February 2011

Notices

Regulatory Notices

Information Notice

Financial Industry Regulatory Authority

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

Regulatory Notice 11-05

Arbitration Panel Composition

Customer Option to Choose an All Public Arbitration Panel in All Cases

Effective Date: February 1, 2011

Executive Summary

Effective immediately, customers in FINRA arbitration have the option to choose an all public arbitration panel in all cases with three arbitrators.[1] FINRA amended the Code of Arbitration Procedure for Customer Disputes to allow customers with claims over $100,000 to choose between two panel composition methods. The first method, called the composition rules **for majority-public panel**, is the composition method FINRA used prior to the rule amendments. It provides for a panel comprised of a chair-qualified public arbitrator, a public arbitrator and a non-public arbitrator.

The second method, called the composition rules for **optional all public panel**, allows any party to select an all public arbitration panel. FINRA believes that providing customers with the right to exclude a non-public arbitrator from the panel deciding their case will enhance customers' perception of the fairness of FINRA's rules and the securities arbitration process.

The amendments apply to all customer cases in which FINRA has not sent lists of arbitrators to the parties. The text of the amendments is available on our website at *www.finra.org/notices/11-05*.

Questions concerning this *Notice* should be directed to:

- Richard W. Berry, Senior Vice President and Director of Case Administration and Regional Office Services, Dispute Resolution, at (212) 858-4307 or *richard.berry@finra.org*; or
- Margo A. Hassan, Assistant Chief Counsel, Dispute Resolution, at (212) 858-4481 or *margo.hassan@finra.org*.

Financial Industry Regulatory Authority

February 2011

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics

- Arbitration
- Code of Arbitration Procedure
- Panel Composition

Referenced Rules & Notices

- FINRA Rule 12402
- FINRA Rule 12403
- FINRA Rule 12404
- FINRA Rule 12405
- FINRA Rule 12406
- FINRA Rule 12407
- FINRA Rule 12408
- FINRA Rule 12409
- FINRA Rule 12410
- FINRA Rule 12411
- FINRA Rule 12412
- FINRA Rule 12413
- FINRA Rule 12414

Background & Discussion

Under FINRA rules, for claims up to $100,000, the Code of Arbitration Procedure for Customer Disputes (Customer Code) provides, generally, for a single public arbitrator. Prior to the amendments, for all customer claims of more than $100,000, the Customer Code provided for a three-arbitrator panel comprised of a chair-qualified public arbitrator, a public arbitrator and a non-public arbitrator. FINRA amended the Customer Code to give customers the option to choose between two panel selection methods for claims over $100,000—the majority-public panel or the optional all public panel. The amendments provide that only customers (whether they are claimants or respondents in a case) may choose the panel-selection method; neither firms nor associated persons may choose. The majority-public panel option provides for a panel of one chair-qualified public arbitrator, one public arbitrator and one non-public arbitrator. And the optional all public panel provision, if chosen by the customer, allows any party to select an all public arbitration panel.

Parties in arbitration participate in selecting the arbitrators who serve on their cases. Under the rule amendments, for claims over $100,000, FINRA will send parties three lists of 10 arbitrators randomly generated by the computerized Neutral List Selection System (NLSS)—10 chair-qualified public arbitrators, 10 public arbitrators and 10 non-public arbitrators. Under the majority-public panel method, each party may strike up to four arbitrators on each list; under the optional all public panel method, each party may strike up to four arbitrators on the chair-qualified public arbitrator list and on the public arbitrator list. However, under the optional all public panel method, each party may strike up to ***all*** of the arbitrators on the non-public arbitrator list. After striking arbitrators from the lists, the parties will rank the remaining arbitrators in order of preference and FINRA will appoint the panel from among the names remaining on the lists that the parties return. By striking all the arbitrators on the non-public list, any party may ensure that the panel will have three public arbitrators. The method for completing the panel is outlined in the description of new Rule 12403 below.

The amendments apply *only* to customer disputes; they do not apply to disputes involving only industry parties. FINRA believes giving customers the option of an all public panel will enhance confidence in and increase the perception of fairness in the FINRA arbitration process. Customers will have expanded power in choosing arbitration panels, and all customers will have the ability to exclude non-public arbitrators from their panels.

Details of the Customer Code Amendments

Prior to the amendments, FINRA Rule 12402 (Composition of Arbitration Panels) specified the panel composition for all customer cases.[2] And FINRA Rules 12403 (Generating and Sending Lists to the Parties),[3] 12404 (Striking and Ranking Arbitrators),[4] 12405 (Combining Lists),[5] 12406 (Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on List)[6] and 12411 (Replacement of Arbitrators)[7] enumerated the procedures for selecting, appointing and replacing arbitrators.

FINRA consolidated these rules into two new rules: FINRA Rule 12402 relating to customer cases with one arbitrator, and FINRA Rule 12403 relating to customer cases with three arbitrators. FINRA deleted Rules 12402, 12403, 12404, 12405, 12406, and 12411 in their entirety, and renumbered the remaining rules in the 12400 series so that the numbering would remain consecutive after the consolidation of these rules.

New Rule 12402—Cases With One Arbitrator

New Rule 12402 consolidates the content of old Rules 12402, 12403, 12404, 12405, 12406 and 12411, relating to single arbitrator cases. The rule also describes the procedures for selecting, appointing and replacing the arbitrator in a single-arbitrator case; FINRA did not make any substantive changes to these procedures.

New Rule 12403—Cases With Three Arbitrators

New Rule 12403 describes the two options that customers have for selecting panels in three-arbitrator cases, as explained above. The first option, the majority-public panel, ensures that FINRA will appoint one non-public arbitrator to a three-arbitrator panel. The second option, the optional all public panel, if selected by the customer, guarantees that any party may select an all public panel. As stated above, the amendments only allow customers to make the election between the two panel selection methods. The rule also includes the procedures for appointing and replacing arbitrators in a three-arbitrator case.

Except as outlined below, FINRA incorporated into new Rule 12403 the content of old Rules 12403, 12404, 12405, 12406 and 12411 as they relate to three-arbitrator cases. Under the amendments, the customer may elect in writing to proceed under either panel-selection method in the customer's Statement of Claim if the customer is a claimant, or at any time up to 35 days from service of the Statement of Claim, whether the customer is claimant or respondent. To ensure that the customer understands the options available, FINRA will notify the customer in writing that he or she has 35 days from service of the Statement of Claim to elect the optional all public panel method of panel composition.[8] If the customer declines to make an affirmative election by the 35-day deadline, FINRA will apply the composition rule for a majority-public panel.

Under either panel-selection method, the parties will receive three lists—one with 10 chair-qualified public arbitrators, one with 10 public arbitrators and one with 10 non-public arbitrators. FINRA will permit each party to strike up to four arbitrators on the chair-qualified public and public lists, leaving at least six arbitrator names remaining on each party's list. However, the process for striking arbitrators on the non-public list will be different for each method, as detailed below.

In cases in which FINRA initially appointed a single chair-qualified public arbitrator (claim up to $100,000), and the claim is subsequently amended to an amount over $100,000, FINRA will notify the customer in writing that the panel size has changed to three arbitrators. The customer will then have 35 days to elect the majority-public panel method or the optional all public panel method to fill out the panel.

Striking Arbitrators on the Non-Public List

Majority-Public Panel—Under this method of panel composition:

- each separately represented party may strike up to four arbitrators on the non-public list;
- FINRA will appoint the highest-ranked available non-public arbitrator from the combined rankings; and
- in cases in which the parties strike all of the arbitrators appearing on the non-public list or when all remaining arbitrators on the non-public list are unable or unwilling to serve for any reason, FINRA will appoint a non-public arbitrator selected randomly by NLSS.

Optional All Public Panel—Under this method of panel composition:

- all parties have unlimited strikes with respect to the non-public list (meaning that any party may strike up to all names on the non-public list);and
- FINRA will not appoint a non-public arbitrator if the parties (individually or collectively) strike all the arbitrators appearing on the non-public list or if all remaining arbitrators on the non-public list are unable or unwilling to serve for any reason. In addition:
  - FINRA will return to the parties' lists and appoint the next highest-ranked public arbitrator to complete the panel;
  - if all public arbitrators are stricken or unavailable to serve, FINRA will appoint the next highest-ranked arbitrator on the public chair-qualified list; and
  - if all public chair-qualified arbitrators are stricken or unavailable to serve, FINRA will appoint a public arbitrator selected randomly by NLSS.

If a party fails to return a ranking list within the required timeframe, the Director of Arbitration will proceed as though the party did not want to strike any arbitrator or have any preferences among the listed arbitrators. This could result in the appointment of a non-public arbitrator if the other party or parties do not collectively strike all 10 names. Therefore, when sending the lists to the parties, FINRA will include a reminder alerting parties that a failure to comply with the required timeframe for returning lists to FINRA may result in the appointment of a panel consisting of two public arbitrators and one non-public arbitrator.

Public Arbitrator Pilot Program

In October 2008, FINRA launched a voluntary Public Arbitrator Pilot Program (Pilot), which allowed investors in cases with a three-person panel naming only a participating firm to have a panel consisting of three public arbitrators, instead of two public arbitrators and one non-public arbitrator.

Effective immediately, FINRA will not accept any new cases under the Pilot. In existing Pilot cases in which FINRA has *not* sent lists of arbitrators to the parties, FINRA will notify the parties that the case will proceed under the optional all public panel method of panel composition. If FINRA has sent lists of arbitrators to the parties, FINRA will administer the case under the Pilot procedures.

Effective Date

The amendments are effective immediately and apply to all customer cases in which FINRA has not sent lists of arbitrators to the parties.[9]

Endnotes

1 *See* Securities Exchange Act Rel. No. 63799 (January 31, 2011), (File No. SR-FINRA-2010-053).

2 Rule 12402 provided that a single arbitrator panel consisted of a chair-qualified public arbitrator, and that a three-arbitrator panel consisted of a chair-qualified public arbitrator, ºa public arbitrator and a non-public arbitrator.

3 Rule 12403 provided that if a panel consisted of one arbitrator, NLSS generated a list of 10 chair-qualified public arbitrators. If a panel consisted of three arbitrators, NLSS generated a list of 10 chair-qualified public arbitrators, 10 public arbitrators and 10 non-public arbitrators. The rule detailed how NLSS generated lists, and how FINRA sent lists to the parties and handled requests for additional information about arbitrators. NLSS excludes arbitrators from lists based on current known conflicts of interest identified in NLSS.

