision

Referenced Rules & Notices

- NASD Rule 1022
- NASD Rule 1032

Background and Discussion

NASD Rule 1032(i) requires an associated person to register with FINRA as a Limited Representative – Investment Banking (Investment Banking Representative) and pass a corresponding qualification examination if such person's activities involve:

- (1) advising on or facilitating debt or equity securities offerings through a private placement or a public offering, including but not limited to origination, underwriting, marketing, structuring, syndication, and pricing of such securities and managing the allocation and stabilization activities of such offerings, or
- (2) advising on or facilitating mergers and acquisitions, tender offers, financial restructurings, asset sales, divestitures or other corporate reorganizations or business combination transactions, including but not limited to rendering a fairness, solvency or similar opinion.

The registration category does not cover individuals whose investment banking work is limited to public (municipal) finance or direct participation programs as defined in NASD Rule 1022(e)(2). Moreover, individuals whose investment banking work is limited to effecting private securities offerings as defined in NASD Rule 1032(h)(1)(A) may continue to function in such capacity by registering as a Limited Representative – Private Securities Offerings and passing the corresponding Series 82 exam.

Individuals whose activities require registration as an Investment Banking Representative will be required to pass the Investment Banking Representative Qualification Examination (Series 79) or obtain a waiver. FINRA has developed this exam to provide a more targeted assessment of the job functions performed by the individuals that fall within the registration category. The exam will be required in lieu of the current General Securities Representative (Series 7) exam or equivalent exams¹ by the individuals who perform the job functions described in the new registration category. Any person whose activities go beyond those of the Investment Banking Representative registration category must separately qualify and register in the appropriate category or categories of registration attendant to such activities.

Transition “Opt-In” Period

Beginning on the effective date of NASD Rule 1032(i) and ending May 3, 2010, six months following implementation of these requirements, registered individuals as well as new applicants whose job functions are described in Rule 1032(i) will be able to register as an Investment Banking Representative as follows:

► **Currently registered representatives who have passed the Series 7 or a Series 7-equivalent exam.**

Investment bankers who hold the Series 7 registration, as well as those who have passed and are registered with a “Series 7-equivalent exam” may opt in to the Investment Banking Representative registration,² provided that, as of the date they opt in, such individuals are engaged in investment banking activities covered by Rule 1032(i).³ Those individuals who choose to opt in will retain their Series 7 or Series 7-equivalent registered representative registration in addition to the investment banking registration. After May 3, 2010, any person who wishes to engage in the specified investment banking activities will be required to pass the Series 79 Exam or obtain a waiver.

► **New Investment Banking Representative Candidates**

During the six-month transition period, FINRA will permit new Limited Representative – Investment Banking candidates to take either the Series 7 Exam, Series 7-equivalent exam (if eligible) or Series 79 Exam. Those who choose to take and pass the Series 7 Exam or Series 7-equivalent exam may then opt in to the Investment Banking Representative registration.

Training Program Exception

Rule 1032 provides an exception for member firms that operate training programs in which certain new employees are exposed to the firm’s various business lines by rotating among departments, including investment banking. Specifically, Rule 1032(i) does not require an employee placed in such program to register as an Investment Banking Representative for a period of up to six months from the time the employee first engages in activities that otherwise would trigger the requirement to register as an Investment Banking Representative. This exception is available for up to two years after the employee commences the training program. Firms that wish to avail themselves of this exception are required to maintain documents evidencing the details of the training program and identifying the program participants who engage in activities that otherwise would require registration as an Investment Banking Representative and the date on which such participants commenced such activities.

Principals

The Series 79 Exam will be added to the list of representative exams that satisfy the prerequisite requirement for the General Securities Principal exam (Series 24). Note that the scope of the general securities principal's supervisory responsibility will be determined by the representative-level exam passed. Individuals who wish to act as a general securities principal for activities requiring registration under Rule 1032(i) must obtain the Investment Banking Representative registration—either by opting in or passing the Series 79 Exam—and also pass the General Securities Principal exam. Such individuals will be limited to acting as a general securities principal for the investment banking activities covered by Rule 1032(i). Individuals who wish to function in the capacity of general principal for broader securities-related activities must take another appropriate qualification examination, such as the Series 7 or Series 7-equivalent exam, in addition to the General Securities Principal exam.

Individuals currently functioning as a general securities principal supervising investment banking activities as described in Rule 1032(i) have the same six-month period during which they may opt in to the Investment Banking Representative registration. Those individuals who choose to opt in will retain their Series 7 or Series 7-equivalent registered representative registration in addition to the Investment Banking Representative registration. After the end of the opt-in period, individuals who wish function as a general securities principal overseeing investment banking activities covered by the rule change will be required to pass the Series 79 Exam to function as a general securities principal supervising investment banking activities pursuant to Rules 1022 and 1032(i).

Exam Content

The qualification exam consists of 175 multiple-choice questions. Candidates are allowed 300 minutes (five hours) to take the exam. Candidates will receive an informational breakdown of their performance on each section of the exam, along with their overall score and pass/fail status at the completion of the exam session.

A content outline that provides a comprehensive guide to the topics covered on the examination and is intended to familiarize candidates with the range of subjects covered by the examination is available at www.finra.org/brokerqualifications/series79. Firms may wish to use the content outline to structure or prepare training material, develop lecture notes and seminar programs, and as a training aide for the candidates. The examination questions are distributed among four major functions reflecting the

overall knowledge, skills and abilities required of an investment banker. Detail on the content of each of these four major job functions, the tasks associated with the job functions and the knowledge necessary to perform the tasks is included in the text of the content outline. The allocation of test questions among the four major functions is described below:

Section	Description	Number of Questions
1	Collection, Analysis and Evaluation of Data	75
2	Underwriting/New Financing Transactions, Types of Offerings and Registration Of Securities	43
3	Mergers and Acquisitions, Tender Offers and Financial Restructuring Transactions	34
4	General Securities Industry Regulations	23
	Total	175

The questions used in the examination will be updated to reflect the most current interpretations of the rules and regulations on which they are based. Questions on new rules will be added to the pool of questions for this examination within a reasonable time period of the effective dates of those rules. Questions on rescinded rules will be deleted promptly from the pool of questions. Candidates will be asked questions only pertaining to rules that are effective at the time they take the exam.

The test is administered as a closed-book exam. Severe penalties are imposed on candidates who cheat on FINRA-administered examinations. The proctor will provide scratch paper, an exhibits book and a *basic electronic calculator* to candidates. These items must be returned to the proctor at the end of the session.

The Investment Banking Representative Qualification Examination will be administered at test centers operated by Pearson VUE and Prometric professional testing center networks. Appointments to take the examinations can be scheduled through either network:

- Pearson Professional Centers: contact Pearson VUE Registration Center at **(866) 396-6273 (toll free)**, or **(952) 681-3873 (toll number)**.
- Prometric Testing Centers: contact Prometric's National Call Center at **(800) 578-6273 (toll free)** or go to www.2test.com for Web-based scheduling.

Registration Procedures

A Uniform Application for Securities Industry Registration or Transfer Form (Form U4) must be submitted to FINRA via Web CRD in order to register an individual as an Investment Banking Representative. For persons already registered with a firm who currently hold the Series 7 or Series 7-equivalent registration and who are opting in to the Investment Banking Representative registration category, the firm need only submit an amended Form U4 to request the Limited Representative—Investment Banking registration.

For new employees, a firm must submit a full Form U4 application to request the registration and any other documents required for registration. The exam fee is \$265; the registration fee for new applicants is \$85.

For new Investment Banking Representative candidates who choose to first take the Series 7 Exam or Series 7-equivalent exam during the opt-in period and then opt in to the Investment Banking Representative registration, the firm must first submit a Form U4 to request the General Securities Representative or Series 7-equivalent registration. Once the candidate has passed the Series 7 Exam or Series 7-equivalent exam, the firm may then submit an amended Form U4 to request the Limited Representative—Investment Banking Representative registration.

Effective Date

The registration and qualification requirements for Investment Banking Representatives will become effective November 2, 2009. The six-month opt-in period will begin November 2, 2009, and end May 3, 2010.

Endnotes

1. The “Series 7 equivalent exams” and registrations are the Limited Representative—Corporate Securities (Series 62), the United Kingdom (Series 17) or Canada (Series 37/38) Modules of the Series 7. pass the Limited Representative—Corporate Securities Series 62 exam, Limited Registered Representative Series 17 exam and Canada Modules of the Series 7 exam Series 37/38 exams are “CS,” “IE” and “CD/CN,” respectively.
2. The Web CRD registration position code for individuals who pass the Investment Banking Representative Series 79 Exam is “IB.” The registration position codes for individuals who
3. No associated persons of a firm will be eligible to opt in unless the firm’s current Form BD indicates that the firm engages in investment banking activities.

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Attachment A

FAQ About Registration as an Investment Banking Representative

General

- Q 1: If I currently hold a Series 7 registration and am engaged in investment banking activities, must I take the Series 79 Exam to engage in a member firm's investment banking business?**
- A 1: No, provided you opt in by May 3, 2010. Current Series 7 or Series 7-equivalent registered representatives who function in the firm's investment banking business as described in NASD Rule 1032(i) may opt in to the Investment Banking Representative position without having to take the Series 79 Exam for a period of six months after implementation of the registration category. Such persons also will be able to retain their Series 7 or Series 7 equivalent registration.
- Q 2: How do I opt in to the new investment banker registration category?**
- A 2: For persons registered with a firm who currently hold the Series 7 or Series 7-equivalent registration and who function in the firm's investment banking business as described in NASD Rule 1032(i), the person's firm need only submit an amended Form U4 to request the Limited Representative – Investment Banking registration. The submission must be made during the six-month opt-in period (November 2, 2009 – May 3, 2010). The Form U4 will not reflect the new registration category until the start of the opt-in period.
- Q 3: My firm has not yet developed a training program for the Series 79 Exam. Will I have to take the Series 79 Exam once it is implemented in order to get the Investment Banking Representative registration?**
- A 3: No, during the six-month transition period (November 2, 2009 – May 3, 2010), new Investment Banking Representative candidates who are in the process of qualifying for the new Investment Banking Representative registration category can take either the Series 79, the Series 7 or a Series 7-equivalent exam. A candidate who takes and passes the Series 7 Exam or Series 7-equivalent exam could then opt in to the Investment Banking Representative registration.
- Q 4: I plan on taking the Series 79 Exam to qualify for the Investment Banking Representative registration. If in the future I move into a different position within my firm, such as retail sales, will I need to take the Series 7 Exam?**
- A 4: Yes. The Series 79 Exam will qualify an Investment Banking Representative for only those activities covered under Rule 1032(i). If the representative engages in activities not covered by the Investment Banking Representative registration, such as retail or institutional sales, the representative will need to take the appropriate qualification exam, such as the Series 7 or Series 7-equivalent exam.

