

Notices

Regulatory Notices

- 10-01** Proposed Consolidated FINRA Rules Governing FINRA's Membership Application Proceedings; **Comment Period Expires: March 5, 2010**
- 10-02** Broker-Dealer, Investment Adviser Firm, Agent and Investment Adviser Representative, and Branch Renewals for 2010; **Payment Deadline: February 5, 2010**
- 10-03** FINRA Requests Comments on Proposed Consolidated FINRA Rules Governing Securities Loans and Borrowings, Permissible Use of Customers' Securities and Callable Securities; **Comment Period Expires: March 8, 2010**
- 10-04** SEC Approves Consolidated FINRA Rules Governing Clearly Erroneous Transactions; **Effective Date: February 15, 2010**
- 10-05** FINRA Reminds Firms of Their Responsibilities Under FINRA Rule 2330 for Recommended Purchases or Exchanges of Deferred Variable Annuities
- 10-06** Guidance on Blogs and Social Networking Web Sites
- 10-07** SEC Approves Amendments to FINRA Rules on Reporting Cancellations of Previously Reported OTC Trades in Equity Securities; **Effective Date: April 12, 2010**



© 2010 FINRA. All rights reserved. FINRA and other trademarks of the Financial Industry Regulatory Authority, Inc. may not be used without permission.

FINRA *Notices* are published monthly by FINRA Corporate Communications, Michelle Volpe-Kohler, Editor, 1735 K Street, NW, Washington, DC 20006-1506, (202) 728-8289. No portion of this publication may be copied, photocopied or duplicated in any form or by any means, except as described below, without prior written consent of FINRA. FINRA member firms are authorized to photocopy or otherwise duplicate any part of this publication without charge, only for internal use by the member firm and its associated persons. Nonmembers of FINRA may obtain permission to photocopy for internal use through the Copyright Clearance Center (CCC) for a \$3-per-page fee to be paid directly to CCC, 222 Rosewood Drive, Danvers, MA 01923.

Notices (December 1996 to current) are also available on the Internet at www.finra.org/notices.

Membership Application Proceedings

Proposed Consolidated FINRA Rules Governing FINRA's Membership Application Proceedings

Comment Period Expires: March 5, 2010

Executive Summary

As part of the process of developing a new, consolidated rulebook (the Consolidated FINRA Rulebook),¹ FINRA is requesting comment on proposals relating to FINRA's membership rules. These rules, which were adopted in August 1997, provide a means for FINRA, through its Membership Application Process (MAP), to know and assess the proposed business activities of its potential and current member firms. The proposed amendments revise certain provisions of the existing membership rules to streamline the standards of review for new and continuing membership applications, clarify certain administrative aspects of the MAP process, update or eliminate outdated terminology and require certain additional information (including certain affiliate information) about the applicant and incorporate certain provisions from the Incorporated NYSE membership rules.

The text of the proposed rules is set forth in Attachment A on our Web site at www.finra.org/notices/10-01.

Questions regarding this *Notice* should be directed to:

- ▶ Steve Kasprzak, Associate Director & Principal Counsel, Sales Practice Policy, Member Regulation, at (646) 315-8505; or
- ▶ Ann-Marie Mason, Counsel, Sales Practice Policy, Member Regulation, at (202) 728-8231.

January 2010

Notice Type

- ▶ Request for Comment
- ▶ Consolidated FINRA Rulebook

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Systems

Key Topics

- ▶ Affiliate Information
- ▶ Continuance in Membership Application
- ▶ Membership Agreement Change
- ▶ Membership Application Process
- ▶ Membership Rules
- ▶ New Member Application
- ▶ Safe Harbor for Business Expansions

Referenced Rules & Notices

- ▶ FINRA By-Laws, Art. I(h)
- ▶ Information Notice 3/12/08
- ▶ NASD IM 1011-1
- ▶ NASD Rule 1010 Series
- ▶ NASD Rule 1011
- ▶ NASD Rule 1012
- ▶ NASD Rule 1013
- ▶ NASD Rule 1014
- ▶ NASD Rule 1015
- ▶ NASD Rule 1016
- ▶ NASD Rule 1017
- ▶ NASD Rule 1019
- ▶ NYSE Rule 311
- ▶ NYSE Rule 312
- ▶ NYSE Rule 313
- ▶ NYSE Rule 321
- ▶ NYSE Rule Interpretation 401/03
- ▶ NYSE Rule Interpretation 401/04
- ▶ NYSE Rule 416
- ▶ SEA Rule 15c3-3

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 5, 2010.

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, DC 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.²

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

Background and Discussion

A. Background

1. FINRA Membership Rules

Exchange Act Section 15A(b)(8) requires that a national securities association, such as FINRA, establish rules providing a fair procedure for the denial of membership in such association. FINRA's current membership rules (NASD Rule 1010 Series (Membership Proceedings)) were adopted in August 1997, and they provide a means for FINRA, through its Membership Application Process (MAP), to know and assess the proposed business activities of its potential and current member firms. The MAP process is a fluid, probing exercise that seeks to evaluate all relevant facts and circumstances regarding each applicant. In particular, the MAP process seeks to identify potential weaknesses in an applicant's supervisory, operational and financial controls. The MAP process's ultimate goal is to ensure that each applicant is capable of conducting its business in compliance with applicable rules and regulations, and that its business practices are consistent with just and equitable principles of trade as required by FINRA rules.

NASD Rule 1011 (Definitions) sets forth the defined terms applicable to the MAP process, and NASD Rule 1012 (General Provisions) sets forth the requirements for submitting MAP applications and supporting documentation. There are three types of MAP applications. One category is new member applications (NMAs) that are filed pursuant to NASD Rule 1013 (New Member Application and Interview).⁴ The other two categories are applications for approval of changes in ownership, control or material changes in business operations (Continuance in Membership Applications or CMAs) and applications for removal or modification of restrictions on a firm's membership (Membership Agreement Changes or MACs) that are filed pursuant to NASD Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations). NASD IM-1011-1 (Safe Harbor for Business Expansions) provides parameters for certain changes in a member firm's business profile (such as the addition of associated persons, registered and unregistered offices and markets made) that would not trigger a CMA filing.

All applications are evaluated to determine whether the applicant meets the 14 standards or criteria (*e.g.*, completeness and accuracy of the application and supporting documentation, the acquisition of all requisite licenses and registrations, a sufficient level of net capital, the establishment of all necessary contractual agreements and business relationships, an adequate supervisory system) set forth in NASD Rule 1014 (Department Decision).

NASD Rule 1014 (with respect to an NMA) and NASD Rule 1017 (with respect to a CMA or MAC) require FINRA staff to determine whether to grant or deny the application. NASD Rule 1015 (Review by National Adjudicatory Council) permits an applicant to submit a request for review by the National Adjudicatory Council of an adverse decision rendered on a NMA, CMA or MAC. NASD Rule 1016 (Discretionary Review by FINRA Board) also permits a Governor of the FINRA Board to call for a discretionary review of a membership proceeding. Finally, a person aggrieved by final action of FINRA under the NASD Rule 1010 Series may apply for review by the SEC pursuant to NASD Rule 1019 (Application to Commission for Review).

2. NYSE Membership Rules

While tailored for broker-dealers operating on a national securities exchange, the current NYSE membership rules also seek to capture information from member organization applicants and set approval criteria for applications. For instance, NYSE Rule 311 (Formation and Approval of Member Organizations) requires an applicant member organization to submit, among other things, shareholder lists, principal executive officer lists and a written authorization by each natural person agreeing to a background investigation. NYSE Rule 311 also requests general corporate information (*e.g.*, date of proposed formation, names of officers) and requires that certain persons (*e.g.*, directors, control persons, principal executives, general partners) within a member organization be appropriately designated and approved. Further, NYSE Rule 313 (Submission of Partnership Articles – Submission of Corporate Documents) requires member organizations to submit to the NYSE for approval certain documents that establish a partnership's or corporation's existence.

NYSE Rule 312 (Changes Within Member Organizations) sets forth the requirements for changes within member organizations. While NYSE Rule 312 does not expressly require notice or approvals of changes in business, NYSE Rule 312(b)(4) requires written notice of a member corporation's failure to comply with all of the approval conditions set forth in NYSE Rule 311. Additionally, NYSE Rule 312(g) requires prior written approval for certain changes to a member corporation's capital structure, while NYSE Rule 312(d) provides that whenever a person approved by the NYSE as a member or approved person ceases to be approved, the member corporation must reduce the amount of that person's outstanding voting stock in the member corporation, such that the person can no longer exercise controlling influence over the management or policies of the corporation. NYSE Rule 312(f) provides that member organizations may not recommend their own publicly held securities or those of certain affiliates and that members may effect transactions in such securities only on an unsolicited basis.⁵ NYSE Rule 313 (Submission of Partnership Articles – Submission of Corporate Documents) delineates certain corporate or partnership documents that each member organization must submit to enter into and continue in NYSE membership. Finally, NYSE Rule 321 requires prior written approval before a member organization forms or acquires a subsidiary that is engaged in a securities or kindred business.

Other NYSE rules also require member organizations to provide the NYSE with additional information or notice of changes in business operations. Specifically, NYSE Rule Interpretation 401/03 (Conversions, Acquisitions and Changes in Business Activities) requires a member organization to provide NYSE with notice of important organization or operational changes (*e.g.*, mergers, acquisitions, new product lines). Also, NYSE Rule Interpretation 401/04 (Early Reporting of Developing Problems) makes clear that the NYSE expects notification from a member organization upon its discovery of any existing or impending condition(s) which it reasonably believes could lead to capital, liquidity or operational problems or impairment of record-keeping, clearance or control functions.⁶ Finally, NYSE Rule 416(a) and (c) (Questionnaires and Reports) and its Supplementary Material paragraph .10 require member organizations to submit, in the format, manner and time frame prescribed by the NYSE, any information the NYSE deems essential for the protection of investors and the public interest, including financial and operational reports for affiliated organizations.

3. Proposal

FINRA proposes to transfer the NASD membership rules, with substantive changes, into the Consolidated FINRA Rulebook. Among other things, the proposed amendments will revise certain provisions of the existing membership rules to streamline the standards of review for new and continuing membership applications, clarify certain administrative aspects of the MAP process, update or eliminate outdated terminology, require certain additional information about the applicant and incorporate certain provisions from the NYSE membership rules. The proposed amendments also will require applicants to provide information regarding their affiliates, which will, in turn, enhance FINRA's ability to assess applicants, as well as significant changes in the business activities and control relationships of member firms and their affiliates. The proposed rule changes are detailed further below.

B. Proposed FINRA Rule 1111 (Definitions)

FINRA proposes adopting NASD Rule 1011 (Definitions) as FINRA Rule 1111 (Definitions) with the following substantive changes.

1. Definition of “Affiliate”

The proposed rule change defines, for the first time, the term “affiliate” to mean (1) a person that directly or indirectly controls an applicant (excluding a natural person who controls an applicant solely in his or her role as a director, general partner or officer (or occupies a similar status or performs a similar function)); or (2) an entity that is controlled by, or is under common control with, an applicant.

2. Definition of “Control”

Proposed FINRA Rule 1111 defines, for the first time, the term “control” to mean the power to direct or cause the direction of the management or policies of a person whether through ownership of securities, by contract or otherwise. Pursuant to the proposed definition, control over a person is presumed if another person, directly or indirectly (1) has the right to vote 25 percent or more of the voting securities; (2) is entitled to receive 25 percent or more of the net profits; or (3) is a director, general partner or officer (or occupies a similar status or performs similar functions) of the other person. The proposed definition also clarifies that any person that does not meet the conditions above shall be presumed not to control such other person. Additionally, the proposed definition clarifies that any presumption may be rebutted by evidence, but will continue until a determination to the contrary has been made by FINRA.

FINRA is proposing this new definition rather than continuing to rely on the current FINRA By-Laws definition of “controlling”⁷ as it is more consistent with the control standards that are in proposed FINRA Rule 1160 (Continuing Membership Application for Approval of Change in Ownership, Control, or Business Operations).

3. Definition of “Material Change in Business Operations”

As discussed further below in the context of proposed FINRA Rule 1160, the proposed rule change relocates the definition of the term “material change in business operations” to proposed FINRA Rule 1160, as that term establishes the standards for when a member firm has a material change in business operations that requires the filing of a CMA.

4. Definition of “Sales Practice Event”

Proposed FINRA Rule 1111 amends the NASD Rule 1011 definition of “sales practice event” to include “statutory disqualification” as defined in Exchange Act Section 3(a)(39) as one of the events that must be reported to FINRA via the Central Registration Depository (CRD®) or other mechanism, thereby expanding the definition to include certain misconduct by an applicant or associated person, such as having been convicted of misdemeanor tax evasion, that it does not currently capture.

5. Other Proposed Amendments

The proposed rule change also makes the following minor amendments to the current definitions being transferred to proposed FINRA Rule 1111:

- amending the definition of “Applicant” to clarify that, in the context of proposed FINRA Rule 1160, an applicant may also be referred to as a “member”;
- amending the definition of “Associated Person” to add an LLC managing member to the examples of persons with supervisory responsibilities who would be associated persons and to clarify that an associated person includes any employee of the applicant, except any person whose functions are solely clerical or ministerial;
- adding the term “Executive Vice President(s)” to the definition of “Interested FINRA Staff”; and
- adding the term “LLC managing member” to the definition of the term “principal place of business” to reflect the existence of limited liability corporations.

C. Proposed FINRA Rule 1112 (General Procedures)

The proposed rule change adopts NASD Rule 1012 (General Provisions) as proposed FINRA Rule 1112 (General Procedures), subject to certain clarifying amendments. First, the proposed rule clarifies that an applicant for membership must file its application in accordance with proposed FINRA Rule 1112 and submit in a timely manner its application fee pursuant to Schedule A of FINRA's By-Laws. The proposed rule also clarifies that a CMA or MAC applicant must file its application in accordance with proposed FINRA Rule 1112 and in the manner prescribed in Rule 1160.

Proposed FINRA Rule 1112 clarifies that filing an application and supporting documentation via electronic delivery encompasses delivery by facsimile, email or a dedicated electronic filing system. Additionally, proposed FINRA Rule 1112 clarifies that, for purposes of the membership rule series, service by FINRA or a filing by an applicant via electronic delivery will be deemed complete on the date recorded by FINRA's electronic systems for such communications.

Proposed FINRA Rule 1112 also reduces from 60 days to 30 days the time for an applicant to respond to an initial written request by FINRA for information or documentation before the application is deemed to have lapsed (absent a showing of good cause). The response time frame for subsequent written requests remains at 30 days. The proposed rule also includes a new provision providing that, absent a showing of good cause, an application will lapse if an applicant fails to schedule, within 30 days of filing its Form NMA, all of the qualification examinations of those associated persons that are necessary for the applicant to conduct its intended business and ensure that such associated persons successfully complete their required qualification examinations within 120 days of filing the Form NMA. Another new provision similarly provides that, absent a showing of good cause, an application will lapse if an applicant fails to schedule, within 30 days of filing its CMA, all of the qualification examinations of those associated persons that are necessary for the applicant to commence its proposed change in ownership, control or business operations and ensure that such associated persons successfully complete their required qualification examinations within 120 days of filing the CMA.

The proposed rule change also eliminates the current NASD Rule 1012 requirement that an applicant submit a new fee if it resubmits, subsequent to a lapse, a CMA or MAC application as FINRA does not currently charge a fee for filing those applications. Proposed supplementary material clarifies that an applicant is required throughout the application process to correct, amend or modify, by submitting supplementary amendments and/or any documentation, any application filed with FINRA that is or becomes inaccurate or misleading.

D. Proposed FINRA Rule 1121 (New Member Application, Interview, and Department Decision)

The proposed rule change adopts NASD Rule 1013 (New Member Application and Interview) as proposed FINRA Rule 1121 (New Member Application, Interview, and Department Decision), subject to the amendments discussed below.