4 Rule 12404 stated that parties may strike up to four arbitrators from each list, leaving at least six arbitrator names remaining. It also explained the process for ranking arbitrator preferences and returning the lists to FINRA.

5 Rule 12405 explained how FINRA prepared combined ranked lists of arbitrators based on the parties' numerical rankings.

6 Rule 12406 explained that FINRA appoints the highest-ranked available arbitrator from each of the combined lists and described FINRA's procedures for appointing an arbitrator when the number of arbitrators available to serve from a combined list was not sufficient to fill the panel. The rule also provided that appointment occurred when FINRA sent notice to the parties of the names of the arbitrators on the panel and that arbitrators must execute FINRA's arbitrator oath or affirmation before making any decision as an arbitrator or attending a hearing.

7 Rule 12411 provided that if FINRA removed an arbitrator, or an arbitrator became otherwise unable or unwilling to serve, FINRA appointed as a replacement arbitrator the arbitrator who was the most highly ranked available arbitrator from the applicable combined list. It also stated the procedure for replacing an arbitrator if there weren't any arbitrators left on a combined list.

8 If the customer is a respondent, under Rule 12403(b), when FINRA serves the Statement of Claim on the customer, FINRA will notify the customer in writing that the customer may elect the composition rules for the optional all public panel within 35 days from service of the Statement of Claim.

9 FINRA stopped sending lists of arbitrators to parties in customer cases the day that the SEC approved the proposed rule change. FINRA will advise customers in cases that have not been sent lists that they have 35 days to elect the majority-public panel method or the optional all public panel method of panel composition.

Regulatory Notice 11-06

Reporting Requirements

SEC Approves Consolidated FINRA Rule Governing Reporting Requirements

Effective Date: July 1, 2011

Executive Summary

The SEC approved FINRA's proposal to adopt a rule governing reporting requirements[1] for the consolidated FINRA rulebook.[2] The new rule, FINRA Rule 4530, is based in large part on NASD Rule 3070, taking into account certain requirements under NYSE Rule 351.[3]

The text of the new rule is set forth in Attachment A. The new event codes for batch reporting specified events via the Rule 4530 Application are set forth in Attachment B. The rule takes effect on July 1, 2011.

Questions regarding this *Notice* should be directed to Afshin Atabaki, Assistant General Counsel, Office of General Counsel, at (202) 728-8902.

Technical questions regarding the Rule 4530 Application, including testing, should be directed to the FINRA Help Desk, at (800) 321-6273 (if your question relates to testing, please indicate that your question is about a test system issue, and not an actual submission).

Background & Discussion

FINRA Rule 4530, which is modeled after NASD Rule 3070 and NYSE Rule 351, requires member firms to:

(1) report to FINRA certain specified events and quarterly statistical and summary information regarding written customer complaints; and

(2) file with FINRA copies of certain criminal actions, civil complaints and arbitration claims.

February 2011

Notice Type
- Consolidated FINRA Rulebook
- Rule Approval

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topics
- Customer Complaints
- Disclosure Events
- Filing Requirements
- Internal Conclusions
- Reporting Deadlines
- Reporting Requirements
- Quarterly Reporting
- Form U5

Referenced Rules & Notice
- FINRA Rule 4530
- Information Notice 3/12/08
- NASD Rule 3070
- NYSE Rule 351

FINRA Financial Industry Regulatory Authority

FINRA uses the information for regulatory purposes to identify and initiate investigations of firms, offices and associated persons that may pose a risk. The new rule applies to all FINRA member firms. In most cases, the requirements of FINRA Rule 4530 are based on similar requirements in the NASD and NYSE rules. FINRA Rule 4530 strengthens and clarifies these requirements, as explained below.

Internal Conclusions

FINRA Rule 4530(b) requires a member firm to report to FINRA within 30 calendar days after the firm has concluded, or reasonably should have concluded, on its own that the firm or an associated person of the firm has violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization (SRO). This requirement is generally modeled after a requirement in the NYSE rule.

The new rule does not require firms to report every instance of noncompliant conduct. With respect to violative conduct by a firm, this provision requires the firm to report only conduct that has widespread or potential widespread impact to the firm, its customers or the markets, or conduct that arises from a material failure of the firm's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts.[4] Regarding violative conduct by an associated person, the provision requires a firm to report only conduct that has widespread or potential widespread impact to the firm, its customers or the markets; conduct that has a significant monetary result on a member firm(s), customer(s) or market(s); or multiple instances of any violative conduct.[5]

For purposes of compliance with the "reasonably should have concluded" standard, FINRA will rely on a firm's good faith reasonable determination. If a reasonable person would have concluded that a violation occurred, then the matter is reportable; if a reasonable person would not have concluded that a violation occurred, then the matter is not reportable.

Additionally, a firm determines the person(s) within the firm responsible for reaching such conclusions, including the person's required level of seniority. However, stating that a violation was of a nature that did not merit consideration by a person of such seniority is not a defense to a failure to report such conduct. Further, it may be possible that a department within a firm reaches a conclusion of violation, but on review senior management reaches a different conclusion. Nothing in the rule prohibits a firm from relying on senior management's determination, provided such determination is reasonable as described above.

Moreover, the reporting obligation under FINRA Rule 4530 and the internal review processes set forth under other rules (*e.g.*, FINRA Rule 3130) are mutually exclusive. While internal review processes may inform a firm's determination that a specific violation occurred, they do not by themselves lead to the conclusion that the matter is reportable.[6]

For example, FINRA would not view a discussion in an internal audit report regarding the need for enhanced controls in a particular area, standing alone, as determinative of a reportable violation. It should also be noted that an internal audit finding would serve only as one factor, among others, that a firm should consider in determining whether a reportable violation occurred.

Lastly, the new rule provides that certain disciplinary actions taken by a firm against an associated person must be reported under a separate provision (discussed below),[7] rather than under the internal conclusion provision.[8]

Other Reportable Events

In addition to internal conclusions, FINRA Rule 4530 requires a member firm to report to FINRA within 30 calendar days[9] after the firm knows or should have known[10] of the existence of certain other events relating to the firm or an associated person of the firm. These events are based on existing requirements in NASD Rule 3070 or NYSE Rule 351, with a few modifications as described below.

External Findings

FINRA Rule 4530(a)(1)(A) requires the reporting of certain external findings similar to the NASD rule,[11] but limits the scope of the requirement to where the firm or an associated person has been found[12] by an external body[13] to have violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body, SRO or business or professional organization.[14]

Complaints Involving Certain Allegations

FINRA Rule 4530(a)(1)(B) requires that a firm report any written customer complaint against the firm or an associated person alleging theft or misappropriation of funds or securities or forgery. The new rule clarifies that, for purposes of this requirement, a “customer” includes any person (other than a broker or dealer) with whom the firm has engaged, or *has sought to engage*, in securities activities.[15] Further, it codifies existing staff guidance reminding firms to report quarterly statistical and summary information regarding such complaints.[16]

Named in a Regulatory Proceeding; Subject to Other Regulatory Actions; or Associated with a Financial Entity Subject to Certain Actions

FINRA Rules 4530(a)(1)(C), (D) and (F) generally require firms to report whenever they or their associated persons are:

(1) named as a defendant or respondent in a regulatory proceeding alleging the violation of securities, insurance or commodities laws, rules or regulations;

(2) denied registration or membership or disciplined by a securities, insurance or commodities regulator; or

(3) associated with certain financial entities that were denied registration, suspended, expelled or had their registration revoked by a regulator or associated with a financial institution that was convicted of, or pleaded no contest to, any felony or misdemeanor.

These provisions apply to domestic and foreign matters,[17] including actions by a foreign regulatory body or, in the case of criminal actions, actions brought in a foreign court. The term "regulatory body," which is used in these provisions and the provisions relating to internal conclusions and external findings,[18] is defined as a governmental regulatory body or an authorized non-governmental regulatory body, such as the Financial Services Authority.[19]

Criminal Actions Involving Felonies and Certain Misdemeanors

FINRA Rule 4530(a)(1)(E) generally requires that a firm report any indictment, conviction, or guilty or no contest plea of the firm or an associated person involving:

(1) any felony or certain misdemeanors, such as a misdemeanor involving the purchase or sale of a security or involving forgery;

(2) a conspiracy to commit any of these offenses; or

(3) substantially equivalent actions.

Civil Litigation; Arbitration Matters; or Certain Claims for Damages

FINRA Rule 4530(a)(1)(G) generally requires that a firm submit a report if it or an associated person is a defendant or respondent in any securities- or commodities-related civil litigation or arbitration, or is subject to a claim for damages by a customer, broker or dealer, that is disposed of for certain dollar thresholds (above $15,000 for associated persons; above $25,000 for firms).

The new rule extends this requirement to any financial-related insurance civil litigation or arbitration. "Financial-related" means related to the provision of financial services.[20] By its terms, the rule excludes certain insurance products, such as traditional auto and health insurance. However, the scope of the rule is not limited to insurance products that are securities. Civil litigation or arbitration involving a non-securities insurance product that is related to the provision of financial services is subject to the rule.

Additionally, the new rule limits the scope of the requirement to report certain claims for damages by requiring the reporting of claims that relate to the provision of financial services or relate to a financial transaction, such as a loan by a customer to an associated person.

When calculating the dollar thresholds for reporting civil litigations, arbitrations or claims for damages subject to reporting, the new rule requires firms to include attorney's fees and interest.[21] Further, it codifies existing staff guidance regarding "joint and several" liability.[22] If parties are subject to "joint and several" liability, firms must use the aggregate dollar amount for reporting purposes since each party is separately liable for the aggregate amount. For instance, if two parties have "joint and several" liability for $40,000, the amount reported would be $40,000 for *each* party.

Statutory Disqualifications

FINRA Rule 4530(a)(1)(H) requires that firms report certain "statutory disqualification" matters. The rule provides that a firm is required to report whenever the firm or an associated person is subject to a "statutory disqualification." In addition, it provides that firms are required to report whenever they or their associated persons are "involved in the sale of any financial instrument, the provision of any investment advice or the financing of any such activities" with any person who is subject to a "statutory disqualification."[23]

Disciplinary Actions Taken by a Firm Against an Associated Person

FINRA Rule 4530(a)(2) requires that a firm report any disciplinary action taken by the firm against an associated person involving a suspension or termination, the imposition of fines above $2,500, or any other disciplinary action that would have a significant limitation on the associated person's activities. The rule clarifies that any disciplinary action involving the withholding of compensation or of any other remuneration above $2,500 is also reportable.[24]

Obligation of Associated Persons

Under FINRA Rule 4530(c), associated persons continue to have an obligation to promptly report to their member firms the existence of the events described above. The new rule clarifies that this obligation does not extend to internal conclusions and disciplinary actions taken by a firm against an associated person.