- Q 5:** I currently have a Series 7 registration. If I do not opt in to the Investment Banking Representative registration during the opt-in period, but subsequently decide to become an investment banker, must I take the Series 79 Exam to get the Investment Banking Representative registration?
- A 5:** Yes. FINRA is providing a grace period of six months for Series 7 or Series 7-equivalent representatives who function in the member firm's investment banking business as described in NASD Rule 1032(i) to opt in to the Investment Banking Representative registration position. After May 3, 2010, persons who seek Investment Banking Representative registration will need to take and pass the Series 79 Exam, regardless of whether or not they have a Series 7 or Series 7-equivalent registration.
- Q 6:** I work at a small investment banking firm and engage in activities ranging from investment banking to institutional and retail sales. I have a Series 7 registration. How will this new exam and registration category affect me?
- A 6:** If you opt-in to the Investment Banking Representative registration position within the designated time period, you will have both the General Securities Representative and Investment Banking Representative registrations. Therefore, you would be able to engage in activities covered in both registration categories.
- Q 7:** I own a small investment banking firm and have employees that engage in activities ranging from investment banking to institutional and retail sales. These employees have a Series 7 registration. If I hire a new employee after the end of the opt-in period, how will this new exam and registration category affect this employee?
- A 7:** If the new employee engages in activities that fall into both the General Securities Representative and Investment Banking Representative registration categories, then he or she will need to take and pass both the Series 7 and Series 79 Exams.
- Q 8:** Will I be able to register as agent with a state after passing the Series 63 Exam if I have the Investment Banking Representative registration?
- A 8:** Yes (provided all of the other state requirements are met).
- Q 9:** Currently, for a candidate to qualify to register as agent and investment adviser with a state with the Series 66 Exam in lieu of the Series 63 and 65 Exams, the Series 7 Exam is required. Will the Series 79 Exam also allow me to qualify in those capacities with the Series 66 Exam?
- A 9:** No. States will continue to require the Series 7 Exam for use with the Series 66 Exam.

Test Administration

Q 10: Since the Series 79 Exam is a five-hour test, will I be allowed to take a break during the session?

A 10: The Series 79 Exam must be taken in one continuous, five-hour session. Candidates are permitted to take an unscheduled break during the exam session. However, the test clock will not stop while the candidate takes a break.

Q 11: Will I be allowed to use my own calculator during the exam session?

A 11: No. Series 79 Exam candidates are only allowed to use a basic electronic calculator provided by the testing center.

Principals

Q 12: I am currently a General Securities Principal supervising investment bankers. Do I need to opt in to the Investment Banking Representative position?

A 12: Yes. However, if you do not opt in prior to the end of the opt-in period, you will need to take and pass the Series 79 Exam in order to continue supervising Investment Banking Representatives.

Q 13: I plan on taking the Series 79 Exam. In the future, will I be able to qualify for the General Securities Principal registration category by taking and passing the Series 24 exam?

A 13: Yes, the Series 79 Exam will meet the prerequisite for taking the Series 24 Exam. However, such persons will be limited to acting as a general principal for investment banking-related activities and will need to take and pass another qualification examination, such as the Series 7 or Series 7 equivalent exam, to act as a general securities principal for broader securities-related activities.

Q 14: I am currently a General Securities Principal in a non-investment banking firm. If I do not opt in now and then move in five years to an investment banking firm in which I will supervise investment bankers, will I need to take the Series 79 Exam?

A 14: Yes. The opt-in accommodation is available only to individuals who are currently functioning in a firm's investment banking business. A General Securities Principal who qualifies via the Series 7 or Series 7 equivalent exam cannot act as a general principal for investment banking activities. Such person would need to take and pass the Series 79 Exam to do so.

Q 15: I currently hold a Series 7 registration and plan to opt in to the Investment Banking Representative position. If in the future I become a General Securities Principal by passing the Series 24 Exam, will I be able to supervise other securities-related activities including investment banking activities?

A 15: Yes. If you are eligible to opt in and do so, you will be able to supervise the firm's investment banking activities upon passing the Series 24 Exam. In addition, because you also held the Series 7 position, you will be able to act as a general securities principal for broader securities-related activities.

Public Financing

Q 16: Are public finance offerings (municipals) covered on the Series 79 Exam?

A 16: No. Individuals who work on public finance offerings will continue to take the Series 7 or Series 52 Exams.

Q 17: I work on both corporate and public finance offerings. I have a Series 7 registration. How will this new exam and registration category affect me?

A 17: If you opt in to the Investment Banking Representative position by May 3, 2010, you can continue to engage in all activities without taking the Series 79 Exam.

Q 18: I plan on taking the Series 79 Exam to qualify for the Investment Banking Representative position. If in the future I want to work on public finance offerings, will I need to take the Series 7 or Series 52 Exams?

A 18: Yes. The Series 79 Exam will qualify you for only the Investment Banking Representative position and activities covered under that registration position. If you begin to work on public finance offerings, you will need to take the Series 7 or Series 52 Exam.

Prerequisites

Q 19: Aside from satisfying the prerequisite for taking the Series 24 Exam, will the Series 79 Exam meet the prerequisite for any other exams that currently require either a Series 7 or Series 7 equivalent exam?

A 19: No. The Series 79 Exam will not fulfill the prerequisite requirement for the following exams:

Series 4 – Registered Options Principal

Series 9/10 – General Securities Sales Supervisor

Series 23 – General Securities Principal Sales Supervisor Module

Series 26 – Investment Company Products/Variable Contracts Principal

Series 39 – Direct Participation Program Principal

Series 42 – Registered Options Representative

Series 52 – Municipal Securities Principal

Series 55 – Equity Trader Limited Representative

Series 86/87 – Research Analyst/Research Principal

Continuing Education

Q 20: If I pass the Series 79 Exam and hold an Investment Banking Representative registration, will I still take the Regulatory Element S101 continuing education session?

A 20: Yes. A person holding an Investment Banking Representative registration will continue to take the Regulatory Element S101. However, in the future, FINRA is planning to modify the Regulatory Element to tailor it to certain types of job functions, such as investment banking.

Attachment B

Text of Amended Rule

New language is underlined; deletions are in brackets.

* * * * *

1022. Categories of Principal Registration

(a) General Securities Principal

(1) Each person associated with a member who is included within the definition of principal in Rule 1021, and each person designated as a Chief Compliance Officer on Schedule A of Form BD, shall be required to register with the Association as a General Securities Principal and shall pass an appropriate Qualification Examination before such registration may become effective unless such person's activities are so limited as to qualify such person for one or more of the limited categories of principal registration specified hereafter. A person whose activities in the investment banking or securities business are so limited is not, however, precluded from attempting to become qualified for registration as a General Securities Principal, and if qualified, may become so registered.

(A) Subject to paragraphs (a)(1)(B), (a)(2) and (a)(5), [E]each person seeking to register and qualify as a General Securities Principal must, prior to or concurrent with such registration, become registered, pursuant to the Rule 1030 Series, either as a General Securities Representative or [as] a Limited Representative-Corporate Securities.

(B) A person seeking to register and qualify as a General Securities Principal who will have supervisory responsibility over investment banking activities described in NASD Rule 1032(i)(1) must, prior to or concurrent with such registration, become registered as a Limited Representative—Investment Banking.

(C) A person who has been designated as a Chief Compliance Officer on Schedule A of Form BD for at least two years immediately prior to January 1, 2002, and who has not been subject within the last ten years to any statutory disqualification as defined in Section 3(a)(39) of the Act; a suspension; or the imposition of a fine of \$5,000 or more for violation of

any provision of any securities law or regulation, or any agreement with or rule or standard of conduct of any securities governmental agency, securities self-regulatory organization, or as imposed by any such regulatory or self-regulatory organization in connection with a disciplinary proceeding shall be required to register as a General Securities Principal, but shall be exempt from the requirement to pass the appropriate Qualification Examination. If such person has acted as a Chief Compliance Officer for a member whose business is limited to the solicitation, purchase and/or sale of “government securities,” as that term is defined in Section 3(a)(42)(A) of the Act, or the activities described in Rule 1022(d)(1)(A) or Rule 1022(e)(2), he or she shall be exempt from the requirement to pass the appropriate Qualification Examination only if he or she registers as a Government Securities Principal, or a Limited Principal pursuant to Rules 1022(d) or Rule 1022(e), as the case may be, and restricts his or her activities as required by such registration category. A Chief Compliance Officer who is subject to the Qualification Examination requirement shall be allowed a period of 90 calendar days following January 1, 2002, within which to pass the appropriate Qualification Examination for Principals.

(2) through (5) No change.

(b) through (h) No change.

* * * * *

1032. Categories of Representative Registration

(a) through (h) No change.

(i) Limited Representative-Investment Banking

(1) Each person associated with a member who is included within the definition of a representative as defined in NASD Rule 1031 shall be required to register with FINRA as a Limited Representative-Investment Banking and pass a qualification examination as specified by the Board of Governors if such person’s activities involve:

(A) advising on or facilitating debt or equity securities offerings through a private placement or a public offering, including but not limited to origination, underwriting, marketing, structuring, syndication, and pricing of such securities and managing the allocation and stabilization activities of such offerings, or

(B) advising on or facilitating mergers and acquisitions, tender offers, financial restructurings, asset sales, divestitures or other corporate reorganizations or business combination transactions, including but not limited to rendering a fairness, solvency or similar opinion.

(2) Notwithstanding the foregoing, an associated person shall not be required to register as a Limited Representative-Investment Banking if such person's activities described in paragraph (i)(1) are limited to:

(A) advising on or facilitating the placement of direct participation program securities as defined in NASD Rule 1022(e)(2);

(B) effecting private securities offerings as defined in paragraph (h)(1)(A);

or

(C) retail or institutional sales and trading activities.

(3) An associated person who participates in a new employee training program conducted by a member shall not be required to register as a Limited Representative-Investment Banking for a period of up to six months from the time the associated person first engages within the program in activities described in paragraphs (i)(1)(A) or (B), but in no event more than two years after commencing participation in the training program. This exception is conditioned upon the member maintaining records that:

(A) evidence the existence and details of the training program, including but not limited to its scope, length, eligible participants and administrator; and

(B) identify those participants whose activities otherwise would require registration as a Limited Representative-Investment Banking and the date on which each participant commenced such activities.