1. New Affiliate Information

As previously noted, NASD Rule 1013 outlines the filing requirements for new member applicants. To meet these requirements, applicants submit certain information regarding their associated persons, business models, finances and supervisory structures. In addition to this required information, proposed FINRA Rule 1121 requires an applicant for membership to provide certain additional information about itself. Specifically, the proposed rule requires an applicant to provide:

- its establishing constituent documents, including any corporate resolution, charter, by-laws, partnership agreement, operating agreement, certificate of LLC and any analogous documents;
- an organizational chart identifying the associated person (by name and CRD number) responsible for supervising each office, division and business line;
- its anti-money laundering procedures, including the associated person responsible for implementation; and
- the independent audit firm (which, pursuant to SEC requirements, must be registered with the Public Company Accounting Oversight Board) the applicant will use for audits, the anticipated annual audit schedule and, if applicable, a copy of the applicant's most recent audit report.

FINRA believes that this additional information will assist the staff in performing more comprehensive new member application reviews.

Additionally, proposed FINRA Rule 1121 requires an applicant for FINRA membership to provide information regarding its affiliate relationships, including an organizational chart that identifies the applicant and all of its affiliates, provides a brief summary of each affiliate's principal activity and identifies the legal relationship between the applicant and each affiliate. Proposed FINRA Rule 1121 also requires an applicant to provide a detailed and comprehensive summary of the business relationship between the applicant and any affiliate:

- whose financial information is consolidated with that of the applicant;
- whose liabilities or obligations have been, directly or indirectly, guaranteed by the applicant;
- that is the source of flow-through capital to the applicant in accordance with Appendix C of SEA Rule 15c3-1;
- upon which the applicant or its customers rely for operational support or services that are used in connection with the applicant's securities, investment banking or investment advisory business;
- that has the authority or the ability to withdraw, or cause the withdrawal of, capital from the applicant;
- that has a mutually dependent financial relationship with the applicant, including any expense-sharing agreements;
- that has a financial or marketing relationship with the applicant; or
- that provides any third-party products and/or services as part of any operation or function of the applicant required to be supervised by the applicant pursuant to FINRA rules.

The proposed rule also requires the applicant, at FINRA's discretion, to provide evidence of, and information regarding, any business relationship disclosed pursuant to the items listed above from the books and records of the applicant and/or the books and records of any affiliate that is a party to such business relationship.

In addition, proposed FINRA Rule 1121 clarifies that an applicant must disclose any plans to enter into contractual commitments including underwriting agreements or other activities, such as investment advisory business, whether or not exempt from SEC registration under Section 203A of the Investment Advisers Act.

FINRA is proposing to require this additional affiliate information from new membership applicants as FINRA previously has found during the NMA review process that some applicants and their affiliates have such close, and sometimes interwoven, business relationships that a more thorough review is needed to ensure that adequate investor protection safeguards are in place. In short, these amendments seek to ensure FINRA's access to all of the relevant aspects of an applicant's business that are within the scope of FINRA's statutory authority.

Further, self-regulatory organizations (SROs) previously have required member firms to provide affiliate information. For instance, NYSE Rule 304(e) (Allied Members and Approved Persons)⁸ requires persons that control a member organization, or that are engaged in a securities or kindred business and are controlled by or under common control with a member organization (namely, affiliates), become approved persons, thus subjecting them to the jurisdiction of the NYSE. Such entities are often not otherwise subject to the NYSE's regulatory authority. Unlike NYSE Rule 304, proposed FINRA Rule 1121 does not require affiliates of a firm to consent to FINRA's jurisdiction.

Finally, proposed supplementary material, consistent with the current NYSE requirements, prohibits an applicant from identifying any division that is not a separate legal entity by words such as "Company," "Corporation" or "Incorporation."

2. Procedural Amendments Relating to New Membership Applications

The proposed rule change transfers to proposed FINRA Rule 1121 the NMA application procedural guidelines that are currently positioned in NASD Rule 1014 (Department Decision) as FINRA believes that these guidelines fit more logically into the NMA application rule.

Proposed FINRA Rule 1121 also increases from \$350 to \$500 the amount of the application fee FINRA will retain as a processing fee if the staff determines within 30 days after the application's filing that the application is not substantially complete. Proposed FINRA Rule 1121 also permits a one-time opportunity for an applicant to refile its membership application within 30 days of service of written notice that the application is not substantially complete by submitting only a new Form NMA and the application fee, rather than being required to submit the entire application. After the 30-day period, an applicant will need to submit a new application (the Form NMA and other documents such as the Form BD and CRD entitlement forms) and fee.

Proposed FINRA Rule 1121 also requires for the first time that an applicant file its Form NMA no later than 180 days after the submission of its Form BD or FINRA will deem the application to be abandoned and refund the application fee, less a \$250 processing fee. FINRA is proposing this new provision to address the problem of applicants who wait six months or more after filing their Form BD and entitlement forms to file their Form NMA, thereby causing administrative back log while their membership applications remain "in limbo" with both the SEC and FINRA.

Currently, unless FINRA directs otherwise for good cause shown, a membership interview shall be scheduled within 90 days after the filing of an application or within 60 days after the filing of all additional information requested by FINRA, whichever is later. To streamline the application process, proposed FINRA Rule 1121 reduces the latter time frame to 30 days.

Finally, the proposed rule change transfers, with the changes described below, NASD IM-1013-1 (Membership Waive-in Process for Certain New York Stock Exchange Member Organizations) and NASD IM-1013-2 (Membership Waive-in Process for Certain NYSE Alternext US LLC Member Organizations) as supplementary material. The two IMs permitted certain NYSE and NYSE Amex member organizations to be eligible for a streamlined application process for FINRA membership. The proposed rule change deletes the descriptions of such application processes, while retaining those provisions that specify the rules applicable to such members. More specifically, the proposed supplementary material clarifies that such waive-in members are subject to the consolidated FINRA rules, including the obligation to file a CMA if the member seeks to expand its business operations to include any activities other than the permitted floor activities, as well as the remaining Incorporated NYSE Rules. The supplementary material continues to specify that such members also are subject to the remaining NASD rules to the extent they expand their business operations beyond the permitted floor activities. FINRA intends to eliminate this new supplementary material as unnecessary once all of the Incorporated NYSE Rules and NASD Rules have been eliminated from the Transitional Rulebook.

E. Proposed FINRA Rule 1130 (Basis for Department Decision)

The proposed rule change adopts the majority of NASD Rule 1014 (Department Decision) as proposed FINRA Rule 1130 (Basis for Department Decision), subject to the amendments outlined below.

First, proposed FINRA Rule 1130 requires all NMAs, CMAs and MAC applications to address all of the application evaluation standards outlined in the rule, but permits a CMA or MAC applicant to provide a written explanation regarding why the applicant believes a particular standard(s) is not applicable based on the nature and scope of the application.

Second, the proposed rule change adds a new application evaluation standard that requires an applicant to fully disclose and document all of its funding sources and permit FINRA to determine that such sources are not objectionable.

Third, proposed FINRA Rule 1130 clarifies as a standard that the applicant is required to have adequate financial and operational controls to comply with its net capital requirements. Additionally, the proposed rule expands the circumstances when FINRA staff may impose a higher minimum net capital on an applicant to include situations where an applicant is entering into contractual commitments regarding any investment advisory business.

Fourth, proposed FINRA Rule 1130 permits FINRA staff to consider certain information regarding an applicant's affiliates (*e.g.*, any pending or settled state, federal or self-regulatory action or investigation against the affiliate) in determining whether an applicant meets the standard requiring it to be capable of complying with the federal securities laws and regulations and FINRA rules.

Fifth, as noted above, the proposed rule changes transfers the NMA application procedural guidelines that are currently positioned in NASD Rule 1014 (Department Decision) into proposed FINRA Rule 1121.

Finally, the proposed rule change streamlines and consolidates the standards such that their total number is reduced from 14 to 11.

F. Proposed FINRA Rule 1140 (Review by National Adjudicatory Council)

As noted above, NASD Rule 1015 (Review by National Adjudicatory Council) permits an applicant to submit a request for review by the National Adjudicatory Council of an adverse decision. The proposed rule change adopts NASD Rule 1015 as proposed FINRA Rule 1140 (Review by National Adjudicatory Council) with no substantive changes.

G. Proposed FINRA Rule 1150 (Discretionary Review by FINRA Board)

As stated above, NASD Rule 1016 (Discretionary Review by FINRA Board) permits a Governor of the FINRA Board to call for a discretionary review of a membership proceeding. The proposed rule change adopts NASD Rule 1016 as proposed FINRA Rule 1150 (Discretionary Review by FINRA Board) with no substantive changes.

H. Proposed FINRA Rule 1160 (Continuing Membership Application for Approval of Change in Ownership, Control, or Business Operations)

The proposed rule change adopts NASD Rule 1017 (Application for Approval of Change in Ownership, Control, or Business Operations), the membership rule requiring a member to file an application for approval of certain changes to its ownership, control or business operations, as proposed FINRA Rule 1160 (Continuing Membership Application for Approval of Change in Ownership, Control, or Business Operations), subject to the following amendments.

1. Procedural Amendments Relating to Continuing Membership Applications

The proposed rule change makes a number of procedural amendments to the current NASD Rule 1017 requirements. Specifically, proposed FINRA Rule 1160 clarifies that an application that does not address all of the decision standards in proposed FINRA Rule 1130 will be deemed substantially incomplete. However, as stated above, proposed FINRA Rule 1130 permits a CMA or MAC applicant that does not believe a certain standard applies to provide a written explanation of such belief.

The proposed rule also amends the current NASD Rule 1017 provision permitting FINRA to impose interim restrictions on a member that effects a change in ownership or control pending final FINRA action on the application to clarify that an applicant may only effect such change 30 days after submitting a complete application. A new provision provides that any interim restrictions remain in effect for the applicant and all successors to the applicant's ownership or control unless removed by final action of FINRA or stayed by the NAC, FINRA Board or the SEC.

Proposed FINRA Rule 1160 also includes a new provision clarifying that the staff will serve a request for additional information or documents within 30 days after the filing of a complete application and that the applicant must provide the requested information within 30 days of the request. The proposed provision also reserves the right of FINRA staff to request additional information or documents at any time during the application process. Also, to reduce redundancy, a new provision permits FINRA staff the discretion to permit the filing of a single application by one party where the circumstances of a particular transaction or event would generally require the filing of a CMA by two or more member firms.

Proposed FINRA Rule 1160 increases from 30 days to 45 days the time frame for the Department of Member Regulation (Department) to issue a written decision on a CMA after the conclusion of the final CMA interview or a CMA applicant's final filing of additional information or documents, whichever is later. Proposed FINRA Rule 1160 also retains the requirement that the Department's decision shall state whether the application is granted or denied in whole or in part and include a rationale for the decision referencing the applicable decision standards in proposed FINRA Rule 1130. Additionally, the proposed rule clarifies that the decision shall also state whether the CMA is subject to one or more restrictions reasonably designed to address a specific financial, operational, supervisory, disciplinary, investor protection or other regulatory concern based on the decision standards in proposed FINRA Rule 1130.

2. Amendments to Business Operation Changes Requiring an Application

Proposed FINRA Rule 1160 expands the criteria under which a CMA filing is triggered under NASD Rule 1017 by requiring a CMA when a change “directly or indirectly” in the equity ownership, partnership capital “or other ownership interest” in a member results in one person directly or indirectly owning, controlling “or holding a presently exercisable option” to own or control 25 percent or more of the equity, partnership capital “or other ownership interest” in the member. However, proposed FINRA Rule 1160 permits FINRA staff to waive a CMA when the direct or indirect change in ownership or control does not result in any practical change in the member firm’s business activities, management, supervision, assets, liabilities or ultimate ownership or control.

Also, the staff is proposing to clarify the current requirement that a member firm file an application if there is a direct or indirect acquisition of 25 percent or more of its assets or any asset, business or line of operation that generates revenues comprising 25 percent or more of its earnings to include all “purchases or transfers.” Additionally, the proposed rule expands that requirement to include any divestitures (including sales or transfers) that meet those percentages. This proposed change is designed to address those instances where a member firm’s transfer of assets is intended, or would have the effect of, rendering the member firm “judgment proof” if the firm was the subject of a significant arbitration award or litigation penalty. However, proposed FINRA Rule 1160 permits FINRA to waive the filing requirement if the member firm is ceasing operations and filing a Form BDW, and neither the member firm nor its registered persons is subject to any claim that could be adversely affected by the proposed transaction.

Additionally, the filing requirements of Rule 1160 apply not only to FINRA member firms that engage in certain mergers and direct or indirect acquisitions with other FINRA member firms, but also to FINRA member firms that engage in such transactions with broker-dealers that are *not* member firms of FINRA. FINRA believes that all such transactions engaged in by FINRA member firms should be subject to FINRA’s review and approval, regardless whether the counterparty is a FINRA member firm.

Currently, NASD Rule 1017 excludes from its filing requirements certain transactions where (1) in the case of mergers, both member firms are also NYSE members or the surviving entity will continue to be an NYSE member; (2) in the case of acquisitions, the acquiring member firm is an NYSE member; and (3) in the case of direct or indirect acquisitions of 25 percent or more of the member firm’s assets or any asset, business or line of operation that generates revenues comprising 25 percent or more of the member’s earnings, both the seller and the acquirer are NYSE members. At the time these exclusions were incorporated into the rule, their primary purpose was to avoid subjecting applicants to duplicative review processes (by FINRA (then NASD) and NYSE Regulation). However, since NYSE Regulation no longer independently conducts regulatory reviews of such transactions, the proposed rule change deletes these exclusions so that all such transactions are subject to FINRA’s review and approval.

As noted earlier, the proposed amendments reposition the definition of “material change in business operations” from NASD Rule 1011 to proposed FINRA Rule 1160. The proposed rule change also amends the definition to include instances where a change in business operations would result in the settling or clearing of transactions for the applicant’s own business, the settling or clearing of transactions for other broker-dealers or the carrying of customer accounts for the first time. The definition also essentially incorporates NASD Rule 3140’s requirement that a firm obtain FINRA approval before making a business change that would alter its SEA Rule 15c3-3(k) exemptive status by defining any change in a firm’s SEA Rule 15c3-3(k) exemptive status as a material change in business, thereby requiring a CMA filing that must be approved before making such change. Finally, the proposed rule clarifies that the definition’s list of material changes in business operations is illustrative only and is not meant to be an exhaustive listing of what is deemed to be material.

3. Amendments to the Filing and Content of Applications

Proposed FINRA Rule 1160 requires a member firm to file its application “in the manner prescribed by FINRA” rather than retain NASD Rule 1017’s current requirement that a member firm’s application be filed at the district office in the district in which the member firm’s principal place of business is located. This proposed change reflects new operational procedures that are being developed for application submissions.

Proposed FINRA Rule 1160 also retains NASD Rule 1017’s requirement that a CMA or MAC application describe in detail the proposed change(s) in ownership, control or business operations and include a business plan, pro forma financials and written supervisory procedures reflecting the change. However, to ensure better accuracy of CMA and MAC application materials, proposed FINRA Rule 1160 also requires that CMAs and MAC applications identify and update any member firm application information (*e.g.*, organizational charts, constituent documents) required pursuant to proposed FINRA Rule 1121(a) that has been rendered inaccurate or incomplete as a result of any applicable event(s) triggering the application. The proposed rule clarifies that, to the extent a member firm has not previously submitted member firm application information required pursuant to Rule 1121(a) to the Department that is relevant to, or implicated by, the event(s) triggering the application, the member firm would have to include such information in its CMA or MAC application. Additionally, the proposed rule requires a CMA or MAC application to include a schedule and timeline for any systems changes and associated system testing.

In addition, if the application requests approval of a change in ownership or control, proposed FINRA Rule 1160 requires that the application include the names of the new owners or controlling parties, their percentage of ownership or control, the ultimate sources of their funding for the purchase and recapitalization of the member, copies of any agreements relating to the change in ownership or control and an indication of whether, if at all, the procedures and operations of the member firm will be impacted by the change.

