

# Notices

## Regulatory Notices

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## Fixed Price Offerings

### FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Sale of Securities in a Fixed Price Offering

Comment Period Expires: September 18, 2009

#### Executive Summary

As part of the process to develop a new consolidated rulebook (the Consolidated FINRA Rulebook),<sup>1</sup> FINRA is requesting comment on a proposed new rule governing fixed price offerings. Proposed FINRA Rule 5141 (Sale of Securities in a Fixed Price Offering) would be a new consolidated rule that simplifies the provisions of current NASD Rules 2730, 2740 and 2750 and their associated Interpretive Materials and eliminates outdated requirements.

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

Questions regarding this *Notice* should be directed to:

- Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104; or
- Adam H. Arkel, Assistant General Counsel, OGC, at (202) 728-6961.

#### August 2009

##### Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

##### Suggested Routing

- Corporate Financing
- Compliance
- Legal
- Operations
- Senior Management

##### Key Topic(s)

- Fixed Price Offerings
- Papilsky Rules

##### Referenced Rules & Notices

- NASD Rule 2730
- NASD Rule 2740
- NASD Rule 2750
- NASD IM-2730
- NASD IM-2740
- NASD IM-2750
- NTM 03-73
- FINRA Rule 5130

## Action Requested

FINRA encourages all interested parties to comment on the proposed rule. Comments must be received by September 18, 2009.

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

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

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, N.W.  
Washington, D.C. 20006-1506

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.<sup>2</sup>

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

## Background

NASD Rules 2730, 2740 and 2750 and their associated Interpretive Materials (IMs) regulate fixed price offerings.<sup>4</sup> Generally, the purpose of the rules and the associated IMs<sup>5</sup> is to protect the integrity of fixed price offerings by ensuring that securities in such offerings are sold to the public at the stated public offering price or prices, thereby preventing an undisclosed better price. The rules reach this goal by prohibiting the grant or reallowance of certain preferences (*e.g.*, discounts, selling concessions, underwriting recapture or various economic equivalents) to persons outside of the selling groups and selling syndicates<sup>6</sup> formed to distribute the offered securities.<sup>7</sup>

FINRA believes that, though the fixed price offering rules continue to play an important role in protecting market integrity, certain requirements of the rules have become outdated. Accordingly, FINRA is proposing to delete NASD Rules 2730, 2740, 2750 and their associated IMs in their entirety from FINRA's rulebook and to adopt a single, simplified rule—proposed FINRA Rule 5141—in their place.

## Proposed FINRA Rule 5141

Like the current fixed price offering rules, the goal of proposed FINRA Rule 5141 is to ensure that, if an offering is presented to the public as a fixed price offering, then the public should be able to have confidence that no one is able to gain an unfair advantage by obtaining the securities at less than the stated public offering price. Paragraph (a) of the proposed rule addresses this core objective by providing that no member or person associated with a member that participates in a selling syndicate or selling group in connection with a fixed price offering may offer or grant, directly or indirectly, to any person<sup>8</sup> or account that is not a member of such selling syndicate or selling group any securities in the offering at a price below the stated public offering price (*i.e.*, a “reduced price”).

The proposed rule provides that, subject to the requirements of FINRA Rule 5130, a member of a selling syndicate or selling group is permitted to sell securities in the offering to an affiliated person, provided the member does not sell the securities to the affiliated person at a reduced price (as set forth under the rule).<sup>9</sup> The requirements of the proposed rule would apply until the termination of the offering.

Proposed FINRA Rule 5141(b) provides that nothing in the rule shall prohibit the purchase and sale of securities in a fixed price offering between members of the selling syndicate or selling group.

The proposed rule contains supplementary material that elaborates the concept of “reduced price” and prohibits various means—addressed in the current fixed price offering rules—by which the economic equivalent of a reduced price could be offered or granted. The supplementary material largely preserves NASD Rule 2740’s exclusion for research services. Further, the supplementary material generally protects ordinary-course business transactions between members of a selling syndicate or selling group members and affiliates from being deemed transactions that confer a reduced price. The proposed supplementary material provides the following:

- ▶ **Reduced Price:** Proposed FINRA Rule 5141.01 provides that, for purposes of the rule, “reduced price” includes, without limitation, any offer or grant of any selling concession, discount or other allowance, credit, rebate, reduction of any fee (including any advisory or service fee), any sale of products or services at prices below reasonable commercially available rates for similar products or services (except for research, which, as noted below, is subject to proposed FINRA Rule 5141.02), or any purchase of or arrangement to purchase securities from the person or account at more than their fair market price in exchange for securities in the offering;<sup>10</sup>

- ▶ **Research:** Proposed FINRA Rule 5141.02 generally preserves the allowance that NASD Rule 2740 makes with respect to research services. Specifically, the supplementary material provides that nothing in the new rule prohibits a member or person associated with a member that participates in a selling syndicate or selling group from selling securities in the offering to a person or account to which it has provided or will provide research, provided the person or account pays the stated public offering price for the securities and the research is in conformity with the requirements of Exchange Act Section 28(e)(3)(A) and (B) and SEC guidance. The supplementary material provides, like the current NASD rule, that investment management or investment discretionary services are not research. The supplementary material further requires that any product or service provided by a member or person associated with a member that does not qualify as research must not confer a reduced price as set forth in proposed FINRA Rule 5141.01;
- ▶ **Ordinary-Course Transactions with Affiliates:** Proposed FINRA Rule 5141.03 provides that transactions between a member of a selling syndicate or selling group and an affiliated person that are part of the normal and ordinary course of business and are unrelated to the sale or purchase of securities in a fixed price offering shall not be deemed to confer a reduced price under the rule;
- ▶ **Definition of Fixed Price Offering:** The supplementary material incorporates the current definition of “fixed price offering” as set forth in NASD Rule 0120(h) with only minor changes, primarily to reflect the new conventions of the Consolidated FINRA Rulebook;
- ▶ **Asset-Based Fees:** Lastly, the rule’s supplementary material clarifies that a member that is an investment adviser may exempt securities that are purchased as part of a fixed price offering from the calculation of annual or periodic asset-based fees that the member charges a customer, provided the exemption is part of the member’s normal and ordinary course of business with the customer and is not in connection with the offering.

## Endnotes

- 1 The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 03/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members (NTM) 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 NASD Rule 0120(h) defines the term “fixed price offering” to mean the offering of securities at a stated public offering price or prices, all or part of which securities are publicly offered in the United States or any territory thereof, whether or not registered under the Securities Act of 1933. The term does not include offerings of “exempted securities” or “municipal securities” as those terms are defined in Sections 3(a)(12) and 3(a)(29), respectively, of the Exchange Act or offerings of redeemable securities of investment companies registered pursuant to the Investment Company Act of 1940 which are offered at prices determined by the net asset value of the securities. The definition of “fixed price offering” would be incorporated into the proposed rule in substantially identical form (see proposed FINRA Rule 5141.04).
- 5 The fixed price offering rules are also known as the *Papilsky* rules because of the court decision with which they are commonly associated. See *Papilsky v. Berndt, et al.*, No. 71 Civ. 2534, 1976 U.S. Dist. LEXIS 14442 (S.D.N.Y., June 24, 1976). For more information regarding the rules’ background, see Exchange Act Release No. 17371 (December 12, 1980), 45 FR 83707 (December 19, 1980) (Order Approving Proposed Rule Change; File No. SR-NASD-78-3) (Approval Order). See also Exchange Act Release No. 15807 (May 9, 1979), 44 FR 28574 (May 15, 1979) (Notice of Proposed Rule Change; File No. SR-NASD-78-3); NTM 77-31 (September 23, 1977) (Proposed Rule Changes and Interpretations Concerning Securities Distribution Practices).

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## Endnotes continued

- 6 The terms “selling group” and “selling syndicate” are defined in NASD Rules 0120(p) and (q), respectively. Other than to reflect the new conventions of the Consolidated FINRA Rulebook, FINRA does not propose to alter these definitions, which will be addressed later in the rulebook consolidation process.
- 7 The fixed price offering rules address three broad areas. First, NASD Rule 2730 generally provides that a member, engaged in a fixed price offering, that purchases or arranges the purchase of other securities in connection with or in exchange for the underwritten securities must purchase the other securities at value equating to the current market price at the time of purchase or act as agent in the sale of such securities and charge the commission at the rate applied by members in the normal course of business. (The rule thereby prohibits overtrading.) The rule sets forth, among other things, certain presumptions of compliance versus non-compliance and recordkeeping requirements.
- Second, NASD Rule 2740 generally requires that in connection with a fixed price offering, selling concessions, discounts or other allowances may only be paid to brokers or dealers actually engaged in the investment banking or securities business and only as consideration for services rendered in distribution. (The rule permits an exception where the member has provided, or will provide, “bona fide research” consistent with Exchange Act Section 28(e), if the purchaser pays the stated public offering price for the securities.) The rule sets forth, among other things, certain requirements with respect to written agreements to comply with the rule that members must obtain and interpretive material on “bona fide research,” as well as certain transaction reporting and recordkeeping requirements.
- Third, NASD Rule 2750 generally bars any member engaged in a fixed price offering from selling the securities to, or placing the securities with, any person or account that is a related person of the member, unless the related person is itself subject to the rule or is a non-member broker-dealer that has entered into the agreements required under Rule 2740. (The rule thereby operates to prevent underwriting recapture through an affiliate.) *See also* Approval Order.
- 8 NASD Rule 0120(n) defines “person” to include any natural person, partnership, corporation, association, or other legal entity.
- 9 FINRA Rule 5130 (former NASD Rule 2790) addresses restrictions on the purchase and sale of initial equity public offerings. The rule generally prohibits sales to and purchases by a broker-dealer and accounts in which a broker-dealer has a beneficial interest.
- 10 The supplementary material defines “fair market price” to refer generally to a price or range of prices at which a willing buyer and a willing seller, each unrelated to the other, would purchase the securities in the ordinary course of business in transactions that are of similar size and similar characteristics and are independent of any other transaction.

## ATTACHMENT A

Below is the text of proposed FINRA Rule 5141.

\* \* \* \* \*

### 5000. SECURITIES OFFERING AND TRADING STANDARDS AND PRACTICES

#### 5100. SECURITIES OFFERINGS, UNDERWRITING AND COMPENSATION

\* \* \* \* \*

#### 5140. Integrity of Fixed Price Offerings

##### 5141. Sale of Securities in a Fixed Price Offering

(a) No member or person associated with a member that participates in a selling syndicate or selling group in connection with a fixed price offering shall offer or grant, directly or indirectly, to any person or account that is not a member of such selling syndicate or selling group any securities in the offering at a price below the stated public offering price (“reduced price”). Subject to the requirements of Rule 5130, a member of a selling syndicate or selling group is permitted to sell securities in the offering to an affiliated person, provided such member does not sell the securities to the affiliated person at a reduced price under this Rule. The requirements of this Rule shall apply until the termination of the offering.

(b) Nothing in this Rule shall prohibit the purchase and sale of securities in a fixed price offering between members of the selling syndicate or selling group.