Exception for Information Disclosed on the Form U5

FINRA Rule 4530(e) provides, similar to the NASD rule, that firms and associated persons have a separate obligation to disclose required information on the Uniform Forms, as applicable, to make any other required filings and to respond to FINRA with respect to any customer complaint, examination or inquiry. Further, the new rule clarifies that the reporting obligations under the rule apply regardless of whether the information is reported or disclosed pursuant to any other rule or requirement.

However, the rule creates an exception for information disclosed on the Form U5. More specifically, a firm is not required to report an event otherwise required to be reported under the provisions discussed above if the firm discloses the event on the Form U5, consistent with the requirements of that form.[25] This exception does not extend to the reporting of quarterly statistical and summary complaint information, which is addressed below.

Reporting an Event Under the Most Appropriate Provision

Member firms have an obligation to report an event under the most appropriate provision of FINRA Rule 4530 and not to report the same event under more than one provision.[26] The rule recognizes that related events may have to be reported under more than one provision, such as being named as a respondent in an SRO proceeding alleging violation of the SRO's rules and subsequently found to have violated those rules.

Quarterly Statistical and Summary Complaint Information

FINRA Rule 4530(d) retains the requirement of the NASD and NYSE rules that firms report quarterly statistical and summary written customer complaint information, with the following modification. If a firm *has engaged in securities activities* with a person (other than a broker or dealer), the firm is required to report *any written grievance* by such person involving the firm or an associated person.[27] If a firm *has sought to engage in securities activities* with a person (other than a broker or dealer), the firm is only required to report *any securities-related written grievance* by such prospective customer involving the firm or an associated person or any written complaints alleging theft or misappropriation of funds or securities or forgery.[28]

Obligation to Report Matters Relating to Former Associated Persons

Under the new rule, a firm is required to report a matter relating to a former associated person if it occurred while the person was associated with the firm.[29] If a firm, however, becomes aware of a matter, but based on its records or information available through Web CRD® the firm cannot determine that the person was an associated person of the firm, the firm is not obligated to report it.[30]

Filing Requirements

FINRA Rule 4530(f) keeps the requirement of the NASD rule that firms promptly file with FINRA copies of certain: (1) criminal complaints and plea agreements; (2) civil complaints; and (3) arbitration claims. FINRA Rule 4530 extends this filing requirement to any financial-related insurance civil complaint filed against the firm or any financial-related insurance arbitration claim against the firm. FINRA Rule 4530(g) retains the exception for any arbitration claim that is originally filed in the FINRA Dispute Resolution forum and for those documents that have already been requested by FINRA's Registration and Disclosure (RAD) staff, provided that the firm produces those requested documents to RAD staff within 30 days after receipt of such request.

Technical Changes to Reporting Application

Member firms should continue to report specified events and quarterly statistical and summary information on written customer complaints via the Regulatory Filings Application on the FINRA Firm Gateway.[31] Beginning July 1, 2011, the application will be renamed the Rule 4530 Application.

Firms must use new event codes for batch reporting specified events on or after July 1, 2011. The new codes are 11 through 20, and are described in detail in Attachment B. The old event codes, 01 through 10, will continue to be available for amending batch events that were reported prior to July 1, 2011, pursuant to NASD Rule 3070 or NYSE Rule 351. There are no changes to the codes for reporting quarterly statistical and summary information regarding written customer complaints.

Beginning June 6, 2011, firms will have an opportunity to test the new event codes for batch reporting through FINRA's test site at: *https://regfilingtest.finra.org*.

Effective Date

Any matter that becomes subject to reporting[32] or filing prior to July 1, 2011, must be reported or filed in accordance with the requirements of NASD Rule 3070 and NYSE Rule 351, as applicable, including the reporting and filing deadlines of those rules. Any matter that becomes subject to reporting or filing on or after July 1, 2011, must be reported or filed in accordance with the requirements of FINRA Rule 4530.

For purposes of compliance with FINRA Rule 4530(d) (quarterly statistical and summary complaint information), starting on July 1, 2011, the beginning of the third calendar quarter, firms must report such information in accordance with the requirements of the new rule. The first report based on the requirements of FINRA Rule 4530(d) is due by October 15, 2011, which is the reporting deadline for customer complaints received during the third calendar quarter.

Endnotes

1 *See* Securities Exchange Act (SEA) Release No. 63260 (November 5, 2010), 75 FR 69508 (November 12, 2010) (Notice of Filing of Amendment Nos. 1 and 2 and Order Granting Accelerated Approval to Proposed Rule Change; File No. SR-FINRA-2010-034).

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 03/12/08* (Rulebook Consolidation Process). For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

3 FINRA Rule 4530 replaces NASD Rule 3070 and the corresponding provisions in NYSE Rule 351. Accordingly, effective July 1, 2011, NASD Rule 3070, paragraphs (a) through (d) of NYSE Rule 351, and NYSE Rules 351.10 and 351.13 will be deleted from the Transitional Rulebook.

4 *See* FINRA Rule 4530.01.

5 *Id.*

6 During the rulemaking process, some commenters asked whether a settlement with a customer creates the presumption that a reportable violation has occurred. FINRA reiterates that it is not the fact that a firm has settled a matter that makes it a reportable event under the rule; rather, it is whether the firm has reached an internal conclusion or reasonably should have reached an internal conclusion that the firm or an associated person has engaged in the enumerated violative conduct. Firms should note that certain settlements will have to be reported based on other reporting requirements (*e.g.*, securities-related civil litigation settled for certain dollar thresholds set forth in the rule).

7 *See* FINRA Rule 4530(a)(2).

8 *See* FINRA Rule 4530.01.

9 The reporting deadline under NASD Rule 3070 is 10 business days. The reporting deadline under NYSE Rule 351 is 30 calendar days, which is also consistent with the reporting deadline for disclosing information on the Forms BD (Uniform Application for Broker-Dealer Registration), U4 (Uniform Application for Securities Industry Registration or Transfer) and U5 (Uniform Termination Notice for Securities Industry Registration) (collectively referred to as the Uniform Forms).

10 The purpose of the "should have known" standard is to ensure that member firms do not intentionally avoid becoming aware of a reportable event.

11 NASD Rule 3070 extends to a finding of violation of "any" rule or standard of conduct of "any" governmental agency, SRO, or financial business or professional organization.

12 FINRA Rule 4530.03 defines the term "found" generally consistent with the definition of the term in the Uniform Forms. In addition, the term includes any formal finding (regardless of whether the finding will be appealed), but it does not include a minor rule violation involving a fine of $2,500 or less.

Endontes continued

13 An external body includes, but is not limited to, a court, domestic or foreign regulatory body, SRO or business or professional organization. *See* FINRA Rule 4530.02.

14 During the rulemaking process, FINRA provided the following examples of the types of reportable external findings: (1) court finding relating to the violation of insurance laws; (2) finding of violation of an SRO's just and equitable principles of trade rule, such as FINRA Rule 2010; or (3) finding of violation of the Code of Professional Conduct of the American Institute of Certified Public Accountants. These examples are provided for illustrative purposes and are not exhaustive.

15 *See* FINRA Rule 4530.08.

16 *Id.*

17 Other provisions of FINRA Rule 4530 also apply to domestic and foreign matters, including the provisions relating to internal conclusions, external findings and criminal actions involving felonies and certain misdemeanors. *See* FINRA Rules 4530(a)(1)(A), (a)(1)(E) and (b).

18 *See* FINRA Rules 4530(a)(1)(A) and (b).

19 *See* FINRA Rule 4530.04.

20 *See* FINRA Rule 4530.09. The term "financial-related" is also used in other provisions, including the provisions regarding internal conclusions, external findings and filing requirements. See FINRA Rules 4530(a)(1)(A), (b) and (f).

21 *See* FINRA Rule 4530.06. Based on FINRA's experience, some firms have considered structuring settlements using attorney's fees to avoid the dollar thresholds for reporting. The inclusion of attorney's fees and interest is intended to address this concern.

22 *See id.*

23 The requirement in the NASD and NYSE rules is based on whether the firm or associated person is "associated in any business or financial activity" with a person who is subject to a "statutory disqualification."

24 The requirement in the NASD and NYSE rules is limited to the withholding of *commissions* above $2,500.

25 While this exception only applies to information that is disclosed on the Form U5, FINRA will work toward the goal of extending this exception to information that is disclosed on the Forms BD and U4.

26 *See* FINRA Rule 4530.05.

27 *See* FINRA Rule 4530.08.

28 *See id.*

29 *See* FINRA Rule 4530.07.

30 Firms are reminded that records relating to associated persons must be preserved consistent with the requirements of SEA Rule 17a-4(e)(1).

31 In general, firms should report the information in their custody, possession or control or to which they have knowledge and provide an explanation in the appropriate Rule 4530 Application fields of the information that they were unable to obtain due to circumstances beyond their control, with the understanding that firms cannot intentionally avoid becoming aware of a reportable event.

32 Firms should continue to use the Regulatory Filings Application on the FINRA Firm Gateway for purposes of reporting such matters.

ATTACHMENT A

Below is the text of the new FINRA rule.