4. Safe Harbor Amendments

As noted above, the proposed rule change relocates the contents of NASD IM-1011-1 (Safe Harbor for Business Expansion) as proposed supplementary material to proposed FINRA Rule 1160 as these provisions pertain specifically to the CMA process. The proposed rule change, however, makes one significant amendment to the relocated provisions. Specifically, the proposed supplementary material prohibits the safe harbor from being available to any member that seeks to acquire either an office (registered or unregistered) or associated persons involved in sales from a member firm where either that firm or its associated persons to be acquired have a “disciplinary history,” as defined in the supplementary material.

I. Proposed FINRA Rule 1170 (Notice of Certain Member Changes and Continuous Access to Affiliate Information)

NASD Rule 1017 currently requires a member firm to file a CMA when there is a 25 percent or more change in its equity ownership or partnership capital. While FINRA has found that the 25 percent threshold is sufficient to meet some regulatory concerns, FINRA is also aware that knowledge of certain transactions and/or patterns of transactions (whether or not coordinated) that occur below the 25 percent threshold is useful in maintaining effective oversight of member firms by identifying potential regulatory issues. For example, a 20 percent change of ownership of a broker-dealer purchased at a price reflecting 100 percent of the broker-dealer’s value can be a transaction structured to circumvent filing a CMA. Further, when a member firm’s senior management does not remain at the firm beyond the asset transaction transition period this may also indicate a potential regulatory issue. Additionally, in instances where a business expansion occurs (especially where the expansion requires a substantial infusion of capital or requires additional licenses or other regulatory or agency approval), FINRA has discovered that these expansions are often material events in the sense that they may have an impact on a firm’s supervisory and compliance infrastructure and/or finances. While current practices allow FINRA staff to review these changes on an ad hoc basis, they are not codified and present the risk that similar transactions may be given disparate treatment among the various districts.

Accordingly, proposed new FINRA Rule 1170 (Notice of Certain Member Changes and Continuous Access to Affiliate Information) requires a member firm to provide timely, prior written notice of certain significant changes in its business 30 days prior to the event's occurrence (or as soon as possible if circumstances make it impracticable to meet the 30-day time period), notwithstanding that such changes may not trigger a CMA filing. These events include:

1. direct or indirect acquisitions or divestitures of 10 percent or more in the aggregate of the member's assets or any asset, business or line of operation that generates revenues comprising 10 percent or more in the aggregate of the member's revenues;
2. direct or indirect acquisitions or divestitures of 10 percent or more of the member's shares, partnership interests or other ownership interests by any one person or by a control group;
3. the addition, removal or subsequent modification of a business relationship between the member and an affiliate requiring disclosure under proposed FINRA Rule 1121;
4. a change or loss of the member's key personnel (such as its CEO, CFO, COO, CCO or any individual with similar status or functions);
5. a change in the member's service bureau, clearance activities (other than those that would require a CMA pursuant to proposed FINRA Rule 1160) or method of bookkeeping or recordkeeping, or utilizing an outside service provider;
6. the expansion of business: (a) requiring an infusion of capital that is 25 percent or more of the member firm's net capital as calculated from the ending date of the member's previous FOCUS filing period, or (b) requiring additional licenses, registrations, memberships or approvals as required by a self-regulatory organization or other regulatory agency;
7. the expansion of business adding products or services that would be new in terms of the type of investments, transactions or risks from those business products or services offered by the member firm since the time of the last approval of a membership application;
8. increasing the number of sales personnel, office locations or markets made beyond the scope of the safe harbor provisions of proposed FINRA Rule 1160;
9. the listing of the member firm (on an identified or anonymous basis) on any facility or medium that is designed to solicit offers or inquiry with respect to the possible purchase of the member in whole or in part, or the transfer of some or all of the member's assets; or
10. the discovery of any existing or impending condition(s) that the member firm reasonably believes could lead to capital, liquidity or operational problems, or the impairment of recordkeeping, clearance or control functions.

Upon notice of items (5) through (8) or item (10), proposed FINRA Rule 1170 permits FINRA staff to determine whether such event would substantively affect the business or resources of the member and, in the public interest, require the member to submit a CMA.

Proposed FINRA Rule 1170 also clarifies that the disclosure of an event under the rule in no way obviates a member's obligation to make a CMA filing should the member determine, or have a reasonable basis to believe, that the event requires such a filing.

Additionally, proposed FINRA Rule 1170 requires a member firm to submit promptly any affiliate information that the member firm or applicant would otherwise be required to provide under FINRA's membership rules. This provision essentially incorporates NYSE Rule 416 and its related supplementary material, which requires NYSE member organizations to provide financial and operational reports for affiliated organizations if requested. As noted above, a member firm's affiliate information has previously been helpful in identifying potential regulatory issues.

J. Proposed FINRA Rule 1180 (Application to the SEC for Review)

As noted above, NASD Rule 1019 (Application to Commission for Review) permits a person aggrieved by final action of FINRA under the NASD Rule 1010 Series to apply for review by the SEC. The proposed rule change adopts NASD Rule 1019 as proposed FINRA Rule 1180 (Application to the SEC for Review) without substantive changes.

K. Proposed Eliminated Requirements

Finally, the proposed rule change deletes NYSE Rules 311, 312, 313, 321 and related supplementary materials and rule interpretations, NYSE Rule 416(a) and (c) and related supplementary material and NYSE Rule Interpretation 401/03 as either redundant or obsolete.

Endnotes

- 1 The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those member firms of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See SEA Section 19 and rules thereunder.
- 4 NASD IM-1013-1 (Membership Waive-In Process for Certain New York Stock Exchange Member Organizations) and NASD IM-1013-2 (Membership Waive-In Process for Certain NYSE Alternext US LLC Member Organizations) set forth a membership waive-in process for certain NYSE and NYSE Alternext US LLC (n/k/a NYSE Amex LLC) member organizations that, pursuant to certain conditions, were automatically eligible to become FINRA members. As discussed in further detail herein, FINRA is proposing to amend these provisions to reflect the expiration of the waive-in period.
- 5 FINRA recently eliminated NYSE Rule 312(f) from FINRA's rulebook in connection with the adoption of FINRA Rules 2262 (Disclosure of Control Relationship with Issuer) and 2269 (Disclosure of Participation or Interest in Primary or Secondary Distribution). See Exchange Act Release No. 60659 (September 11, 2009), 74 FR 48117 (September 21, 2009) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-044); see also *Regulatory Notice 09-60* (October 2009) (SEC Approves New Consolidated FINRA Rules) (announcing, among other things, the December 14, 2009, effective date of FINRA Rules 2262 and 2269).
- 6 FINRA is not addressing NYSE Rule Interpretation 401/04 in this proposed rule change but will consider it as part of its ongoing review and consolidation of FINRA's financial and operational rules.
- 7 See FINRA By-Laws, Art. I(h): "'controlling' shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting stock, by contract or otherwise. A person who is the owner of 20% or more of the outstanding voting stock of any corporation, partnership, unincorporated association or other entity shall be presumed to have control of such entity, in the absence of proof by a preponderance of the evidence to the contrary. Notwithstanding the foregoing, a presumption of control shall not apply where such person holds voting stock, in good faith, as an agent, bank, broker, nominee, custodian or trustee for one or more owners who do not individually or as a group have control of such entity."
- 8 NYSE Rule 304(e) was not incorporated into the FINRA rulebook.

© 2010 FINRA. All rights reserved. FINRA and other trademarks of the Financial Industry Regulatory Authority, Inc. may not be used without permission. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

2010 BD and IA Final Renewal Statements

Broker-Dealer, Investment Adviser Firm, Agent and Investment Adviser Representative, and Branch Renewals for 2010

Payment Deadline: February 5, 2010

Executive Summary

FINRA is issuing this *Notice* to help firms review, reconcile and respond to their Final Renewal Statements and reports that are currently available in Web CRD/IARD for the 2010 Registration Renewal Program.

Questions concerning this *Notice* should be directed to the FINRA Gateway Call Center at (301) 869-6699.

Background & Discussion

Final Renewal Statements

On January 4, 2010, Final Renewal Statements and reports became available for viewing and printing in Web CRD. These statements reflect the final status of broker-dealer, registered representative (AG), investment adviser firm and investment adviser representative (RA) registrations and/or notice filings as of December 31, 2009. Any adjustments in fees owed as a result of registration terminations, approvals, firm IA registrations or notice filings subsequent to the Preliminary Renewal Statement are included in this final reconciled statement.

January 2010

Notice Type

- Renewals

Suggested Routing

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

Key Topic(s)

- Web CRD®
- IARD™
- Renewals
- Registration

Referenced Rules & Notices

- Regulatory Notice 09-62

If the amount assessed on the Final Renewal Statement is greater than the amount assessed on the Preliminary Renewal Statement, the additional renewal fees are due by February 5, 2010. If the amount assessed on the Final Renewal Statement is less than the amount assessed on the Preliminary Renewal Statement, a credit will be issued to the firm's CRD/IARD Daily Account.

Final Renewal Statements include the following fees (if applicable):

- Web CRD system processing fees;
- FINRA branch office fees;
- FINRA branch renewal processing fees;
- BATS Exchange, Inc. (BATS), Boston Stock Exchange (BX), Chicago Board Options Exchange (CBOE), Chicago Stock Exchange (CHX), International Securities Exchange (ISE), NASDAQ Stock Market (NOX), New York Stock Exchange (NYSE), NYSE-Amex (AMEX), NYSE Arca, Inc. (ARCA) and Philadelphia Stock Exchange (PHLX) maintenance fees;
- state agent renewal fees;
- state BD renewal fees;
- state BD branch fees;
- investment adviser firm and representative renewal fees, if applicable; and
- broker-dealer and/or investment adviser branch renewal fees.

Full payment of the Final Renewal Statement fees must be posted to firms' Renewal Accounts with FINRA by February 5, 2010.

CRD Renewals Contact

As mentioned in *Regulatory Notice 09-62*, FINRA has added a CRD Renewals contact to the FINRA Contact System (FCS). FINRA encourages its registered firms to designate an individual who should receive important hardcopy and electronic notifications regarding the FINRA Renewal Program (e.g., the person responsible for paying the firm's registration renewal fees).

Renewal Payment

A Final Renewal Statement that reflects a zero balance requires no further action by the firm. If you believe your firm overpaid and is due a renewal refund, please check your firm's Daily (registration) Account to verify that the overpayment was transferred. All renewal overpayments were systematically transferred to firms' Daily Accounts on January 4, 2010. To request a refund check, the appropriate firm contact should send a request on firm letterhead to:

FINRA Finance Department
9509 Key West Avenue
Rockville, MD 20850

If the Final Renewal Statement reflects an amount due, FINRA must receive payment no later than February 5, 2010. Firms have four payment options:

1. Automatic Daily-to-Renewal Account Transfer;
2. Web CRD/IARD E-Pay;
3. check; or
4. wire transfer.

Automatic Daily-to-Renewal Account Transfer

To facilitate payment of renewal fees, FINRA will automatically transfer funds from a firm's Daily Account to its Renewal Account on February 5, 2010, the Final Renewal Statement payment deadline. FINRA will transfer funds only if a firm has sufficient funds available in its Daily Account on February 5 to cover the full amount due.

Please Note: If your firm does not want funds automatically transferred, ensure that payment is posted in your Renewal Account by February 5. Separately, if your firm wishes to transfer funds between affiliated firms, contact the Gateway Call Center at (301) 869-6699 for further instructions prior to the renewal deadline.

Web CRD/IARD E-Pay

The Web CRD/IARD E-Pay application is accessible from both the Preliminary and Final Renewal Statements and the FINRA (www.finra.org/crd) or IARD (www.iard.com) Web sites and allows a firm to make an electronic payment from a designated bank account to its Web CRD/IARD Renewal Account. Please note that in order for funds to be posted to a firm's Renewal Account by February 5, 2010, firms must submit payment electronically, no later than 8 p.m. Eastern Time on February 3, 2010.

Check

The check should be drawn on the firm's account. To ensure prompt processing of your renewal payment check:

- Include a printout of the first page of your Final Renewal Statement with payment. (**Do not** include any other forms or fee submissions.)
- Write your firm's CRD number and "Renewal" on the check memo line.
- Mail payment to:

U.S. Mail

FINRA
P.O. Box 7777-8705
Philadelphia, PA 19175-8705

(Note: This box will not accept courier or overnight deliveries.)

Overnight or Express Delivery

FINRA
8705
Mellon Bank Room 3490
701 Market Street
Philadelphia, PA 19106
Telephone: (301) 869-6699

Please note: The addresses for renewal payments are different from the addresses for funding firms' CRD/IARD Daily Account.

Wire Payment

A firm may wire full payment for its Final Renewal Statement by requesting its bank to initiate the wire transfer to: **"Mellon Financial, Philadelphia, PA."** A firm should provide its bank the following information:

Transfer funds to:	Mellon Financial, Philadelphia, PA
ABA Number:	031 000 037
Beneficiary:	FINRA
FINRA Account Number:	8-234-353
Reference Number:	Firm CRD number and "Renewals"

To ensure prompt processing of a renewal payment by wire transfer, remember to:

- Inform the bank that the funds are to be credited to the FINRA bank account.
- Provide the firm's CRD number and refer to the word "Renewal."
- Record the confirmation number of the wire transfer that the bank provides.

Renewal Reports

Renewal reports include all individual registrations renewed for 2010; however, they do not include registrations that were “pending approval” or “deficient” at year-end. Firms should examine their reports carefully to ensure that all registration approvals are properly listed. FINRA also suggests that firms include these reports in firms’ permanent records.

Firm Renewal Report: This report lists all renewed personnel with FINRA and participating regulators. Individuals whose registrations are “approved” with any of these regulators during November and December will be included in this report, while registrations that are still pending approval or are deficient at year-end will not be included. Firms should use this report to reconcile their records for renewal purposes.

Branches Renewal Report: This report lists each branch registered with FINRA and other regulators that renew branches registered with them through Web CRD/IARD for which the firm was assessed a fee. Firms should use this report to reconcile their records for renewal purposes.

Discrepancies

If a firm finds any discrepancies between its records and those maintained on Web CRD/IARD, the firm must report the discrepancy to FINRA at the same address used for refund requests. Firms should report all discrepancies by February 5, 2010. Copies of appropriate documentation from the firm’s Web CRD/IARD queues, such as a Web CRD-generated notice of termination, notification of deficient condition, or notice of approval, should be readily available.

The 2010 Renewal Program Bulletin, which contains detailed instructions to help firms complete the renewal process, is available at www.finra.org/renewals.

Financial Responsibility and Operational Rules

FINRA Requests Comments on Proposed Consolidated FINRA Rules Governing Securities Loans and Borrowings, Permissible Use of Customers' Securities and Callable Securities

Comment Period Expires: March 8, 2010

Executive Summary

As part of the process of developing a new, consolidated rulebook (the Consolidated FINRA Rulebook),¹ FINRA is requesting comment on three proposed FINRA rules. Proposed FINRA Rule 4314 (Securities Loans and Borrowings) sets forth the requirements applicable to a member firm that is a party to an agreement for the loan or borrowing of securities. Proposed FINRA Rule 4330 (Customer Protection— Permissible Use of Customers' Securities) sets forth the requirements applicable to a member firm's borrowing or lending of a customer's margin securities that are eligible to be pledged or loaned. Proposed FINRA Rule 4340 (Callable Securities) sets forth the obligations applicable to any callable securities a member firm has in its possession or control.

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

Questions regarding this *Notice* should be directed to:

- Kris Dailey, Vice President, Risk Oversight & Operational Regulation, at (646) 315-8434; or
- Yui Chan, Managing Director, Risk Oversight & Operational Regulation, at (646) 315-8426.