• • • Supplementary Material: — — — — —

**.01 Reduced Price.** For the purposes of this Rule, “reduced price” includes, without limitation, any offer or grant of any selling concession, discount or other allowance, credit, rebate, reduction of any fee (including any advisory or service fee), any sale of products or services at prices below reasonable commercially available rates for similar products and services (except for research subject to Rule 5141.02), or any purchase of or arrangement to purchase securities from the person or account at more than their fair market price in exchange for securities in the offering. For purposes of this Supplementary Material, “fair market price” refers generally to a price or range of prices at which a willing buyer and a willing seller, each unrelated to the other, would purchase the securities in the ordinary course of business in transactions that are of similar size and similar characteristics and are independent of any other transaction.

**.02 Research.** Nothing in this Rule shall prevent a member or person associated with a member that participates in a selling syndicate or selling group from selling securities in the offering to a person or account to which it has provided or will provide research, provided the person or account pays the stated public offering price for the securities and the research is in conformity with the requirements of Section 28(e)(3)(A) and (B) of the Exchange Act and SEC guidance. Investment management or investment discretionary services are not research for purposes of this Supplementary Material. Any product or service provided by a member or person associated with a member that does not qualify as research under this Supplementary Material must not confer a reduced price as set forth in Rule 5141.01.

**.03 Affiliated Persons.** Transactions between a member of a selling syndicate or selling group and an affiliated person that are part of the normal and ordinary course of business and are unrelated to the sale or purchase of securities in a fixed price offering shall not be deemed to confer a reduced price under this Rule.

**.04 Fixed Price Offering.** The term “fixed price offering” means the offering of securities at a stated public offering price or prices, all or part of which securities are publicly offered in the United States or any territory thereof, whether or not registered under the Securities Act, except that the term does not include offerings of “exempted securities” or “municipal securities” as those terms are defined in Sections 3(a)(12) and 3(a)(29), respectively, of the Exchange Act or offerings of redeemable securities of investment companies registered pursuant to the Investment Company Act which are offered at prices determined by the net asset value of the securities.

**.05 Asset-Based Fees.** A member that is an investment adviser may exempt securities that are purchased as part of a fixed price offering from the calculation of annual or periodic asset-based fees that such member charges to a customer, provided such exemption is part of the member’s normal and ordinary course of business with the customer and is not in connection with an offering.

\* \* \* \* \*

## Alternative Trading Systems

### FINRA Reminds Alternative Trading Systems of Their Reporting Obligations

#### Executive Summary

This *Notice* reminds firms that are alternative trading systems or operate alternative trading systems that, in addition to filing all reports required by Regulation ATS with the Securities and Exchange Commission, they also must simultaneously file duplicate copies of most such reports with FINRA. Firms may submit these reports to FINRA either in hard copy via U.S. mail or electronically to [atsfilings@finra.org](mailto:atsfilings@finra.org).

Questions concerning this *Notice* should be directed to Seth Levy, Department of Market Regulation, at (240) 386-5483.

#### Background & Discussion

On April 21, 1999, Securities Exchange Act (SEA) Rules 3a1-1 and 3b-16 and Regulation ATS became effective. Rule 301(b)(2) of Regulation ATS requires alternative trading systems (ATSs) to file an initial operation report, necessary amendments and cessation of operations reports on Form ATS within specified time frames.

In *Notice to Members 99-42*, FINRA provided guidance to firms on complying with the Regulation ATS reporting requirements. This *Notice* reminds firms that all required reports under Regulation ATS should be filed with:

U.S. Securities & Exchange Commission  
Division of Trading and Markets  
100 F Street, NE  
Washington, DC 20549

August 2009

#### Notice Type

- Guidance

#### Suggested Routing

- Compliance
- Internal Audit
- Legal
- Operations
- Senior Management
- Systems
- Trading

#### Key Topic(s)

- Alternative Trading Systems
- Form ATS Filings

#### Referenced Rules & Notices

- SEA Rule 3a1-1
- SEA Rule 3b-16
- SEC Regulation ATS
- NTM 99-42

All reports are considered filed upon receipt by the SEC. Firms also are reminded that, if FINRA is the designated examining authority for the ATS, duplicate originals of all reports that must be filed with the SEC on Form ATS also must be filed simultaneously with FINRA.<sup>1</sup> Firms may submit their reports to FINRA electronically by sending them to [atsfilings@finra.org](mailto:atsfilings@finra.org), or by mailing a copy to:

FINRA  
Department of Market Regulation  
Attn: Form ATS Maintenance Coordinator  
9509 Key West Avenue  
Rockville, MD 20850

All reports submitted to FINRA are deemed confidential when filed.

## Endnote

- 1 Rule 301(b)(9) of Regulation ATS requires ATSS to file certain summary transaction information on Form ATS-R within 30 calendar days after the end of each calendar quarter and 10 calendar days after the ATS ceases to operate. Originals of these reports should be filed only with the SEC. Firms must provide duplicate copies to FINRA upon request.

## LOPR Requirements

### New Large Options Positions Report (LOPR) Requirements Due to Implementation of Options Symbology Initiative

#### Executive Summary

The Options Clearing Corporation and its participant exchanges have begun implementation of the Options Symbology Initiative, which will affect member firms' reporting of positions to the Large Options Positions Report (LOPR) system. This *Notice* highlights changes to LOPR reporting as a result of the implementation.

Questions concerning this *Notice* should be directed to:

- Max Tourtelot, Director, Options Regulation, at (212) 858-4013; or
- Matthew E. Vitek, Counsel, Office of General Counsel, at (202) 728-8156.

#### Background

In June 2008, The Options Clearing Corporation (OCC) and its participant exchanges began the implementation of the Options Symbology Initiative (OSI). The OSI is a plan to overhaul the existing method of identifying exchange-traded options contracts that will enable market participants to provide more accurate and consistent information. All current information regarding the OSI is located at [www.theocc.com/initiatives/symbology/default.jsp](http://www.theocc.com/initiatives/symbology/default.jsp).

As part of the OSI, by February 12, 2010, all exchange-traded options are expected to be described using explicit data elements, instead of the current Options Price Reporting Authority (OPRA) codes. These changes will impose new requirements related to LOPR. In conjunction with these changes, OCC will take over the collection and dissemination of all LOPR data from the Securities Industry Automation Corporation (SIAC). SIAC will no longer accept LOPR data after January 19, 2010.

August 2009

#### Notice Type

- Guidance

#### Suggested Routing

- Compliance
- Institutional
- Legal
- Operations
- Options
- Senior Management
- Technology

#### Key Topic(s)

- Large Options Positions Report
- Options
- Options Symbology Initiative

Although the threshold for the LOPR will not change, the submission of LOPR data and the LOPR layout will have significant changes that will affect the reporting of both listed and conventional options positions. Key requirements and changes related to the new LOPR include:

- ▶ All member firms must report LOPR data to OCC in FIXML format.
- ▶ The reportable window for submitting updates related to adjustments, assignments, error corrections and position transfers will be reduced from T+10 to T+5. However, firms are still required to report all reportable positions to the LOPR system by T+1.
- ▶ Member firms should only report a position to OCC if it has been added, modified or deleted. If a position in a series is reported to OCC that matches the previously reported position in that series, the record will be rejected.
- ▶ Each submitted LOPR will be required to include additional data fields (*e.g.*, Account Type and Expiration Date) that are not present on the current LOPR.
- ▶ Member firms may submit one file to OCC, which will include Listed Options Positions, Conventional Options Positions, Listed LOPR Hedges and Conventional LOPR Hedges.
- ▶ “In Concert” data, including the addition or deletion of accounts, will be submitted directly to OCC each time there is a change to an “In Concert” Group. OCC will accept changes to “In Concert” records each day.
- ▶ OCC will purge all records after expiration or following a corporate event, where the option symbol is changed. Member firms will not need to send records indicating the removal of these positions; however, member firms must submit new add records for positions in the newly created option symbols following a corporate action.
- ▶ Member firms will be able to access their rejected LOPR records via OCC’s FTP site.

The milestone dates related to the implementation of the new LOPR are as follows:

ACTION	TARGET DATE
LOPR firms must verify connectivity to OCC External Test Environment	Complete by September 30, 2009
LOPR firms perform external testing with OCC	Starting August 17, 2009, through November 19, 2009
LOPR firms can begin sending production LOPRs to OCC's production environment once external testing is deemed successful	October 1, 2009
LOPR firms must transmit production LOPR data to OCC on a daily basis and maintain their LOPRs at OCC	Complete by November 23, 2009
Simultaneous submission of LOPR data to SIAC and OCC	4th Quarter 2009 and first half of January 2010
LOPR firms may stop sending LOPR data to SIAC	Activity of January 19, 2010

This *Notice* briefly summarizes key requirements and changes related to the new LOPR. Further information regarding the OCC's collection of LOPR data, including record layouts, field mappings and milestone dates is available online at [www.optionsclearing.com/products/large\\_options\\_positions\\_reporting/default.jsp](http://www.optionsclearing.com/products/large_options_positions_reporting/default.jsp).

## Promissory Note Proceedings

### SEC Approves Rule Establishing Expedited Procedures for Arbitrating Promissory Note Cases

Effective Date: September 14, 2009

#### Executive Summary

Effective September 14, 2009, FINRA will begin expediting the administration of cases that solely involve a brokerage firm's claim that an associated person failed to pay money owed on a promissory note. Under the new procedures, a single public arbitrator from the roster of arbitrators approved to hear statutory discrimination claims will decide such promissory note cases. FINRA amended Rules 13214 and 13600 of the Code of Arbitration Procedure for Industry Disputes to make conforming changes.

The SEC approved new FINRA Rule 13806 and amendments to FINRA Rules 13214 and 13600 relating to promissory note proceedings.<sup>1</sup> The text of the rules is set forth in Attachment A, and will apply to all promissory note cases filed on or after the effective date.

Questions concerning this *Notice* should be directed to:

- Richard W. Berry, Vice President and Director of Case Administration, FINRA Dispute Resolution, at (212) 858-4307 or [richard.berry@finra.org](mailto:richard.berry@finra.org); or
- Margo A. Hassan, Counsel, FINRA Dispute Resolution, at (212) 858-4481 or [margo.hassan@finra.org](mailto:margo.hassan@finra.org).

August 2009

#### Notice Type

- Rule Amendment

#### Suggested Routing

- Compliance
- Legal
- Registered Representatives

#### Key Topic(s)

- Arbitration
- Associated Person
- Code of Arbitration Procedure
- Dispute Resolution
- Promissory Note

#### Referenced Rules & Notices

- FINRA Rule 13806
- FINRA Rule 13214
- FINRA Rule 13600

## Background & Discussion

FINRA is amending its Code of Arbitration Procedure for Industry Disputes (Industry Code) to establish new procedures for administering cases that solely involve a firm's claim that an associated person failed to pay money owed on a promissory note. In the absence of additional allegations by firms or associated persons, promissory note cases involve straightforward contracts with few documents entered into evidence. Rule 13806 is limited to claims related to promissory notes with no additional allegations being made in the Statement of Claim. Rule 13806 provides that a single public arbitrator from the roster of arbitrators approved to hear statutory discrimination claims will serve on the arbitration panel hearing a promissory note case. FINRA is also amending Rules 13214 and 13600 of the Industry Code to make conforming changes.