* * * * *

4530. Reporting Requirements

(a) Each member shall promptly report to FINRA, but in any event not later than 30 calendar days, after the member knows or should have known of the existence of any of the following:

(1) the member or an associated person of the member:

(A) has been found to have violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body, self-regulatory organization or business or professional organization;

(B) is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery;

(C) is named as a defendant or respondent in any proceeding brought by a domestic or foreign regulatory body or self-regulatory organization alleging the violation of any provision of the Exchange Act, or of any other federal, state or foreign securities, insurance or commodities statute, or of any rule or regulation thereunder, or of any provision of the by-laws, rules or similar governing instruments of any securities, insurance or commodities domestic or foreign regulatory body or self-regulatory organization;

(D) is denied registration or is expelled, enjoined, directed to cease and desist, suspended or otherwise disciplined by any securities, insurance or commodities industry domestic or foreign regulatory body or self-regulatory organization or is denied membership or continued membership in any such self-regulatory organization; or is barred from becoming associated with any member of any such self-regulatory organization;

(E) is indicted, or convicted of, or pleads guilty to, or pleads no contest to, any felony; or any misdemeanor that involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities, or a conspiracy to commit any of these offenses, or substantially equivalent activity in a domestic, military or foreign court;

(F) is a director, controlling stockholder, partner, officer or sole proprietor of, or an associated person with, a broker, dealer, investment company, investment advisor, underwriter or insurance company that was suspended, expelled or had its registration denied or revoked by any domestic or foreign regulatory body, jurisdiction or organization or is associated in such a capacity with a bank, trust company or other financial institution that was convicted of or pleaded no contest to, any felony or misdemeanor in a domestic or foreign court;

(G) is a defendant or respondent in any securities- or commodities-related civil litigation or arbitration, is a defendant or respondent in any financial-related insurance civil litigation or arbitration, or is the subject of any claim for damages by a customer, broker or dealer that relates to the provision of financial services or relates to a financial transaction, and such civil litigation, arbitration or claim for damages has been disposed of by judgment, award or settlement for an amount exceeding $15,000. However, when the member is the defendant or respondent or is the subject of any claim for damages by a customer, broker or dealer, then the reporting to FINRA shall be required only when such judgment, award or settlement is for an amount exceeding $25,000; or

(H) is, or is involved in the sale of any financial instrument, the provision of any investment advice or the financing of any such activities with any person who is, subject to a “statutory disqualification” as that term is defined in the Exchange Act. The report shall include the name of the person subject to the statutory disqualification and details concerning the disqualification; or

(2) an associated person of the member is the subject of any disciplinary action taken by the member involving suspension, termination, the withholding of compensation or of any other remuneration in excess of $2,500, the imposition of fines in excess of $2,500 or is otherwise disciplined in any manner that would have a significant limitation on the individual’s activities on a temporary or permanent basis.

(b) Each member shall promptly report to FINRA, but in any event not later than 30 calendar days, after the member has concluded or reasonably should have concluded that an associated person of the member or the member itself has violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization.

(c) Each person associated with a member shall promptly report to the member the existence of any of the events set forth in paragraph (a)(1) of this Rule.

(d) Each member shall report to FINRA statistical and summary information regarding written customer complaints in such detail as FINRA shall specify by the 15th day of the month following the calendar quarter in which customer complaints are received by the member.

(e) Nothing contained in this Rule shall eliminate, reduce or otherwise abrogate the responsibilities of a member or person associated with a member to promptly disclose required information on the Forms BD, U4 or U5, as applicable, to make any other required filings or to respond to FINRA with respect to any customer complaint, examination or inquiry. In addition, members are required to comply with the reporting obligations under paragraphs (a), (b) and (d) of this Rule, regardless of whether the information is reported or disclosed pursuant to any other rule or requirement, including the requirements of the Forms BD or U4. However, a member need not report an event otherwise required to be reported under paragraphs (a) or (b) of this Rule if the member discloses the event on the Form U5, consistent with the requirements of that form.

(f) Each member shall promptly file with FINRA copies of:

(1) any indictment, information or other criminal complaint or plea agreement for conduct reportable under paragraph (a)(1)(E) of this Rule;

(2) any complaint in which a member is named as a defendant or respondent in any securities- or commodities-related private civil litigation, or is named as a defendant or respondent in any financial-related insurance private civil litigation;

(3) any securities- or commodities-related arbitration claim, or financial-related insurance arbitration claim, filed against a member in any forum other than the FINRA Dispute Resolution forum;

(4) any indictment, information or other criminal complaint, any plea agreement, or any private civil complaint or arbitration claim against a person associated with a member that is reportable under question 14 on Form U4, irrespective of any dollar thresholds Form U4 imposes for notification, unless, in the case of an arbitration claim, the claim has been filed in the FINRA Dispute Resolution forum.

(g) Members shall not be required to comply separately with paragraph (f) in the event that any of the documents required by paragraph (f) have been the subject of a request by FINRA's Registration and Disclosure staff, provided that the member produces those requested documents to the Registration and Disclosure staff not later than 30 days after receipt of such request. This paragraph does not supersede any FINRA rule or policy that requires production of documents specified in paragraph (f) sooner than 30 days after receipt of a request by the Registration and Disclosure staff.

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

.01 Reporting of Firms' Conclusions of Violations. For purposes of paragraph (b) of this Rule, with respect to violative conduct by a member, FINRA expects a member to report only conduct that has widespread or potential widespread impact to the member, its customers or the markets, or conduct that arises from a material failure of the member's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts. With respect to violative conduct by an associated person, FINRA expects a member to report only conduct that has widespread or potential widespread impact to the member, its customers or the markets, conduct that has a significant monetary result with respect to a member(s), customer(s) or market(s), or multiple instances of any violative conduct. In addition, with respect to violative conduct by an associated person, the reporting obligation under paragraph (b) must be read in conjunction with the reporting obligation under paragraph (a)(2) of this Rule. If a member has concluded that an associated person has engaged in violative conduct and imposes the discipline set forth under paragraph (a)(2) of this Rule, then the member is required to report the event under paragraph (a)(2), and it need not report the event under paragraph (b).

.02 Firms' Conclusions of Violations versus External Findings. Members should be aware that paragraph (b) of this Rule is limited to situations where the member has concluded or reasonably should have concluded on its own that violative conduct has occurred. Paragraph (a)(1)(A) of this Rule is limited to situations where there has been a finding of violative conduct by an external body, such as a court, domestic or foreign regulatory body, self-regulatory organization or business or professional organization.

.03 Meaning of "Found." The term "found" as used in paragraph (a)(1)(A) of this Rule includes among other formal findings, adverse final actions, including consent decrees in which the respondent has neither admitted nor denied the findings, but does not include informal agreements, deficiency letters, examination reports, memoranda of understanding, cautionary actions, admonishments and similar informal resolutions of matters. For example, a Letter of Acceptance, Waiver and Consent or an Offer of Settlement is considered an adverse final action. The term "found" also includes any formal finding, regardless of whether the finding will be appealed. The term "found" does not include a violation of a self-regulatory organization rule that has been designated as "minor" pursuant to a plan approved by the SEC, if the sanction imposed consists of a fine of $2,500 or less, and if the sanctioned person does not contest the fine.

.04 Meaning of "Regulatory Body." For purposes of this Rule, the term "regulatory body" refers to governmental regulatory bodies and authorized non-governmental regulatory bodies, such as the Financial Services Authority.

.05 Reporting of Individual and Related Events. With respect to a reportable event under paragraphs (a) or (b) of this Rule, members should not report the same event under more than one paragraph or subparagraph. Members should report the event under the most appropriate paragraph or subparagraph. However, members should be aware that they may be required to report related events under more than one paragraph or subparagraph. For instance, if a member is named as a respondent in a proceeding brought by a self-regulatory organization alleging the violation of the self-regulatory organization's rules, the member would be required to report that event under paragraph (a)(1)(C) of this Rule. In addition, if the member subsequently is found to have violated the self-regulatory organization's rules, the member would be required to report that finding under paragraph (a)(1)(A) of this Rule.

.06 Calculation of Monetary Thresholds. For purposes of paragraph (a)(1)(G) of this Rule, when determining the dollar amount that would require a report, members must include any attorneys fees and interest in the total amount. In addition if the parties are subject to "joint and several" liability, the amount for each party must be aggregated and reported, if above the dollar thresholds under paragraph (a)(1)(G), as if each party is separately liable for the aggregated amount. For instance, if two parties have "joint and several" liability for $40,000, the amount reported would be $40,000 for each party.

.07 Former Associated Persons. For purposes of paragraphs (a), (b) and (d) of this Rule, members should report an event relating to a former associated person if the event occurred while the individual was associated with the member. A member is not required to report such an event where, based on its records or information available through Web CRD, the member cannot determine that the person was an associated person of the member.

.08 Customer Complaints. For purposes of paragraph (a)(1)(B) of this Rule, a "customer" includes any person, other than a broker or dealer, with whom the member has engaged, or has sought to engage, in securities activities. Any written customer complaint reported under paragraph (a)(1)(B) of this Rule also must be reported pursuant to paragraph (d) of this Rule. For purposes of paragraph (d) of this Rule, with respect to a person, other than a broker or dealer, with whom the member has engaged in securities activities, the member must report any written grievance by such person involving the member or a person associated with the member. In addition, with respect to a person, other than a broker or dealer, with whom the member has sought to engage in securities activities, the member must report any securities-related written grievance by such person involving the member or a person associated with the member and any written complaint reportable under paragraph (a)(1)(B) of this Rule.

.09 Financial Related. For purposes of this Rule, the term "financial related" means related to the provision of financial services.

* * * * *

ATTACHMENT B

New Event Codes for Batch Reporting Pursuant to FINRA Rule 4530

Event Code	Paragraph	Description
11	(a)(1)(A)	External Finding
12	(a)(1)(B)	Customer Complaint Involving Certain Allegations
13	(a)(1)(C)	Named in a Regulatory Proceeding
14	(a)(1)(D)	Subject to Other Regulatory Actions
15	(a)(1)(E)	Criminal Actions Involving Felonies and Certain Misdemeanors
16	(a)(1)(F)	Associated with a Financial Entity Subject to Certain Actions
17	(a)(1)(G)	Civil Litigation; Arbitration Matters; or Certain Claims for Damages
18	(a)(1)(H)	Statutory Disqualification
19	(a)(2)	Disciplinary Action Taken by a Firm Against an Associated Person
20	(b)	Internal Conclusion

Regulatory Notice 11-07

Sanction Guidelines

FINRA Revises the Sanction Guidelines

Effective Immediately

Executive Summary

This *Notice* advises FINRA firms of modifications to the *FINRA Sanction Guidelines*. The changes reflect the experience of FINRA's Departments of Market Regulation and Enforcement in settling and litigating cases, and incorporate the teachings of federal appellate court and SEC precedent in recent FINRA disciplinary cases. Specifically, the revisions:

- remove the Minor Rule Violation Plan Letter from the definition of a disciplinary "action" for purposes of considering prior actions and the provision that discusses respondents charging fines and costs to credit cards;
- modify the guidelines for violations related to the sale of unregistered securities to reflect that adjudicators should consider higher fines and firm suspensions in egregious cases;
- incorporate into the FINRA Rule 8210 guidelines relevant federal court and SEC precedent. The FINRA Rule 8210 guidelines also now delineate principal considerations for the three categories of violations. And for a partial but incomplete response to a FINRA Rule 8210 request, the guidelines now reflect parity with the fine for a failure to respond or respond truthfully;
- expressly provide for restitution or disgorgement in certain trading halt and best execution cases, and amend the suitability guidelines for use in cases where respondents have violated the "Recommendation Rule";
- add new guidelines for failing to comply with rule requirements related to customer confirmations and extended hours trading risk disclosure; and
- reflect the new FINRA rule numbers for rules that have been adopted into the consolidated FINRA rulebook.