January 2010

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Systems

Key Topic(s)

- Books and Records
- Callable Securities
- Customer Funds and Securities
- Disclosure of Agency Capacity
- Lending and Borrowing Arrangements
- Liquidation
- Loan Consent Agreements
- Margin Securities
- Redemptions
- SIPC Protection

Referenced Rules & Notices

- NASD IM-2330
- NASD Rule 2330
- NYSE Rule 296
- NYSE Rule 402
- NYSE Rule 402.30
- NYSE Rule Interpretation 402(b)/01
- SEA Rule 15c3-3

Action Requested

FINRA encourages all interested parties to comment on the proposed rule. Comments must be received by March 8, 2010. 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.²

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

Discussion

I. Proposed FINRA Rule 4314 (Securities Loans and Borrowings)

A. Background

NYSE Rule 296 (Liquidation of Securities Loans and Borrowings)⁴ sets forth the obligations of a member that is party to an agreement with another member for the loan and borrowing of securities. Specifically, the rule provides that a member that is party to an agreement with another member for the loan and borrowing of securities has the right to liquidate such transaction whenever the other party to the transaction:

- (1) applies for or consents to a receiver, custodian, trustee or liquidator of itself or its property;
- (2) admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due;

- (3) makes a general assignment for the benefit of its creditors; or
- (4) files, or has filed against it, a petition for a Chapter 11 bankruptcy filing or a protective decree under Section 5 of the Securities Investor Protection Act of 1970 (SIPA) (liquidation conditions).

The rule further provides that no member may lend or borrow any security to or from any non-member of the NYSE, except pursuant to a written agreement, which may consist of the exchange of contract confirmations, which confers upon the member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified above.

NYSE Rule 296.10 defines the term “agreement for the loan and borrowing of securities,” for purposes of NYSE Rule 296. NYSE Rule 296.20 provides that each member that is subject to SEA Rule 15c3-3 and that borrows from a customer (as the term is defined in SEA Rule 15c3-3) must comply with Rule 15c3-3’s provisions requiring a written agreement between the borrowing member and the lending customer.

FINRA believes that the rule has been the basis for similar provisions incorporated in the industry standard Master Securities Lending Agreement (MSLA). Furthermore, FINRA believes that the rule provides protection to members that may enter into a securities lending transaction without a duly signed MSLA with a counterparty, should one of the counterparties become insolvent, allowing for the ability to immediately liquidate against collateral received.

FINRA proposes to adopt NYSE Rule 296 as FINRA Rule 4314 (Securities Loans and Borrowings) into the Consolidated FINRA Rulebook with the changes described below.

B. Proposed FINRA Rule 4314

In 2006, the industry began to adopt voluntary practices initiated by the SEC, including books and records and disclosure practices, as a result of an industry-wide initiative to address the risks associated with agency lending (the Agency Lending Disclosure Initiative). Consistent with the industry-wide initiative, FINRA is proposing a new requirement to address concerns about whether parties are acting as principals or agents when entering into an agreement to loan or borrow securities. The proposed rule requires a member firm that acts as agent in a loan or borrow transaction to disclose its capacity, and, in cases where the member firm lends securities to or borrows securities from a counterparty that is acting in an agency capacity, requires that the member firm maintain books and records to reflect the identity of both the agent and the principal(s) on whose behalf the agent is acting and the contract terms between the parties.

Specifically, proposed new FINRA Rule 4314(a) requires a member firm that enters into a transaction to lend or borrow securities as agent to disclose its capacity to the other party (or parties) to the transaction. The provision further requires the member firm, prior to lending securities to or borrowing securities from a person that is not a member of FINRA, to determine whether the other party is acting as principal or agent in the transaction. When the other party (who may or may not be a member) is acting as agent in the transaction, the member firm is required to maintain books and records that: (1) reflect the details of the transaction with each such agent; and (2) reflect each principal(s) on whose behalf the agent is acting and the details of each transaction therewith.

Proposed FINRA Rule 4314(b), based on NYSE Rule 296(a), continues to provide each member firm that is a party to an agreement with another member firm for the loan and borrowing of securities with the right to liquidate such transaction whenever the other party to such transaction becomes subject to one of the liquidation conditions specified in the rule.

In addition, FINRA is proposing to expand upon the written agreement requirement in NYSE Rule 296(b). Specifically, proposed FINRA Rule 4314(c) requires that no member firm shall lend or borrow securities to or from any person that is not a member of FINRA, except pursuant to a written agreement, which may consist of the exchange of contract confirmations, which confers upon such member the contractual right to liquidate such transaction because of a liquidation condition of the kind specified in proposed FINRA Rule 4314(b), as detailed above. In contrast, NYSE Rule 296(b) requires a member to have a written agreement only with any non-member of the NYSE. FINRA believes that expanding the requirement to have a written agreement with all non-members of FINRA, including any customer, protects the member firm's interests in the event of a liquidation condition specified in proposed FINRA Rule 4314(b) and supports the member's compliance with net capital requirements.

Further, FINRA is proposing to transfer NYSE Rule 296.10, which defines the term "agreement for the loan and borrowing of securities," as Supplementary Material .01 to proposed FINRA Rule 4314, without substantive change. In addition, FINRA is proposing to add new Supplementary Material .02 through .04 to the proposed FINRA rule. Proposed Supplementary Material .02 clarifies the methods by which a member firm may satisfy its disclosure obligation in new paragraph (a) by, among other things, providing specific disclosure of its capacity as agent in the written agreement between the parties or in the individual confirmations of each transaction between the parties. Proposed Supplementary Material .03 clarifies the books and records requirements imposed by new paragraph (a). Proposed Supplementary Material .04 reminds member firms of their obligations under proposed FINRA Rule 4330(b) (discussed further below) to provide a written notice when borrowing securities from customers regarding the associated risks of such transactions, and requires that member firms disclose in such written notice their right to liquidate under the conditions specified in paragraph (c) of proposed FINRA Rule 4314.

C. Eliminated Rules and Requirements

FINRA is proposing to eliminate existing NYSE Rule 296.20, which, as discussed above, requires each member firm that is subject to the provisions of SEA Rule 15c3-3 and that borrows securities from a customer to comply with the provisions relating to the requirements for a written agreement between the borrowing member and the lending customer, as the substance of this provision has been included in proposed FINRA Rule 4330(b).

FINRA is also proposing to eliminate NYSE Rule Interpretation 296(b)/01, which addresses transactions with non-member organizations and the written agreements required in regard to repurchase and reverse repurchase transactions not subject to SEA Rule 15c3-3, as the interpretation is beyond the scope of the proposed rule.

II. Proposed FINRA Rule 4330 (Customer Protection—Permissible Use of Customers' Securities)

A. Background

NYSE Rule 402(a)-(b) (Customer Protection—Reserves and Custody of Securities), NASD Rule 2330(b)-(d) (Customers' Securities or Funds) and NASD IM-2330 (Segregation of Customers' Securities) set forth the requirements applicable to a member firm's use of customers' securities. Specifically, NYSE Rule 402 and NASD Rule 2330 prohibit a member firm from lending, either to itself or others, securities that are held on margin for a customer and that are eligible to be pledged or loaned, unless the firm first obtains a written authorization from the customer permitting the lending of the customer's securities. NYSE Rule Interpretation 402(b)/01 (Agreements for Use of Customers' Securities/Application) permits a member firm to use a single customer-signed margin agreement/loan consent in lieu of obtaining separate written documents. Both the NYSE and NASD rules contain similar provisions requiring members to comply with SEA Rule 15c3-3 in obtaining custody and control of securities and maintaining appropriate cash reserves.

FINRA proposes to adopt NYSE Rule 402 as FINRA Rule 4330 (Customer Protection—Permissible Use of Customers' Securities), subject to certain significant changes, and eliminate NASD Rule 2330(b)-(d) and NASD IM-2330 as duplicative or otherwise unnecessary.

B. Proposed FINRA Rule 4330(a) (Authorization to Lend Customers' Margin Securities)

Proposed FINRA Rule 4330(a) continues to require a member firm to obtain a customer's written authorization prior to lending the customer's eligible margin securities. Also, proposed supplementary material retains and codifies NYSE Rule Interpretation 402(b)/01, thereby continuing to permit a member firm to satisfy the written authorization requirement by using a single customer-signed margin agreement/loan consent, provided that it contains a legend in bold type face placed directly above the signature line that states:

"BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

C. Proposed FINRA Rule 4330(b) (Requirements for Borrowing of Customers' Fully Paid or Excess Margin Securities)

Additionally, FINRA is proposing new requirements to address the increase in the borrowing and lending of customers' fully paid or excess margin securities. Specifically, proposed FINRA Rule 4330(b)(1) requires a member firm to notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to engaging in such activities. FINRA may request related information, including the written agreement authorizing such arrangements, the types of customers, the accounts used and the collateral involved in the transactions.

Proposed FINRA Rule 4330(b)(2) also imposes a new requirement that a member firm, prior to entering into a securities borrow transaction with a customer, provide the customer, in writing (which may be electronic), with a clear and prominent notice that the provisions of SIPA may not protect the customer with respect to such transaction and that the collateral delivered to the customer may constitute the only source of satisfaction of the member firm's obligation in the event the member firm fails to return the securities. In addition, a member firm would be required to provide the customer with information regarding risks associated with the transaction (*e.g.*, the potential loss of SIPC protection as described above, a loss of voting rights, possible limitations on the ability to sell the borrowed securities); the economics of the transaction, including potential tax implications; and the member firm's right to liquidate the transaction because of a condition of the kind specified in proposed FINRA Rule 4314(b) (Securities Loans and Borrowings—Right to Liquidate Transaction) (discussed above).

Additionally, proposed FINRA Rule 4330(b)(2) requires for the first time that a member firm determine whether the transaction is suitable for the customer. However, proposed supplementary material, while clarifying that the member firm borrowing a customer's securities is responsible for making the suitability determination regarding the customer, permits the member firm to rely on any representations made by another member firm that has a customer relationship with the lender. Proposed FINRA Rule 4330(b)(3) also requires that a member maintain books and records evidencing compliance with proposed FINRA Rule 4330(b)(2).

D. Eliminated Rules and Requirements

Proposed FINRA Rule 4330 does not retain the provisions in NYSE Rule 402 that are duplicative of the requirements in SEA Rule 15c3-3 or the outdated provisions regarding the physical segregation of securities. Additionally, the proposed rule change eliminates NASD Rule 2330(b)-(d) and NASD IM-2330, which contain similar duplicative and outdated provisions.

III. Proposed FINRA Rule 4340 (Callable Securities)

A. Background

NYSE Rule 402.30 (Securities Callable in Part) requires a member firm that has in its possession or control securities that are callable in part to identify each such security so that its records clearly show for whose account it is held. The following securities are exempt from this requirement:

- (1) certain bonds that have not paid interest for at least two interest periods;
- (2) Euro-dollar bonds deposited in a central clearing facility for such bonds, provided that customers are notified of the deposit into the central clearing facility and also that the member has the right to withdraw uncalled bonds from the facility at any time; and
- (3) bonds or preferred stocks, provided that the member has satisfied certain requirements, including adopting an impartial lottery system in which the probability of a customer's bonds or preferred stocks being selected as called is proportional to the holdings of all customers of such securities held in bulk by or for the member firm.

NYSE Rule 402.30 also requires that a member firm provide written disclosure to all customers of the systems and the manner in which securities are held and their rights to withdraw uncalled securities, as described above, prior to: (1) the member depositing the securities in bulk; or (2) the customer purchasing such securities, except in the case of a new account, provided that such notice was sent to the customer prior to the settlement date. The rule further requires that in the event of a favorable call of the securities, the member shall not allocate any securities to any account in which it or its general, limited, or special partners, officers, directors, approved persons or employees have an interest until all other customers' positions in the securities have been satisfied. There is no comparable NASD rule.

FINRA proposes to adopt FINRA Rule 4340 (Callable Securities), based in part on NYSE Rule 402.30. The proposed rule changes are detailed further below.

B. Proposed FINRA Rule 4340(a): Allocation Procedures and Customer Notice

Proposed FINRA Rule 4340(a) retains in concept the provision in NYSE Rule 402.30 requiring each member firm that has in its possession or control certain callable securities to establish procedures by which it will allocate among its customers the shares to be redeemed or selected as called in the event of a partial redemption or call. However, proposed FINRA Rule 4340(a) applies this provision to any security, which by its terms, may be called or redeemed prior to maturity.

The proposal eliminates the specific requirements in NYSE Rule 402.30 regarding the establishment of an impartial lottery system in which the probability of a customer's securities being selected as called is proportional to the holdings of all customers of such securities held in bulk by the member firm. Instead, proposed FINRA Rule 4340(a) adopts a more flexible approach and allows member firms to establish procedures that require the allocation to be conducted on a fair and impartial basis. Proposed supplementary material clarifies that such procedures may include the use of an impartial lottery system, acting on a pro-rata basis or such other means as will achieve a fair and impartial allocation of the partially redeemed or called securities.

Proposed FINRA Rule 4340(a) also requires the member firm to post its allocation procedures on its Web site and provide written notice (which may be electronic) to new customers at the opening of an account, and to all customers at least once every calendar year, explaining how customers may access the procedures on the member's Web site and that, upon a customer's request, the member will provide hard copies of the allocation procedures to the customer.

C. Proposed FINRA Rule 4340(b) and (c): Favorable and Unfavorable Redemptions

Proposed FINRA Rule 4340(b) retains in concept the restriction in NYSE Rule 402.30 prohibiting a member firm from allocating securities to any of its accounts or those of its "employees, partners, officers, directors, and approved persons" in a redemption offered on terms favorable to a customer until all other customers' positions have been satisfied. However, proposed FINRA Rule 4340(b) applies the restriction to a member and its "associated persons," rather than to a member's "employees, partners, officers, directors, and approved persons."

Proposed supplementary material clarifies that the term “associated person” as used in the proposed rule would have the meaning provided in Exchange Act Section 3(a)(18), which expressly excludes for certain purposes any persons associated with the member firm whose functions are solely clerical or ministerial (referred to as “clerical and ministerial associated persons”).⁵ Proposed supplementary material also makes clear that, in the event of a redemption offered on terms favorable to a customer, a member firm may include the accounts of clerical and ministerial associated persons in the pool of securities eligible to be called. However, where the redemption of callable securities is offered on terms unfavorable to a customer, proposed FINRA Rule 4340(c) expressly prohibits a member firm from excluding its accounts and those of its associated persons, including the accounts of clerical and ministerial associated persons, from the pool of securities eligible to be called.

Additionally, proposed supplementary material codifies that where an introducing member firm is a party to a carrying agreement with another member firm that is conducting an allocation pursuant to proposed FINRA Rule 4340(a), any account in which the introducing member firm or its associated persons have an interest shall be subject to the provisions regarding participation in favorable and unfavorable calls or redemptions. In addition, the introducing member firm must identify such accounts to the member firm conducting the allocation.

D. Eliminated Rules and Requirements

Finally, the proposed rule change eliminates NYSE Rule 402.30 in its entirety, including eliminating as unnecessary the rule’s provision permitting customers to withdraw uncalled fully paid securities at any time prior to a partial call, and also to withdraw excess margin securities, provided that the customers’ accounts are not subject to restrictions under Regulation T, or such withdrawals will not cause an under-margined condition.

Endnotes

- 1 The current FINRA rulebook consists of 1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those member firms of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See SEA Section 19 and rules thereunder.
- 4 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.
- 5 Although the FINRA By-Laws define associated persons, FINRA is proposing the Exchange Act definition of “associated person” to permit members to include accounts held by clerical and ministerial persons in favorable calls or redemptions.

Attachment A

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

* * * * *

Text of Proposed New FINRA Rules

* * * * *

4000. FINANCIAL AND OPERATIONAL RULES

* * * * *

4300. OPERATIONS

* * * * *

[Rule 296]4314. [Liquidation of] Securities Loans and Borrowings

(a) Disclosure of Parties' Capacity in Loan or Borrow Transactions

(1) A member that lends or borrows securities in the capacity of agent shall disclose such capacity to the other party (or parties) to the transaction.

(2) Prior to lending securities to or borrowing securities from a person that is not a member of FINRA, a member shall determine whether the other party is acting as principal or agent in such transaction.