The new procedures streamline the process for administering promissory note cases and reduce expenses for the parties while maintaining the procedural safeguards in the Industry Code for the associated person against whom a brokerage firm asserts a claim.

Specifically, under the new procedures:

- ▶ Parties choose a single public arbitrator from the roster of arbitrators approved to hear statutory discrimination claims. FINRA believes that the arbitrators on this roster are especially suited to resolve these disputes because of the depth of their experience and their familiarity with employment law.<sup>2</sup>
- ▶ If the associated person does not file an answer, simplified discovery procedures will apply and, regardless of the amount in controversy, the single arbitrator will render an award based on the pleadings and other materials submitted by the parties.
- ▶ If the associated person files an answer (but does not seek any additional relief or assert any counterclaims or third party claims), regular discovery procedures will apply and, regardless of the amount in controversy, the single arbitrator will hold a hearing.
- ▶ If the associated person files a counterclaim or third party claim, then regular discovery procedures will apply and the number of arbitrators will be based on the amount of the counterclaim or third party claim. If the counterclaim and/or third party claim is not more than \$100,000, exclusive of interest and expenses, the Director will appoint a single public arbitrator from the roster of arbitrators approved to hear statutory discrimination claims. If the counterclaim and/or third party claim is more than \$100,000, then the Director will appoint a three-arbitrator panel comprised of one public arbitrator from the roster of arbitrators approved to hear statutory discrimination claims who would serve as chairperson, one arbitrator from the public roster and one arbitrator from the non-public roster. If the counterclaim or third party claim is filed after the single arbitrator is appointed, and a three-arbitrator panel is required, the Director will retain the appointed arbitrator as chair and appoint two additional arbitrators (one public and one non-public arbitrator) to the panel.

Rule 13806(f) provides that FINRA will pay an arbitrator an honoraria of \$125 for each arbitration in which the associated person does not file an answer and the award is based on the arbitrator's review of the pleadings and other materials submitted by the parties. As these are expedited proceedings, FINRA is amending Rule 13214 (Payment of Arbitrators) to reflect that FINRA will not pay an honoraria for resolving a discovery-related motion without a hearing session or for resolving a contested motion concerning issuance of a subpoena without a hearing session. In instances where full discovery is conducted under the 13500 series of rules, FINRA will pay the honoraria prescribed in Rule 13214 for deciding these motions.

FINRA is also amending Rule 13600 (Required Hearings) to reflect that a hearing will not be held if the associated person does not file an answer. In such cases, the arbitrator will render the award on the pleadings and other materials submitted by the parties.

The amendments become effective on September 14, 2009, and apply to all arbitration cases filed on or after the effective date.

## Endnotes

- 1 Exchange Act Release No. 60132 (June 17, 2009), 74 Federal Register 30191 (June 24, 2009) (File No. SR-FINRA-2009-015).
- 2 See Rule 13802(c)(3). These specially qualified arbitrators are attorneys familiar with employment law and who have at least ten years of legal experience. In addition, the arbitrator may not have represented primarily the views of employers or employees within the last five years. "Primarily" means 50 percent or more of the arbitrator's business or professional activities within the last five years.

## Attachment A

New language is underlined; deletions are in brackets.

### Code of Arbitration Procedure for Industry Disputes

\* \* \*

#### 13806. Promissory Note Proceedings

##### (a) Applicability of Rule

This rule applies to arbitrations solely involving a member's claim that an associated person failed to pay money owed on a promissory note. To proceed under this rule, a claim may not include any additional allegations. Except as otherwise provided in this rule, all provisions of the Code apply to such arbitrations.

##### (b) Number of Arbitrators

(1) The Director will appoint one arbitrator if:

- the associated person does not file an answer;
- the associated person files an answer but does not allege any counterclaims or third party claims; or
- the associated person files an answer which includes any counterclaims or third party claims requesting money damages, and the amount of the counterclaims or third party claims is not more than \$100,000, exclusive of interest and expenses.

(2) The Director will appoint three arbitrators if the associated person files any counterclaims or third party claims and the amount of the counterclaims or third party claims is more than \$100,000, exclusive of interest and expenses, or is unspecified, or if the counterclaims or third party claims do not request money damages.

##### (c) Composition of Panel

(1) If the panel consists of one arbitrator, the arbitrator will be a public arbitrator qualified to resolve a statutory discrimination claim as set forth in Rule 13802(c)(3).

(2) If the panel consists of three arbitrators, one arbitrator will be a public arbitrator who meets the qualifications in Rule 13802(c)(3); one arbitrator will be selected from the roster of public arbitrators; and one arbitrator will be selected from the roster of non-public arbitrators. The arbitrator who meets the criteria in Rule 13802(c)(3) will serve as the chairperson of the panel.

(3) If the Director appoints a panel pursuant to (c)(1) above, and an associated person subsequently files a counterclaim or third party claim that requires appointment of a three-arbitrator panel, the appointed arbitrator will remain on the panel, and will serve as chairperson. In addition, one arbitrator will be selected from the roster of public arbitrators; and one arbitrator will be selected from the roster of non-public arbitrators.

**(d) Discovery**

(1) If the associated person does not file an answer, discovery will be conducted under Rule 13800(d) concerning Simplified Arbitration.

(2) If the associated person files an answer, discovery will be conducted under the 13500 series of rules.

**(e) Hearings**

(1) If the associated person does not file an answer, no initial prehearing conference or hearing will be held, and the arbitrator will render an award based on the pleadings and other materials submitted by the parties.

(2) If the associated person files an answer, a hearing will be held. If a hearing is held, the regular provisions of the Code relating to prehearing conferences and hearings, including fee provisions and payment of arbitrators, will apply.

**(f) Arbitrator Honoraria**

FINRA will pay the arbitrator an honorarium of \$125 for each arbitration administered under paragraph (e)(1).

\* \* \* \* \*

### 13214. Payment of Arbitrators

(a) Except as provided in paragraph (b), [and] Rule 13800, and Rule 13806(f), FINRA will pay the panel an honorarium, as follows:

- \$200 to each arbitrator for each hearing session in which he or she participates;
- an additional \$75 per day to the chairperson for each hearing on the merits;
- \$50 for travel to a hearing session that is postponed pursuant to Rule 13601; and
- \$100 for each arbitrator if a hearing session other than a prehearing conference is postponed within three business days before a scheduled hearing session pursuant to Rules 13601(a)(2) and (b)(2).

(b) The Director may authorize a higher or additional honorarium for the use of a foreign hearing location.

(c) Payment for Deciding Discovery-Related Motions Without a Hearing Session

(1) FINRA will pay each arbitrator an honorarium of \$200 to decide a discovery-related motion without a hearing session. This paragraph does not apply to cases administered under Rule 13800 or pursuant to Rule 13806(d)(1).

(2) – (3) No Change.

(d) Payment for Deciding Contested Subpoena Requests Without a Hearing Session

(1) The honorarium for deciding one or more contested motions requesting the issuance of a subpoena without a hearing session shall be \$200. The honorarium shall be paid on a per case basis to each arbitrator who decides the contested motion(s). The parties shall not be assessed more than \$600 in fees under this paragraph in any arbitration proceeding. The honorarium shall not be paid for cases administered under Rule 13800 or pursuant to Rule 13806(d)(1).

(2) – (3) No change.

\* \* \* \* \*

### 13600. Required Hearings

(a) Hearings will be held, unless:

- The arbitration is administered under Rule 13800, [or] Rule 13801, or Rule 13806(e)(1);
- The parties agree otherwise in writing; or
- The arbitration has been settled, withdrawn or dismissed.

(b) – (c) No change.

\* \* \*

## Conflicts of Interest

### SEC Approves Amendments to Modernize and Simplify NASD Rule 2720 Relating to Public Offerings in Which a Member Firm With a Conflict of Interest Participates

Effective Date: September 14, 2009

#### Executive Summary

Effective September 14, 2009, firms must comply with the requirements of new NASD Rule 2720 (Public Offerings of Securities with Conflicts of Interest), which governs public offerings of securities in which a member firm with a conflict of interest participates. The new rule amends and replaces the previous NASD Rule 2720 in its entirety.

As described more fully in this *Notice*, the rule prohibits a member firm with a conflict of interest from participating in a public offering, unless the nature of the conflict is prominently disclosed and:

- a qualified independent underwriter (QIU) participates in the offering; or
- the member firm(s) primarily responsible for managing the offering does not itself have a conflict (and is not an affiliate of a firm with a conflict); or
- the offered securities are exchange-listed and satisfy the requirements for a bona fide public market or are investment grade rated by a nationally recognized statistical rating organization.

Additionally, member firms with a conflict of interest must comply with certain net capital, discretionary accounts and filing requirements, as applicable.

The text of new NASD Rule 2720 is set forth in Attachment A of this *Notice*.

#### August 2009

##### Notice Type

- Rule Amendment

##### Suggested Routing

- Compliance
- Corporate Financing
- Legal
- Operations
- Senior Management

##### Key Topic(s)

- Affiliate
- Conflicts of Interest
- Control
- Investment Banking
- Public Offerings
- Qualified Independent Underwriter
- Underwriting Compensation

##### Referenced Rules & Notices

- FINRA Rule 5110
- FINRA Rule 9600 Series
- NASD Rule 2720
- NTM 06-52

Questions regarding this *Notice* should be directed to:

- ▶ Paul Mathews, Director, Corporate Financing Department, at (240) 386-4623;
- ▶ Lisa Toms, Associate Director and Senior Counsel, Corporate Financing Department, at (240) 386-4661;
- ▶ Gary Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104; and
- ▶ Lisa Horrigan, Associate General Counsel, OGC, at (202) 728-8190.

## Background & Discussion

NASD Rule 2720 governs public offerings of securities issued by participating member firms or their affiliates, public offerings in which a member or any of its associated persons or affiliates has a conflict of interest, and public offerings that result in a FINRA member becoming a public company.

On June 15, 2009, the SEC approved amendments to Rule 2720 to modernize and simplify the rule.<sup>1</sup> New Rule 2720 prohibits a member firm with a “conflict of interest” from participating in a public offering unless certain requirements are met. The new rule also significantly revises the definition of “conflict of interest,” as described in more detail below.