(4) Any person qualified solely as a Limited Representative-Investment Banking shall not be qualified to function in any area not described in paragraph (i)(1) hereof, unless such person is separately qualified and registered in the appropriate category or categories of registration.

(5) Any person who was registered with FINRA as a Limited Representative-Corporate Securities or General Securities Representative (including persons who passed the UK (Series 17) or Canada (Series 37/38) Modules of the Series 7) prior to [effective date of the proposed rule change], shall be qualified to be registered as a Limited Representative-Investment Banking without first passing the qualification examination set forth in paragraph (i)(1), provided that such person requests registration as a Limited Representative-Investment Banking within the time period prescribed by FINRA.

* * * * *

Variable Life Settlement Transactions

FINRA Reminds Firms of Their Obligations With Variable Life Settlement Activities

Executive Summary

Sales of existing life insurance policies to third parties—referred to as life settlements—have increased in recent years and the trend appears likely to continue. FINRA is concerned about variable life settlements because they involve materially different factors and raise materially different issues than more widely held securities such as stocks or bonds. Additionally, firms' marketing of variable life settlements is directed almost exclusively toward senior investors who, concerned about current economic conditions and retirement, may consider selling their variable life insurance policies without fully appreciating the risks and costs of variable life settlements.

FINRA reminds firms that:

- ▶ variable life settlements are securities transactions that are subject to the federal securities laws and all applicable FINRA rules;
- ▶ if they seek to enter the business of variable life settlements, they must file an application for approval of this material change in business under NASD Rule 1017;
- ▶ they must present balanced and fair information in their advertising and other communications with the public and customers about variable life settlements and related products,¹ and otherwise comply with all aspects of NASD Rule 2210; and
- ▶ they must adhere to suitability obligations under NASD Rule 2310; fair and reasonable commissions under FINRA Rule 2010 (formerly NASD Rule 2110), NASD Rule 2440 and related guidance; and fair fees and the disclosure of fees under NASD Rule 2430.

July 2009

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Advertising
- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management
- ▶ Variable Contracts

Key Topics

- ▶ Communications with the Public
- ▶ Commissions
- ▶ Fees
- ▶ Membership Rules
- ▶ Suitability
- ▶ Variable Insurance Policies
- ▶ Variable Life Settlements

Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ NASD Rule 1017
- ▶ NASD Rule 2210
- ▶ NASD Rule 2310
- ▶ NASD Rule 2430
- ▶ NASD Rule 2440
- ▶ NASD IM-2440-1
- ▶ NTM 75-65
- ▶ NTM 00-73
- ▶ NTM 03-71
- ▶ NTM 05-26
- ▶ NTM 06-38
- ▶ Regulatory Notice 07-43
- ▶ Regulatory Notice 08-57
- ▶ SEA Rule 10b-5

Questions concerning this *Notice* should be directed to:

- Lawrence Kosciulek, Director, Investment Companies Regulation, at (240) 386-4535;
- Matthew E. Vitek, Counsel, Office of General Counsel (OGC), at (202) 728-8156 (regarding membership); or
- Sharon Zackula, Associate Vice President and Associate General Counsel, OGC, at (202) 728-8985 (regarding compensation).

Background & Discussion

Current poor economic conditions, volatility in the financial markets and negative economic forecasts have depressed the value of housing and many traditional financial instruments, such as stocks and corporate bonds. Many individual investors, particularly those who are retired or close to retirement, may be concerned about their financial situation. In this economic environment, and at all times, FINRA is concerned that investors may consider selling their variable life insurance policies to obtain additional cash without fully appreciating the risks of variable life settlements, such as:

- unexpected tax liabilities;
- decreased access to insurance coverage, if needed; and
- the release of the individual's private medical information.

In addition, investors may not fully understand the transaction-related costs of selling their variable life insurance policy in a life settlement transaction. Business models differ, but often a number of intermediaries are involved in a single, variable life settlement transaction. In some, the number of intermediaries can result in increased commission charges and additional expenses, which substantially reduce the amount of money the selling investor receives as proceeds from the variable life settlement.²

The sale of investment products that are derivative of or based on life settlements — “related products” — is also likely to increase.³ Transactions in related products are also securities transactions that are subject to the federal securities laws and all applicable FINRA rules. FINRA is also concerned about investors who purchase these related products, as investors may not fully understand the risks of such investments.⁴ Retail investors may be attracted to related products that pay a higher yield than conventional investments or, in some cases, guarantee a return by a specific date, without being aware that generally, related products are illiquid investments and an investor may be unable to sell the investment, or may be forced to sell at a steep discount, if the investor needs the funds prior to maturity. Also, the yield on a related product may be adversely affected by the parties structuring the related product — by an inexperienced or incomplete actuarial analysis or an incomplete assessment of the medical conditions of any insured(s) covered by any policy in which an investor has an interest, or by a failure to follow applicable law regarding life settlements that may result in legal challenges at the time a death benefit is payable.

External developments, such as advances in medical research and treatment regarding certain diseases, also may reduce the yield of related products. In addition, an investor purchasing certain related products, such as a “guaranteed” life settlement—*e.g.*, the investment matures and repayment with interest is guaranteed not later than a specific date, even if the insured person has not passed away—may rely on the creditworthiness of the firm that structured the guaranteed life settlement or of a third-party guarantor whose creditworthiness may be unknown.

Material Change in Business Operations

Notice to Members (NTM) 00-73 describes the factors that identify a “material change in business operations.” Among the factors FINRA considers are the relationship, if any, between the proposed new business line and the firm’s existing business, and the degree to which the firm’s existing financial, operational, supervisory and compliance systems can accommodate the proposed new business activity.

Based on these factors, firms should be aware that expansion into business activities related to variable life settlements constitutes a material change in business operations under NASD Rule 1011(k). Therefore, before engaging in variable life settlements, a firm must first file a Continuing Membership Application and receive approval of this change in business operations under NASD Rule 1017. Some of the most important obligations and applicable FINRA rules in connection with variable life settlements are addressed in *NTM 06-38*.⁵ In addition, other FINRA Notices provide guidance regarding a firm’s responsibilities and obligations when a firm introduces a new product or buys or sells products that are complex or non-conventional, and the special concerns that are present when marketing a product focused almost exclusively toward senior retail investors.⁶

Suitability and Disclosure

The unique factors involved in an investor’s decision to enter into a variable life settlement are also the factors that a firm recommending such a transaction must consider when determining, among other things, if the transaction is suitable. In accordance with a firm’s suitability obligation under NASD Rule 2310, a firm recommending a variable life settlement to a customer must determine the necessity and extent of disclosure of those aspects of a life settlement transaction that may be material to a potential seller. A firm may not be in a position to complete its due diligence obligations under the suitability requirement in the absence of disclosure and detailed conversations with solicited customers. Often, the unique particularity of factors determining the suitability of a recommended life settlement transaction are such that disclosure to and detailed conversations with the customer are necessary to make the due diligence determinations required of firms under the suitability obligation.

There are several financial issues that an investor selling a variable life policy may need to consider. An investor should understand the tax treatment of the cash payment when paid in a variable life settlement as compared to the tax treatment of the death benefit to the beneficiary. Balancing the investor's need for current income with the future financial needs of a survivor also may be an important part of the analysis. An investor should also be aware that a variable life settlement transaction takes a longer time to complete than a typical securities transaction. The investor may need to consider how the sale could affect his or her eligibility for certain public assistance programs, such as Medicaid. The benefits of a sale must be weighed against the transaction-related costs of a variable life settlement, which are often substantial. Also, if an investor needs or desires to obtain replacement life insurance, there should be an understanding and consideration of the impact that the variable life settlement may have on the ability to obtain replacement insurance. If replacement insurance will be sought, there needs to be consideration of the costs of premiums of the policy to be sold compared to a new policy, and the comparability of the coverage.

An investor interested in selling his or her variable life policy in a variable life settlement must provide complete access to the investor's medical history (*e.g.*, all past and current medical conditions, their treatment, all drugs prescribed) and any other information, no matter how personal, that may affect the investor's life expectancy, and must do so without any assurance that the life settlement will occur. This access may be granted to many people, including persons involved in the transaction at the closing, third parties evaluating the transaction, investors and potential investors. Most of these people will never be identified to the investor. Also, the investor may have an on-going obligation to disclose personal information, including his or her general health, new medical conditions and changes in pre-existing conditions, until his or her death. Moreover, the investor should appreciate fully that the buyer has a financial interest in the seller's death.

Consequently, it is FINRA's view that NASD Rule 2310's due diligence component requires, before firms can make a suitability determination, that firms must take appropriate steps to make investors aware of the issues raised above and other pertinent information regarding a variable life settlement. If a firm fails to disclose information that would be viewed as material to a reasonable investor in making a decision to buy or sell a security, or the firm does not present pertinent information clearly, the firm may violate the anti-fraud provisions of the federal securities laws in addition to FINRA's suitability rule.⁷

Communications

FINRA understands that advertising and marketing materials and sales campaigns about variable life settlements are directed almost exclusively towards senior investors because their remaining life expectancy provides the potential of an attractive yield to investors. Firms seeking to identify investors who may consider selling their variable life insurance policy to a third party must present balanced, fair and comprehensive information in its advertising and marketing materials and any other communication. Firms, their associated persons and other intermediaries must not use high-pressure sales tactics and other aggressive advertising, marketing and sales efforts. Some investors may be unduly influenced by communications that are overly aggressive, not fair or balanced, or lack important information or disclosures. This may be especially true if an investor is concerned about current cash needs, is under financial pressure because his or her retirement assets have fallen in value or interest income from fixed income securities has been reduced, or the investor is concerned about current or future medical expenses, long-term care or other needs.

NASD Rule 2210 prohibits firms from making any false, exaggerated, unwarranted or misleading statement or claim in any communication with the public. A firm's communications, including those about variable life settlements or related products—whether the firm is acting as a broker soliciting business or a dealer—must be fair and balanced and based on principles of fair dealing and good faith. These obligations may not be waived or met by disclaimer.

New firms that engage in the business of variable life settlements or related products must file their advertisements with FINRA. NASD Rule 2210 requires any firm that has not previously filed advertisements with FINRA to file all of its advertisements at least 10 days prior to first use; this filing requirement continues for one year from the first submission. In addition, all firms must file advertisements and sales literature concerning variable life settlements or related products (involving any variable products) within 10 business days of first use or publication. Finally, NASD Rule 2210's internal approval and recording-keeping provisions apply to communications in connection with variable life settlement or related products activities. The rule requires that a registered principal approve all advertisements and sales literature prior to use, in writing.