(3) With respect to paragraphs (a)(1) and (2) above, when the other party to a security loan or borrow transaction is acting as agent in such transaction, the member shall:

(A) maintain books and records that reflect the details of the transaction with each such agent; and

(B) maintain books and records that reflect each principal(s) on whose behalf the agent is acting and the details of each transaction therewith.

([a]b) Right to Liquidate Transaction

Each member [or member organization] that is a party to an agreement with another member [or member organization] providing for the loan and borrowing of securities shall have the right to liquidate such transaction whenever the other party to such transaction:

(1) applies for or consents to, or is the subject of an application for, the appointment of or the taking of possession by a receiver, custodian, trustee, or liquidator of itself or of all or a substantial part of its property[.];

(2) admits in writing its inability, or becomes generally unable, to pay its debts as such debts become due[.];

(3) makes a general assignment for the benefit of its creditors[.]; or

(4) files, or has filed against it, a petition under Title 11 of the United States Code, or has filed against it an application for a protective decree under Section 5 of the Securities Investor Protection Act of 1970 ("SIPA")[.];

unless that right is stayed, avoided, or otherwise limited by an order authorized under the provisions of [the Securities Investor Protection Act of 1970] SIPA or any statute administered by the [Securities and Exchange Commission] SEC.

([b]c) Written Agreement with Non-Members

No member [or member organization] shall lend or borrow any security to or from any person that is not a member of FINRA [non-member of the Exchange], except pursuant to a written agreement, which may consist of the exchange of contract confirmations, that confers upon such member [or member organization] the contractual right to liquidate such transaction because of a condition of the kind specified in paragraph ([a]b) above.

• • • Supplementary Material: — — — — —

[.10].01 Definition of Agreement. [As used herein] For purposes of this Rule, an agreement for the loan and borrowing of securities shall mean a securities contract or other agreement, including related terms, for the transfer of securities against the transfer of funds, securities, or other collateral, with a simultaneous agreement by the transferee to transfer to the transfer or against the transfer of funds, securities, or other collateral, upon notice, at a date certain, or upon demand, the same or substituted securities.

.02 Disclosure of Capacity. A member may satisfy its disclosure obligation in paragraph (a)(1) of this Rule by, among other things, providing specific disclosure of its capacity as agent in the written agreement between the parties or in the individual confirmations of each security exchanged between the parties for each loan and borrow transaction.

.03 Details of Transactions with Parties Acting as Agents. For purposes of paragraph (a)(3) of this Rule, when entering into a security loan or borrow transaction with a party that is acting as agent on behalf of another principal(s), the member shall maintain a record of the details of each security loan or borrow with each agent, identifying the specific security and quantity loaned or borrowed, the contract value and the type and description of the collateral provided to such agent. In addition, the member's records shall reflect the quantity of securities loaned or borrowed from each principal on whose behalf the agent is acting and the amount and description of the collateral allocated to each such principal. Such records shall be maintained in accordance with the requirements of SEA Rule 17a-4(a).

.04 Compliance with Rule 4330 When Borrowing Securities from a Customer. When a member borrows securities from a customer, the member is also subject to Rule 4330(b)(2)(A)(ii), which requires members to provide information to customers regarding the risks associated with the customer's securities loan transaction. Such written notice shall include a disclosure of the right of the member to liquidate the borrow transactions with the customer, as provided by paragraph (c) of this Rule.

[.20 Each member or member organization subject to the provisions of Rule 15c3-3 under the Securities Exchange Act of 1934 that borrows securities from a customer (as defined in said rule) shall comply with the provisions thereof relating to the requirements for a written agreement between the borrowing member or member organization and the lending customer.]

* * * * *

[Rule 402]4330. Customer Protection—[Reserves and Custody of Securities] Permissible Use of Customers' Securities

[(a) General Provisions]

[Each member organization shall obtain custody and control of securities and maintain reserves as prescribed by Rule 15c3-3 promulgated under the Securities Exchange Act of 1934. For the purpose of this Rule the definitions contained in such Rule 15c3-3 shall apply.]

([b]a) [Agreements for Use of] Authorization to Lend Customers' Margin Securities

No member [organization] shall lend, either to itself [as a broker-dealer] or to others, securities [which] that are held on margin for a customer and [which] that are eligible to be pledged or loaned, unless such member [organization] shall first have obtained a written authorization from such customer permitting the [loan] lending of such securities [by the member organization].

(b) Requirements for Borrowing of Customers' Fully Paid or Excess Margin Securities

(1) A member that borrows fully paid or excess margin securities carried for the account of any customer shall comply with the requirements of SEA Rule 15c3-3 and shall notify FINRA, in such manner and format as FINRA may require, at least 30 days prior to engaging in such borrow activities.

(2) A member that engages in borrow activities pursuant to paragraph (b)(1) of this Rule shall, prior to entering into a securities borrow transaction with a customer:

(A) provide the customer, in writing (which may be electronic), with:

(i) clear and prominent notice stating that the provisions of the Securities Investor Protection Act of 1970 may not protect the customer with respect to the customer's securities loan transaction and that the collateral delivered to the customer may constitute the only source of satisfaction of the member's obligation in the event the member fails to return the securities; and

(ii) information regarding the risks associated with the customer's securities loan transaction, including but not limited to:

- a. potential loss of SIPC protection as described in paragraph (b)(2)(A)(i) of this Rule;
- b. loss of voting rights;
- c. the type and sufficiency of collateral provided to the customer;
- d. any limitations on the customer's ability to sell the loaned securities, if applicable;

e. the economics of the transaction, including potential tax implications, as applicable; and

f. the member's right to liquidate the transaction because of a condition of the kind specified Rule 4314(b); and

(B) determine that such transaction is suitable for the customer.

(3) A member that engages in borrow activities pursuant to paragraph (b)(1) of this Rule shall create and maintain records evidencing the member's compliance with the requirements of paragraph (b)(2) of this Rule.

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

.01 Definitions. For purposes of this Rule, the definitions contained in SEA Rule 15c3-3 shall apply.

.02 Authorization to Lend Customers' Margin Securities. For purposes of paragraph (a) of this Rule, members may use a single margin agreement/loan consent signed by a customer as written authorization to permit the lending of a customer's margin eligible securities in lieu of obtaining a separate written authorization. Such margin agreement/loan consent must contain a legend in bold type face placed directly above the signature line that states substantially the following:

"BY SIGNING THIS AGREEMENT I ACKNOWLEDGE THAT MY SECURITIES MAY BE LOANED TO YOU OR LOANED OUT TO OTHERS."

.03 Notification to FINRA. FINRA, upon receipt of a member's written notification pursuant to paragraph (b)(1) of this Rule of the member's intent to engage in such borrow activities, may request such additional information as it may deem necessary to evaluate compliance with SEA Rule 15c3-3 and other applicable FINRA rules or federal securities laws or rules. Examples of additional information include, but are not limited to:

(a) the written agreement authorizing such borrowing of securities, which shall reflect the material terms of the arrangement;

(b) the types of customers that are parties to such arrangements;

(c) the types of accounts used to effect such transactions (i.e., whether the subject securities are contained in customers' cash or margin accounts or separate accounts);

(d) the types of collateral provided to customers in connection with such transactions, the frequency of marking to market and the custody of such types of collateral;

(e) net capital compliance of such transactions;

(f) the operational and recordkeeping processes related to such transactions;

(g) the rebates paid/received in connection with such transactions and any other compensation arrangements related thereto; or

(h) the procedures for handling customers' requests to sell the fully paid or excess margin securities subject to such transactions; and

(i) any applicable disclosure requirements.

.04 Suitability Determination. The member borrowing a customer's fully paid or excess margin securities is responsible for making the suitability determination regarding the customer required by paragraph (b)(2)(B) of this Rule. However, in making that determination, the member may rely on the representations of another member that has a customer relationship with the lender.

[.30 Securities Callable in Part]

* * * * *

4340. Callable Securities

(a) Each member that has in its possession or control any security which, by its terms, may be called or redeemed prior to maturity, shall:

(1) establish and make available on the member's Web site procedures by which it will allocate among its customers, on a fair and impartial basis, the shares to be redeemed or selected as called in the event of a partial redemption or call; and

(2) provide written notice (which may be electronic) to new customers at the opening of an account, and all customers at least once every calendar year, of the manner in which they may access the allocation procedures on the member's Web site and that, upon a customer's request, the member will provide hard copies of the allocation procedures to the customer.

(b) Where redemption of callable securities is offered on terms favorable to a customer, a member shall not allocate the securities to any account in which it or its associated persons have an interest until all other customers' positions in such securities have been satisfied.

(c) Where the redemption of callable securities is made on unfavorable terms to a customer, a member shall not exclude its positions or those of its associated persons (including those persons performing solely clerical and ministerial functions) from the pool of the securities eligible to be called.

• • • Supplementary Material: — — — — —

.01 Definition of Associated Person; Clerical and Ministerial Functions. The term "associated person" as used in this Rule shall have the meaning provided in Section 3(a)(18) of the Exchange Act, which expressly excludes, for certain purposes, any person associated with the member whose functions are solely clerical or ministerial (referred to as "clerical and ministerial associated persons"). With respect to a redemption offered on terms favorable to a customer, for purposes of paragraph (b) of this Rule, a member may include the accounts of clerical and ministerial associated persons in the pool of the securities eligible to be called. With respect to a redemption offered on unfavorable terms to a customer, for purposes of paragraph (c) of this Rule, a member shall not exclude the accounts of clerical and ministerial associated persons from the pool of the securities eligible to be called.

.02 Allocations of Partial Redemptions or Calls. For purposes of paragraph (a)(1) of this Rule, a member's procedures may include the use of an impartial lottery system, acting on a pro-rata basis, or such other means as will achieve a fair and impartial allocation of the partially redeemed or called securities.

.03 Accounts of an Introducing Member and its Associated Persons. Where an introducing member is a party to a carrying agreement with another member that is conducting an allocation pursuant to paragraph (a) of this Rule, any accounts in which the introducing member or its associated persons have an interest shall be subject to paragraphs (b) and (c) of this Rule. The introducing member also shall identify such accounts to the member conducting the allocation.

Clearly Erroneous Transactions

SEC Approves Consolidated FINRA Rules Governing Clearly Erroneous Transactions

Effective Date: February 15, 2010

Executive Summary

On December 1, 2009, the SEC approved FINRA's proposed rule change¹ to adopt a new set of rules governing clearly erroneous transactions in the consolidated rulebook.² The new FINRA Rule 11890 Series replaces NASD Rule 11890, IM-11890-1 and IM-11890-2 and was adopted as part of a market-wide effort by multiple self-regulatory organizations to provide transparency and finality with respect to clearly erroneous executions. Among other things, the new rule series includes a new general rule defining "clearly erroneous" transactions, separate provisions for the determination of clearly erroneous transactions depending upon whether the transaction involves an exchange-listed security or an over-the-counter equity security and procedures for appealing FINRA clearly erroneous determinations. In addition, the new rule series codifies minimum numerical criteria necessary for a transaction to qualify as clearly erroneous.³

The text of the new rules is set forth on FINRA's Web site at www.finra.org/rulefilings/2009-068.

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

January 2010

Notice Type

- Consolidated FINRA Rulebook
- Rule Approval

Suggested Routing

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

Key Topic(s)

- Clearly Erroneous Transactions

Referenced Rules & Notices

- Information Notice 3/12/08
- Information Notice 10/6/08
- FINRA Rule 11890
- FINRA Rule 11891
- FINRA Rule 11892
- FINRA Rule 11893
- FINRA Rule 11894

Background

NASD Rule 11890 provides that, in the event of a disruption or malfunction related to the use or operation of any quotation, communication or trade reporting system owned or operated by FINRA, or under extraordinary market conditions, designated officers of FINRA can review an over-the-counter (OTC) transaction arising out of or reported through any such quotation, communication or trade reporting system. If any such officer determines that the transaction is clearly erroneous or that action is necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest, the officer may declare the transaction null and void or modify its terms. IM-11890-1 and IM-11890-2 address rulings made by FINRA and the UPC Committee pursuant to NASD Rule 11890 and the review of those rulings. These three rules provide important safeguards against market disruptions caused by trader errors, system malfunctions or other extraordinary events that result in erroneous executions affecting multiple market participants and/or securities. FINRA has used NASD Rule 11890 in the context of events affecting a single stock, such as an extraordinary erroneous order causing a large number of trades involving multiple market participants in a single stock, and events affecting multiple stocks, such as a system malfunction resulting in a more widespread problem.

As part of the process of developing the consolidated rulebook (Consolidated FINRA Rulebook), the SEC has approved FINRA's proposal to move NASD Rule 11890, IM-11890-1 and IM-11890-2 into the Consolidated FINRA Rulebook as part of a new FINRA Rule 11890 Series governing clearly erroneous transactions.⁴ FINRA has also amended these rules as part of a market-wide effort among multiple self-regulatory organizations (SROs) designed to provide transparency and finality with respect to clearly erroneous executions.⁵ This market-wide effort among SROs seeks to achieve consistent results for participants across U.S. equities exchanges while maintaining a fair and orderly market, protecting investors and protecting the public interest. Unlike the rules of the U.S. equities exchanges, however, FINRA's rules also address clearly erroneous executions in OTC Equity Securities.⁶

Discussion

The new FINRA Rule 11890 Series includes:

- (1) a general rule defining the term “clearly erroneous” (Rule 11891) with accompanying supplementary material;
- (2) a rule governing clearly erroneous determinations for transactions in exchange-listed securities (Rule 11892) with accompanying supplementary material;
- (3) a rule governing clearly erroneous determinations for transactions in OTC Equity Securities (Rule 11893) with accompanying supplementary material; and
- (4) a rule governing the review by the UPC Committee of FINRA staff determinations that a transaction was clearly erroneous (Rule 11894).

Each of these rules, and their accompanying supplementary material, are described in detail below.

FINRA Rule 11891: Definition & General Guidelines

FINRA Rule 11891 defines the term “clearly erroneous” for purposes of the FINRA Rule 11890 Series. The rule specifies that “the terms of a transaction are ‘clearly erroneous’ when there is an obvious error in any term, such as price, number of shares or other unit of trading, or identification of the security.” This definition is consistent with the definitions used by other SROs in the recently approved market-wide clearly erroneous rule amendments.⁷

FINRA has also adopted four paragraphs of supplementary material to Rule 11891 to address broader issues that arise under the clearly erroneous rules. Supplementary Material .01 is based on NASD IM-11890-1 regarding a member firm’s failure to abide by clearly erroneous determinations made by FINRA or the UPC Committee. Supplementary Material .02 and .03 set forth the general standards applicable to clearly erroneous determinations and clarify that FINRA generally considers a transaction to be clearly erroneous when there is a systemic problem that involves large numbers of parties or trades, or conditions where it would be in the best interests of the market. Further, extraordinary market conditions may include situations where an extraordinary event has occurred or is ongoing that has had a material effect on the market for a security traded over the counter or has caused major disruption to the marketplace. Supplementary Material .02 also emphasizes that firms are responsible for ensuring that the appropriate price and type of order are entered into FINRA systems.

Finally, Supplementary Material .04 specifically addresses suspicious trading activities, such as unauthorized trading activity or attempts to manipulate stock prices by illegally gaining access to legitimate accounts or opening new accounts using false information (often referred to as “account intrusion”). Although FINRA continues to be concerned about protecting markets from unauthorized or illegal activity like account intrusion that could disrupt a fair and orderly market, FINRA’s clearly erroneous authority does not extend to such suspicious trading activities. Rather, such activities relate to allegations of fraud and fall outside the scope of the clearly erroneous rules. Consequently, the supplementary material clarifies this position while also noting that firms should routinely review the adequacy of their internal controls and ensure that appropriate system safeguards are in place to minimize or eliminate the potential for account intrusion.