When a member firm with a conflict of interest participates in a public offering, the new rule requires “prominent disclosure” in the prospectus, offering circular or similar document of the nature of the conflict of interest and, where a QIU is required, the name of the member firm acting as the QIU and a brief statement regarding the role and responsibilities of the QIU.<sup>2</sup> The prominent disclosure requirement applies to all offerings within the scope of new Rule 2720, whether or not a filing with FINRA is required.<sup>3</sup>

The new rule combines the previous rule’s tests of what constitutes an affiliate and conflict of interest into a single definition of “conflict of interest.”<sup>4</sup> As defined in Rule 2720(f)(5), a conflict of interest exists, if at the time of a member firm’s participation in a public offering, any of the following four conditions applies:

- ▶ The securities are to be issued by the member firm.
- ▶ The issuer controls, is controlled by or is under common control with the member firm or the member firm’s associated persons.<sup>5</sup>
- ▶ At least five percent of the net offering proceeds, not including underwriting compensation, are intended to be: (i) used to reduce or retire the balance of a loan or credit facility extended by the member firm, its affiliates and its associated persons, in the aggregate; or (ii) otherwise directed to the member firm, its affiliates and associated persons, in the aggregate.<sup>6</sup>

- If, as a result of the public offering and any transactions contemplated at the time of the public offering: (i) the member firm will be an affiliate of the issuer; (ii) the member firm will become publicly owned; or (iii) the issuer will become a member firm or form a broker-dealer subsidiary.

When a member firm with a conflict of interest participates in a public offering, a QIU may be required. If so, the QIU must participate in the preparation of the registration statement and the prospectus, offering circular or similar document (*i.e.*, the offering document) and exercise the usual standards of due diligence with respect to the offering document. The new rule eliminates the pricing responsibilities of the QIU. Any offering that requires a QIU must be filed with FINRA's Corporate Financing Department for review pursuant to FINRA Rule 5110 (Corporate Financing Rule).<sup>7</sup>

FINRA notes that while the term "participation in a public offering" in Rule 2720 generally has the same meaning as in FINRA Rule 5110,<sup>8</sup> the new rule continues to apply specifically to a member firm's participation in the distribution of a public offering as an underwriter, member of the underwriting syndicate or selling group, or otherwise assisting in the distribution of the public offering (*i.e.*, not when a member firm acts solely as a finder, consultant or advisor, given these capacities generally do not involve managing or distributing a public offering).

There are circumstances in which a member firm with a conflict of interest may participate in a public offering without the use of a QIU. Specifically, the new rule eliminates the need for a QIU if: (i) the member firm with a conflict of interest or an affiliate is not managing the offering; or (ii) the offered securities have a "bona fide public market" or are "investment grade rated" or are securities in the same series that have equal rights and obligations as investment grade rated securities (*e.g.*, securities issued under a medium-term note program). FINRA notes that the definition of "bona fide public market" in Rule 2720(f)(3) is changed substantially from the definition of "bona fide independent market," which it replaces, in that the new rule defines a bona fide public market in accordance with the numerical standards set forth in the SEC's Regulation M under the Exchange Act.<sup>9</sup>

In cases where two or more book-running lead managers have equal responsibilities with regard to due diligence, each must be free of conflicts of interest, otherwise the QIU provisions under the new rule would apply and the offering would be subject to the filing requirements under Rule 5110.

If a QIU is not required, the offering will not have to be filed with FINRA. Whether or not a filing is required, however, the new rule still requires prominent disclosure of the nature of the conflict in the offering documents. In addition, a member firm with a conflict of interest must comply with the discretionary accounts requirement, and where applicable the escrow, net capital computation and related disclosure provisions of the rule, as described below.

## Public Offering of a Member Firm: Escrow and Net Capital Computation

When a member firm participates in a public offering of its own securities, the new rule requires that all of the offering proceeds be placed in a duly established escrow account and not be released or used by the member firm in any manner until the member firm has complied with the net capital requirements set forth in the rule.<sup>10</sup> The new rule also requires any member firm offering its securities to disclose in the registration statement, offering circular or similar document a date by which the offering is reasonably expected to be completed and the terms upon which the proceeds will be released from the escrow account. These requirements are substantively similar to the provisions under previous Rule 2720.

## Discretionary Accounts

The new rule also requires a member firm that has a conflict of interest to comply with a prohibition on sales to discretionary accounts, unless the member firm has received specific written approval of the transaction from the account holder and retains documentation of the approval in its records.<sup>11</sup> These requirements only apply to the member firm with the conflict. FINRA notes, however, that they apply whether or not the offering must be filed and whether or not the securities are investment grade rated or have a bona fide public market. In addition, the “specific written approval” requirement can be satisfied by an email from the customer.

## Definitions

New Rule 2720 provides a set of definitions for purposes of the rule and incorporates, by reference, the definitions in FINRA Rule 5110. A number of definitions in the new rule are substantially similar to the definitions set forth in previous Rule 2720, while other terms in new Rule 2720 are newly defined, including “control,” “entity,” “investment grade rated” and “prominent disclosure.”

FINRA notes that the definition of “control” under Rule 2720(f)(6) includes beneficial ownership of ten percent or more of the outstanding common equity (which is defined to expressly include non-voting stock), subordinated debt or preferred equity of an “entity,” which is defined in Rule 2720(f)(7).<sup>12</sup> FINRA also notes that the exclusions in the term “entity” are substantially similar to the exemptions from the conflict of interest provisions contained in previous Rule 2720, with the exception of an entity that issues financing instrument-backed securities, which is now subject to the rule.

“Control” includes not only shares beneficially owned by a participating member firm, but also the right to receive such securities within 60 days of the member firm’s participation in the public offering. As a result, the determination of control is based on when the member firm participates in an offering, not the date that a registration statement for the offering is declared effective. For example, warrants or rights to acquire voting securities that are exercisable within 60 days of the member firm’s participation in the public offering would be included in the calculation of voting securities when determining whether control exists. The calculation to determine control, however, is limited to securities that could be received by the participating member firm only and would not include securities underlying warrants or rights held by other investors.<sup>13</sup>

FINRA also notes that the term “qualified independent underwriter” is defined in new Rule 2720(f)(12). The definition retains the provisions that require Section 11 liability undertakings and eligibility requirements relating to experience in managing offerings. The new rule extends to ten years the disqualification provisions regarding the disciplinary history of associated persons responsible for due diligence.

The new rule prohibits QIUs from receiving more than five percent of the offering proceeds. Receipt of such proceeds would disqualify a member firm from acting as a QIU because it would fall within the definition of “conflict of interest.” In addition, a QIU cannot beneficially own, as of the date of its participation in the public offering, more than five percent of the class of securities that would give rise to a conflict of interest, including any right to receive any such securities exercisable within 60 days.

Member firms are reminded that FINRA permits firms to provide information establishing that they meet the QIU qualification requirements in advance of participating in a particular public offering and that they may update this information annually. In the course of its review of information in connection with a public offering requiring a QIU, FINRA staff routinely asks for information that establishes that a member firm identified as a QIU is qualified to participate in that capacity. If a member firm has already provided this information within the last 12 months or has done an annual update, it will generally not need to provide the information in connection with that particular offering. In this regard, firms should consider updating the information that they previously provided in light of the changes to the QIU qualification requirements that are in the new rule.

## Requests for Exemption from NASD Rule 2720

Paragraph (e) provides that, pursuant to the FINRA Rule 9600 Series, FINRA may in exceptional and unusual circumstances, taking into consideration all relevant factors, exempt a member firm unconditionally or on specified terms from any or all of the provisions of Rule 2720 that it deems appropriate.

## Endnotes

- 1 See Exchange Act Release No. 60113 (June 15, 2009), 74 FR 29255 (June 19, 2009) (order approving SR-FINRA-2007-009). See also *Notice to Members (NTM) 06-52* (September 2006). The SEC also approved conforming changes to FINRA Rule 5110, including the transfer of certain definitions from Rule 2720 to FINRA Rule 5110.
- 2 See Rule 2720(a)(2)(B) regarding QIU disclosure requirements. “Prominent disclosure” is defined in Rule 2720(f)(10) and may include the notation “(Conflicts of Interest)” following the listing of the Plan of Distribution in the Table of Contents section and a disclosure in the Plan of Distribution section and any Prospectus Summary section as required in SEC Regulation S-K. For offering documents not subject to SEC Regulation S-K, prominent disclosure may be provided on the front page of the offering document stating that a conflict exists, with a cross-reference to the discussion within the offering document. These methods of disclosure are non-exclusive, and FINRA will consider alternative—but equally prominent—disclosures on a case-by-case basis.
- 3 With regard to a takedown from a shelf registration statement that became effective prior to September 14, 2009, the disclosure requirements in Rule 2720(a) could be included in, and would apply only to, a post effective amendment or prospectus supplement that is filed with the SEC on or after September 14, 2009.
- 4 A revised definition of “affiliate” under Rule 2720(f)(1) means an entity that controls, is controlled by or is under common control with a member firm.
- 5 The definition of “control” under Rule 2720(f)(6) includes beneficial ownership of ten percent or more of the outstanding common equity, subordinated debt or preferred equity of an “entity,” which is defined in Rule 2720(f)(7).
- 6 FINRA notes that the five-percent threshold applies to each participating member firm individually (including the member firm’s affiliates and its associated persons). Thus, for example, a conflict of interest would exist where a member firm receives five percent of the offering proceeds, but not where two unaffiliated member firms each receive three percent of the proceeds.
- 7 See NASD Rule 2720(d). FINRA Rule 5110 generally requires member firms to file with FINRA public offerings for review of the proposed underwriting terms and arrangements and requires disclosure of underwriting compensation and that a member firm obtains a “no objections” opinion prior to participating in the offering. FINRA Rule 5110(b)(7) contains certain exemptions from the filing requirements for, among others, public offerings of the securities of seasoned issuers and offerings of investment grade debt, but such offerings must be filed if subject to the filing requirement under Rule 2720.
- 8 See FINRA Rule 5110(a)(5).

## Endnotes continued

- 9 Specifically, “bona fide public market” is defined as a market for a security issued by a company that has been reporting under the Exchange Act for at least 90 days, is current in its reporting requirements and whose securities are traded on a national securities exchange with an average daily trading volume of at least \$1 million, provided that the issuer’s common equity securities have a public float value of at least \$150 million.
- 10 The rule also requires any member firm offering its securities to immediately notify FINRA when the public offering has been terminated and file with FINRA a computation of its net capital computed pursuant to the provisions of SEC Rule 15c3-1 (the net capital rule) as of the settlement date. Member firms are also reminded that additional escrow account maintenance and payment requirements may be applicable under SEC Rule 15c2-4 for “best efforts” offerings.
- 11 This prohibition is independent of any provisions in NASD Rule 2510.
- 12 For purposes of the rule, the percentage of control may be calculated using a “flow through” concept by looking through ownership levels to calculate the total percentage of control.
- 13 FINRA clarified in Amendment No. 1 to its rule filing (SR-FINRA-2007-009) that in calculating the percentage of beneficial ownership, it is appropriate to include the securities to be received by the participating member firm in both the numerator and denominator, but that this calculation should not include securities that could be received by all other investors. See Exchange Act Release No. 60113 (June 15, 2009), 74 FR 29255 (June 19, 2009) (order approving SR-FINRA-2007-009).

## ATTACHMENT A

Below is the text of the amendments. New language is underlined; deletions are in brackets.