Commissions and Fees

FINRA is concerned that investors selling their variable life policies may be charged excessively high commissions or fees. Under NASD Rule 2440 and IM-2440-1 (collectively, the "commission rules"), a firm is prohibited from charging a customer more than a fair and reasonable commission in any securities transaction, which

include variable life settlements and transactions in related products.⁸ In addition, under FINRA Rule 2010, a firm that charges an unfair commission violates the firm's obligation to observe just and equitable principles of trade in the conduct of the firm's business.⁹ Similarly, any fees a firm charges a customer must be reasonable. Under NASD Rule 2430, firms are prohibited from charging unreasonable fees or fees that unfairly discriminate among the firm's customers for miscellaneous services.¹⁰ In 2006, FINRA discussed variable life settlements and reminded firms and associated persons of their obligations under various FINRA rules, including those related to compensation.¹¹ At that time, FINRA noted its concern that the lure of very high commissions might lead firms and their associated persons to aggressively market such transactions and engage in other inappropriate sales practices.

FINRA continues to receive questions about the application of the commission rules with regard to variable life settlements. Often these inquiries reflect, in membership applications or other sources, a firm's intention to charge commissions that exceed, by 100 percent or more, any commission that FINRA historically has considered fair and reasonable. Firms are reminded that although the commission rules do not state specific commission amounts for a variable life settlement or any other security, most securities products are sold for commissions of considerably less than five percent and those in excess of five percent are subject to heightened scrutiny.

Under NASD Rule 2440, the fairness of a commission is determined by the factors set out in the rule. A firm is required to take into consideration all relevant facts and circumstances regarding the transaction, including market conditions with respect to the security, the expense of executing the transaction and the value of the services the firm renders in setting the firm's commission. A firm should be prepared to justify that its commission is fair as to each customer and transaction.¹²

Additional guidance is provided in NASD IM-2440-1, which applies to commission charges. Some factors that may be relevant are set forth in NASD IM-2440-1(b)(1) through (7) and include:

- the type of security;
- any unusual circumstances connected with the acquisition or sale of a security, including availability of the security in the market;
- the price of a security;
- transactions involving small amounts of money;
- disclosure of the firm's commission to the customer;
- the firm's pattern of mark-ups; and
- the nature of the firm's business.

Depending on the particular transaction, additional factors may be part of the facts and circumstances to be considered when determining if a commission is fair.

According to some firms, the completion of variable life settlement transactions may take much longer than other securities transactions and include unique costs. Nevertheless, such summary conclusions supporting increased commission costs are not sufficient as a basis; a firm should be prepared to justify and evidence that its commission is fair and reasonable as to each customer and variable life settlement and apply the factors in the commission rules, including those in NASD IM-2440-1(b). Additionally, disclosures of commissions (if made) on a variable life settlement transaction, should be based on the gross offer (the readily available market value of the policy) made to the seller, not the face value of the policy or the net offer.

Firms should understand that:

- the length of time that a transaction takes to complete does not by itself translate into the effort or cost in completing that transaction on the part of the firm;
- the paperwork that a selling investor may need to provide is not necessarily indicative of the firm's effort in completing the transaction;
- the general level of liquidity in the market does not necessarily mean that any particular transaction was difficult or required enhanced efforts to complete;
- the use of interpositioned parties may not necessarily form a basis for higher commission rates, as some firms are able to complete these transactions without such parties; and
- the general level of compensation for such similar transactions outside of the securities industry is not relevant because of the lack of applicability to non-regulated parties of FINRA's fair and reasonable commission rules.

Firms Currently Engaged in Life Settlement or Related Products Activity

Firms that currently engage in variable life settlement or related products business activities must be aware of their obligations under all applicable FINRA rules. As discussed in this *Notice* and *NTM 06-38*, variable life settlements and transactions in related products raise a number of unique regulatory and compliance issues. Among other things, firms must carefully and thoroughly address these issues and other relevant compliance matters in their policies and procedures, and supervision of such transactions and associated persons engaged in such transactions.¹³

Endnotes

- 1 For the purpose of this *Notice*, “related products” are defined as a security that is an interest in a single life policy, or a group or a pool of such policies, whether variable or not, such as an asset-backed security backed by life insurance policies, or a security where the obligation to pay interest or principal to the holder is contingent or partially contingent upon the death of one or more insured persons under life insurance policies, or a bonded or a guaranteed life settlement security based on one or more policies.

A bonded or guaranteed life settlement security may include the following elements:
 - the maturity of the bond is set at approximately the same time or occurs shortly after the death benefit(s) is expected to be paid under the life insurance policy(ies) that is the reference policy(ies) for the security;
 - the security includes a call, which the issuer may exercise if the issuer receives the death benefit(s) earlier than projected; and
 - if, at maturity, the issuer has not received the death benefit(s), the bondholder(s) will be paid the accrued interest and principal by the issuer, who may look to a bonding entity or a guarantor.
- 2 For purposes of this *Notice*, “commission charges” refers to commissions, commission-equivalents, fees and any other compensation, however named, that a firm charges a customer in a life settlement.
- 3 See endnote 1.
- 4 Generally, the returns or yields to investors on life settlements, including variable life settlements and related products, do not correlate to other investments. During periods when many assets decline in value, there may be more demand for non-correlated investments.
- 5 See *NTM 06-38* (August 2006) (Life Settlements: Member Obligations with Respect to the Sale of Existing Variable Life Insurance Policies to Third Parties).
- 6 See *NTM 05-26* (April 2005) (New Products: NASD Recommends Best Practices for Reviewing New Products); *NTM 03-71* (November 2003) (Non-Conventional Investments); and *Regulatory Notice 07-43* (September 2007) (Senior Investors: FINRA Reminds Firms of Their Obligations Relating to Senior Investors and Highlights Industry Practices to Serve these Customers). In *Regulatory Notice 07-43*, FINRA discusses specific issues (*e.g.*, exhibiting diminished capacity and suspected financial abuse) that firms sometime encounter when dealing with senior investors, including providing guidance about steps that some firms have taken as a matter of sound business practice and as a way of serving their senior customers.
- 7 See NASD Rule 2310 and NASD IM-2310-2; NASD Rule 2120; and Securities Exchange Act Rule 10b-5. Professionals must discuss clearly all issues because some statements, although literally accurate, can become, through their context and manner of presentation, misleading.

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- 8 Under NASD Rule 2440, if a firm charges a customer a commission, the firm shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the markets therefore.
- NASD IM-2440-1 provides additional guidance regarding fair and reasonable commissions. A second interpretation to NASD Rule 2440, IM-2440-2, primarily deals with mark-ups and is not included in this discussion.
- 9 FINRA Rule 2010 (formerly NASD Rule 2110) requires a firm to observe high standards of commercial honor and just and equitable principles of trade. NASD Rule 2110 was transferred without change to the new consolidated FINRA rulebook (Consolidated FINRA Rulebook) as FINRA Rule 2010 and became effective on December 15, 2008. *See Regulatory Notice 08-57* (October 2008) (FINRA Announces SEC Approval and Effective Date for New Consolidated FINRA Rules).
- 10 NASD Rule 2430 provides that charges, if any, for services performed, including miscellaneous services such as collection of moneys due for principal, dividends or interest; exchange or transfer of securities; appraisals, safe-keeping or custody of securities, and other services, shall be reasonable and not unfairly discriminatory among customers.
- 11 *See NTM 06-38.*
- 12 *See NTM 75-65* (October 1975).
- 13 *See NTM 06-38.*

Arbitration Panel Composition

SEC Approves Amendments to the Panel Composition Rules of the Arbitration Code for Industry Disputes

Effective Date: August 31, 2009

Executive Summary

Effective August 31, 2009, the criteria for determining the panel composition for an arbitration when the claim involves an associated person¹ will change. The amendment to the Arbitration Code for Industry Disputes will apply to claims filed on or after the effective date.

The text of the amendment is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- Kenneth L. Andrichik, Senior Vice President, Chief Counsel and Director of Mediation and Strategy, Dispute Resolution, at (212) 858-3915 or ken.andrichik@finra.org; or
- Mignon McLemore, Assistant Chief Counsel, Dispute Resolution, at (202) 728-8151 or mignon.mclemore@finra.org.

Background and Discussion

Currently, FINRA Rule 13402(a) of the Industry Code requires an all non-public panel for disputes between member firms, and for employment disputes between or among member firms and associated persons that relate exclusively to employment contracts, promissory notes or receipt of commissions.² In all other disputes between or among member firms and associated persons, Rule 13402(b) requires a majority public panel, where one arbitrator would be a non-public arbitrator and two would be public arbitrators.³

July 2009

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics

- Arbitration
- Code of Arbitration Procedure
- Dispute Resolution
- Panel Composition

Referenced Rules & Notices

- FINRA Rule 13402
- FINRA Rule 13403
- FINRA Rule 13406

The amendments to Rules 13402, 13403 and 13406 of the Arbitration Code for Industry Disputes (Industry Code) change the criteria for determining panel composition when the claim involves an associated person in industry disputes.⁴ Specifically, the amendments to the rules of the Industry Code:

- ▶ require that the parties receive a majority public panel for all industry disputes involving associated persons (excluding disputes involving statutory employment discrimination claims, which require a specialized all public panel);⁵
- ▶ clarify that in disputes involving only member firms, parties will receive an all non-public panel; and
- ▶ provide that if a party amends its pleadings to add an associated person to a previously all-member firm case, parties will receive a majority public panel.

Employment Disputes Involving Associated Persons

Currently, in employment disputes between or among member firms and associated persons, FINRA requires that the panel consist of all non-public arbitrators in cases that arise out of the employment or termination of employment of an associated person, and that relate exclusively to employment contracts, promissory notes or receipt of commissions. However, if a party adds a claim that does not meet these criteria, the parties receive a majority public panel.

The amendments to Rule 13402 provide that for all employment disputes between or among member firms and associated persons (except for statutory employment discrimination cases), the parties must select a majority public panel. To implement this change, FINRA is deleting the title of Rule 13402(a), which contains the exceptions to the majority public panel requirement, and is replacing it with a concise description, which clarifies that Rule 13402(a) would apply to disputes involving only member firms (“Disputes Between Members”).