FINRA Rule 11892: Review of Transactions in Exchange-Listed Securities

Unlike NASD Rule 11890, which applies to transactions in both exchange-listed securities and OTC Equity Securities, the new FINRA Rule 11890 Series establishes different rules for determining whether a transaction is clearly erroneous depending upon whether the transaction involves an exchange-listed security or an OTC Equity Security. FINRA Rule 11892 establishes the criteria for exchange-listed securities, and FINRA Rule 11893 governs determinations involving transactions in OTC Equity Securities.

FINRA Rule 11892 and its supplementary material set forth the standards FINRA uses to determine whether a transaction in an exchange-listed security is clearly erroneous. Coordinating with other SROs with the goal of having consistency and transparency regarding the clearly erroneous process is important to the marketplace and to investors. For this reason, for OTC transactions in exchange-listed securities that are reported to a FINRA system, such as a FINRA Trade Reporting Facility (TRF) or the Alternative Display Facility (ADF), FINRA will generally follow the determination of a national securities exchange to break a trade (or multiple trades) when that national securities exchange has broken one or more trades at or near the price range in question at or near the time in question (in FINRA staff’s sole discretion) such that FINRA breaking such trade(s) would be consistent with market integrity and investor protection. When multiple national securities exchanges have related trades, FINRA will leave a trade(s) unbroken when any of those national securities exchanges has left a trade(s) unbroken at or near the price range in question at or near the time in question (in FINRA staff’s sole discretion) such that FINRA breaking such trade(s) would be inconsistent with market integrity and investor protection.⁸

With respect to OTC transactions in exchange-listed securities for which there is no corresponding or related on-exchange trading activity, FINRA will follow the exchanges' criteria when making a clearly erroneous determination. In this sector of the market, consistency in application of clearly erroneous authority across markets is critical to ensure that one investor does not receive disparate treatment based solely on the ultimate execution or reporting venue of his or her order. Consequently, for OTC transactions in exchange-listed securities that are reported to a FINRA system, such as a FINRA TRF or the ADF, but for which there is no corresponding or related on-exchange trading activity, FINRA will generally make its own clearly erroneous determination.⁹ As part of the market-wide effort to provide transparency to clearly erroneous determinations, the new rules establish minimum numerical thresholds for clearly erroneous transactions. To ensure that transactions in exchange-listed securities are treated consistently regardless of where the trade is executed (*i.e.*, on an exchange or OTC), Rule 11892 replicates the numerical thresholds used by the exchange SROs to determine whether a transaction is eligible for consideration as clearly erroneous.¹⁰ The rule also establishes provisions for the use of alternative reference prices in unusual circumstances, additional factors that FINRA may consider when making a clearly erroneous determination and numerical guidelines applicable to volatile market opens. Each of these provisions is modeled on similar provisions in the recently approved market-wide amendments.¹¹

The numerical guidelines for clearly erroneous determinations for transactions in exchange-listed securities are as follows:

Reference Price: Consolidated Last Sale	Normal Market Hours (9:30 a.m. Eastern Time (ET) to 4 p.m. ET) Numerical Guidelines (Subject Transaction's % Difference From the Consolidated Last Sale):	Outside Normal Market Hours Numerical Guidelines (Subject Transaction's % Difference From the Consolidated Last Sale):
Greater than \$0.00 up to and including \$25.00	10%	20%
Greater than \$25.00 up to and including \$50.00	5%	10%
Greater than \$50.00	3%	6%
Multi-stock event – filings involving five or more securities by the same member will be aggregated into a single filing	10%	10%
Leveraged ETF/ETN securities	Normal market hours numerical guidelines multiplied by the leverage multiplier (<i>i.e.</i> , 2x)	Normal market hours numerical guidelines multiplied by the leverage multiplier (<i>i.e.</i> , 2x)

FINRA Rule 11893: Review of Transactions in OTC Equity Securities

FINRA Rule 11893 governs clearly erroneous determinations involving transactions in OTC Equity Securities. The rule is structured similarly to FINRA Rule 11892, including numerical guidelines, the use of alternative reference prices in unusual circumstances and additional factors FINRA officers may consider when making a clearly erroneous determination. Because of the differences in the OTC and exchange markets, the numerical guidelines in Rule 11893 for transactions in OTC Equity Securities differ from the guidelines used for transactions in exchange-listed securities. In some instances, the percentage deviations set forth in the numerical guidelines for OTC Equity Security transactions are based on a sliding scale where the maximum percentage deviation applies to the lower execution price in the range and the minimum percentage deviation applies to the higher execution price in the range. The provisions in Rule 11893 regarding alternative reference prices and additional factors are substantially similar to those set forth in Rule 11892 for exchange-listed securities.

The numerical guidelines for clearly erroneous determinations for transactions in OTC Equity Securities are as follows:

Reference Price	Numerical Guidelines (Subject Transaction's Percentage Difference From the Reference Price)
\$0.9999 and under	20%
\$1.0000 and up to and including \$4.9999	Low end of range minimum 20% High end of range minimum 10%
\$5.0000 and up to and including \$74.9999	10%
\$75.0000 and up to and including \$199.9999	Low end of range minimum 10% High end of range minimum 5%
\$200.0000 and up to and including \$499.9999	5%
\$500.0000 and up to and including \$999.9999	Low end of range minimum 5% High end of range minimum 3%
\$1,000.0000 and over	3%

Supplementary material to Rule 11893 emphasizes that FINRA has historically exercised its clearly erroneous authority in very limited circumstances, particularly with respect to OTC Equity Securities. This more narrow approach for OTC Equity Securities is due to the differences in the OTC equity and exchange-listed markets, including the lack of compulsory information flows in the OTC equity market that come as a result of the listing process and the fact that aberrant trading in the OTC market is often due to issues other than systems problems or extraordinary events. The supplementary material also explains that FINRA does not expect to use its clearly erroneous authority in most situations; rather, FINRA expects the parties to settle any dispute privately.

FINRA Rule 11894: Review Procedures

As noted above, the new clearly erroneous rules remove language that allows a FINRA officer to modify one or more of the terms of a transaction under review. Under the new rules, a FINRA officer will have the authority only to declare transactions null and void. An executive vice president of FINRA's Market Regulation Department or Transparency Services Department, or any officer designated by such executive vice president, may, on his or her own motion, review any transaction arising out of or reported through any FINRA facility. With respect to determinations involving transactions in exchange-listed securities, absent extraordinary circumstances, the officer shall take action generally within 30 minutes after becoming aware of the transaction. When extraordinary circumstances exist, any such action of the officer must be taken no later than the start of trading on the day following the date of execution(s) under review. With respect to determinations involving transactions in OTC Equity Securities, a FINRA officer must make a determination as soon as possible after becoming aware of the transaction, but in all cases by 3 p.m., ET, on the next trading day following the date of the transaction at issue. If a FINRA officer declares any transaction null and void, FINRA will notify each party involved in the transaction as soon as practicable, and any party aggrieved by the action may appeal such action in accordance with Rule 11894, unless the officer making the determination also determines that the number of affected transactions is such that immediate finality is necessary to maintain a fair and orderly market and to protect investors and the public interest.

Rule 11894 codifies the provisions governing the appeal to the UPC Committee of a FINRA officer's determination to declare an execution null and void.¹² NASD IM-11890-2, which concerns review by panels of the UPC Committee, has been incorporated into the text of Rule 11894. Under the rule, an appeal must be made in writing and must be received by FINRA within 30 minutes after the person making the appeal is given the notification of the determination being appealed. With respect to appeals regarding exchange-listed securities, the UPC Committee will render determinations as soon as practicable, but generally on the same trading day as the execution(s) under review. On requests for appeal received after 3 p.m., ET, the UPC Committee will render a determination as soon as practicable, but in no case later than the trading day following the date of the execution(s) under review. With respect to appeals regarding OTC Equity Securities, the committee will render determinations as soon as practicable, but in no case later than two trading days following the date of the execution(s) under review.

Endnotes

- 1 See Securities Exchange Act Release No. 61080 (December 1, 2009), 74 FR 64117 (December 7, 2009) (Order Granting Approval to Proposed Rule Change; SR-FINRA-2009-068).
- 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 FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).
- 3 FINRA notes that, in devoting this *Notice* to announcing the effective date of a single set of rules and rule amendments, it is deviating from the protocol by which FINRA generally announces the effective dates of the new FINRA rules that are being adopted as part of the Consolidated FINRA Rulebook. See *Information Notice 10/06/08* (Rulebook Consolidation Process: Effective Dates of New Consolidated Rules; Introduction of Rule Conversion Chart). FINRA believes that a single *Notice* devoted to the new clearly erroneous rules is warranted in view of the market-wide amendments to multiple SRO clearly erroneous rules and the nature of the changes.
- 4 The rules concerning clearly erroneous transactions are part of the Uniform Practice Code (UPC). The rule filing approved by the SEC approved only the transfer of NASD Rule 11890, IM-11890-1 and IM-11890-2 into the Consolidated FINRA Rulebook. FINRA will address the remaining rules in the UPC in a separate rule filing.

© 2010 FINRA. All rights reserved. FINRA and other trademarks of the Financial Industry Regulatory Authority, Inc. may not be used without permission. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

Endnotes continued

- 5 *See, e.g.*, Securities Exchange Act Release No. 60706 (September 22, 2009), 74 FR 49416 (September 28, 2009) (approving NYSE Arca's amendments to its clearly erroneous rules); Securities Exchange Act Release No. 60776 (October 2, 2009), 74 FR 51891 (October 8, 2009) (approving Nasdaq's amendments to its clearly erroneous rules); Securities Exchange Act Release No. 60781 (October 2, 2009), 75 FR 51926 (October 8, 2009) (approving NYSE's amendments to its clearly erroneous rules for equity securities).
- 6 For purposes of the clearly erroneous rules, the term "OTC Equity Security" has the same meaning as defined in FINRA Rule 6420, except that the term does not include any equity security that is traded on any national securities exchange.
- 7 *See* NASDAQ Rule 11890(a)(1); NYSE Rule 128(a); NYSE Arca Rule 7.10(a). *See also* Securities Exchange Act Release No. 60706 (September 22, 2009), 74 FR 49416 (September 28, 2009) (approving SR-NYSE-Arca-2009-36).
- 8 Under NASD Rule 11890, if a FINRA officer determined that a transaction was clearly erroneous, the officer could modify the terms of a transaction or declare the transaction null and void. Under FINRA Rules 11892 and 11893, FINRA's ability to modify a clearly erroneous execution has been eliminated, and a FINRA officer can only declare the transaction null and void.
- 9 The FINRA rules do not allow member firms to initiate reviews of transactions. All reviews conducted by FINRA are conducted on FINRA's own motion.
- 10 *See* FINRA Rule 11892(b)(1); NASDAQ Rule 11890(a)(2)(C); NYSE Rule 128(c)(1); NYSE Arca Rule 7.10(c)(1).
- 11 *See* FINRA Rule 11892; NASDAQ Rule 11890; NYSE Rule 128; NYSE Arca Rule 7.10.
- 12 A FINRA officer's determination not to break a trade is not appealable.

Deferred Variable Annuities

FINRA Reminds Firms of Their Responsibilities Under FINRA Rule 2330 for Recommended Purchases or Exchanges of Deferred Variable Annuities

Executive Summary

FINRA reminds firms of their responsibilities under the new consolidated FINRA rule on deferred variable annuities.¹ The implementation date of the FINRA rule—as well as previously approved amendments to parts of the rule covering principal review and supervisory procedures—is February 8, 2010.² This *Notice* also addresses issues raised about a firm's ability to hold checks made payable to entities other than itself (third parties) pursuant to interpretive relief that FINRA previously issued.³

For easy reference, the text of new FINRA Rule 2330 is set forth in Attachment A.

Questions regarding this *Notice* should be directed to:

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

Background & Discussion

FINRA Rule 2330 (formerly NASD Rule 2821) establishes sales practice standards regarding recommended purchases and exchanges of deferred variable annuities.⁴ The rule has the following six main sections:

- ▶ General considerations, such as the rule's applicability;
- ▶ Recommendation requirements, including suitability and disclosure obligations;
- ▶ Principal review and approval obligations;

January 2010

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topic(s)

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

Referenced Rules & Notices

- ▶ FINRA Rule 2150
- ▶ FINRA Rule 2320
- ▶ FINRA Rule 2330
- ▶ NASD Rule 2330
- ▶ NASD Rule 2820
- ▶ NASD Rule 2821
- ▶ SEA Rule 15c3-1
- ▶ SEA Rule 15c3-3
- ▶ Regulatory Notice 07-53
- ▶ Regulatory Notice 09-32
- ▶ Regulatory Notice 09-72

- Requirements for establishing and maintaining supervisory procedures;
- Training obligations; and
- Supplementary material that addresses a variety of issues ranging from the handling of customer funds and checks to information gathering and sharing.

As noted above, all of the rule's provisions are applicable as of February 8, 2010.

Recently, questions have been raised regarding FINRA's limited interpretive relief from the requirements of FINRA Rule 2150(a) (formerly NASD Rule 2330(a)) and FINRA Rule 2320(d) (formerly NASD Rule 2820(d)).⁵ The former rule generally prohibits firms from making improper use of customer funds, and the latter requires firms to transmit promptly to issuers applications and purchase payments for variable contracts. FINRA provided limited interpretive relief from these rules to allow firms to perform comprehensive and rigorous reviews of recommended transactions in deferred variable annuities under FINRA Rule 2330.⁶

FINRA originally stated that "a firm may hold an application for a deferred variable annuity and a customer's non-negotiated check payable to an insurance company for up to seven business days without violating either NASD Rule 2330 or 2820 if the reason for the hold is to allow completion of principal review of the transaction pursuant to NASD Rule 2821."⁷ After the SEC approved amendments that changed the starting point for the review period—from the date when the customer signs the application to the date when a firm's office of supervisory jurisdiction (OSJ) receives a complete and correct application package—FINRA explained that its limited interpretive relief "continues to apply even though the triggering event for the principal review period has changed via the recently approved amendments."⁸

Concerns have been expressed, however, regarding the breadth of the interpretive relief and the conditions that must be present for it to apply. FINRA now clarifies that the interpretive relief applies only if the seven conditions delineated below are present.⁹

1. The reason that the firm is holding the application for a deferred variable annuity and/or a customer's non-negotiated check payable to a third party is to allow completion of principal review of the transaction pursuant to FINRA Rule 2330.
2. The associated person who recommended the purchase or exchange of the deferred variable annuity makes reasonable efforts to safeguard the check and to promptly prepare and forward a complete and correct copy of the application package to an OSJ.
3. The firm has policies and procedures in place that are reasonably designed to ensure that the check is safeguarded and that reasonable efforts are made to promptly prepare and forward a complete and correct copy of the application package to an OSJ.

4. A principal reviews and makes a determination of whether to approve or reject the purchase or exchange of the deferred variable annuity in accordance with the provisions of FINRA Rule 2330.
5. The firm holds the application and/or check no longer than seven business days from the date an OSJ receives a complete and correct copy of the application package.
6. The firm maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company or returned to the customer.
7. The firm creates a record of the date when the OSJ receives a complete and correct copy of the application package.

If these seven conditions are not present, FINRA's interpretive relief will not apply and it will enforce FINRA Rules 2150(a) and 2320(d), as appropriate.