\* \* \* \* \*

### 5000. SECURITIES OFFERING AND TRADING STANDARDS AND PRACTICES

### 5100. SECURITIES OFFERINGS, UNDERWRITING AND COMPENSATION

#### 5110. Corporate Financing Rule – Underwriting Terms and Arrangements

##### (a) Definitions

For purposes of this Rule, the following terms shall have the meanings stated below. The definitions in NASD Rule 2720 are incorporated herein by reference.

(1) through (10) No Change.

##### (11) Company

A corporation, a partnership, an association, a joint stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.

##### (12) Effective Date

The date on which an issue of securities first becomes legally eligible for distribution to the public.

##### (13) Immediate Family

The parents, mother-in-law, father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children of an employee or associated person of a member, except any person other than the spouse and children who does not live in the same household as, have a business relationship with, provide material support to, or receive material support from, the employee or associated person of a member. In addition, the immediate family includes any other person who either lives in the same household as, provides material support to, or receives material support from, an employee or associated person of a member.

**(14) Person**

Any natural person, partnership, corporation, association, or other legal entity.

**(b) Filing Requirements**

(1) through (6) No Change.

**(7) Offerings Exempt from Filing**

Notwithstanding the provisions of subparagraph (1) above, documents and information related to the following public offerings need not be filed with FINRA for review, unless subject to the provisions of NASD Rule 2720(a)(2). However, it shall be deemed a violation of this Rule or NASD Rule 2810, for a member to participate in any way in such public offerings if the underwriting or other arrangements in connection with the offering are not in compliance with this Rule or NASD Rule 2810, as applicable:

(A) through (G) No Change.

(8) through (9) No Change.

(c) through (g) No Change.

**[(h) Proceeds Directed to a Member]****[(1) Compliance With NASD Rule 2720]**

[No member shall participate in a public offering of an issuer's securities where more than 10% of the net offering proceeds, not including underwriting compensation, are intended to be paid to participating members, unless the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established pursuant to NASD Rule 2720(c)(3).]

**[(2) Disclosure]**

[All offerings included within the scope of paragraph (h)(1) shall disclose in the underwriting or plan of distribution section of the registration statement, offering circular or other similar document that the offering is being made pursuant to the provisions of this subparagraph and, where applicable, the name of the member acting as qualified independent underwriter, and that such member is assuming the responsibilities of acting as a qualified independent underwriter in pricing the offering and conducting due diligence.]

**[(3) Exception From Compliance]**

[The provisions of paragraphs (h)(1) and (2) shall not apply to:]

[(A) an offering otherwise subject to the provisions of NASD Rule 2720;]

[(B) an offering of securities exempt from registration with the SEC under Section 3(a)(4) of the Securities Act;]

[(C) an offering of a real estate investment trust as defined in Section 856 of the Internal Revenue Code; or]

[(D) an offering of securities subject to NASD Rule 2810, unless the net offering proceeds are intended to be paid to the above persons for the purpose of repaying loans, advances or other types of financing utilized to acquire an interest in a pre-existing company.]

(i) through (j) redesignated as (h) through (i).

\* \* \* \* \*

**NASD Rule 2720 is replaced in its entirety by the following new rule language.**

**2720. Public Offerings of Securities With Conflicts of Interest****(a) Requirements for Participation in Certain Public Offerings**

No member that has a conflict of interest may participate in a public offering unless the offering complies with subparagraphs (1) or (2).

(1) There must be prominent disclosure of the nature of the conflict of interest in the prospectus, offering circular or similar document for the public offering, and one of the following conditions must be met:

(A) the member(s) primarily responsible for managing the public offering does not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest, and meets the requirement of paragraph (f)(12)(E);

(B) the securities offered have a bona fide public market; or

(C) the securities offered are investment grade rated or are securities in the same series that have equal rights and obligations as investment grade rated securities.

(2) (A) A qualified independent underwriter has participated in the preparation of the registration statement and the prospectus, offering circular, or similar document and has exercised the usual standards of “due diligence” in respect thereto; and

(B) there must be prominent disclosure in the prospectus, offering circular or similar document for the offering of:

(i) the nature of the conflict of interest;

(ii) the name of the member acting as qualified independent underwriter; and

(iii) a brief statement regarding the role and responsibilities of the qualified independent underwriter.

**(b) Escrow of Proceeds; Net Capital Computation**

(1) All proceeds from a public offering by a member of its securities shall be placed in a duly established escrow account and shall not be released therefrom or used by the member in any manner until the member has complied with subparagraph (2) hereof.

(2) Any member offering its securities pursuant to this Rule shall immediately notify FINRA when the public offering has been terminated and settlement effected and shall file with FINRA a computation of its net capital computed pursuant to the provisions of SEC Rule 15c3-1 under the Act (the net capital rule) as of the settlement date. If at such time its net capital ratio as so computed is more than 10:1 or, net capital fails to equal 120 percent of the minimum dollar amount required by Rule 15c3-1 or, in the event the member calculates its net capital requirement using the alternative standard (set forth in Rule 15c3-1(a)(1)(ii)), its net capital is less than seven percent of aggregate debit items as computed in accordance with Rule 15c3-3a, all monies received from sales of securities of the public offering must be returned in full to the purchasers thereof and the offering withdrawn, unless the member has obtained from the Commission a specific exemption from the net capital rule. Proceeds from the sales of securities in the public offering may be taken into consideration in computing net capital ratio for purposes of this paragraph.

(3) Any member offering its securities pursuant to this Rule shall disclose in the registration statement, offering circular or similar document a date by which the offering is reasonably expected to be completed and the terms upon which the proceeds will be released from the escrow account described in paragraph (b)(1).

**(c) Discretionary Accounts**

Notwithstanding Rule 2510, no member that has a conflict of interest may sell to a discretionary account any security with respect to which the conflict exists, unless the member has received specific written approval of the transaction from the account holder and retains documentation of the approval in its records.

**(d) Application of Rule 5110**

Any public offering subject to paragraph (a)(2) is subject to Rule 5110, whether or not the offering would be otherwise exempted from the filing or other requirements of that rule.

**(e) Requests for Exemption from Rule 2720**

Pursuant to the Rule 9600 Series, FINRA may in exceptional and unusual circumstances, taking into consideration all relevant factors, exempt a member unconditionally or on specified terms from any or all of the provisions of this rule that it deems appropriate.

**(f) Definitions**

The definitions in Rule 5110 are incorporated herein by reference. For purposes of this Rule, the following words shall have the stated meanings:

**(1) Affiliate**

The term “affiliate” means an entity that controls, is controlled by or is under common control with a member.

**(2) Beneficial Ownership**

The term “beneficial ownership” means the right to the economic benefits of a security.

### **(3) Bona Fide Public Market**

The term “bona fide public market” means a market for a security of an issuer that has been reporting under the Act for at least 90 days and is current in its reporting requirements, and whose securities are traded on a national securities exchange with an Average Daily Trading Volume (as provided by Regulation M under the Act) of at least \$1 million, provided that the issuer’s common equity securities have a public float value of at least \$150 million.

### **(4) Common Equity**

The term “common equity” means the total number of shares of common stock outstanding without regard to class, whether voting or non-voting, convertible or non-convertible, exchangeable or non-exchangeable, redeemable or non-redeemable, as reflected on the consolidated financial statements of the company.

### **(5) Conflict of Interest**

The term “conflict of interest” means, if at the time of a member’s participation in an entity’s public offering, any of the following applies:

(A) the securities are to be issued by the member;

(B) the issuer controls, is controlled by or is under common control with the member or the member’s associated persons;

(C) at least five percent of the net offering proceeds, not including underwriting compensation, are intended to be:

(i) used to reduce or retire the balance of a loan or credit facility extended by the member, its affiliates and its associated persons, in the aggregate; or

(ii) otherwise directed to the member, its affiliates and associated persons, in the aggregate; or

(D) as a result of the public offering and any transactions contemplated at the time of the public offering:

(i) the member will be an affiliate of the issuer;

(ii) the member will become publicly owned; or

(iii) the issuer will become a member or form a broker-dealer subsidiary.

**(6) Control**

(A) The term “control” means:

(i) beneficial ownership of 10 percent or more of the outstanding common equity of an entity, including any right to receive such securities within 60 days of the member’s participation in the public offering;

(ii) the right to 10 percent or more of the distributable profits or losses of an entity that is a partnership, including any right to receive an interest in such distributable profits or losses within 60 days of the member’s participation in the public offering;

(iii) beneficial ownership of 10 percent or more of the outstanding subordinated debt of an entity, including any right to receive such subordinated debt within 60 days of the member’s participation in the public offering;

(iv) beneficial ownership of 10 percent or more of the outstanding preferred equity of an entity, including any right to receive such preferred equity within 60 days of the member’s participation in the public offering;  
or

(v) the power to direct or cause the direction of the management or policies of an entity.

(B) The term “common control” means the same natural person or entity controls two or more entities.

**(7) Entity**

For purposes of the definitions of affiliate, conflict of interest and control under this Rule, the term “entity”:

(A) includes a company, corporation, partnership, trust, sole proprietorship, association or organized group of persons; and

(B) excludes the following:

(i) an investment company registered under the Investment Company Act of 1940;

(ii) a “separate account” as defined in Section 2(a)(37) of the Investment Company Act of 1940;

(iii) a “real estate investment trust” as defined in Section 856 of the Internal Revenue Code; or

(iv) a “direct participation program” as defined in Rule 2810.

**(8) Investment Grade Rated**

The term “investment grade rated” refers to securities that are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.

**(9) Preferred Equity**

The term “preferred equity” means the aggregate capital invested by all persons in the preferred securities outstanding without regard to class, whether voting or non-voting, convertible or non-convertible, exchangeable or non-exchangeable, redeemable or non-redeemable, as reflected on the consolidated financial statements of the company.

**(10) Prominent Disclosure**

A member may make “prominent disclosure” for purposes of paragraphs (a)(1) and (a)(2)(B) by:

(A) providing the notation “(Conflicts of Interest)” following the listing of the Plan of Distribution in the Table of Contents section required in Item 502 of SEC Regulation S-K, and by providing such disclosures in the Plan of Distribution section required in Item 508 and any Prospectus Summary section required in Item 503 of SEC Regulation S-K; or

(B) for an offering document not subject to SEC Regulation S-K, by providing disclosure on the front page of the offering document that a conflict exists, with a cross-reference to the discussion within the offering document and in the summary of the offering document if one is included.

**(11) Public Offering**

The term “public offering” means any primary or secondary offering of securities made pursuant to a registration statement or offering circular including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition and all other securities offerings of any kind whatsoever, except any offering made pursuant to:

(A) an exemption from registration under Sections 4(1), 4(2), or 4(6) of the Securities Act of 1933;

(B) SEC Rule 504, if the securities are “restricted securities” under SEC Rule 144(a)(3), SEC Rules 505 or 506; or

(C) SEC Rule 144A or Regulation S.

The term public offering shall exclude exempted securities as defined in Section 3(a)(12) of the Act.