The revised *Sanction Guidelines* are effective immediately and available on FINRA's website at *www.finra.org/Industry/Enforcement/SanctionGuidelines*.

February 2011

Notice Type
- Guidance

Suggested Routing
- Legal
- Registered Representatives
- Senior Management

Key Topics
- FINRA Sanction Guidelines

Referenced Rules & Notices
- FINRA Rule 2010
- FINRA Rule 2114
- FINRA Rule 2265
- FINRA Rule 5260
- FINRA Rule 8210
- NASD Rule 2230
- NASD Rule 2310
- NASD Rule 2320
- SEA Rule 10b-10
- SEA Rule 19d-1
- Section 5 of the Securities Act of 1933

Financial Industry Regulatory Authority

Questions concerning this *Notice* may be directed to:

- Emily Gordy, Department of Enforcement, at (202) 974-2916;
- Louise Corso, Department of Market Regulation, at (240) 386-5241; and
- Jennifer Brooks, Office of General Counsel, at (202) 728-8083.

Background & Discussion

The *FINRA Sanction Guidelines* are designed to address a wide variety of potential violations of FINRA's rules and provide fact-specific guidance for crafting appropriately remedial sanctions. FINRA's adjudicators rely on the guidelines to determine sanctions, and FINRA's Departments of Market Regulation and Enforcement and the defense bar rely on them when negotiating settlements in disciplinary matters. The National Adjudicatory Council approved these revisions, several of which are small adjustments designed to reflect the experience of FINRA's Departments of Market Regulation and Enforcement in settling and litigating disciplinary cases.

Revisions to Technical Matters

The revised *Sanction Guidelines* remove the Minor Rule Violation Plan Letter (MRVP) from the definition of an "action." MRVPs (that do not exceed $2,500) are not "final disciplinary actions" as that term is defined in SEA Rule 19d-1 and therefore, FINRA is not obligated to file notice of the "action" with the Securities and Exchange Commission (SEC). Eliminating the MRVPs from the definition of an action is consistent with their being a nonreportable event. While MRVPs, Cautionary Action Letters and other informal actions are not "actions" as defined in the *Sanction Guidelines*, FINRA's Departments of Market Regulation and Enforcement retain the option of considering them in settlement discussions when negotiating an appropriate level of monetary sanction or when determining whether subsequent findings of violations should result in formal or informal action.

The revised *Sanction Guidelines* also remove the sentence that respondents may charge fines and costs to credit cards. Because FINRA seeks to minimize the credit card fees that it pays when it accepts payments via credit cards, going forward FINRA will be managing the payment method for fines and costs through its Billing Services Department. FINRA is not immediately changing its acceptance of credit card payments; it will communicate a new policy before it takes effect.

Revisions to Distributions of Securities Guidelines

FINRA amended the guidelines for sales of unregistered securities, which address the unlawful distributions of securities in violation of Section 5 of the Securities Act of 1933 and FINRA Rule 2010. The rules prohibiting the sale of unregistered securities are an important component of maintaining the integrity of the securities registration process. Broker-dealers perform an important gatekeeper role. When broker-dealers properly assume their regulatory responsibilities, they guard against the entry of unregistered securities into the markets and against market manipulations and pump-and-dump schemes. These schemes are often accompanied by unlawful distributions of unregistered securities. The revisions emphasize that adjudicators consider, in egregious cases, suspending a firm with respect to any or all activities or functions for up to 30 business days or until procedural deficiencies are remedied and imposing a fine higher than the recommended range in the *Sanction Guidelines*. These revisions allow adjudicators to impose increased sanctions, in egregious situations, and reflect the importance of deterring market manipulations that are often accompanied by unregistered securities.

Revisions to Impeding Regulatory Investigations Guidelines

In order to harmonize the *Sanction Guidelines* with federal court and SEC precedent, and to clarify several aspects, FINRA amended the FINRA Rule 8210 guidelines. The revisions reflect that violations of FINRA Rule 8210 threaten FINRA's ability to ensure investor protection and market integrity and should, in appropriate cases, result in significant sanctions to protect the public from industry members who prevent FINRA from fully investigating their activities.

- The revisions delineate principal considerations for the three categories of violations under FINRA Rule 8210: failure to respond or to respond truthfully, providing a partial but incomplete response, and a failure to respond in a timely manner.
- The revisions incorporate the SEC's guidance that the importance of the information sought is from FINRA's perspective.[1]
- The guidelines also clarify that a failure to respond completely is really a partial but incomplete response. Consistent with the existing sanction for a complete failure to respond, the revised guidelines state that if a respondent does not respond to an information request until after FINRA files a complaint in a matter, a bar should be the presumptive sanction.[2]
- Likewise, to emphasize the seriousness of failing to provide FINRA with complete information, the guidelines revise the high end of the fine range for a partial but incomplete response from $25,000 to $50,000 to reflect parity with the fine for a failure to respond or respond truthfully. The amendment further reflects this point by stating that a bar is recommended for a partial but incomplete response unless the person can demonstrate that the information provided substantially complied with all aspects of the information request.
- The revised guidelines also make clear that the lack of customer harm or benefit to a violator does not mitigate a FINRA Rule 8210 violation.[3]

Revisions to Quality of Markets Guidelines

The revised *Sanction Guidelines* expressly allow for restitution or disgorgement in cases where respondents have executed trades or published quotes or indications of interest during a trading halt in violation of FINRA Rules 2010 and 5260 and where respondents failed to comply with best execution requirements under FINRA Rule 2010 and NASD Rule 2320. Inclusion of these provisions aims to deprive respondents of monetary benefits from their misconduct when it resulted in quantifiable losses for customers.

Revisions to Sales Practices Guidelines

The revisions address the lack of guidelines for the "Recommendation Rule," FINRA Rule 2114 (Recommendations to Customers in OTC Equity Securities, formerly NASD Rule 2315), by specifying that the suitability guidelines for violations of FINRA Rule 2010 and NASD Rule 2310 are appropriate for use in cases where respondents have violated the Recommendation Rule.

New Guidelines

The revisions create two new *Sanction Guidelines* for the failure to comply with SEA Rule 10b-10 and NASD Rule 2230 requirements related to customer confirmations, and FINRA Rule 2265 related to extended hours trading risk disclosure. The addition of these new guidelines sets forth violation-specific principal considerations and eliminates the need to use analogous guidelines. The extended hours trading risk disclosure guidelines are located in the Quality of Markets section of the *Sanction Guidelines*, and the customer confirmations guidelines are in the Financial and Operational Practices section.

Revisions to Reflect FINRA Rule Numbers

The revised *Sanction Guidelines* refer to "FINRA" instead of "NASD," where appropriate, and to the new FINRA rule numbers for rules that have been adopted into the new consolidated FINRA rulebook.

Endnotes

1 *See PAZ Sec., Inc.*, Exchange Act Rel. No. 57656, 2008 SEC LEXIS 820, at *21 (Apr. 11, 2008) ("We emphasize that the importance of the information requested must be viewed from NASD's perspective at the time it seeks information."), *aff'd*, 566 F.3d 1172 (D.C. Cir. 2009).

2 *See Joseph Ricupero*, Exchange Act Rel. No. 62891, 2010 SEC LEXIS 2988, at *12 (Sept. 10, 2010) ("Ricupero's failure to respond until after NASD filed a complaint constitutes a complete failure to respond . . . .").

3 *See PAZ Sec.*, 566 F.3d at 1175 ("We hold the Commission did not abuse its discretion in determining the lack of direct harm or benefit does not mitigate a complete failure to respond in violation of Procedural Rule 8210.").

Regulatory Notice 11-08

Markups, Commissions and Fees

FINRA Requests Comment on Proposed Consolidated FINRA Rules Governing Markups, Commissions and Fees

Comment Period Expires: March 28, 2011

Executive Summary

As part of the process to develop a new consolidated rulebook (the Consolidated FINRA Rulebook)[1] FINRA is requesting comment on the proposed consolidated FINRA rules governing markups, markdowns, commissions and fees.

The text of the proposed rules is available as Attachment A on our website at *www.finra.org/notices/11-08*.

Questions regarding this *Notice* should be directed to Sharon K. Zackula, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8985.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 28, 2011.

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

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

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

Financial Industry Regulatory Authority

February 2011

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management

Key Topics

- Markups and Markdowns
- Commissions
- Commission Schedule
- Service Fees and Charges
- Service Fee Schedule

Referenced Rules & Notices

- FINRA Rule 2010
- NASD Rule 2430
- NASD Rule 2440
- NASD IM-2440-1
- NASD IM-2440-2
- NTM 92-11
- NYSE Rule 375 and Interpretation 375/01
- Regulatory Notice 08-80
- SEA Section 19

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

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. 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

NASD Rule 2440 (Fair Prices and Commissions), NASD IM-2440-1 (Mark-Up Policy) and NASD IM-2440-2 (Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities)—collectively referred to as the "markup rules"—govern markups, markdowns and commissions in transactions with customers. Charges or fees that are not transaction-related, such as charges for safekeeping or collecting dividends or interest for a customer, are governed by NASD Rule 2430 (Charges for Services Performed).

NYSE Rule 375 (Missing the Market) prohibits a member from charging a customer a commission without the customer's knowledge and consent on an order if the member has accepted the order for execution and, by neglecting to execute the order or otherwise, takes or supplies for its own account the securities named in the order.[4] NYSE Rule Interpretation 375/01 (Customer Contact and "As of" Reports) states that a member that has "missed the market" should contact the customer, inform the customer of the circumstances and permit the customer to choose one of two ways the member will fill the order.

Proposal

As further detailed below, FINRA proposes to transfer NASD Rule 2440, NASD IM-2440-1 and NYSE Rule 375 to the Consolidated FINRA Rulebook as FINRA Rule 2121 (Fair Prices and Markups, Markdowns and Commissions), subject to significant changes. Among other things, FINRA proposes to eliminate the "5% policy" and the "proceeds provision" in NASD Rule IM-2440-1. FINRA also proposes to require firms to provide commission schedule(s) for equity securities to retail customers, and to notify and obtain consent from a customer to charge a commission when a firm misses the market and trades with the customer on a principal basis.

In addition, FINRA proposes to transfer the requirements set forth in NASD IM-2440-2 to the Consolidated FINRA Rulebook as FINRA Rule 2122 (Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities), without significant change. FINRA proposes not to incorporate in the Consolidated FINRA Rulebook the substantive provisions of NYSE Rule Interpretation 375/01 (Customer Contact and "As of" Reports), which addresses the execution price of orders where a member has missed the market.