Further, FINRA is modifying the title of Rule 13402(b) to provide that for all industry disputes involving associated persons (excluding disputes involving statutory employment discrimination claims), the parties will select a majority public panel (*i.e.*, “Disputes Between Associated Persons or Between or Among Members and Associated Persons”). FINRA is also making similar, consistent title changes to Rules 13403(a) and 13403(b), which govern generating and sending lists to parties, and to Rules 13406(a) and 13406(b), which govern appointment of arbitrators and discretion to appoint arbitrators not on the list.

Disputes Involving Only Member Firms

The amendments to the rule also clarify that, in all disputes involving only member firms, the parties will select an all non-public panel.

Amendments to Pleadings that Add an Associated Person

Occasionally, in a case that begins with an all non-public arbitrator panel, a party will amend its pleadings in such a way that a majority public panel will be required. For example, if a party files a claim regarding only an issue of compensation (one of the three “causes of action” listed in the existing rule), FINRA currently requires parties to select an all non-public panel. However, if a party adds a claim that falls outside of those three causes of action (*e.g.*, adds a cause of action involving a tort), then the parties receive a majority public panel instead.

Under the new rule, if a member firm (in a dispute involving only member firms) amends a pleading to add a party who is an associated person, the parties will select a majority public panel.

The deadlines for arbitrator list selection determine how FINRA processes an amended pleading. For example, if lists of potential arbitrators have not been sent to parties, the Neutral List Selection System (NLSS)⁶ generates three lists of arbitrators to send to the parties: a public chairperson list, a public arbitrator list and a non-public arbitrator list.⁷ If the panel consists of one arbitrator,⁸ NLSS will generate a public chairperson list, and FINRA sends only this list to the parties.⁹

If lists of potential non-public arbitrators have been sent to parties but the deadline for their return to FINRA has not yet passed, FINRA provides two new lists of public arbitrators to the parties, so that the parties may select a majority public panel. Specifically, FINRA sends a public chairperson list and a public arbitrator list to the parties,¹⁰ and the parties select the two public arbitrators for the panel from these lists using the striking and ranking procedures set forth in the Code.¹¹ The arbitrator selected from the public chairperson list becomes the chairperson of the panel. The parties keep the non-public chairperson list previously provided to them, and select the non-public arbitrator from this list.¹² In a single arbitrator case, FINRA sends only a new public chairperson list to the parties, including the newly added party, so that the parties may select a public arbitrator.¹³

If the ranked lists of potential arbitrators are due to FINRA, then the parties may not amend a pleading to add a new party until a panel is selected and the panel grants a motion to add the party.¹⁴ Once the panel is selected, if it grants the motion to add an associated person, FINRA retains the non-public chairperson from the panel, and removes the remaining non-public arbitrators.¹⁵ The parties select two public arbitrators from new lists that FINRA sends to them in the same manner as if the ranked lists are not yet due to be returned to FINRA. The arbitrator selected from the public chairperson list becomes the chairperson of the panel. If the panel consists of one non-public arbitrator and the non-public arbitrator grants a motion to add an associated person, the non-public arbitrator will be replaced with a public chair-qualified arbitrator that the parties select from a new public chairperson list that NLSS generates.¹⁶

Effective Date

The amendment becomes effective on August 31, 2009, and will apply to claims filed on or after this date.

Endnotes

- 1 Exchange Act Release No. 60061 (June 5, 2009), 74 Federal Register 28318 (June 15, 2009) (File No. SR-FINRA-2009-011).
- 2 If the panel consists of one arbitrator, the arbitrator will be a non-public arbitrator selected from the non-public chairperson roster described in Rule 13400(c). *See* Rule 13402(a).
- 3 If the panel consists of one arbitrator, the arbitrator will be a public arbitrator selected from the chairperson roster described in Rule 12400(c) of the Code of Arbitration Procedure for Customer Disputes (Customer Code). *See* Rule 13402(b).
- 4 The amendments discussed in this *Notice* do not apply to claims filed under the Customer Code.
- 5 The amendments will not apply to disputes involving a claim of statutory employment discrimination. *See* Rule 13802.
- 6 The NLSS is a computer system that generates, on a random basis, lists of arbitrators from FINRA's rosters of arbitrators. The parties select their panel through a process of striking and ranking the arbitrators on lists generated by NLSS. *See* Rule 13400(a).
- 7 *See* Rule 13403(b)(2).
- 8 In a dispute between member firms, if the panel consists of one arbitrator, the arbitrator will be selected from FINRA's non-public chairperson arbitrator roster. *See* Rule 13402(a).
- 9 *See* Rule 13403(b)(1). FINRA has raised the amount in controversy that will be heard by a single chair-qualified arbitrator to \$100,000. *See* Securities Exchange Rel. No. 59340 (Feb. 2, 2009), 74 FR 6335 (Feb. 6, 2009) (File No. FINRA-2008-047); *see also* *Regulatory Notice 09-13*.
- 10 Each new list will contain eight arbitrators. *See* Rule 13403(b)(2).
- 11 *See* Rule 13404.
- 12 FINRA will send the list of non-public arbitrators to the new party, with employment history for the past 10 years and other background information for each arbitrator listed. The newly added party may rank and strike arbitrators in accordance with Rule 13404. *See* Rule 13407(a).
- 13 Notes 9 and 12.
- 14 *See* Rule 13309(c).
- 15 Under Rule 13407(b), the newly added party may not strike the non-public arbitrator, but may challenge the arbitrator for cause in accordance with Rule 13410.
- 16 Note 9.

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Attachment A

New language is underlined; deleted language is in brackets.

Code of Arbitration Procedure for Industry Disputes

Industry Code

13402. Composition of Arbitration Panels in Cases Not Involving a Statutory Discrimination Claim

For disputes involving statutory employment discrimination claims, see Rule 13802.

(a) [Disputes Between Members, or Employment Disputes Between or Among Member Firms and Associated Persons Relating Exclusively To Employment Contracts, Promissory Notes, or Receipt of Commissions] Disputes Between Members

(1) In an arbitration between members, the panel composition will be as follows:

- No change.
- No change.

(2) If an arbitration involves only members and a member amends a pleading, pursuant to Rule 13309(c) to add an associated person, the majority of the panel will be public arbitrators, as described in Rule 13402(b). Once an associated person has been added to the proceeding, the rules that apply to cases between associated persons and members will govern list selection and the administration of the arbitration proceeding.

(b) [Other] Disputes Between Associated Persons or Between or Among Members and Associated Persons

- No change.
- No change.

13403. Generating and Sending Lists to the Parties

For disputes involving statutory employment discrimination claims, see Rule 13802.

(a) [Disputes Between or Among Members, or Employment Disputes Between or Among Member Firms and Associated Persons Relating Exclusively To Employment Contracts, Promissory Notes, or Receipt of Commissions] Lists Generated in Disputes Between Members

(1) – (4) No change.

(b) [Other Disputes Between or Among Members and Associated Persons] Lists Generated in Disputes Between Associated Persons or Between or Among Members and Associated Persons

(1) - (4) No change.

(c) Sending Lists to Parties

No change.

* * * *

13406. Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on List

For disputes involving statutory employment discrimination claims, see Rule 13802.

(a) [Disputes Between Members, or Employment Disputes Between or Among Member Firms and Associated Persons Relating Exclusively To Employment Contracts, Promissory Notes, or Receipt of Commissions] Appointment of Arbitrators in Disputes Between Members

(1) – (2) No change.

(b) [Other] Appointment of Arbitrators in Disputes Between Associated Persons or Between or Among Members and Associated Persons

(1) - (2) No change.

(c) No change.

(d) No change.

* * * * *

Fidelity Bonds

FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Fidelity Bonds

Comment Period Expires: September 14, 2009

Executive Summary

As part of the process to develop a new consolidated rulebook (the Consolidated FINRA Rulebook),¹ FINRA is requesting comment on a proposed consolidated FINRA rule governing fidelity bond requirements.

The text of the proposed rule is set forth in Attachment A. Examples of estimated fidelity bond premiums for different-sized firms under the proposed rule are set forth in Attachment B.

Questions concerning this *Notice* may be directed to:

- Susan DeMando Scott, Associate Vice President, Financial Operations Policy, at (202) 728-8411; or
- Erika L. Lazar, Senior Attorney, Office of General Counsel, at (646) 315-8512.

Action Requested

FINRA encourages all interested parties to comment on the proposed rule. Comments must be received by September 14, 2009.

Members 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, N.W.
Washington, D.C. 20006-1506

July 2009

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topic(s)

- Fidelity Bonds

Referenced Rules & Notices

- NASD Rule 3020
- NYSE Rule 319 and Its Interpretation
- SEA Rule 15c3-1

To help FINRA process and review comments more efficiently, persons should only use 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.²

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*.³

Background & Discussion

NASD Rule 3020 and NYSE Rule 319⁴ (and its Interpretation) require member firms to maintain minimum amounts of fidelity bond coverage for officers and employees, and that such coverage address losses incurred due to certain specified events. The purpose of a fidelity bond is to protect a firm against certain types of losses, including, but not limited to, those caused by the malfeasance of its officers and employees, and the effect of such losses on the firm's capital.

FINRA proposes adopting NASD Rule 3020 as FINRA Rule 4360, taking into account requirements under NYSE Rule 319 (and its Interpretation). The proposed FINRA rule updates the fidelity bond requirements to clarify the rule and reflect current industry practices. Unless otherwise noted below, the provisions in NASD Rule 3020 would transfer, subject only to non-substantive changes, as part of the consolidated FINRA rule.

Proposed FINRA Rule 4360 (Fidelity Bonds)

General Requirements

Proposed FINRA Rule 4360 requires each firm that is required to join the Securities Investor Protection Corporation (SIPC) to maintain a blanket fidelity bond with specified amounts of coverage based on its net capital requirement, with certain exceptions. The proposed rule requires each firm to maintain, at a minimum, fidelity bond coverage for any person associated with the firm, except directors or trustees of a firm who are not performing acts within the scope of the usual duties of an officer or employee.

Proposed FINRA Rule 4360 requires all firms to maintain fidelity bond coverage with the Securities Dealer Blanket Bond (securities blanket bond), unless the firm is unable to obtain this coverage. Today, firms that carry \$5 million or more in fidelity bond coverage, or that have had an insurance claim paid out by the insurance company within the past five years, cannot obtain the securities blanket bond, so they use the Financial Institution Form 14 Bond (Form 14 bond). The securities blanket bond provides “per event” coverage and the Form 14 bond provides “per year” coverage.⁵ FINRA believes that all firms required to maintain fidelity bond coverage should carry “per event” coverage offered by the securities blanket bond, unless they are unable to secure such coverage, in which case, they may carry the Form 14 bond as long as it offers coverage that is otherwise consistent with the requirements of the proposed rule. If a firm is unable to obtain either the securities blanket bond or the Form 14 bond, the firm must maintain coverage with a bond that is substantially similar to the securities blanket bond and is otherwise consistent with the requirements of the proposed rule.