### **(12) Qualified Independent Underwriter**

The term “qualified independent underwriter” means a member:

(A) that does not have a conflict of interest and is not an affiliate of any member that has a conflict of interest;

(B) that does not beneficially own as of the date of the member’s participation in the public offering, more than 5% of the class of securities that would give rise to a conflict of interest, including any right to receive any such securities exercisable within 60 days;

(C) that has agreed in acting as a qualified independent underwriter to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act of 1933, specifically including those inherent in Section 11 thereof; and

(D) that has served as underwriter in at least three public offerings of a similar size and type during the three-year period immediately preceding the filing of the registration statement or the date of first sale in an offering without a registration statement. This requirement will be deemed satisfied if, during the past three years, the member:

(i) with respect to a proposed public offering of debt securities, has acted as sole underwriter or book-running lead or co-manager of at least three public offerings of debt securities each with gross proceeds of not less than 25% of the anticipated gross proceeds of the proposed offering; and

(ii) with respect to a proposed public offering of equity securities, has acted as sole underwriter or book-running lead or co-manager of at least three public offerings of equity securities (or of securities convertible into equity securities), each with gross proceeds of not less than 50% of the anticipated gross proceeds of the proposed offering.

(E) none of whose associated persons in a supervisory capacity who are responsible for organizing, structuring or performing due diligence with respect to corporate public offerings of securities:

(i) has been convicted within ten years prior to the filing of the registration statement or the preparation of an offering circular in an offering without a registration statement of a violation of the anti-fraud provisions of the federal or state securities laws, or any rules or regulations promulgated thereunder, in connection with a registered or unregistered offering of securities;

(ii) is subject to any order, judgment, or decree of any court of competent jurisdiction entered within ten years prior to the filing of the registration statement, or the preparation of an offering circular in an offering without a registration statement, permanently enjoining or restraining such person from engaging in or continuing any conduct or practice in violation of the anti-fraud provisions of the federal or state securities laws, or any rules or regulations promulgated thereunder in connection with a registered or unregistered offering of securities; or

(iii) has been suspended or barred from association with any member by an order or decision of the Commission, any state, FINRA or any other self-regulatory organization within ten years prior to the filing of the registration statement, or the preparation of an offering circular in an offering without a registration statement, for any conduct or practice in violation of the anti-fraud provisions of the federal or state securities laws, or any rules, or regulations promulgated thereunder, or the anti-fraud rules of any self-regulatory organization in connection with a registered or unregistered offering of securities.

### **(13) Registration Statement**

The term “registration statement” means a registration statement as defined by Section 2(a)(8) of the Securities Act of 1933; notification on Form 1A filed with the Commission pursuant to the provisions of SEC Rule 252 under the Securities Act of 1933; or any other document, by whatever name known, initiating a registration or similar process for an issue of securities which is required to be filed by the laws or regulations of any federal or state agency.

**(14) Subordinated Debt**

The term “subordinated debt” includes (A) debt of an issuer which is expressly subordinate in right of payment to, or with a claim on assets subordinate to, any existing or future debt of such issuer; or (B) all debt that is specified as subordinated at the time of issuance. Subordinated debt shall not include short-term debt with maturity at issuance of less than one year and secured debt and bank debt not specified as subordinated debt at the time of issuance.

\* \* \* \* \*

## SEC Approves New Consolidated FINRA Rules

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

Effective Date (FINRA Rule 2320): October 19, 2009

Effective Date (Repeal of Incorporated NYSE Rules 134 and 440I): August 17, 2009

### Executive Summary

Following the consolidation of NASD and the member regulation, enforcement and arbitration functions of NYSE Regulation into FINRA, FINRA established a process to develop a new consolidated rulebook (Consolidated FINRA Rulebook), which FINRA has discussed in previous *Information Notices*.<sup>1</sup> FINRA is proposing new consolidated rules in phases for approval by the SEC as part of the Consolidated FINRA Rulebook.<sup>2</sup> In June and July 2009, the SEC approved two rule filings relating to the Consolidated FINRA Rulebook. New FINRA Rule 2320 will take effect on October 19, 2009. The repeal of Incorporated NYSE Rules 134 and 440I will take effect on August 17, 2009.

Questions regarding this *Notice* should be directed to:

- Kosha Dalal, Associate Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-6903 (regarding the repeal of Incorporated NYSE Rules 134 and 440I); or
- Stan Macel, Assistant General Counsel, OGC, at (202) 728-8056 (regarding FINRA Rule 2320).

### August 2009

#### Notice Type

- Rule Approvals
- Consolidated Rulebook

#### Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management

#### Key Topic(s)

- Effective Dates of Consolidated Rules
- FINRA Manual
- Rulebook Consolidation
- Variable Annuity Contracts
- Variable Life Insurance

#### Referenced Rules & Notices

- FINRA Rule 2320
- Information Notice 03/12/08
- Information Notice 10/06/08
- Regulatory Notice 08-57

## Discussion

In June 2009, the SEC approved new consolidated FINRA Rule 2320 (Variable Contracts of an Insurance Company), which will take effect on October 19, 2009.<sup>3</sup>

The attachment to this *Notice* sets forth additional information regarding this new consolidated rule and includes a hyperlink to the related rule filing. The filing provides, among other things, FINRA's statement of the purpose of the rule change and an exhibit showing the changes between the new rule text and the text of the NASD Rule as it exists in the Transitional Rulebook. Also, the text of the new FINRA Rule is available in the online FINRA Manual at [www.finra.org/finramanual](http://www.finra.org/finramanual).<sup>4</sup>

The attachment to this *Notice* further summarizes an additional rule filing relating to the Consolidated FINRA Rulebook approved by the SEC in July 2009. The rule filing addresses FINRA's repeal of Incorporated NYSE Rules 134 (Differences and Omissions – Cleared Transactions) and 440I (Records of Compensation Arrangements – Floor Brokerage) as part of the process of developing the Consolidated FINRA Rulebook.<sup>5</sup> The repeal of Incorporated NYSE Rules 134 and 440I will take effect on August 17, 2009.

## Rule Conversion Chart

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

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

## Endnotes

- 1 *See Information Notice 10/06/08* (Rulebook Consolidation Process: Effective Dates of New Consolidated Rules; Introduction of Rule Conversion Chart); *see also Information Notice 03/12/08* (Rulebook Consolidation Process).
- 2 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The new FINRA Rules apply to all member firms, unless such rules have a more limited application by their terms. As the Consolidated FINRA Rulebook expands with the SEC's approval and with the new FINRA Rules taking effect, the rules in the Transitional Rulebook that address the same subject matter of regulation will be eliminated. When the Consolidated FINRA Rulebook is completed, the Transitional Rulebook will have been eliminated in its entirety.
- 3 *See* Exchange Act Release No. 60086 (June 10, 2009), 74 FR 28743 (June 17, 2009) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-023).
- 4 FINRA updates the rule text on its online Manual within two business days of SEC approval of changes to the rule text.
- 5 *See* Exchange Act Release No. 60367 (July 22, 2009), 74 FR 38077 (July 30, 2009) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-038).

## Attachment A

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

The SEC approved the following rule filings relating to the Consolidated FINRA Rulebook in June and July 2009. The effective date of new FINRA Rule 2320 (SR-FINRA-2009-023) is October 19, 2009. The effective date of the repeal of Incorporated NYSE Rules 134 and 440I (SR-FINRA-2009-038) is August 17, 2009.

#### FINRA Rule Filing SR-FINRA-2009-023

[www.finra.org/rulefilings/2009-023](http://www.finra.org/rulefilings/2009-023)

The rule change adopts, with certain modifications, NASD Rule 2820 (Variable Contracts of an Insurance Company) as FINRA Rule 2320.

FINRA Rule 2320 regulates member firms in connection with the sale and distribution of variable life insurance and variable annuity contracts (together, variable contracts). It prohibits member firms from participating in the offer or sale of a variable contract unless certain conditions are met. It also regulates member compensation in connection with the sale and distribution of variable contracts, including both cash and non-cash compensation arrangements. The rule change requires members to determine and keep records of the value of non-cash compensation received from offerors in all cases (as opposed to NASD Rule 2820, which requires members to provide and keep records for the value of non-cash compensation only “if known”). Member firms are permitted to estimate the actual value of non-cash compensation for which a receipt (or similar documentation) assigning a value is not available. The rule change also makes certain non-substantive, technical changes to the rule to reflect FINRA’s corporate name and the new format of the Consolidated FINRA Rulebook.

Rule/Series No.	Rule Title
Rule 2000 Series	DUTIES AND CONFLICTS
Rule 2300 Series	SPECIAL PRODUCTS
Rule 2320	Variable Contracts of an Insurance Company

#### FINRA Rule Filing SR-FINRA-2009-038

[www.finra.org/rulefilings/2009-038](http://www.finra.org/rulefilings/2009-038)

The rule change repeals Incorporated NYSE Rule 134 (Differences and Omissions – Cleared Transactions) and Incorporated NYSE Rule 440I (Records of Compensation Arrangements – Floor Brokerage) to remove requirements that are specific to the NYSE marketplace and relate primarily to activities by floor brokers.

## Recordkeeping Requirements

### SEC Approves Amendments Relating to Recordkeeping and the Unsolicited Customer Order Exception of SEA Rule 15c2-11

Effective Date: September 21, 2009

#### Executive Summary

Effective September 21, 2009, firms are required to create a contemporaneous record of certain customer and order information demonstrating eligibility for the unsolicited customer order exception of SEA Rule 15c2-11 when the firm is relying on such exception.

The text of the amendments can be found in the online *FINRA Manual* at [www.finra.org/finramanual](http://www.finra.org/finramanual).

Questions regarding this *Notice* should be directed to Racquel Russell, Assistant General Counsel, Office of General Counsel, at (202) 728-8363.

#### Background and Discussion

FINRA Rule 6440 sets forth certain standards applicable to member firms to demonstrate compliance with Rule 15c2-11 under the Securities Exchange Act of 1934 (SEA). SEA Rule 15c2-11 prescribes information review and maintenance requirements for broker-dealers that publish quotations<sup>1</sup> in a quotation medium<sup>2</sup> for certain over-the-counter equity securities (e.g., those quoted on the OTC Bulletin Board and Pink Sheets). Specifically, SEA Rule 15c2-11 prohibits a broker-dealer from publishing, or submitting for publication, a quotation for a covered OTC equity security unless it has obtained and reviewed current information about the issuer whose security is the subject of the quotation that the broker-dealer believes is accurate and obtained from a reliable source.

August 2009

#### Notice Type

- Rule Amendment

#### Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Trading and Market Making

#### Key Topic(s)

- Recordkeeping
- Unsolicited Customer Orders

#### Referenced Rules & Notices

- FINRA Rule 6440
- FINRA Rule 6540
- SEA Rule 15c2-11

There are several exceptions to SEA Rule 15c2-11, including paragraph (f)(2) of the rule, which excepts quotations that represent a customer's unsolicited order or indication of interest (the unsolicited customer order exception).

FINRA has found that firms maintain varying levels of documentation for demonstrating eligibility for the unsolicited customer order exception and, in some cases, have been unable to produce any proof that a quote in fact represented a customer's unsolicited order or indication of interest.