With respect to service charges and fees, FINRA proposes to transfer NASD Rule 2430 to the Consolidated FINRA Rulebook as FINRA Rule 2123 (Charges and Fees for Services Performed). Similar to the proposed commission disclosure requirement, FINRA proposes to require members to provide retail customers with schedule(s) of charges and fees for services.[5]

The most significant proposed changes are described generally below. However, FINRA encourages member firms to carefully review the entire proposed rule text (in Attachment A at *www.finra.org/notices/11-08*) to understand the full extent of the proposed changes.

A. Fair Prices and Markups, Markdowns and Commissions (Proposed FINRA Rule 2121)

1. Fair and Reasonable Markups, Markdowns and Commissions (Proposed FINRA Rule 2121(a))

Proposed FINRA Rule 2121(a) incorporates the requirements of NASD Rule 2440 with minor changes.[6] Generally, NASD Rule 2440 requires that securities be sold to or purchased from customers at fair and reasonable prices and, if firms act as agents, be subject to fair and reasonable commissions or commission-equivalent charges. Fairness is judged by the facts and circumstances of the particular transaction. NASD Rule 2440 also lists a few of the circumstances or factors that are generally relevant in determining a markup (or a markdown); the rule sets forth similar factors to apply when a firm acts as agent and charges a commission.[7]

In the new rule, FINRA proposes to clarify a provision in NASD Rule 2440 regarding a member engaged in a principal transaction, which provides: "he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including... the fact that he is entitled to a profit." FINRA proposes to amend the provision to state: "the member shall buy or sell at a price which is fair and reasonable, taking into consideration all relevant facts and circumstances, including... the fact that the member is entitled to remuneration." While members may set customer transaction remuneration charges that are profitable, the markups, markdowns and commissions charged by a member must be established in line with the considerations set forth in the rule. For example, a member that charges a fixed commission of $20 per transaction generally would be entitled to charge this same commission for a purchase transaction of 20 shares of a security at an execution price of

$2. However, a member's right to set profitable transaction charges does not obviate the requirement to comply with the standards of the rule; is not a license to set high minimum markup, markdown or commission charges; and does not allow a member to factor into such charges realized and unrealized market losses on securities that a member holds or has held in inventory.

2. General Considerations; Deletion of the "5% Policy" (Proposed FINRA Rule 2121(b))

FINRA proposes two significant changes to NASD-IM-2440-1 to be transferred to FINRA Rule 2121. First, FINRA proposes not to incorporate the existing "5% Policy" in proposed FINRA Rule 2121(b) (General Considerations).

The "5% Policy" of NASD IM-2440-1 is set forth and discussed in the preamble of NASD IM-2440-1 and referenced in NASD IM-2440-1(a). The preamble states that the question of fair markups (or spreads) is one for which there is no definitive answer or single interpretation because a markup that may be considered fair in one transaction could be unfair in another transaction based on the different circumstances of the two transactions. The preamble also refers to a 1943 survey of the FINRA (then NASD) membership, which revealed that 71 percent of respondents indicated that transactions were executed with markups of 5 percent or less.[8] The Board then determined that in most transactions, markups of 5 percent or less would fall within the "fair and reasonable" standard and adopted the "5% Policy" as guidance.[9] In addition, NASD IM-2440-1(a) provides several "General Considerations." Two address the "5% Policy," stating that the "5% Policy" is a guide and not a rule (NASD IM-2440-1(a)(1)), and that a markup pattern of 5 percent or even less may be considered unfair or unreasonable under the "5% Policy" (NASD IM-2440-1(a)(4)).

FINRA believes that the "5% Policy"—which is based on the execution practices and market efficiencies of nearly 70 years ago—should not be transferred to proposed FINRA Rule 2121. The "5% Policy" is viewed by many as establishing a presumption that markups, markdowns and commissions in excess of 5 percent are prohibited, or, at best, are subject to additional scrutiny, requiring the firm to provide more justification to prove that such remuneration is not "excessive." Conversely, the "5% Policy" is also viewed by many as establishing a specific ceiling or cap below which most markups, markdowns or commissions will not be viewed as excessive (or will not be questioned).

Five percent is significantly higher than the average markup, markdown or commission currently charged by most firms in equity transactions. In a recent study conducted by an independent consultant, based on a sample of more than 161,000 equity transactions with customers, the mean markup was 2.2 percent and the average or median markup was 2 percent.[10] Markdowns were even lower: the mean markdown was 1.9 percent and the median markdown was 1.3 percent.[11]

For debt securities transactions, FINRA also believes that 5 percent is higher than the average markup or markdown charged currently. In this regard, FINRA's preliminary review indicates that debt markups and markdowns in TRACE-Eligible Securities transactions are generally lower than 5 percent.[12] Such markups and markdowns are consistent with the SEC staff's position that debt markups and markdowns generally are expected to be lower than equivalent remuneration in equity transactions.[13]

As the markups, markdowns and commissions that members currently charge in equity and debt transactions are generally lower than 5 percent, FINRA believes the "5% Policy" is outdated and should be deleted. **FINRA emphasizes that the elimination of the "5% Policy" would not be an opportunity to increase markups, markdowns and commissions, but instead reflects FINRA's determination that the "5% Policy" does not reflect current industry practices.** The decision to delete the "5% Policy" also reflects FINRA's view that competition, market pricing efficiency and automation generally have reduced markups, markdowns and commissions materially below 5 percent, and rather than base remuneration for transaction executions off an outdated metric from 1943, a member must use the factors in proposed FINRA Rule 2121(c) to rationalize its remuneration for the execution of a transaction.

At this time, FINRA also does not propose a new policy based upon a lower percentage as this may encourage members to artificially peg (or cap) their markups, markdowns and commissions based upon the new percentage,[14] instead of using the factors in the rule to rationalize their remuneration for the execution of transactions.

With the deletion of the "5% Policy," proposed FINRA Rule 2121(b) is based upon three "General Considerations" from NASD IM-2440-1(a) and an additional provision regarding sales from inventory previously located in NASD IM-2440-1(c)(2). More specifically, FINRA proposes to transfer:[15]

- NASD IM-2440-1(a)(2) regarding excessive expenses as proposed FINRA Rule 2121(b)(1), and to amend the provision to reference explicitly markdowns and commissions.
- NASD IM-2440-1(a)(3) as proposed FINRA Rule 2121(b)(2), subject to certain amendments to clarify the presumption that the member's own contemporaneous cost is the best indication of the prevailing market price, unless other bona fide, more credible evidence of the prevailing market price can be evidenced. Currently, NASD IM-2440-1(a)(3) provides: "In the absence of other bona fide evidence of the prevailing market, a member's own contemporaneous cost is the best indication of the prevailing market price of a security." In contrast, proposed FINRA Rule 2121(b)(2) provides: "For a markup, a member's own contemporaneous cost is the best indication of the prevailing market price of a security, and for a markdown, a member's own contemporaneous proceeds are the best indication of the prevailing market price of a security, unless other bona fide, more credible evidence of the prevailing market price can be evidenced."

- NASD IM-2440-1(c)(2), regarding sales from or to inventory, as proposed FINRA Rule 2121(b)(3). The provision provides that in a principal transaction, when a member sells a security from inventory to a customer, the amount of profit or loss to the member from market appreciation or depreciation before, or after, the date of the transaction with the customer would not ordinarily enter into the determination of the amount or fairness of the dealer's markup. FINRA proposes to amend this provision to apply explicitly to markdowns in the case where the member purchases a security into inventory from a customer.
- NASD IM-2440-1(a)(5),which provides that determination of the fairness of a markup must be based on a consideration of all the relevant factors, of which the percentage of markup is only one, as FINRA Rule 2121(b)(4). FINRA proposes to amend the provision to reference explicitly markdowns and commissions.

3. Deletion of the "Proceeds Provision"

In addition to the elimination of the "5% Policy," the second significant change to the consolidation and transfer of IM-2440-1 to FINRA Rule 2121 is the elimination of the "proceeds provision" (NASD IM-2440-1(c)(5)). Currently, when a customer sells one security and buys a second security at the same time, using the proceeds of the securities position liquidated to pay for the second position, the "proceeds provision" requires that both trades be treated as a single transaction for markup, markdown or commission purposes. Consequently, the total remuneration for both transactions would generally not be allowed to exceed the remuneration amount for a single transaction. FINRA proposes to eliminate it because the provision is confusing and raises concerns that it represents a standard that may not be susceptible to consistent application. For example, it is not always clear when two transactions occurring close in time are related (the two transactions may represent unrelated investment decisions) or how close in time transactions must be to be considered "proceeds" transactions. Further, the "proceeds provision" cannot be applied where a customer decides to sell a position at one broker-dealer to purchase a position at another broker-dealer. FINRA believes the more rational approach is that transaction remuneration be determined on a fair basis pertaining to each transaction.

4. Relevant Factors (Proposed FINRA Rule 2121(c))

FINRA proposes to transfer to FINRA Rule 2121(c) (Relevant Factors) the non-exclusive list of seven relevant factors that a member should take into consideration in determining if a markup, markdown or commission is fair and reasonable. The factors are:

(1) type of security involved;

(2) availability of the security in the market;

(3) price of the security;

(4) amount of money involved in a transaction;

(5) disclosure;

(6) pattern of markups; and

(7) nature of the firm's business.

Also, the transferred provisions incorporate minor stylistic changes to delete certain outdated language.

5. Transactions to Which the Rule is Not Applicable (FINRA Rule 2121(d))

Proposed FINRA Rule 2121(d) includes, with minor, non-substantive amendments, the provision that the markup rule (formerly "policy") does not apply to the sale of securities where a prospectus or offering circular must be delivered and the securities are sold at the specific public offering price (NASD IM-2440-1(d)). Also, proposed FINRA Rule 2121(d) is updated to reflect that FINRA Rule 2121 does not apply to a transaction with a qualified institutional buyer (QIB) that meets the conditions of proposed FINRA Rule 2122(b)(9) (current NASD IM-2440-2(b)(9)).

6. Commission Schedules (Proposed FINRA Rule 2121(e))

In proposed FINRA Rule 2121(e), FINRA proposes an additional requirement regarding transaction-based remuneration. The proposed rule requires a member to establish and make available to retail customers the schedule(s) of standard commission charges for transactions in equity securities with retail customers.[16] A member would be allowed to establish and publish multiple schedules of standard commission charges, as long as it discloses in or with the schedule(s) how the commissions are stratified among all retail customers.