Like NASD Rule 3020, proposed FINRA Rule 4360 requires that a firm’s fidelity bond include a cancellation rider providing that the insurer will use its best efforts to promptly notify FINRA in the event the bond is cancelled, terminated or “substantially modified.” Also, the proposed rule adopts the definition of “substantially modified” in NYSE Rule 319⁶ and incorporates NYSE Rule 319’s standard that a firm must *immediately* advise FINRA in writing if its insurance is cancelled, terminated or substantially modified.

Minimum Required Coverage

Proposed FINRA Rule 4360 increases the minimum required fidelity bond coverage for firms, while continuing to base the coverage on their net capital requirement.⁷ To that end, the proposed rule requires a firm with a net capital requirement that is less than \$250,000 to maintain minimum coverage of the greater of 120 percent of the firm’s required net capital under SEA Rule 15c3-1 or \$100,000. The increase to \$100,000 modifies the present minimum requirement of \$25,000. FINRA believes this increase is warranted since the NASD and NYSE fidelity bond rules have not been materially modified since adoption—over 30 years ago—and \$25,000 in 1974 (the year the NASD rule was adopted) is equal to approximately \$124,000 today (adjusted for inflation).

Historically, firms that have maintained minimum coverage of \$25,000 have had claims that exceed this amount. Although firms may experience a slight increase in costs for their premiums under the proposal, FINRA believes that the proposed changes to the fidelity bond minimum requirements are necessary to provide meaningful and practical coverage for losses covered by the bond.

Under proposed FINRA Rule 4360, firms with a net capital requirement of at least \$250,000 will use a table in the rule to determine their minimum fidelity bond coverage requirement. The table is a modified version of the table in NASD Rule 3020, incorporating aspects of NYSE Rule 319. The identical NASD and NYSE requirements for firms that have a minimum net capital requirement that exceeds \$1 million are retained in proposed FINRA Rule 4360. However, the proposed rule adopts the higher requirements in NYSE Rule 319 for a firm with a net capital requirement of at least \$250,000, but less than \$1 million.⁸

Insuring Agreements

The securities blanket bond provides the same level of coverage (100 percent) for all Insuring Agreements required by the NASD and NYSE rules. To reflect this industry practice, proposed FINRA Rule 4360 eliminates the specific coverage provisions in the NASD and NYSE rules that permit less than 100 percent of coverage⁹ for certain Insuring Agreements (*i.e.*, fraudulent trading and securities forgery) to require that coverage for all Insuring Agreements be equal to 100 percent of the bond coverage. Firms may elect to carry optional Insuring Agreements not required by proposed FINRA Rule 4360 for an amount less than 100 percent of the bond coverage.

Also, proposed FINRA Rule 4360 aligns the Insuring Agreements required by the rule with the securities blanket bond that is offered to FINRA member firms. Under the proposed rule, a firm's fidelity bond must provide against loss and have Insuring Agreements covering at least the following: fidelity, on premises, in transit, forgery and alteration, securities and counterfeit currency. These areas of coverage are modified, in part, from NASD Rule 3020; however, the proposal does not substantively change what is required to be covered by the bond.

Deductibles

Proposed FINRA Rule 4360 provides for an allowable deductible amount of up to 25 percent of the fidelity bond coverage purchased by a firm. Similar to NASD Rule 3020, any deductible amount elected by the firm that is greater than 10 percent of the coverage purchased by the member is deducted from the firm's net worth in the calculation of its net capital for purposes of SEA Rule 15c3-1.¹⁰ FINRA notes that a firm may elect, subject to availability, a deductible less than 10 percent of the coverage purchased.

Annual Review and Adjustments

Consistent with NASD Rule 3020 and NYSE Rule 319, proposed FINRA Rule 4360 requires each firm—including a firm that signs a multi-year insurance policy—annually as of the yearly anniversary date of the issuance of the fidelity bond to review the adequacy of its fidelity bond coverage and make any required adjustments to its coverage, as set forth in the rule. Under the proposed rule, a firm’s highest net capital requirement during the preceding 12-month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), is used as the basis for determining the firm’s required minimum fidelity bond coverage for the succeeding 12-month period. The “preceding 12-month period” includes the 12-month period that ends 60 days before the yearly anniversary date of a member’s fidelity bond. This gives a firm time to determine its required fidelity bond coverage by the anniversary date of the bond.

Exemptions

Proposed FINRA Rule 4360 provides an exemption from the fidelity bond requirements for firms in good standing with a national securities exchange that maintain a fidelity bond subject to requirements of such exchange that are equal to or greater than the requirements set forth in the proposed rule.¹¹

Additionally, consistent with NYSE Rule Interpretation 319/01, proposed FINRA Rule 4360 continues to exempt from the fidelity bond requirements any firm that acts solely as a Designated Market Maker (DMM),¹² floor broker or registered floor trader and does not conduct business with the public.

Proposed FINRA Rule 4360 does not maintain the exemption in NASD Rule 3020 for a one-person firm.¹³ Historically, a sole proprietor or sole stockholder member firm was excluded from the fidelity bond requirements based upon the assumption that such firms were one-person shops and, therefore, could not obtain coverage for their own acts. FINRA has determined that sole proprietor and sole stockholder firms can and often do acquire fidelity bond coverage, even though it is currently not required, since all claims (irrespective of firm size) are likely to be paid or denied on a facts-and-circumstances basis. Also, certain provisions of the fidelity bond benefit a one-person shop (*e.g.*, those covering customer property lost in transit).

Implementation Date

FINRA understands that changes to a firm’s fidelity bond policy, in coordination with insurance providers, may be impacted by bond renewal cycles and changes required by the insurance industry. As such, FINRA will work with firms to establish a reasonable implementation date for the proposed rule change upon approval by the SEC.

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 member firms 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 3/12/08* (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* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA or 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 SEA Section 19 and rules thereunder.
- 4 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.
- 5 Since 1982, firms electing to acquire coverage through the FINRA-sponsored Insurance Program (Sponsored Program) have been provided with the securities blanket bond. It is the “default” insurance for FINRA member firms in that when a firm completes the application for the Sponsored Program, they are applying for the securities blanket bond.
- 6 NYSE Rule 319 defines the term “substantially modified” as any change in the type or amount of fidelity bonding coverage, or in the exclusions to which the bond is subject, or any other change in the bond such that it no longer complies with the requirements of the rule.
- 7 See Attachment B for examples of estimated premiums for different sized firms under the proposed rule.
- 8 For example, NASD Rule 3020 permits a small clearing and carrying firm (*i.e.*, one subject to a \$250,000 net capital requirement) to obtain \$300,000 in coverage. The same firm, had it been designated to NYSE, would have needed \$600,000 in coverage. FINRA believes the increased coverage requirements are appropriate given the larger number/amount of claims that can be satisfied at these levels.
- 9 See NASD Rule 3020(a)(4) and (a)(5); NYSE Rule 319(d)(ii)(B) and (C), and (e)(ii)(B) and (C).
- 10 NASD Rule 3020 bases the deduction from net worth for an excess deductible on a firm’s minimum required coverage while proposed FINRA Rule 4360 bases such deduction from net worth on coverage purchased by the firm.

- 11 In general, the notification provisions of the corresponding exchange rules (*i.e.*, cancellation rider and notification upon cancellation, termination or substantial modification of the bond) require notification to the respective exchange rather than to FINRA. Accordingly, the practical effect for a firm that avails itself of the proposed exemption is that such firm must maintain a fidelity bond subject to the same requirements as in Proposed FINRA Rule 4360; however, such firm is exempt from the requirement that FINRA be notified of changes to the bond and will alternatively comply with the notification provisions of the respective exchange.
- 12 See Exchange Act Release No. 58845 (October 24, 2008), 73 FR 64379 (October 29, 2008) (Approval Order; SR-NYSE-2008-46). In this rule filing, the role of the specialist was altered in certain respects and the term “specialist” was replaced with the term “Designated Market Maker.”
- 13 A one-person firm (that is, a firm owned by a sole proprietor or stockholder that has no other associated persons, registered or unregistered) has no “employees” for purposes of NASD Rule 3020, and therefore such a firm currently is not subject to the fidelity bonding requirements. Conversely, a firm owned by a sole proprietor or stockholder that has other associated persons has “employees” for purposes of NASD Rule 3020, and currently is, and will continue to be, subject to the fidelity bonding requirements.

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 3020; NASD Rule 3020 and NYSE Rule 319 (and Its Interpretation) to Be Deleted in Their Entirety from the Transitional Rulebook)

* * * * *

[3020]4360. Fidelity Bonds

(a) [Coverage Required]General Provision

(1) Each member required to join the Securities Investor Protection Corporation [who has employees and who is not a member in good standing of the American Stock Exchange, Inc.; the Boston Stock Exchange; the Midwest Stock Exchange, Inc.; the New York Stock Exchange, Inc.; the Pacific Stock Exchange, Inc.; the Philadelphia Stock Exchange, Inc.; or the Chicago Board Options Exchange] shall[:]

[(1) M] maintain [a] blanket fidelity bond coverage, in a form substantially similar to with the [standard form of] Securities Dealer [Brokers] Blanket Bond, [promulgated by the Surety Association of America, covering officers and employees] which provides against loss and has Insuring [a] Agreements covering at least the following:

- (A) Fidelity
- (B) On Premises
- (C) In Transit
- [(D) Misplacement]
- [(E) D] Forgery and Alteration [(including check forgery)]
- [(F) E] Securities [Loss (including securities forgery)]
- [(G) E] [Fraudulent Trading] Counterfeit Currency

[(H) 2] The fidelity bond must include a [C] cancellation [R] rider providing that the insurance carrier will use its best efforts to promptly notify [the National Association of Securities Dealers, Inc.] FINRA in the event the bond is cancelled, terminated or substantially modified.