While a firm relying on this or any exception should be able to proffer evidence of its eligibility for and compliance with the exception, FINRA believes that providing specific recordkeeping requirements for demonstrating eligibility for the SEA Rule 15c2-11(f)(2) exception is appropriate and will promote more uniform recordkeeping and compliance with this exception.

Specifically, contemporaneous with the receipt of any unsolicited customer order or indication of interest, firms are now required to record the following details:

- ▶ the identity of the associated person who receives the unsolicited customer order or indication of interest directly from the customer, if applicable;<sup>3</sup>
- ▶ the identity of the customer;
- ▶ the date and time the unsolicited customer order or indication of interest was received; and
- ▶ the terms of the unsolicited customer order or indication of interest that is the subject of the quotation (*e.g.*, security name and symbol, size, side of the market, the duration (if specified) and, if priced, the price).

To the extent a firm is displaying a quote representing an unsolicited customer order or indication of interest that was received from another broker-dealer, the firm is still required to create a contemporaneous record of:

- ▶ the identity of the person from whom information regarding the unsolicited customer order or indication of interest was received, if applicable;<sup>4</sup>
- ▶ the date and time the unsolicited customer order or indication of interest was received by the firm displaying the quotation; and
- ▶ the terms of the unsolicited customer order or indication of interest that is the subject of the quotation (*e.g.*, security name and symbol, size, side of the market, the duration (if specified) and, if priced, the price).

The firm displaying the unsolicited customer order or indication of interest may rely on the information provided by the routing firm if the member firm has a reasonable basis for believing that the information is valid.<sup>5</sup>

In addition, FINRA has amended Rule 6540 (Requirements Applicable to Market Makers) to delete footnote #1. Formerly, footnote #1 provided a summary of exemptive relief granted by the SEC from the requirements of SEA Rule 15c2-11 (subject to certain conditions). However, given that the SEC has since granted additional exemptive requests from the requirements of SEA Rule 15c2-11 that were not included in footnote #1 (and may continue to grant further requests in the future), FINRA deleted footnote #1 in its entirety and has instead specified in Rule 6540 that members must demonstrate compliance with (or qualify for an exception or *exemption* from) SEA Rule 15c2-11.<sup>6</sup>

## Endnotes

- 1 SEA Rule 15c2-11 defines “quotation” as any bid or offer at a specified price with respect to a security, or any indication of interest by a broker or dealer in receiving bids or offers from others for a security, or any indication by a broker or dealer that advertises its general interest in buying or selling a particular security.
- 2 SEA Rule 15c2-11 defines “quotation medium” as any “inter-dealer quotation system” or any publication or electronic communications network or other device that is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell. “Inter-dealer quotation system” means any system of general circulation to brokers or dealers that regularly disseminates the quotations of identified brokers or dealers.
- 3 In cases where a firm is displaying a quote representing an unsolicited customer order or indication of interest that was received electronically, it is understood that there may not be a “person” associated with the receipt or submission of such unsolicited customer order or indication of interest. Thus, with respect to the requirement that firms record (1) the identity of the associated person who received the unsolicited customer order or indication of interest; or (2) the identity of the person from whom information regarding the unsolicited customer order or indication of interest was received where the unsolicited customer order or indication of interest is received from another broker-dealer, firms are only required to record such information if applicable.
- 4 *Id.*

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## Endnotes continued

- 5 It is critical that the firm receiving an unsolicited customer order or indication of interest be advised of and understand the terms of the order or indication of interest that are relevant to the exception so that the receiving member firm may reasonably and accurately rely on the unsolicited customer order exception. For example, if the customer order is a “day” order, the receiving member firm must be advised of that fact so that it can withdraw the quote upon the expiration of the order. Similarly, to the extent that the terms of the unsolicited customer order or indication of interest change or other significant information is received by the firm routing the order (*e.g.*, a “good-till-cancelled” order is cancelled or there is a change in the terms of the order), the firm routing such order must promptly update the member firm displaying the quote as to the change in the terms of the order. To the extent the firm routing the unsolicited customer order or indication of interest is not a member firm, the member firm should make periodic inquiry as to whether the terms of the order have changed. Member firms may not rely on the unsolicited customer order exception where a displayed quote no longer accurately represents current unsolicited customer interest.
- 6 SEA Rule 15c2-11(h) sets forth the SEC’s exemptive authority with respect to the requirements of SEA Rule 15c2-11 and provides that SEA Rule 15c2-11 shall not prohibit any publication or submission of any quotation if the SEC, upon written request or upon its own motion, exempts such quotation either unconditionally or on specified terms and conditions, as not constituting a fraudulent, manipulative or deceptive practice comprehended within the purpose of the rule.

## Trade Reporting

### SEC Approves Amendments to FINRA Trade Reporting Rules on OTC Equity Transactions Executed Outside Normal Market Hours

Effective Date: January 11, 2010

#### Executive Summary

Effective January 11, 2010, firms that execute OTC trades in equity securities during the hours that a FINRA trade reporting facility is closed must report the trade within 15 minutes of the opening of the facility—*i.e.*, by 8:15 a.m. Eastern Time.

Additionally, effective January 11, 2010, the FINRA/NASDAQ Trade Reporting Facility and the OTC Reporting Facility will allow firms to submit during normal market hours trade reports with a modifier designating the trade as executed outside normal market hours.

The text of the amendments can be found at [www.finra.org/rulefilings/2009-031](http://www.finra.org/rulefilings/2009-031).

Questions regarding this *Notice* may be directed to:

- The Legal Section, Market Regulation, at (240) 386-5126; or
- The Office of General Counsel at (202) 728-8071.

#### Background and Discussion

FINRA rules prescribe special requirements for reporting over-the-counter (OTC) equity trades executed outside normal market hours (*i.e.*, trades executed outside the hours of 9:30 a.m. to 4 p.m. Eastern Time [ET]). The rules distinguish between “outside normal market hours” trades that are executed during the hours the FINRA Facilities are open and trades that are executed during the hours the facilities are closed.<sup>1</sup>

### August 2009

#### Notice Type

- Rule Amendment

#### Suggested Routing

- Compliance
- Executive Representatives
- Legal
- Operations
- Senior Management
- Systems
- Trading
- Training

#### Key Topic(s)

- Alternative Display Facility
- NMS Stocks
- Outside Normal Market Hours Trades
- OTC Equity Securities
- OTC Reporting Facility
- Trade Reporting
- Trade Reporting Facilities

#### Referenced Rules & Notices

- FINRA Rule 6282
- FINRA Rule 6380A
- FINRA Rule 6380B
- FINRA Rule 6622

Specifically, trades executed outside normal market hours and during the hours that the FINRA Facility to which the firm is reporting is open must be reported within 90 seconds of execution. For example, a trade executed at 9 a.m. or a trade executed at 5 p.m. must be reported within 90 seconds.<sup>2</sup> “Outside normal market hours” trades executed during the hours that the FINRA Facility to which the firm is reporting is closed are not subject to 90-second reporting, since the facility is not open to facilitate the reporting of the trade. Such trades are reported as follows: (1) trades executed between midnight and 8 a.m. must be reported on trade date; and (2) trades executed between the close of the facility (*i.e.*, either 6:30 p.m. for the ADF or 8 p.m. for the TRFs and ORF) and midnight must be reported on an “as/of” basis the following business day (T+1). All “outside normal market hours” trades are designated with a unique trade report modifier, as specified by FINRA.

On July 23, 2009, the SEC approved a proposed rule change to amend FINRA trade reporting rules to require that trades executed during the hours that the FINRA Facility is closed be reported within 15 minutes of the opening of the facility (*i.e.*, by 8:15 a.m. ET for all FINRA Facilities).<sup>3</sup> Specifically, firms must report as follows:

- ▶ Trades executed between midnight and 8 a.m. must be reported by 8:15 a.m. ET on trade date and be designated with the unique trade report modifier to denote their execution outside normal market hours. Trades reported after 8:15 a.m. on trade date will be late and marked with the “outside normal market hours trade reported late” modifier.
- ▶ Trades executed between the close of the FINRA Facility (*i.e.*, either 6:30 p.m. for the ADF or 8 p.m. for the TRFs and ORF) and midnight must be reported on an “as/of” basis by 8:15 a.m. ET the following business day (T+1) and be designated with the unique trade report modifier to denote their execution outside normal market hours. Trades reported after 8:15 a.m. on T+1 will be late and marked with the “outside normal market hours trade reported late” modifier.<sup>4</sup>

Firms that report trades to the FINRA/NASDAQ TRF or the ORF also should be aware of an additional change specific to these facilities. Under current rules and system functionality, firms cannot submit a trade with a modifier designating the trade as executed outside normal market hours to these two facilities during normal market hours. For example, if a firm executes a trade at 9:29:00 a.m. and reports the trade at 9:30:15 a.m. (in compliance with the 90-second reporting requirement under FINRA rules), the FINRA/NASDAQ TRF and ORF will reject the trade report, as the trade cannot be reported until after 4 p.m. Pursuant to the amendments, firms now can submit a trade with a modifier designating the trade as executed outside normal market hours (and late reports of such trades, as applicable) to the FINRA/NASDAQ TRF and ORF throughout the day.<sup>5</sup>

The chart below summarizes the reporting requirements discussed above (as well as the requirements applicable to trades executed during normal market hours), including the appropriate Extended Hours/Sold – Field 3 (or “byte 3”) trade report modifiers. Firms must consult the applicable technical specifications for the FINRA Facility to which they are reporting for information on specific data entries for that facility.<sup>6</sup>

The amendments become effective January 11, 2010; however, firms can begin complying with the 8:15 a.m. ET reporting deadline at any time. Additionally, firms reporting to the FINRA/NASDAQ TRF and ORF will be able to submit trade reports with the “outside normal market hours” modifier during normal market hours prior to the January 11, 2010, effective date; technical availability will be announced shortly.