In addition, the prior disclosure of commissions for equity securities transactions would not preclude a member from negotiating lower commission rates with retail customers, provided that the member discloses, in or with the schedule(s), that the member may do so from time to time. A member would be required to provide in writing (which may be electronic) the schedule(s) of commissions to new retail customers at the opening of an account, and all retail customers at least once every calendar year. In addition, a member would be required to provide in writing (which may be electronic) any amendments to the schedule(s) of commissions (including any new forms of commissions or new disclosures) to all retail customers at least 30 days prior to imposing any change in the commissions set forth in the schedules or any new forms of commission charges for retail customers.

Alternatively, a member would be permitted to make available to retail customers its schedule(s) of standard commission charges applicable to retail customers by posting them on its website if the member provides written notice (which may be electronic) to new retail customers at the opening of an account, and all retail customers at least once every calendar year, of the manner in which they may access the commission schedules, and that, upon a retail customer's request, the member will provide a copy of the commission schedules to the customer. In such case, a member also would be required to provide written notice (which may be electronic) to all retail customers at least 30 days prior to imposing any change in the commissions set forth in the schedules or any new forms of commission charges for retail customers.

The proposed requirement is limited to commissions on equity securities because such commissions are most easily compared by retail customers and more readily reduced to fixed amount or ranges than are commissions applicable to other securities transactions, such as debt, or negotiated by institutional accounts. FIINRA anticipates that a retail customer's ability to compare equity commissions among members may, by competition, result in lower commissions (and markups and markdowns).

7. Notice of "Missing the Market" and Consent to Commission Charge (Proposed FINRA Rule 2121(f))

FINRA proposes to incorporate the substantive requirements of NYSE Rule 375 in proposed FINRA Rule 2121(f). NYSE Rule 375 prohibits a member from charging a commission without the customer's knowledge and consent on an order if the member has accepted the order for execution and, by reason of neglect to execute the order or otherwise, takes or supplies for its own account the securities named in the order. FINRA proposes to transfer these requirements to proposed FINRA Rule 2121 because there are no similar requirements in the NASD markup rules regarding whether, and under what circumstances, a member may charge a commission if a member "misses the market." Proposed FINRA Rule 2121(f) would be a new requirement for former NASD-only members.

8. Other Provisions Transferring With Minor Changes or to be Deleted (Paragraphs (a), (b) and (d) of Proposed FINRA Rule 2121)

FINRA also proposes the following minor amendments and deletions as part of the transfer and consolidation of NASD Rule 2440, NASD IM-2440-1 and NYSE Rule 375 into FINRA Rule 2121:

- FINRA proposes deleting (in addition to the "proceeds provision" in IM-2440-1(c) as discussed above) the remaining provisions in NASD IM-2440-1(c) because they are redundant or readily implied in other provisions to be incorporated in FINRA Rule 2121. Specifically, the following provisions would not be transferred to FINRA Rule 2121:
  - IM-2440-1(c)(1), stating that "riskless" transactions are subject to the markup rules;
  - IM-2440-1(c)(3), providing that member purchases from customers are subject to the markup rules and the price paid to the customer or the markdown applied by the member must be reasonably related to the prevailing market price of the security; and

  - IM-2440-1(c)(4), stating that transactions where the member acts as agent are subject to the markup rules and a commission charged a customer must be fair in light of all relevant circumstances.
- FINRA also proposes several conforming changes to FINRA Rule 2121 to add the term "reasonable" when referring to markups, markdowns and commissions that must be "fair" to incorporate the more widely used phrase "fair and reasonable."
- The proposed amendments include additional non-substantive, technical changes to FINRA Rule 2121 not specifically referenced above to modify outdated language; to clarify that generally the provisions of FINRA Rule 2121 refer to markups, markdowns and commissions; and to reflect the new format, terminology and other conventions of the Consolidated FINRA Rulebook.

B. Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities (Proposed FINRA Rule 2122)

FINRA proposes to transfer NASD IM-2440-2 to the Consolidated FINRA Rulebook as FINRA Rule 2122 without significant changes.[17] Proposed FINRA Rule 2122 contains:

- the standards for determining a markup or a markdown in a transaction with a customer in a debt security (except a municipal security);
- the procedures to identify prevailing market price;
- the role of the dealer's contemporaneous cost in determining prevailing market price;
- the characteristics of "similar securities"; and
- the role of similar securities in determining a markup or a markdown that are currently set forth in NASD IM-2440-2.

The proposed rule also includes an exemption from the requirements of proposed FINRA Rule 2121 and FINRA Rule 2122 for certain transactions in non-investment grade securities effected with certain QIBs that is currently in NASD IM-2440-2(b)(9). In addition, proposed FINRA Rule 2122 includes minor changes to update rule cross-references and to reflect the new format, terminology and other conventions of the Consolidated FINRA Rulebook.

C. Charges and Fees for Services Performed (Proposed FINRA Rule 2123)

FINRA proposes to transfer NASD Rule 2430, with a significant change, to the Consolidated FINRA Rulebook as FINRA Rule 2123.[18] Proposed FINRA Rule 2123(a) restates the current requirement that charges and fees for services must be reasonable and not unfairly discriminate among customers and, like NASD Rule 2430, applies to all charges and fees for services provided by a member that are not related to the execution of a transaction.

Similar to the proposed commission disclosure requirement discussed above, FINRA proposes to require a member to establish and make available to retail customers a member's schedule(s) of standard charges and fees for services for retail customers (proposed FINRA Rule 2123(b)).[19] A member that establishes and publishes more than one schedule of standard charges and fees for services for retail customers would be required to disclose, in or with the schedule(s), the manner in which such schedules apply to various types or classes of retail customers, accounts or services. Also, a member would not be precluded from negotiating lower charges and fees with retail customers, provided that the member discloses, in or with the schedule(s), that it may do so from time to time. A member would be required to provide in writing (which may be electronic) the schedule(s) of standard charges and fees for services to new retail customers at the opening of an account, and all retail customers at least once every calendar year. In addition, a member would be required to provide in writing (which may be electronic) any amendments to the schedule(s) of standard charges and fees for services (including any new charges or fees) to all retail customers at least 30 days prior to imposing any change in the charges and fees or disclosures set forth in the schedule(s) or any new charges or fees for retail customers.

Alternatively, a member would be permitted to make available to retail customers the member's schedule(s) of standard charges and fees for services by posting them on its website if it provides written notice (which may be electronic) to new retail customers at the opening of any account, and all retail customers at least once every calendar year, of the schedule(s) and the manner in which they may be accessed. Upon a retail customer's request, the member would provide a copy of the schedule(s) of standard charges and fees to the customer. In such case, a member also would be required to provide written notice (which may be electronic) to all retail customers at least 30 days prior to imposing any change in the charges and fees or disclosures set forth in the schedule(s) or any new charges or fees for retail customers.[20]

Proposed FINRA Rule 2123(a) also includes additional non-substantive, technical changes to reflect the new format, terminology and other conventions of the Consolidated FINRA Rulebook.

D. NYSE Provision Proposed for Deletion (NYSE Rule Interpretation 375/01)

FINRA proposes not to incorporate NYSE Rule Interpretation 375/01 in the Consolidated FINRA Rulebook, relating to the execution price of orders where a member has missed the market. A member's existing obligations under NASD Rule 2320,[21] which broadly requires that a member execute a customer order in the best market for that security "so that the resultant price to the customer is as favorable as possible under prevailing market conditions," and NASD Rule 2111, which requires a member to "make every effort to execute a customer market order that it receives fully and promptly," adequately address such situations.[22]

E. Market Makers

Proposed FINRA Rule 2121 and proposed FINRA Rule 2122, as is the case with the current markup rules, do not address a market maker's allowance, subject to the limitations in regulation, to capture the trading spread between the bid and the ask prices. Nothing in the proposed markup rules affects that body of law and regulation.

Endnotes

1 The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 03/12/08* (Rulebook Consolidation Process).

2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members (NTM) 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily temporarily suspend these types of rule changes within 60 days of filing. If the SEC takes such action, the SEC shall institute proceedings to determine whether the proposed rule should be approved or disapproved. See SEA Section 19 and rules thereunder.

4 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

5 NASD Rules 2440 and 2430, NASD IMs 2440-1 and 2440-2, and NYSE Rule 375 would be deleted in their entirety from the Transitional Rulebook with the adoption of FINRA Rules 2121, 2122 and 2123. NYSE Rule Interpretation 375/01 (Customer Contact and "As of" Reports) would not be transferred to the Consolidated FINRA Rulebook and would be deleted in its entirety from the Transitional Rulebook.

6 There is no NYSE rule equivalent to NASD Rule 2440 or to NASD IM-2440-1.

7 Additional factors that are generally relevant in determining a markup, markdown or commission are set forth in NASD IM-2440-1.

8 Although the entire membership was surveyed, 82 percent of the membership responded.

9 The preamble also states that a firm violates NASD Rule 2110 (now FINRA Rule 2010) and NASD Rule 2440 if it enters into any transaction with a customer at any price not reasonably related to the current market price of the security or charges a commission that is not reasonable.

10 Ferrell, A., *The Law and Finance of Broker-Dealer Mark-Ups* (2007) (Ferrell Study). The Ferrell Study was conducted at FINRA's request, and is based on more than 161,000 equity transactions. The data is a sample largely consisting of lower-priced, less liquid securities (the median price of stock purchased by customers was $5.50), which were purchased or sold over-the-counter to retail customers. (Approximately 98 percent of the transactions were executed over-the-counter.) FINRA collected the data from 14 broker-dealers that had certain compliance issues in their records, tended to be small to medium-sized firms and tended to deal primarily with retail customers. Most of the transaction data was collected as part of a FINRA sweep examination conducted in 2004 of the firms, which preceded the study and was not done for purposes of the study. The Ferrell Study uses the term "markup" (or "markdown") to also include agency remuneration (commissions).

11 To compare some of the recent transaction data with the 1943 markup data, Ferrell also identified markup levels at the 71st percentile and the 47th percentile. Ferrell found that markups in recent transactions at the 71st percentile were 2.95 percent (compared to 5 percent in 1943) and markups in the 47th percentile were 1.8 percent (compared to 3 percent in 1943).

12 FINRA has commenced, but has not yet completed, a review of transactions in TRACE-Eligible Securities (as defined in FINRA Rule 6710) executed during the first two quarters of 2008 to determine the median and mean markups and markdowns currently charged in such debt securities transactions. (Very few transactions in TRACE-Eligible Securities are executed in an agency capacity.)