Endnotes

- 1 On November 20, 2009, the Financial Industry Regulatory Authority, Inc. (FINRA) filed with the Securities and Exchange Commission (SEC or Commission) a proposed rule change, for immediate effectiveness, to transfer NASD Rule 2821 into the Consolidated FINRA Rulebook, as FINRA Rule 2330, without any substantive changes. See Exchange Act Release No. 61122 (December 7, 2009), 74 FR 65816 (December 11, 2009) (File No. SR-FINRA-2009-083); *Regulatory Notice 09-72* (December 2009) (discussing adoption of consolidated FINRA rules, including FINRA Rule 2330 covering deferred variable annuities). 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 members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice, 3/12/08* (Rulebook Consolidation Process).
- 2 See Exchange Act Release No. 61122 (December 7, 2009), 74 FR 65816 (December 11, 2009) (File No. SR-FINRA-2009-083); *Regulatory Notice 09-72* (December 2009) (discussing adoption of consolidated FINRA rules and an operative date for FINRA Rule 2330 of February 8, 2010); Exchange Act Release No. 59772 (April 15, 2009), 74 FR 18419 (April 22, 2009) (Order Approving File No. SR-FINRA-2008-019); *Regulatory Notice 09-32* (June 2009) (announcing SEC approval of amendments to NASD Rule 2821 governing purchases and exchanges of deferred variable annuities and an effective date for those

© 2010 FINRA. All rights reserved. FINRA and other trademarks of the Financial Industry Regulatory Authority, Inc. may not be used without permission. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

Endnotes continued

- amendments of February 8, 2010). FINRA notes that paragraphs (a) (General Considerations), (b) (Recommendation Requirements), and (e) (Training) of NASD Rule 2821 became effective on May 5, 2008. *See Regulatory Notice 07-53* (November 2007).
- 3 *See Regulatory Notice 07-53* (November 2007); *see also Regulatory Notice 09-32* (June 2009).
 - 4 In general, a variable annuity is a contract between an investor and an insurance company, whereby the insurance company promises to make periodic payments to the contract owner or beneficiary, starting immediately (an immediate variable annuity) or at some future time (a deferred variable annuity). *See Joint SEC and NASD Staff Report on Broker-Dealer Sales of Variable Insurance Products* (June 2004), available at www.sec.gov/news/studies/secnasdvip.pdf.
 - 5 *See Regulatory Notice 07-53* (November 2007); *see also Regulatory Notice 09-32* (June 2009).
 - 6 *See Regulatory Notice 07-53* (November 2007); *see also Regulatory Notice 09-32* (June 2009). The SEC previously has noted that “many broker-dealers are subject to lower net capital requirements under SEA Rule 15c3-1 and are exempt from the requirement to establish and fund a customer reserve account under SEA Rule 15c3-3 because they do not carry customer funds or securities.” *See Exchange Act Release No. 56376* (Sept. 7, 2007), 72 FR 52400 (Sept. 13, 2007) (Order Granting Exemption to Broker-Dealers from Requirements in SEA Rules 15c3-1 and 15c3-3 to Promptly Transmit Customer Checks). Although some of these firms receive checks from customers made payable to third parties, the SEC does not deem a firm to be carrying customer funds if it “promptly transmits” the checks to third parties. The SEC has interpreted “promptly transmits” to mean that “such transmission or delivery is made no later than noon of the next business day after receipt of such funds or securities.” *Id.* at 52400.
- The SEC provided a conditional exemption for broker-dealers from any additional requirements of Rules 15c3-1 and 15c3-3 due solely to a failure to promptly transmit a check made payable to an insurance company for the purchase of a deferred variable annuity product by noon of the business day following the date the broker-dealer receives the check from the customer, provided (i) the transaction is subject to the principal review requirements of NASD Rule 2821 and a registered principal has reviewed and determined whether he or she approves of the purchase or exchange of the deferred variable annuity within seven business days in accordance with that rule; (ii) the broker-dealer promptly transmits the check no later than noon of the business day following the date a registered principal reviews and determines whether he or she approves of the purchase or exchange of the deferred variable annuity; and (iii) the broker-dealer maintains a copy of each such check and creates a record of the date the check was received from the customer and the date the check was transmitted to the insurance company if approved, or returned to the customer if rejected. *Id.* at 52400. In its order approving recent amendments, the SEC explained that the exemption order continues to apply, notwithstanding the new starting point for the principal review period under NASD Rule 2821. *See Exchange Act Release No. 59772* (April 15, 2009), 74 FR 18419, at 18422 n.37 (April 22, 2009) (Order Approving File No. SR-FINRA-2008-019).

Endnotes continued

- 7 *Regulatory Notice 07-53* (November 2007).
- 8 *Regulatory Notice 09-32* (June 2009).
- 9 FINRA emphasizes that firms are not required to collect and hold checks or funds prior to principal review and approval. A firm may elect to wait until after a principal approves the transaction to collect the check or funds for a deferred variable annuity. Moreover, in accordance with Supplementary Material .03 under FINRA Rule 2330, a firm can forward a check made payable to the insurance company or, if the firm is fully subject to SEA Rule 15c3-3, transfer “funds for the purchase of a deferred variable annuity to the insurance company prior to the member’s principal approval of the deferred variable annuity, as long as the member fulfils the following requirements: (a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and (b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member’s principal approval and is provided with the application or is notified of the member’s principal rejection,

it will (1) segregate the member’s customers’ funds in a ‘Special Account for the Exclusive Benefit of Customers’ (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers’ funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers, (2) not issue the variable annuity contract prior to the member’s principal approval, and (3) promptly return the funds to each customer at the customer’s request prior to the member’s principal approval or upon the member’s rejection of the application.”

Attachment A

Text of FINRA Rule 2330

* * * * *

2000. DUTIES AND CONFLICTS

* * * * *

2300. SPECIAL PRODUCTS

* * * * *

2330. Members' Responsibilities Regarding Deferred Variable Annuities

* * * * *

(a) General Considerations

(1) Application

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

(2) Creation, Storage, and Transmission of Documents

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

(3) Definitions

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

(b) Recommendation Requirements

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

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

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

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

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

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

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

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

(iii) the customer has had another deferred variable annuity exchange within the preceding 36 months.

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

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

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

(c) Principal Review and Approval

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

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

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

(d) Supervisory Procedures

In addition to the general supervisory and recordkeeping requirements of NASD Rules 3010, 3012, and 3110, and Rule 3130, a member must establish and maintain specific written supervisory procedures reasonably designed to achieve compliance with the standards set forth in this Rule. The member also must (1) implement surveillance procedures to determine if any of the member's associated persons have rates of effecting deferred variable annuity exchanges that raise for review whether such rates of exchanges evidence conduct inconsistent with the applicable provisions of this Rule, other applicable FINRA rules, or the federal securities laws ("inappropriate exchanges") and (2) have policies and procedures reasonably designed to implement corrective measures to address inappropriate exchanges and the conduct of associated persons who engage in inappropriate exchanges.

(e) Training

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

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

.01 Depositing of Funds by Members Prior to Principal Approval. Under Rule 2330, a member that is permitted to maintain customer funds under SEA Rules 15c3-1 and 15c3-3 may, prior to the member's principal approval of the deferred variable annuity, deposit and maintain customer funds for a deferred variable annuity in an account that meets the requirements of SEA Rule 15c3-3.

.02 Treatment of Lump-Sum Payment for Purchases of Different Products. If a customer provides a member that is permitted to hold customer funds with a lump sum or single check made payable to the member (as opposed to being made payable to the insurance company) and requests that a portion of the funds be applied to the purchase of a deferred variable annuity and the rest of the funds be applied to other types of products, Rule 2330 would not prohibit the member from promptly applying those portions designated for purchasing products other than a deferred variable annuity to such use. A member that is not permitted to hold customer funds can comply with such requests only through its clearing firm that will maintain customer funds for the intended deferred variable annuity purchase in an account that meets the requirements of SEA Rule 15c3-3. In such circumstances, the checks would need to be made payable to the clearing firm.

.03 Forwarding of Checks/Funds to Insurer Prior to Principal Approval. Rule 2330 does not prohibit a member from forwarding a check made payable to the insurance company or, if the member is fully subject to SEA Rule 15c3-3, transferring funds for the purchase of a deferred variable annuity to the insurance company prior to the member's principal approval of the deferred variable annuity, as long as the member fulfills the following requirements: (a) the member must disclose to the customer the proposed transfer or series of transfers of the funds and (b) the member must enter into a written agreement with the insurance company under which the insurance company agrees that, until such time as it is notified of the member's principal approval and is provided with the application or is notified of the member's principal rejection, it will (1) segregate the member's customers' funds in a bank in an account equivalent to the deposit of those funds by a member into a "Special Account for the Exclusive Benefit of Customers" (set up as described in SEA Rules 15c3-3(k)(2)(i) and 15c3-3(f)) to ensure that the customers' funds will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the member, insurance company, or bank where the insurance company deposits such funds or any creditor thereof or person claiming through them and hold those funds either as cash or any instrument that a broker or dealer may deposit in its Special Reserve Account for the Exclusive Benefit of Customers, (2) not issue the variable annuity contract prior to the member's principal approval, and (3) promptly return the funds to each customer at the customer's request prior to the member's principal approval or upon the member's rejection of the application.

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

.05 Gathering of Information Regarding Customer Exchanges. Rule 2330 requires that the member or person associated with a member consider whether the customer has had another deferred variable annuity exchange within the preceding 36 months. Under this provision, a member or person associated with a member must determine whether the customer has had such an exchange at the member and must make reasonable efforts to ascertain whether the customer has had an exchange at any other broker-dealer within the preceding 36 months. An inquiry to the customer as to whether the customer has had an exchange at another broker-dealer within 36 months would constitute a "reasonable effort" in this context. Members shall document in writing both the nature of the inquiry and the response from the customer.

.06 Sharing of Office Space and/or Employees. Rule 2330 requires principal review and approval "[p]rior to transmitting a customer's application for a deferred variable annuity to the issuing insurance company for processing...." In circumstances where an insurance company and its affiliated broker-dealer share office space and/or employees who carry out both the principal review and the issuance process, FINRA will consider the application "transmitted" to the insurance company only when the broker-dealer's principal, acting as such, has approved the transaction, provided that the affiliated broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

.07 Sharing of Information. Rule 2330 does not prohibit using the information required for principal review and approval in the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer. For instance, the rule does not prohibit a broker-dealer from inputting information used as part of its suitability review into a shared database (irrespective of the media used for that database, i.e., paper or electronic) that the insurance company uses for the issuance process, provided that the broker-dealer and the insurance company have agreed that the insurance company will not issue the contract prior to principal approval by the broker-dealer.

* * * * *

Social Media Web Sites

Guidance on Blogs and Social Networking Web Sites

Executive Summary

Americans are increasingly using social media Web sites, such as blogs and social networking sites, for business and personal communications. Firms have asked FINRA staff how the FINRA rules governing communications with the public apply to social media sites that are sponsored by a firm or its registered representatives. This *Notice* provides guidance to firms regarding these issues.

Questions concerning this *Notice* may be directed to:

- Joseph E. Price, Senior Vice President, Advertising Regulation/ Corporate Financing, at (240) 386-4623; or
- Thomas A. Pappas, Vice President and Director, Advertising Regulation, at (240) 386-4500.

Background

According to a recent report by the Pew Internet and American Life Project, 46 percent of American adults who use the Internet logged onto a social networking site in 2009, which is up from 8 percent in 2005.¹ Other studies have shown that use of social media sites by businesses to communicate with customers and the public has grown significantly in the past few years.²

FINRA has provided guidance concerning particular applications of the communications rules to interactive Web sites in the past. For example, in March 1999, FINRA stated that a registered representative's participation in an Internet chat room is subject to the same requirements as a presentation in person before a group of investors.³ This guidance was codified in 2003, when FINRA defined the term "public appearance" in NASD Rule 2210 to include participation in an interactive electronic forum.⁴

January 2010

Notice Type

- Guidance

Suggested Routing

- Advertising
- Compliance
- Legal
- Operations
- Registered Representative
- Senior Management

Key Topics

- Blogs
- Communications with the Public
- Recordkeeping
- Social Networking Web Sites
- Supervision

Referenced Rules & Notices

- ICA Section 24(b)
- NASD Rule 2210
- NASD Rule 2310
- NASD Rule 2711
- NASD Rule 3010
- NASD Rule 3070
- NASD Rule 3110
- NYSE Rule 351
- NYSE Rule 401A
- NYSE Rule 410
- NYSE Rule 472
- NTM 01-23
- NTM 03-33
- Regulatory Notice 07-59
- Regulatory Notice 09-55
- SEA Rule 17a-3
- SEA Rule 17a-4
- Securities Act Rule 482

FINRA also has provided guidance regarding the application of the communication rules in its *Guide to the Internet for Registered Representatives*,⁵ and has released podcasts on these issues to help educate firms and their personnel.⁶ Nevertheless, FINRA staff has continued to receive numerous inquiries from firms and others concerning how the FINRA rules governing communications with the public apply to the use of social media sites by firms and their registered representatives. Firms also have inquired regarding their recordkeeping responsibilities for communications posted on social media sites.

In September 2009, FINRA organized a Social Networking Task Force composed of FINRA staff and industry representatives to discuss how firms and their registered representatives could use social media sites for legitimate business purposes in a manner that ensures investor protection. Based on input from the Task Force and others, and further staff consideration of these issues, FINRA is issuing this *Notice* to guide firms on applying the communications rules to social media sites, such as blogs and social networking sites. The goal of this *Notice* is to ensure that—as the use of social media sites increases over time—investors are protected from false or misleading claims and representations, and firms are able to effectively and appropriately supervise their associated persons' participation in these sites. At the same time, FINRA is seeking to interpret its rules in a flexible manner to allow firms to communicate with clients and investors using this new technology.

While many firms may find that the guidance in this *Notice* is useful when establishing their own procedures, each firm must develop policies and procedures that are best designed to ensure that the firm and its personnel comply with all applicable requirements. Every firm should consider the guidance provided by this *Notice* in the context of its own business and its compliance and supervisory programs.

This *Notice* only addresses the use by a firm or its personnel of social media sites for business purposes. The *Notice* does not purport to address the use by individuals of social media sites for purely personal reasons.

Questions & Answers

Recordkeeping Responsibilities

Q1: Are firms required to retain records of communications related to the broker-dealer's business that are made through social media sites?

A1: Yes. Every firm that intends to communicate, or permit its associated persons to communicate, through social media sites must first ensure that it can retain records of those communications as required by Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 and NASD Rule 3110. SEC and FINRA rules require that for record retention purposes, the content of the communication is determinative and a broker-dealer must retain those electronic communications that relate to its "business as such."⁷

FINRA is aware that some technology providers are developing systems that are intended to enable firms to retain records of communications made through social media sites. Some systems might interface with a firm's network to capture social media participation and feed it into existing systems for the review and retention of email. Other providers are developing technology that might permit a registered representative working off-site to elect to access social media through platforms that will retain the communications on behalf of the firm.

Of course, it is up to each firm to determine whether any particular technology, system or program provides the retention and retrieval functions necessary to comply with the books and records rules. FINRA does not endorse any particular technology necessary to keep such records, nor is it certain that adequate technology currently exists.

Suitability Responsibilities

Q2: If a firm or its personnel recommends a security through a social media site, does this trigger the requirements of NASD Rule 2310 regarding suitability?

A2: Yes. Whether a particular communication constitutes a "recommendation" for purposes of Rule 2310 will depend on the facts and circumstances of the communication. Firms should consult *Notice to Members (NTM) 01-23* (Online Suitability) for additional guidance concerning when an online communication falls within the definition of "recommendation" under Rule 2310.

Various social media sites include functions that make their content widely available or that limit access to one or more individuals. Rule 2310 requires a broker-dealer to determine that a recommendation is suitable for every investor to whom it is made.

Q3: What factors should firms consider when developing procedures for supervising interactive electronic communications on a social media site that recommend specific investment products?

A3: Communications that recommend specific investment products often present greater challenges for a firm's compliance program than other communications. As discussed above, they may trigger the FINRA suitability rule, thus creating possible substantive liability for the firm or a registered representative. These communications must often include additional disclosure in order to provide the customer with a sound basis for evaluating the facts with respect to the product. They also might trigger other requirements under the federal securities laws.⁸ FINRA has brought disciplinary actions regarding interactive electronic communications that contained misleading statements about investment products that the communications recommended.⁹

For these reasons, firms must adopt policies and procedures reasonably designed to address communications that recommend specific investment products. As a best practice, firms should consider prohibiting all interactive electronic communications that recommend a specific investment product and any link to such a recommendation unless a registered principal has previously approved the content.