Trade Execution Time	Reporting Requirement	Extended Hours/Sold – Field 3 Modifier	
		Actual Report Time	Field 3 Modifier
Midnight – 7:59:59 am	By 8:15 am (within 15 minutes of system open) on trade date	8:00 – 8:15 am on trade date	Outside normal market hours trade (.T)
		After 8:15 am on trade date	Outside normal market hours trade reported late (.U)
8:00 – 9:29:59 am	Within 90 seconds of execution on trade date	Within 90 seconds of execution	Outside normal market hours trade (.T)
		More than 90 seconds after execution	Outside normal market hours trade reported late (.U)
9:30 am – 4:00 pm (normal market hours)	Within 90 seconds of execution on trade date	Within 90 seconds of execution	N/A
		More than 90 seconds after execution	Normal market hours trade reported late (.Z)
4:00:01 – 8:00 pm (4:00:01 - 6:30 pm for ADF)	Within 90 seconds of execution on trade date	Within 90 seconds of execution	Outside normal market hours trade (.T)
		More than 90 seconds after execution	Outside normal market hours trade reported late (.U)
8:00:01 – 11:59:59 pm (6:30:01 – 11:59:59 pm for ADF)	By 8:15 am (within 15 minutes of system open) on T+1, “as/of”	8:00 – 8:15 am on T+1	Outside normal market hours trade (.T)
		After 8:15 am on T+1	Outside normal market hours trade reported late (.U)

## Endnotes

- 1 As used herein, the term “FINRA Facilities” refers to the Alternative Display Facility (ADF), a Trade Reporting Facility (TRF) or the OTC Reporting Facility (ORF). The TRFs and ORF are open between 8 a.m. and 8 p.m. ET, and the ADF is open between 8 a.m. and 6:30 p.m. ET.
- 2 The 90-second reporting requirement applicable to this subset of trades is not affected by the amendments described in this *Notice*.
- 3 See Securities Exchange Act Release No. 60377 (July 23, 2009), 74 FR 38250 (July 31, 2009) (order approving SR-FINRA-2009-031).
- 4 See FINRA Rules 6282(a)(2), 6380A(a)(2), 6380B(a)(2) and 6622(a)(3).
- 5 FINRA notes that the ADF and FINRA/NYSE TRF currently permit the submission of reports with the “outside normal market hours” modifier throughout the day.
- 6 The applicable technical specifications can be found on the FINRA Web site at [www.finra.org/Industry/Compliance/MarketTransparency/index.htm](http://www.finra.org/Industry/Compliance/MarketTransparency/index.htm).

FINRA notes that certain FINRA Facilities will automatically append a modifier to denote that a trade was executed outside normal market hours based on the trade execution time reported by the firm. See *Trade Reporting Frequently Asked Questions*, FAQ 400.4, at [www.finra.org/tradereportingfaq](http://www.finra.org/tradereportingfaq).

## Non-Traditional ETFs

### Increased Margin Requirements for Leveraged Exchange-Traded Funds and Associated Uncovered Options

Effective Date: December 1, 2009

#### Executive Summary

Effective December 1, 2009, FINRA is implementing increased customer margin requirements for leveraged ETFs and uncovered options overlying leveraged ETFs, in accordance with NASD Rule 2520 and Incorporated NYSE Rule 431.

Questions concerning this *Notice* should be directed to:

- Rudolph Verra, Managing Director, Risk Oversight and Operational Regulation, at (646) 315-8811;
- Glen Garofalo, Director, Credit Regulation, at (646) 315-8464; or
- Steve Yannolo, Principal Credit Specialist, Credit Regulation, at (646) 315-8621

#### Background & Discussion

ETFs are typically registered unit investment trusts (UITs) or open-end investment companies whose shares represent an interest in a portfolio of securities that track an underlying benchmark or index.<sup>1</sup> However, some ETFs that invest in commodities, currencies, or commodity— or currency— based instruments are not registered as investment companies. Unlike traditional UITs or mutual funds, shares of ETFs typically trade throughout the day on an exchange at prices established by the market.

#### August 2009

##### Notice Type

- Special Alert

##### Suggested Routing

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

##### Key Topics

- ETFs
- Leveraged ETFs
- Margin Requirements
- Uncovered Options on Leveraged ETFs

##### Referenced Rules & Notices

- Incorporated NYSE Rule 431
- NASD Rule 2520
- Regulatory Notice 09-31

Leveraged ETFs are a subset of ETFs that are designed to generate multiples (*e.g.*, 200%, 300% or greater) of the performance of the underlying index or benchmark they track. Some leveraged ETFs are “inverse” or “short” funds, meaning they seek to deliver the opposite of the performance of the index or benchmark they track. FINRA recently reminded firms of their sales practice obligations with respect to leveraged and inverse ETFs, including the risks caused by the fact that most of these funds are designed to achieve their stated performance on a daily basis.<sup>2</sup>

Leveraged ETFs may include among their holdings derivative instruments such as options, futures or swaps. Leveraged ETFs are inherently more volatile than their underlying benchmark or index.

NASD Rule 2520(f)(8)(A) and Incorporated NYSE Rule 431(f)(8)(A) permit FINRA—in response to market conditions—to prescribe higher initial and maintenance margin requirements. In view of the increased volatility of leveraged ETFs compared to their non-leveraged counterparts, FINRA believes higher margin levels are necessary.

## Strategy-Based Margin Account

In general, FINRA is increasing the maintenance margin requirements for leveraged ETFs and associated uncovered options by a factor commensurate with their leverage.

In a strategy-based margin account, the current maintenance margin requirement for any long ETF is 25% of the market value, and for any short ETF, the current maintenance margin requirement is generally 30% of the market value.<sup>3</sup> Effective December 1, 2009, these maintenance margin requirements will increase by a percentage commensurate with the leverage of the ETF, not to exceed 100% of the value of the ETF, as detailed in the following examples:

Long 100 shares ABC ETF @ 28.00 (200% leverage)

Market Value: 2,800

Maintenance Requirement:  $2 \times .25 = .50$

$2,800 \times .50 = 1,400$

Short 100 shares DEF ETF @ 26.00 (300% leverage)

Market Value: 2,600

Maintenance Requirement:  $3 \times .30 = .90$

$2,600 \times .90 = 2,340^4$

FINRA also is increasing the maintenance margin requirements for listed and over-the-counter uncovered options on leveraged ETFs in a similar fashion. Currently, the maintenance margin requirement for a listed, uncovered option overlying an ETF on a broad-based index or benchmark is:

- 100% of the option premium;
- plus 15% of the ETF market value;
- minus any out-of-the-money amount;

subject to a minimum requirement of:

- 100% of the option premium plus 10% of the ETF market value for call options; and
- 100% of the option premium plus 10% of the exercise amount for put options.

For a listed, uncovered option overlying an ETF on a narrow-based index or benchmark, the percentage of the ETF market value is currently 20%.<sup>5</sup>

For a listed, uncovered option on a leveraged ETF, the formula above will continue to apply; however, the percentages of the underlying ETF market value will be determined using the same methodology as the underlying ETF. Thus, instead of using 15% of the ETF market value for a broad-based ETF and 20% for a narrow-based ETF, a leveraged ETF at 200% would use 30% (two times 15%, or 40% for narrow-based) of the market value, and a leveraged ETF at 300% would use 45% (three times 15%, or 60% for narrow-based).

## Portfolio Margin Account

In a portfolio margin account, eligible products and related instruments are grouped into specific portfolio types and theoretical gains and losses are computed based on a prescribed stress range relative to the portfolio type. The stress range of 10 equidistant intervals represents assumed market price movement from the current market value of the underlying instrument. The greatest theoretical loss becomes the margin requirement for that product. Currently, the stress range applied to an ETF and related listed options is based on the portfolio type that the ETF falls under.

For leveraged ETFs and related listed options, the Options Clearing Corporation has increased the stress ranges within its TIMS model proportionately to the amount of leverage on the ETF.<sup>6</sup> For example, an ETF with 300% leverage that falls under the equity or narrow-based index portfolio type would have its stress range increased to -45% / +45% (3 x .15).<sup>7</sup>

## Day Trading

For day-trading purposes, the calculations to determine day-trading buying power and day-trade calls will also be based on the amount of leverage on the ETF. Thus, the day-trading buying power on a leveraged ETF will need to include the higher margin requirements prescribed above.

The following example should help demonstrate the calculation of day-trading buying power as it relates to a leveraged ETF:

Customer A has a total, long market value, based on the previous nights' close of business, of \$100,000. The market value is composed entirely of long positions in a 300% leveraged ETF. The customer is carrying a margin debit balance of \$20,000. The day-trading buying power would be computed as follows:

Total Market Value:	\$100,000
Debit Balance:	\$20,000
Account Equity:	\$80,000
FINRA Maintenance Requirement:	\$75,000 (3 times the normal \$25,000 maintenance requirement)
FINRA Excess Equity:	\$5,000
Day-Trading Buying Power:	\$6,665

The day-trading buying power in this example is computed by multiplying the FINRA excess equity by 1.333, which coincides with a 75% maintenance requirement for the leveraged ETF. It also assumes that the client would be day trading the same, or similar, 300% leveraged ETF.

## Additional Margin

FINRA is aware that other securities that contain inherent leverage (*e.g.*, leveraged mutual funds) may be held and traded in customer accounts on a margin basis, and as such, firms are reminded to assess the adequacy of current maintenance requirements for these products and the need to increase them where appropriate.

Pursuant to NASD Rule 2520(d) and Incorporated NYSE Rule 431(d), firms must have procedures in place to:

- ▶ review limits and types of credit extended to all customers;
- ▶ formulate their own margin requirements; and
- ▶ review the need for instituting higher margin requirements, mark-to-markets and collateral deposits than are required by FINRA's rules for individual securities or customer accounts.

## Endnotes

- 1 In 2008, the SEC began issuing exemptive orders that allow certain ETFs to be actively managed and, thus, not track an underlying benchmark or index. See SEC Rel. No. 338901 (Mar. 11, 2008), 73 FR 14618, 14620 n. 20 (Mar. 18, 2008). See also *Regulatory Notice 09-31*.
- 2 See *Regulatory Notice 09-31*.
- 3 NASD Rule 2520(c) and Incorporated NYSE Rule 431(c) prescribe a maintenance margin requirement of \$2.50 per share or 100% of the current market value, whichever is greater, for each short stock priced at less than \$5.00 per share, and \$5.00 per share or 30% of the current market value, whichever is greater, for each short stock priced at \$5.00 per share or greater.
- 4 As the examples indicate, the maintenance margin levels would double for an ETF offering 200% leverage and triple for an ETF offering 300% leverage. If the leveraged ETF is designed to provide 150% of the performance of the underlying index or benchmark, then the requirement would be the current maintenance requirement for a standard ETF, multiplied by 1.5 (e.g.,  $1.5 \times .25 = .375$ ).
- 5 For an over-the-counter uncovered option overlying an ETF on a broad-based index or benchmark, the percentage of the ETF market value to be used is currently 20%, and for an over-the-counter uncovered option overlying an ETF on a narrow-based index or benchmark, the percentage of the ETF market value is currently 30%. For over-the-counter uncovered options on a leveraged ETF, the percentages of the underlying ETF will increase by a factor commensurate with the ETFs leverage. Firms should refer to NASD Rule 2520(f)(2)(D) and Incorporated NYSE Rule 431(f)(2)(D) when calculating margin requirements on over-the-counter options.
- 6 The Options Clearing Corporation's TIMS model is currently the only model approved by the SEC. For a partial list of leveraged and inverse ETFs, see [www.optionsclearing.com/products/rbh\\_documentation.jsp](http://www.optionsclearing.com/products/rbh_documentation.jsp).
- 7 Currently, the Options Clearing Corporation's (OCC) TIMS model does not have the ability to determine theoretical pricing for all over-the-counter options, and therefore cannot determine the theoretical gains and losses for all such products. A firm that wishes to utilize a risk-based methodology for over-the-counter options that the OCC's model does not recognize must first have its proprietary model approved by the SEC. See NASD Rule 2520(g) and Incorporated NYSE Rule 431(g)).