13 The SEC staff made a similar statement in 1987. *Zero Coupon Securities*, Exchange Act Release No. 24368 (April 21, 1987), 52 FR 15575 (April 29, 1987).

14 In lieu of stating in proposed FINRA Rule 2121 that a markup, markdown or commission of less than a specified amount or percentage, such as 3 percent or 3.5 percent, may not be excessive, FINRA expects to provide guidance in a *Regulatory Notice* that markups, markdowns and commissions above certain specified percentages will be subject to additional regulatory scrutiny, requiring members to provide additional justification to establish that such markups, markdowns, and commissions are not excessive.

15 NASD IM-2440-1(a)(1) and NASD IM-2440-1(a)(4) are based upon the "5% Policy" and, as discussed above, would not be transferred to proposed FINRA Rule 2121.

16 For purposes of the requirement, the term "retail customer" means a customer that does not qualify as an institutional account under NASD Rule 3110(c)(4). The SEC recently approved the adoption of NASD Rule 3110(c)(4) as FINRA Rule 4512(c) without material change. *See* Exchange Act Release No. 63784 (January 27, 2011), 76 FR 5850 (February 2, 2011) (Order Approving File No. SR-FINRA-2010-052). FINRA will announce the effective date of FINRA Rule 4512 in a *Regulatory Notice.*

17 There is no NYSE rule equivalent to NASD IM-2440-2.

18 There is no NYSE rule equivalent to NASD Rule 2430.

19 For purposes of the requirement, the term "retail customer" means a customer that does not qualify as an institutional account under NASD Rule 3110(c)(4). The SEC recently approved the adoption of NASD Rule 3110(c)(4) as FINRA Rule 4512(c) without material change. *See supra* note 16.

20 The requirement to disclose a member's fees and charges to new retail customers and to notify all retail customers of changes to existing fees or new fees at least 30 days prior to imposing the changes in the fees or the new fees is based on current guidance. *See NTM 92-11* (February 1992).

21 FINRA has proposed to adopt new FINRA Rule 5310 (Best Execution and Interpositioning), based largely on NASD Rule 2320. *See Regulatory Notice 08-80* (December 2008).

22 FINRA has proposed to adopt NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders) with significant changes as new FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders). *See* Exchange Act Release No. 61168 (December 15, 2009), 74 FR 68084 (December 22, 2009) (Notice of Filing SR-FINRA-2009-090).

Regulatory Notice 11-09

February 2011

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management
- Systems
- Trading and Market Making

Key Topic(s)
- Company-Related Actions
- Dividends
- Fees
- Non-Exchange Listed Securities
- Over-the-Counter Trading
- Stock Splits

Referenced Rules & Notices
- FINRA Rule 6490
- Regulatory Notice 10-38
- SEA Rule 10b-17
- UPC Rules

Company-Related Actions

New Electronic System for Submitting and Processing Company-Related Actions for Non-Exchange Listed Securities Under Rule 6490

Effective Date: March 14, 2011

Executive Summary

Beginning March 14, 2011, issuers, American Depositary Receipt (ADR) depositary banks and other parties that provide notice of company-related actions to FINRA under Rule 6490 must use a new electronic system to provide such notice to FINRA. As of this effective date, FINRA will no longer accept paper copies of the Company-Related Action Notification Forms.

The new electronic Company-Related Action Forms will be available on March 14, 2011, via *www.finra.org/upc/forms*.

The text of FINRA Rule 6490 is available on FINRA's Web site.

Questions regarding this *Notice* should be directed to:

- FINRA Operations at (866) 776-0800, Option 1; or
- Kosha K. Dalal, Associate Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-6903.

Background & Discussion

FINRA Rule 6490 (Processing of Company-Related Actions), which became effective on September 27, 2010,[1] codifies the requirements in SEA Rule 10b-17 for issuers of a class of publicly traded over-the-counter (OTC) securities to provide timely notice to FINRA of certain corporate actions (*e.g.*, dividend or other distribution of cash or securities, stock split or reverse split, or a rights or subscription offering). Generally (pursuant to SEA Rule 10b-17), issuers must provide notice at least 10 days prior to the record date for the corporate action. Issuers must also notify FINRA of certain other corporate actions (*e.g.*, the issuance or change of trading symbols, mergers or bankruptcy) no later than 10 days prior to the effective date of the company action.

Financial Industry Regulatory Authority

Issuers must complete the required forms and pay the applicable fees within such time periods or they will be subject to late fees and delayed processing of documents to announce corporate actions.

Under Rule 6490, FINRA's Operations Department has the authority to request other documents that may be necessary to verify information provided on the forms. The Operations Department may, in its discretion, conduct detailed reviews of submissions on a case-by-case basis. Moreover, the rule authorizes FINRA not to process a request to announce a corporate action if it determines that the request is deficient and not processing is necessary for the protection of investors and the public interest, and to maintain fair and orderly markets.

Currently, issuers and other parties submit notifications of company-related actions under Rule 6490 by completing the appropriate Company-Related Action Notification Form from FINRA's website and then submitting a paper copy of it to the Operations Department. On March 14, 2011, issuers and other parties must begin using FINRA's new electronic system to provide these notifications. As of this date, FINRA will no longer accept paper copies of Company-Related Action Notification Forms.

The new system offers enhanced functionality that will give issuers and other parties:

- the ability to complete Company-Related Action Forms electronically, including the ability to amend or update the form prior to submission;
- a unique case number for each company-related action to allow for better tracking;
- the ability to create templates for frequently submitted information;
- more streamlined form completion, as the system will automatically direct the issuer or other party only to necessary sections of the form based on the nature of the company-related action notification being submitted; and
- a separate processing system for ADR company-related action notifications for ADR depositary banks.

New Steps for Submitting Company-Related Actions

As of March 14, 2011, an issuer or other duly authorized representative that is obligated to provide notice of a company-related action to FINRA must follow these steps:

1. Complete and submit the appropriate electronic Company-Related Action Notification Form at least 10 days prior to the record date or effective date (as applicable) for the company-related action. **On March 14, the electronic forms and instructions will be available via FINRA's website at *www.finra.org/upc/forms*.**
2. Ensure that the issuer's duly authorized transfer agent simultaneously signs and submits a completed "Transfer Agent Verification Form" to FINRA's Operations Department as required by the Company-Related Action Form.

3. Attach supporting documentation (e.g., copies of Board resolutions authorizing the company-related action, amendments to charters of incorporation) as required by the Company-Related Action Form (which may be attached electronically with the initial submission, or may be submitted subsequently in paper format or by email).
4. Pay all applicable fees, including late fees, as prescribed on the Company-Related Action Notification Form.
5. A unique, identifying case number will be assigned by the Operations Department to each request to process documentation for a Company-Related Action and must be prominently placed on all future submissions, notices and correspondence from the issuer or its duly authorized representative to FINRA relating to the action.

FINRA believes the new electronic system will make compliance with Rule 6490 more efficient. In addition, issuers and other parties that submit corporate action requests will have expanded payment options under the new system for submission of the required Rule 6490 fees that will allow payment by credit card, PayPal or ACH.

Endnotes

1 *See* Securities Exchange Act (SEA) Release No. 62434 (July 1, 2010; 75 FR 39603 (July 9, 2010); SR-FINRA-2009-089 (Order Approving Proposed FINRA Rule 6490 (Processing of Company-Related Actions) to Clarify the Scope of FINRA's Authority When Processing Documents Related to Announcements for Company-Related Actions for Non-Exchange Listed Securities and To Implement Fees for Such Services). *See also Regulatory Notice 10-38* (Obligation of Issuers to Provide Notice of Company-Related Actions) (August 2010).

Information Notice

January 2011 Supplement to the Options Disclosure Document

The SEC approved a supplement to the Options Disclosure Document (ODD) on January 12, 2011. The ODD contains general disclosures on the characteristics and risks of trading standardized options. The recently approved January 2011 supplement amends and restates the June 2007 supplement to provide disclosure to accommodate the listing of credit default options that contemplate only a single credit event, and to incorporate certain technical amendments. As with other supplements to the ODD, this should be read in conjunction with the current ODD, *Characteristics and Risks of Standardized Options*.

Rule 9b-1 under the Securities Exchange Act requires broker-dealers to deliver the ODD and supplements to customers.[1] FINRA has similar requirements in FINRA Rule 2360(b)(11)(A)(1), which requires firms to deliver the current ODD to each customer at or before the time the customer is approved to trade options. In addition, FINRA Rule 2360(b)(11)(A)(1) requires firms to distribute a copy of each ODD supplement to customers who previously received the ODD. Firms must deliver the ODD supplements no later than the time a customer receives a confirmation of a transaction in the category of options to which the amendment pertains. Rule 2360(b)(11)(A)(3) also requires FINRA to advise firms when revisions to the ODD are made.

To comply with the requirements of FINRA Rule 2360(b)(11)(A)(1), firms may distribute the ODD supplement in various ways, including, but not limited to, one of the following:

1. conducting a mass mailing of the supplement to all of its customers approved to trade options who have already received the ODD; or
2. distributing the supplement to a customer who has already received the ODD not later than the time a customer receives a confirmation of a transaction in the category of options to which the amendment pertains.

February 7, 2011

Suggested Routing

- Compliance
- Institutional
- Legal
- Options
- Senior Management
- Trading

Key Topics

- Credit Default Options
- Options
- Options Disclosure Document

Referenced Rules & Notices

- FINRA Rule 2360
- NTM 98-3
- SEA Rule 9b-1

Financial Industry Regulatory Authority

FINRA reminds firms that they may electronically transmit documents that they are required to furnish to customers under FINRA rules, including the ODD and supplements thereto, provided the firm adheres to the standards contained in the May 1996 and October 1995 Securities Exchange Commission Releases,[2] and as discussed in *Notice to Members 98-03*. Firms may also transmit the ODD and supplements to customers who have consented to electronic delivery through the use of a hyperlink.[3]

Questions regarding this Notice may be directed to Kathryn M. Moore, Assistant General Counsel, Office of General Counsel, at (202) 974-2974.

Endnotes

1 17 CFR 240.9b-1.

2 *See* Securities Act Release No. 7288 (May 9, 1996) 61 FR 24644 (May 15, 1996) and Securities Act Release No. 7233 (October 6, 1995) 60 FR 53458 (October 13, 1995).

3 *See* Securities Act Release No. 58738 (October 6, 2008) 73 FR 60371 (October 10, 2008).