Alternatively, many firms maintain databases of previously approved communications and provide their personnel with routine access to these templates. Firms might consider prohibiting communications that recommend a specific investment product unless the communication conforms to a pre-approved template and the specific recommendation has been approved by a registered principal. Firms also should consider adopting policies and procedures governing communications that promote specific investment products, even if these communications might not constitute a "recommendation" for purposes of our suitability rule or otherwise.

Types of Interactive Electronic Forums

The definition of "public appearance" in NASD Rule 2210 includes unscripted participation in an interactive electronic forum such as a chat room or online seminar. Rule 2210 does not require firms to have a registered principal approve in advance the extemporaneous remarks of personnel who participate in public appearances. However, these interactive electronic forums are subject to other supervisory requirements and to the content requirements of FINRA's communications rule.

- Q4:** Does a blog constitute an “interactive electronic forum” for purposes of Rule 2210?
- A4:** The treatment of a blog under Rule 2210 depends on the manner and purposes for which the blog has been constructed. Merriam-Webster’s Online Dictionary defines “blog” as “a Web site that contains an online personal journal with reflections, comments, and often hyperlinks provided by the writer.”¹⁰ Historically, some blogs have consisted of static content posted by the blogger. FINRA considers static postings to constitute “advertisements” under Rule 2210. If a firm or its registered representative sponsors such a blog, it must obtain prior principal approval of any such posting. Today, however, many blogs enable users to engage in real-time interactive communications. If the blog is used to engage in real-time interactive communications, FINRA would consider the blog to be an interactive electronic forum that does not require prior principal approval; however, such communications must be supervised, as discussed below.¹¹
- Q5:** Social networking sites, such as Facebook, Twitter and LinkedIn, typically include both static content and interactive functions. Are these sites interactive electronic forums for purposes of Rule 2210?
- A5:** Social networking sites typically contain both static and interactive content. The static content remains posted until it is changed by the firm or individual who established the account on the site. Generally, static content is accessible to all visitors to the site.

Examples of static content typically available through social networking sites include profile, background or wall information. As with other Web-based communications such as banner advertisements, a registered principal of the firm must approve all static content on a page of a social networking site established by the firm or a registered representative before it is posted.¹² Firms may use an electronic system to document these approvals.

Social networking sites also contain non-static, real-time communications, such as interactive posts on sites such as Twitter and Facebook. The portion of a social networking site that provides for these interactive communications constitutes an interactive electronic forum, and firms are not required to have a registered principal approve these communications prior to use. Of course, firms still must supervise these communications, as discussed below.

Supervision of Social Media Sites

Q6: How must firms supervise interactive electronic communications by the firm or its registered representatives using blogs or social networking sites?

A6: The content provisions of FINRA's communications rules apply to interactive electronic communications that the firm or its personnel send through a social media site. While prior principal approval is not required under Rule 2210 for interactive electronic forums, firms must supervise these interactive electronic communications under NASD Rule 3010 in a manner reasonably designed to ensure that they do not violate the content requirements of FINRA's communications rules.¹³

Firms may adopt supervisory procedures similar to those outlined for electronic correspondence in *Regulatory Notice 07-59* (FINRA Guidance Regarding Review and Supervision of Electronic Communications). As set forth in that *Notice*, firms may employ risk-based principles to determine the extent to which the review of incoming, outgoing and internal electronic communications is necessary for the proper supervision of their business.

For example, firms may adopt procedures that require principal review of some or all interactive electronic communications prior to use or may adopt various methods of post-use review, including sampling and lexicon-based search methodologies as discussed in *Regulatory Notice 07-59*. We are aware that technology providers are developing or may have developed systems that are intended to address both the books and records rules and supervisory procedures for social media sites that are similar or equivalent to those currently in use for emails and other electronic communications. FINRA does not endorse any particular technology. Whatever procedures firms adopt, however, must be reasonably designed to ensure that interactive electronic communications do not violate FINRA or SEC rules.

Firms are also reminded that they must have policies and procedures, as described in *Regulatory Notice 07-59*, for the review by a supervisor of employees' incoming, outgoing and internal electronic communications that are of a specific subject matter that require review under FINRA rules and federal securities laws, including:

- NASD Rule 2711(b)(3)(A) and NYSE Rule 472(b)(3), which require that a firm's legal and compliance department be copied on communications between non-research and research departments concerning the content of a research report;
- NASD Rule 3070(c) and NYSE Rule 351(d), which require the identification and reporting of customer complaints; NYSE Rule 401A requires that the receipt of each complaint be acknowledged by the firm to the customer within 15 business days; and

- NASD Rule 3110(j) and NYSE Rule 410, which require the identification and prior written approval of every order error and other account designation change.

Q7: What restrictions should firms place on which personnel may establish an account with a social media site?

A7: Firms must adopt policies and procedures reasonably designed to ensure that their associated persons who participate in social media sites for business purposes are appropriately supervised, have the necessary training and background to engage in such activities, and do not present undue risks to investors. Firms must have a general policy prohibiting any associated person from engaging in business communications in a social media site that is not subject to the firm's supervision. Firms also must require that only those associated persons who have received appropriate training on the firm's policies and procedures regarding interactive electronic communications may engage in such communications.

As firms develop their policies, they should consider prohibiting or placing restrictions on any associated person who has presented compliance risks in the past, particularly compliance risks concerning sales practices, from establishing accounts for business purposes with a social media site. In its supervision of social networking sites, each firm must monitor the extent to which associated persons are complying with the firm's policies and procedures governing the use of these sites. Firms also should consider policies that address associated persons' continued use of such sites if the firm's supervisory systems demonstrate compliance risks. Firms should take disciplinary action if the firm's policies are violated.

Third-Party Posts

Q8: If a customer or other third party posts content on a social media site established by the firm or its personnel, does FINRA consider the third-party content to be the firm's communication with the public under Rule 2210?

A8: As a general matter, FINRA does not treat posts by customers or other third parties as the firm's communication with the public subject to Rule 2210. Thus, the prior principal approval, content and filing requirements of Rule 2210 do not apply to these posts.

Under certain circumstances, however, third-party posts may become attributable to the firm. Whether third-party content is attributable to a firm depends on whether the firm has (1) involved itself in the preparation of the content or (2) explicitly or implicitly endorsed or approved the content.

The SEC has referred to circumstance (1) above as the “entanglement” theory (*i.e.*, the firm or its personnel is entangled with the preparation of the third-party post) and (2) as the “adoption” theory (*i.e.*, the firm or its personnel has adopted its content).¹⁴ Although the SEC has employed these theories as a basis for a company’s responsibility for third-party information that is hyperlinked to its Web site, a similar analysis would apply to third-party posts on a social media site established by the firm or its personnel.

For example, FINRA would consider such a third-party post to be a communication with the public by the firm or its personnel under the entanglement theory if the firm or its personnel paid for or otherwise was involved with the preparation of the content prior to posting. FINRA also would consider a third-party post to be a communication with the public by the firm or its personnel under the adoption theory if, after the content is posted, the firm or its personnel explicitly or implicitly endorses or approves the post.¹⁵

Q9: Must a firm also use a disclaimer to inform customers that third-party posts do not reflect the views of the firm and have not been reviewed by the firm for completeness or accuracy?

A9: Assuming the disclaimer was sufficiently prominent to inform investors of the firm’s position, such a disclaimer would be part of the facts and circumstances that FINRA would consider in an analysis of whether a firm had adopted or become entangled with a posting.

Q10: Must a firm monitor third-party posts?

A10: FINRA does not consider a third-party post to be a firm communication with the public unless the firm or its personnel either is entangled with the preparation of the third-party post or has adopted its content. Nevertheless, FINRA has found through its discussions with members of the Social Networking Task Force and others that many firms monitor third-party posts on firm Web sites. For example, some firms monitor third-party posts to mitigate the perception that the firm is adopting a third-party post, to address copyright issues or to assist compliance with the “Good Samaritan” safe harbor for blocking and screening offensive material under the Communications Decency Act.¹⁶

Some of the other best practices adopted by Task Force members include:

- ▶ establishing appropriate usage guidelines for customers and other third parties that are permitted to post on firm-sponsored Web sites;
- ▶ establishing processes for screening third-party content based on the expected usage and frequency of third-party posts; and
- ▶ disclosing firm policies regarding its responsibility for third-party posts.

Endnotes

- 1 See Amanda Lenhart, Pew Internet and American Life Project, *The Democratization of Online Social Networks* (Oct. 8, 2009), <http://fe01.pewinternet.org/Presentations/2009/41--The-Democratization-of-Online-Social-Networks.aspx>.
- 2 Sharon Gaudin, *Business Use of Facebook, Twitter Exploding*, Computerworld (Nov. 9, 2009), at www.computerworld.com/s/article/9140579/Business_use_of_Twitter_Facebook_exploding.
- 3 See “Ask the Analyst – Electronic Communications,” NASD Regulation, *Regulatory & Compliance Alert* (Mar. 1999) (“March 1999 Ask the Analyst”).
- 4 See NASD Rule 2210(a)(5).
- 5 See *Guide to the Internet for Registered Representatives*, at www.finra.org/Industry/Issues/Advertising/p006118.
- 6 See “Electronic Communications: Blogs, Bulletin Boards and Chat Rooms” (Feb. 23, 2009), and “Electronic Communications: Social Networking Web Sites” (Mar. 10, 2009) at www.finra.org/podcasts.

FINRA is also hosting webinars on compliance considerations for social networking sites on February 3 and March 17, 2010. Find more information at www.finra.org/webinars.
- 7 See, SEC Rel. No. 34-37182 (May 9, 1996), 61 Fed. Reg. 24644 (May 15, 1996); SEC Rel. No. 34-38245 (Feb. 5, 1997), 62 Fed. Reg. 6469 (Feb. 12, 1997); *Notice to Members 03-33* (July 2003).
- 8 For example, even if FINRA considers a communication made through an interactive electronic forum to be a public appearance, the SEC staff could still conclude that Rule 482 under the Securities Act of 1933 and the filing requirements of Section 24(b) of the Investment Company Act of 1940 apply to the communication. Accordingly, firms must consider these requirements in determining whether to permit interactive electronic communications that discuss registered investment companies.
- 9 For example, in a Default Decision dated November 23, 2009, FINRA fined and suspended a registered principal who held put options for himself and issued unapproved bulletin board messages that urged investors to sell the underlying stock. The bulletin board messages omitted material disclosure regarding his interest in the stock.
- 10 Merriam-Webster’s Online Dictionary, definition of “blog,” at <http://www.merriam-webster.com/dictionary/BLOG>.
- 11 The key to this distinction between whether a blog is considered an advertisement versus an interactive electronic forum is whether it is used to engage in real-time interactive communications with third parties. Thus, the mere updating of a non-interactive blog (or any other firm Web page) does not cause it to become an interactive electronic forum, even if the updating occurs frequently.
- 12 Currently, NASD Rule 2210(b) requires that a registered principal of a firm approve all advertisements and sales literature prior to use either electronically or in writing. FINRA has proposed amendments to this rule. These amendments would retain this prior to use principal approval requirement for “retail communications” as defined in the proposal. See *Regulatory Notice 09-55* (Sept. 2009).

© 2010 FINRA. All rights reserved. FINRA and other trademarks of the Financial Industry Regulatory Authority, Inc. may not be used without permission. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

Endnotes continued

- 13 *See, e.g.*, March 1999 Ask the Analyst, *supra* note 3.
- 14 *See Commission Guidance on the Use of Company Web Sites*, SEC Rel. No. 34-58288 (Aug. 1, 2008), 73 Fed. Reg. 45862, 45870 (Aug. 7, 2008) (“2008 SEC Release”); *Use of Electronic Media*, SEC Rel. No. 33-7856 (April 28, 2000), 65 Fed. Reg. 25843, 25848-25849 (May 4, 2000).
- 15 *See* 2008 SEC Release, *supra* note 14, 65 Fed. Reg. 45870 n.78.
- 16 *See* 47 U.S.C. § 230(c).

Trade Reporting

SEC Approves Amendments to FINRA Rules on Reporting Cancellations of Previously Reported OTC Trades in Equity Securities

Effective Date: April 12, 2010

Executive Summary

Effective Monday, April 12, 2010, firms are no longer prohibited from reporting trade cancellations to the FINRA/NASDAQ Trade Reporting Facility and the OTC Reporting Facility after 5:15 p.m. Eastern Time on trade date, as described more fully in this *Notice*. Firms are reminded that they must report the cancellation of any previously reported over-the-counter transaction in an equity security to FINRA, in accordance with FINRA trade reporting rules.

The text of the amendments is available at www.finra.org/rulefilings/2009-082.

Questions regarding this *Notice* may be directed to:

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

January 2010

Notice Type

- Rule Amendment

Suggested Routing

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

Key Topic(s)

- Alternative Display Facility
- NMS Stocks
- OTC Equity Securities
- OTC Reporting Facility
- Trade Cancellations
- Trade Reporting
- Trade Reporting Facilities

Referenced Rules & Notices

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

Background and Discussion

FINRA rules require firms to report the cancellation of any over-the-counter (OTC) trade that was previously submitted to a FINRA trade reporting facility within certain prescribed time periods.¹ On January 14, 2010, the SEC approved amendments to the rules to (1) allow firms to submit reports of trade cancellations on trade date until the close of the FINRA/NASDAQ Trade Reporting Facility (FINRA/NASDAQ TRF) and the OTC Reporting Facility (ORF) at 8 p.m. Eastern Time (ET); and (2) make certain changes to the requirements applicable to reporting trade cancellations to the Alternative Display Facility (ADF) to conform to the rules relating to the other FINRA trade reporting facilities.²

Thus, for example, in accordance with the amendments, if a trade executed during normal market hours (*i.e.*, 9:30 a.m. to 4 p.m. ET) is canceled on trade date, the firm must report the cancellation to FINRA as follows:

- 1) if the trade is canceled during normal market hours, the firm must report the cancellation within 90 seconds;
- 2) if the trade is canceled after 4 p.m. and before the FINRA facility closes, the firm shall use its best efforts to report the cancellation on the date of execution, and otherwise it shall report on the following business day; and
- 3) if the trade is canceled after the FINRA facility closes, the firm must report the cancellation on the following business day.³

Prior to the amendments, the rules governing the reporting of trade cancellations to the FINRA/NASDAQ TRF and ORF were based on the traditional 5:15 p.m. ET “media” cut-off time (*i.e.*, for the submission of trades for public dissemination purposes) and prohibited the reporting of trade cancellations after 5:15 p.m. on trade date; if a firm did not report a trade cancellation by 5:15 p.m. on trade date, then it was required—by rule and systems limitations—to wait until the next day to report the cancellation. The amendments eliminate this prohibition.

As a result, trade cancellations will be submitted to the Securities Information Processors (SIPs) by the FINRA/NASDAQ TRF and to the Trade Data Dissemination Service (TDDS) feed by the ORF after 5:15 p.m. on trade date, and the SIP high price/low price/last sale price calculations for the day will be updated after 5:15 p.m. FINRA notes that the current rules governing the reporting of cancellations to the ADF and FINRA/NYSE Trade Reporting Facility (FINRA/NYSE TRF) are not based on the 5:15 p.m. media cut-off, and, as such, cancellations of trades submitted to the ADF and FINRA/NYSE TRF after 5:15 p.m. update the SIP high/low/last calculations today.

Firms are reminded that they are required to report the cancellation of a trade to the same FINRA facility to which the trade was originally reported.⁴

Endnotes

- 1 See Rules 6282(j), 6380A(g), 6380B(f) and 6622(f).
- 2 See Securities Exchange Act Release No. 61359 (January 14, 2010), 75 FR 3772 (January 22, 2010) (Order Approving SR-FINRA-2009-082).
- 3 FINRA notes that, as a technical matter, the firm would reverse the trade on any date other than trade date (if on trade date, the firm would cancel the trade). See, e.g., *Trade Reporting Frequently Asked Questions*, #305.6. The rules apply uniformly to cancellations and reversals.
- 4 See Rules 6282(j), 6380A(g), 6380B(f) and 6622(f).