(b) Minimum Required Coverage

([2]1) A member with a net capital requirement of less than \$250,000 must [M]maintain minimum fidelity bond coverage for all [i]Insuring [a]Agreements required [in this] by paragraph (a) of this Rule of [not less than \$25,000;] the greater of (1) 120% of the member's required net capital under SEA Rule 15c3-1 or (2) \$100,000. A member with a net capital requirement of \$250,000 or more must maintain minimum fidelity bond coverage for all Insuring Agreements required by paragraph (a) of this Rule in accordance with the following table:

[(3) Maintain required minimum coverage for Fidelity, On Premises, In Transit, Misplacement and Forgery and Alteration insuring agreements of not less than 120% of its required net capital under SEC Rule 15c3-1 up to \$600,000. Minimum coverage for required net capital in excess of \$600,000 shall be determined by reference to the following table:]

Net Capital Requirement under SE[C]A Rule 15c3-1	Minimum Coverage
\$250,000–300,000	\$600,000
300,001–500,000	700,000
[\$6]500,00[0]1–1,000,000	[75]800,000
1,000,001–2,000,000	1,000,000
2,000,001–3,000,000	1,500,000
3,000,001–4,000,000	2,000,000
4,000,001–6,000,000	3,000,000
6,000,001–12,000,000	4,000,000
12,000,001[–]and above	5,000,000

(2) At a minimum, a member must maintain fidelity bond coverage for any person associated with the member, except directors or trustees who are not performing acts within the scope of the usual duties of an officer or employee.

[(4) Maintain Fraudulent Trading coverage of not less than \$25,000 or 50% of the coverage required in paragraph (a)(3), whichever is greater, up to \$500,000;]

[(5) Maintain Securities Forgery coverage of not less than \$25,000 or 25% of the coverage required in paragraph (a)(3), whichever is greater, up to \$250,000.]

[(b)c] Deductible Provision

[(1) A deductible provision may be included in the bond of up to \$5,000 or 10% of the minimum insurance requirement established hereby, whichever is greater.]

[(2) If a member desires to maintain coverage in excess of the minimum insurance requirement then a deductible provision may be included in the bond of up to \$5,000 or 10% of the amount of blanket coverage provided in the bond purchased, whichever is greater. The excess of any such deductible amount over the maximum permissible deductible amount described in subparagraph (1) above must be deducted from the member's net worth in the calculation of the member's net capital for purposes of SEC Rule 15c3-1. Where the member is a subsidiary of another Association member the excess may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.]

A provision may be included in a fidelity bond to provide for a deductible of up to 25% of the coverage purchased by a member. Any deductible amount elected by the member that is greater than 10% of the coverage purchased by the member must be deducted from the member's net worth in the calculation of its net capital for purposes of SEA Rule 15c3-1. If the member is a subsidiary of another FINRA member, this amount may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.

[(c)d] Annual Review of Coverage

(1) [Each]A member, including a member that signs a multi-year insurance policy,[other than members covered by subparagraph (2),] shall, annually [review,] as of the yearly anniversary date of the issuance of the fidelity bond, review the adequacy [thereof] of its coverage and make any required adjustments, as set forth in paragraphs (d)(2) and (d)(3) of this Rule. [by reference to the highest required net capital during the immediately preceding twelve-month period, which amount shall be used to determine minimum required coverage for the succeeding twelve-month period pursuant to subparagraphs (a)(2), (3), (4) and (5).]

(2) A member's highest net capital requirement during the preceding 12-month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), shall be used as the basis for determining the member's required minimum fidelity bond coverage for the succeeding 12-month period. For the purpose of this paragraph, the "preceding 12-month period" shall include the 12-month period that ends 60 days before the yearly anniversary date of a member's fidelity bond. [Each member which has been in business for one year shall, as of the first anniversary date of the issuance of its original bond, review the adequacy thereof by reference to an amount calculated by dividing the highest it experienced during its first year by 15. Such amount shall be used in lieu of required net capital under SEC Rule 15c3-1 in determining the minimum required coverage to be carried in the member's second year pursuant to subparagraphs (a)(2), (3), (4) and (5). Notwithstanding the above, no such member shall carry less minimum bonding coverage in its second year than it carried in its first year.]

[(3) Each member shall make required adjustments not more than 60days after the anniversary date of the issuance of such bond.]

(3) A member that has only been in business for one year and elected the aggregate indebtedness ratio for calculating its net capital requirement may use, solely for the purpose of determining the adequacy of its fidelity bond coverage for its second year, the 15 to 1 ratio of aggregate indebtedness to net capital in lieu of the 8 to 1 ratio (required for broker-dealers in their first year of business) to calculate its net capital requirement. Notwithstanding the above, such member shall not carry less minimum bonding coverage in its second year than it carried in its first year.

[(4) Any member subject to the requirements of this paragraph (c) may apply for an exemption from the requirements of this paragraph (c). The application shall be made pursuant to Rule 9610 of the Code of Procedure. The exemption may be granted upon a showing of good cause, including a substantial change in the circumstances or nature of the member's business that results in a lower net capital requirement. The NASD may issue an exemption subject to any condition or limitation upon a member's bonding coverage that is deemed necessary to protect the public and serve the purposes of this Rule.]

[(d)e] Notification of Change

Each member shall report the cancellation, termination or substantial modification of the fidelity bond to [the Association] FINRA within ten business days of such occurrence.

[(e) Definitions]

[For purposes of fidelity bonding the term "employee" or "employees" shall include any person or persons associated with a member firm (as defined in Article I, paragraph (q) of the By-Laws) except:]

[(1) Sole Proprietors]

[(2) Sole Stockholders]

[(3) Directors or Trustees of member firms who are not performing acts coming within the scope of the usual duties of an officer or employee.]

[(f) Exemptions]

(1) The requirements of this Rule shall not apply to:

(A) members that maintain a fidelity bond as required by a national securities exchange, registered with the SEC under Section 6 of the Exchange Act, provided that the member is in good standing with such national securities exchange and the fidelity bond requirements of such exchange are equal to or greater than the requirements of this Rule; and

(B) members whose business is solely that of a Designated Market Maker, Floor broker or registered Floor trader and who does not conduct business with the public.

(2) Any member may apply for an exemption, pursuant to the Rule 9600 Series, from the requirements of paragraphs (d)(2) and (d)(3) of this Rule. An exemption may be granted, at the discretion of FINRA, upon a showing of good cause, including a substantial change in the circumstances or nature of the member's business that would result in a lower net capital requirement.

• • • Supplementary Material: -----

.01 Alternative Coverage. Where a member is unable to obtain the Securities Dealer Blanket Bond, the member shall maintain fidelity bond coverage with the Financial Institution Form 14 Bond that is otherwise consistent with the requirements of this Rule. Where a member is unable to obtain either the Securities Dealer Blanket Bond or the Financial Institution Form 14 Bond, the member shall maintain fidelity bond coverage with a bond that is substantially similar to the Securities Dealer Blanket Bond and is otherwise consistent with the requirements of this Rule.

.02 Definitions. For purposes of this Rule, the term "substantially modified" shall mean any change in the type or amount of fidelity bonding coverage, or in the exclusions to which the bond is subject, or any other change in the bond such that it no longer complies with the requirements of this Rule.

Attachment B

Examples:¹

Firm with four employees, no branches.	Estimated Premiums
Present coverage of \$25,000 with \$5,000 deductible.	\$364
Proposed coverage of \$100,000 with \$10,000 deductible.	\$598
Proposed coverage of \$100,000 with \$25,000 deductible.	\$569
Firm with 18 employees, three branches.	
Present coverage of \$25,000 with \$5,000 deductible.	\$790
Proposed coverage of \$100,000 with \$10,000 deductible.	\$1,140
Proposed coverage of \$100,000 with \$25,000 deductible.	\$1,085
Firm with 100 employees, 45 branches.	
Present coverage of \$25,000 with \$5,000 deductible.	\$3,278
Proposed coverage of \$100,000 with \$10,000 deductible.	\$4,168
Proposed coverage of \$100,000 with \$25,000 deductible.	\$3,964
Firm with 375 employees, 150 branches.	
Present coverage of \$25,000 with \$5,000 deductible.	\$9,823
Proposed coverage of \$100,000 with \$10,000 deductible.	\$12,346
Proposed coverage of \$100,000 with \$25,000 deductible.	\$11,743

¹ Branch charges have been factored into the estimated premiums. The above examples do not include the 10 percent discount available to FINRA member firms electing a two-year policy.

Election Notice

NAC Election

FINRA Announces Nominees for Vacant Small Firm and Mid-Size Firm Industry National Adjudicatory Council Seats

Executive Summary

The purpose of this *Election Notice* is to announce FINRA's nominees for two vacancies on the National Adjudicatory Council (NAC) to be filled by one Small Firm NAC Member and one Mid-Size Firm NAC Member.

FINRA's Nominating and Governance Committee reviewed the backgrounds of potential candidates and nominated the following individuals: Thomas T. Wallace for the Small Firm NAC seat and John Muschalek for the Mid-Size Firm NAC seat. Eligible individuals who were not nominated may petition to have their name included on a ballot for a contested election by following the procedure below.

Note: This *Notice* was distributed electronically to the executive representative of each FINRA member firm and it is posted on FINRA's Web site at www.finra.org/Notices/Election/072009. Executive representatives should circulate this *Notice* to their firms' branch managers.

Questions regarding this *Election Notice* may be directed to:

- Marcia E. Asquith, Senior Vice President and Corporate Secretary, at (202) 728-8949; or
- Marc Menchel, Executive Vice President and Regulatory General Counsel, at (202) 728-8410.

July 20, 2009

Suggested Routing

- Executive Representatives
- Senior Management

Background

The NAC is appointed by the FINRA Board of Governors to review all disciplinary decisions issued by FINRA hearing panels and presides over disciplinary matters that have been appealed to or called for review by the NAC. The NAC also reviews statutory disqualification matters and considers appeals of membership proceedings and exemption requests.

Composition of the NAC

On November 6, 2008, the SEC approved a rule change to amend FINRA Regulation's By-Laws to restructure the industry representation on the NAC. Pursuant to these changes, the regionally based approach to appointing industry members to the NAC was replaced by a process that is based on firm size and is similar to the FINRA Board approach. Under the amended FINRA Regulation By-Laws, the seven industry members of the NAC shall include two Small Firm, one Mid-Size Firm, two Large Firm and two At-Large Industry NAC Members. The other members of the NAC are seven Non-Industry Members, three of whom are public.

These changes to the composition of the NAC are being phased in over three years, as the terms of the existing industry members expire.

The Nominating and Governance Committee identifies candidates for all NAC seats, including the five industry member seats that are based on firm size.

Vacancies and Terms

The term of one regionally based industry member will expire at the end of 2009, and another industry member's seat is vacant because a NAC member resigned. These two industry seats will be replaced by one Small and one Mid-Size Firm NAC Member.

The Small Firm NAC Member will be appointed to a three-year term beginning January 1, 2010.

The Mid-Size Firm NAC Member will be appointed to complete the term of the NAC member who resigned, which is scheduled to end in December 2010.

Nominees and Nomination Process

FINRA's Nominating and Governance Committee has nominated the following individuals to fill the vacant seats on the NAC:

Nominee for Small Firm NAC Member

- ▶ Thomas T. Wallace – President/CEO Johnston, Lemon & Co. Incorporated

Nominee for Mid-Size Firm NAC Member

- ▶ John Muschalek – Managing Director Clearing Services Division First Southwest Company

Profiles of the FINRA nominees are included in Attachment A.

Pursuant to Article VI, Section 6.2 of the FINRA Regulation By-Laws, a person who has not been nominated may be included on a ballot for an election to fill the open NAC seats if:

- (a) Within 45 days of the date of this *Election Notice*, such person presents to the Secretary of FINRA, in the case of petitions solely in support of such person, petitions in support of his or her nomination duly executed by three percent of the members entitled to vote (based on firm size classification) for such nominee's election or, in the case of petitions in support of more than one person, petitions in support of the nominations of such persons duly executed by ten percent of the members entitled to vote (based on firm size classification) for such nominees' election; and
- (b) The Secretary certifies that the petitions are duly executed by the executive representatives of the requisite number of members entitled to vote for such nominee's/nominees' election, and the person(s) satisfies/satisfy the classification (Large Firm, Mid-Size Firm or Small Firm) of the NAC seat to be filled, based on such information provided by the person(s) as is reasonably necessary to make the certification.

Firms may only endorse a petition candidate for an open seat that corresponds to the firm's size classification. No firm may endorse more than one such candidate.

Individuals interested in petitioning to become candidates must complete a candidate profile form (Attachment B) and submit it to FINRA's Corporate Secretary. Upon receipt of a candidate profile form, the Corporate Secretary will forward the interested individual a list of all firms eligible to endorse a candidate for that seat (based on firm size classification).

Individuals submitting petitions must provide information sufficient for the Corporate Secretary to determine that the petitions are duly executed by the executive representatives of the requisite number of small or mid-size firms by **Thursday, September 3, 2009**.

The number of FINRA small firms as of the close of business on July 17, 2009, was 4,439, and the number of FINRA mid-size firms as of the close of business on July 17, 2009, was 221. The requisite number of small firm endorsements required to meet the above-referenced threshold is 134, and the requisite number of mid-sized firm endorsements required to meet the above-referenced threshold is 7 for petitions in support of the nomination of a single person. Please note that, if a petition slate includes individuals from different firm size categories, the signatures of 10 percent of each respective class size are required.

Voting Eligibility

In the case of a contested election, firms are eligible to cast one vote for an industry candidate who is running for a seat that is in the same size category as their own firm. Therefore, small firms may vote for a Small Firm NAC candidate and mid-size firms may vote for a Mid-Size Firm NAC candidate.

The size classification of each FINRA member firm will be verified on the day the ballots are mailed. All eligible small and mid-size firms will receive a ballot containing the candidates for the vacant Small Firm or Mid-Size Firm NAC seat.

Firm Contact Information

Firms are reminded to accurately maintain their executive representative's name and email address, as well as their firm's main postal address in FINRA's records. This will ensure that important mailings, such as election information, will be properly directed. A firm's failure to keep this information accurate may jeopardize the firm's ability to participate in elections.

Pursuant to NASD Rule 1160, firms must update their contact information promptly, but in any event not later than 30 days following any change in such information, as well as review and, if necessary, update the information within 17 business days after the end of each calendar year. Additionally, firms must comply with any FINRA request for such information promptly, but in any event not later than 15 days following the request, or such longer period that may be agreed to by FINRA staff.¹

To update an executive representative's name and email address, firms may access the FINRA Contact System, located on FINRA's Web site at www.finra.org/fcs. To update postal address information, firms must file a Form BD Amendment via the Web CRD system. For assistance updating information via either of these systems, please contact the FINRA Call Center at (301) 590-6500.

Endnote

- 1 See NASD Rule 1160 and *FINRA Regulatory Notice 07-42* (September 2007).

Attachment A: Profiles of FINRA's Nominees to the NAC

FINRA Nominee for Small Firm NAC Member Seat

Thomas T. Wallace

President/CEO
Johnston Lemon & Co. Incorporated

Thomas T. Wallace is the President and CEO of Johnston, Lemon & Co. Incorporated, a Washington, DC-based, NYSE member firm founded in 1920. The early part of Mr. Wallace's career was spent as a retail broker concentrating on clients within the Washington, DC, metropolitan area. He later progressed to Branch Office Manager then to Sales Manager and eventually President & CEO.

Mr. Wallace has served on many committees within the securities industry, for both FINRA, formerly known as NASD, and SIFMA, formerly known as SIA. Mr. Wallace served for four years on the FINRA Small Firm Advisory Board and three years on the FINRA District 9 Committee. He is currently serving on the FINRA District 9 Nominating Committee and maintains his status as a hearing officer for District 9. Mr. Wallace currently serves on the SIFMA Small Firms Advisory Board, and has done so for approximate 10 years.

Mr. Wallace graduated from the University of Maryland in 1967 with a bachelor of science degree in business administration. Upon graduation he immediately began active duty in the United States Army.

FINRA Nominee for Mid-Size Firm NAC Member Seat

John Muschalek

Managing Director, Clearing Services Division
First Southwest Company

John Muschalek is Managing Director and head of First Southwest Company's Correspondent Clearing and Securities Lending divisions. He joined First Southwest Company in February 1992. He has also served as the firm's Chief Financial Officer and Financial and Operations Principal. Mr. Muschalek serves on the firm's Risk and Operations Management Committees. Before joining First Southwest Company, he served as the firm's auditor while working with the worldwide accounting firm KPMG Peat Marwick.

Mr. Muschalek represents the firm on numerous industry committees and civic boards. He is a member of the FINRA Financial Responsibility Committee (national committee) and completed a term (2003 – 2005, Chairman 2005) on the FINRA District Committee (District 6). Other FINRA Committees that Mr. Muschalek serves on include the Uniform Practice Code Committee, FINRA Consultative Committee and the District 6 Nominating Committee. Mr. Muschalek also serves on the Securities Industry and Financial Markets Association (SIFMA) Operations Red Group Roundtable (national committee – 2006 Chairman) and the SIFMA Clearing Firms Committee (Vice Chair 2009). He is also a frequent speaker at local and national industry conferences. Additionally, Mr. Muschalek has served five years on the Board of Directors and three years as the Vice Chairman of the Executive Committee of the Wilkinson Center, a Dallas-based charity.

Mr. Muschalek maintains FINRA Series 7, 24, 27 and 63 licenses. He is also a Certified Public Accountant and member of the American Institute of CPAs and the Texas Society of CPAs. He earned a bachelor of science degree in business administration, majoring in accounting, from Texas A&M University in 1988.

ATTACHMENT B - NAC Election Candidate Profile Form

Indicate the position for which you wish to be considered:

Small Firm NAC Member **OR** Mid-Size Firm NAC Member

Current Registration

Name: _____ CRD #: _____

Firm Name: _____ Firm #: _____

Title/Primary Responsibility: _____

Address: _____

City: _____ State: _____ Zip: _____

Phone: _____ Fax: _____

Email: _____

Prior Registration (List the most recent first. Feel free to include extra pages if necessary.)

Firm: _____

Title/Primary Responsibility: _____

Firm: _____

Title/Primary Responsibility: _____

General Areas of Expertise

(please check all that apply)

- Compliance/Legal
- Corporate Finance
- Financial/Operational
- Institutional Sales
- Investment Advisory
- Retail Sales
- Trading/Market Making
- Other

Product Expertise

(please check all that apply)

- Corporate Bonds
- Direct Participation Programs
- Equity Securities
- Investment Company
- Municipal/Government Securities
- Options
- Variable Contracts Securities
- Other

Memberships/Positions in Trade or Business Organizations

Past NASD or FINRA Experience and Dates of Service (please check all that apply)

Committee Member (Identify committee): _____ Approx. Dates: _____

Arbitrator _____ Approx. Dates: _____

Mediator _____ Approx. Dates: _____

Expert Witness (arbitrations; disciplinary proceedings) _____ Approx. Dates: _____

Other: _____ Approx. Dates: _____

Educational Background

School: _____ Degree: _____

School: _____ Degree: _____

Return the completed candidate profile form to Marcia Asquith via fax at (202) 728-8075 or email at CorporateSecretary@finra.org.

Information Notice

New FTC Red Flags Rule Template

Executive Summary

FINRA has developed a new, optional template that firms may use as a guide when fulfilling their requirements under the Federal Trade Commission's (FTC's) Red Flags Rule. The Red Flags Rule, which implements obligations imposed by the Fair and Accurate Credit Transactions Act of 2003 (FACT Act), requires specified firms to create a written Identity Theft Prevention Program (ITPP) that is designed to identify, detect and respond to "red flags"—patterns, practices or specific activities—that could indicate identity theft.

If a firm chooses to use this template as a guide, it must adapt it to reflect the individual firm's business situation. Without such analysis and modification, the firm's ITPP will not comply with regulatory requirements.

The Red Flags Rule requires firms to prepare an ITPP if they are either a "financial institution" or a "creditor" and offer "covered accounts." FINRA anticipates that most member firms will be required to prepare an ITPP under the Red Flags Rule. Even if it does not have to prepare an ITPP now, a firm must have internal controls to periodically review its operations and prepare an ITPP if it later becomes a financial institution or creditor that offers covered accounts. See *Regulatory Notice 08-69* for details.

The FTC Red Flags Rule template is available at www.finra.org/customer-protection/redflags. For more information on the FACT Act, see the *Federal Register* notice at www.ftc.gov/os/fedreg/2007/november/071109redflags.pdf.

Questions about this *Notice* may be directed to:

- ▶ John Komoroske, Vice President, Member Relations, at (202) 728-8475; or
- ▶ Patricia Albrecht, Assistant General Counsel, at (202) 728-8026.

Questions about complying with the FTC Red Flags Rule may be directed to RedFlags@ftc.gov.

July 1, 2009

Suggested Routing

- ▶ Compliance
- ▶ Internal Audit
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Systems
- ▶ Training

Key Topics

- ▶ Covered Accounts
- ▶ Creditors
- ▶ FACT Act
- ▶ Identity Theft
- ▶ Privacy
- ▶ Red Flags

Referenced Rules & Notices

- ▶ FTC Red Flags Rule
- ▶ Regulatory Notice 08-69