

Notices

Regulatory Notices

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Trade Reporting Notice

- 05/10/11** Reporting Asset-Backed Securities to the Trade Reporting and Compliance Engine (TRACE)

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Trade Reporting and Compliance Engine (TRACE)

SEC Approves Amendments to Transaction Reporting and Trading Activity Fee Rules Related to the Reporting of Asset-Backed Securities Transactions

Effective Date: May 16, 2011

Executive Summary

The SEC approved proposed amendments to transaction reporting and notification requirements in the FINRA Rule 6700 Series (TRACE rules) and reporting fees in FINRA Rule 7730, which relate primarily to Asset-Backed Securities,¹ and the method of calculating the Trading Activity Fee (TAF) for such securities in Schedule A of the FINRA By-Laws.²

The effective date is May 16, 2011. The amended text of Schedule A of the FINRA By-Laws and the rules is set forth at www.finra.org/notices/11-20.

Questions regarding this *Notice* should be directed to:

- ▶ Brant Brown, Associate General Counsel, Office of General Counsel (OGC), at (202) 728-6927 (regarding TAF);
- ▶ Patrick Geraghty, Director, Market Regulation, at (240) 386-4973;
- ▶ Elliot R. Levine, Associate Vice President and Counsel, Transparency Services, at (202) 728-8405; or
- ▶ Sharon Zackula, Associate Vice President and Associate General Counsel, OGC, at (202) 728-8985.

May 2011

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Corporate Finance
- ▶ Government Securities
- ▶ Institutional
- ▶ Internal Audit
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Systems
- ▶ Trading
- ▶ Training

Key Topics

- ▶ Asset-Backed Securities
- ▶ Notification
- ▶ Securitized Products
- ▶ TRACE-Eligible Securities
- ▶ TRACE Reporting Fees
- ▶ Trading Activity Fee
- ▶ Transaction Reporting

Referenced Rules & Notices

- ▶ FINRA Rule 6710
- ▶ FINRA Rule 6730
- ▶ FINRA Rule 6760
- ▶ FINRA Rule 7730
- ▶ FINRA By-Laws, Schedule A, Section 1
- ▶ Regulatory Notice 10-55

Background & Discussion

FINRA's TRACE rules provide for the reporting of transactions in TRACE-Eligible Securities to TRACE, and the dissemination of transaction information, with some exceptions. TRACE reporting and data fees are set forth in FINRA Rule 7730. The TAF, a regulatory fee FINRA uses to fund its member regulation activities—which include examinations, financial monitoring and FINRA's policymaking, rulemaking and enforcement activities—is set forth in Schedule A of the FINRA By-Laws.

In February 2010, the SEC approved a rule filing (the TRACE ABS filing)³ which:

- ▶ amends the TRACE rules to classify asset-backed securities, mortgage-backed securities and other similar securities (collectively, Asset-Backed Securities or ABS) as TRACE-Eligible Securities;
- ▶ requires that transactions in ABS be reported to TRACE;
- ▶ modifies certain other reporting requirements and notification provisions; and
- ▶ in FINRA Rule 7730, establishes reporting fees for transactions in ABS.

As previously announced in [Regulatory Notice 10-55](#) (October 2010), the above-referenced rule changes in the TRACE ABS filing become effective on May 16, 2011.⁴

ABS Technical Corrections Filing

On April 28, 2011, the SEC approved additional amendments to the TRACE rules and FINRA Rule 7730, which, in large part, address issues relating to the reporting of, and fees applicable to, ABS transactions. The amendments to the TRACE rules and FINRA Rule 7730 include:

- ▶ adding the defined term "Securitizer"; incorporating minor amendments to clarify, simplify or conform the defined terms "TRACE-Eligible Security," "Reportable TRACE Transaction," "Agency Debt Security," "Asset-Backed Security" and "TRACE System Hours"; and deleting the defined terms "Issuing Entity" and "Sponsor" in FINRA Rule 6710;
- ▶ renumbering as FINRA Rule 6730(a)(3) the ABS reporting requirements previously set forth in FINRA Rule 6730(a)(6);
- ▶ re-setting the expiration of the Pilot Program for reporting ABS transactions to provide that the Pilot Program will expire on Friday, November 18, 2011, in FINRA Rule 6730(a)(3)(A)(i);
- ▶ consolidating and simplifying reporting requirements for ABS transactions that are executed other than during TRACE System Hours in FINRA Rule 6730(a)(3)(B)(ii);

- ▶ adding alternative reporting requirements for ABS transactions that are collateralized mortgage obligation (CMO) or real estate mortgage investment conduit (REMIC) transactions that occur prior to the issuance of the CMO or REMIC (called pre-issuance CMOs/REMICs) as:
 1. FINRA Rule 6730(a)(3)(C)(i) during the Pilot Program; and
 2. FINRA Rule 6730(a)(3)(C)(ii) after the expiration of the Pilot Program;
- ▶ simplifying how settlement is reported for ABS transactions by deleting the requirement to select an indicator that the transaction will be settled regular way (or not settled regular way) in FINRA Rule 6730(d)(4)(B)(ii);
- ▶ adding notification requirements to apply to Securitizers of ABS and alternative notification requirements for pre-issuance CMOs/REMICs in FINRA Rule 6760; and
- ▶ adding the Financial Information eXchange (FIX) as a method to report transactions to TRACE and establish a system-related FIX fee in FINRA Rule 7730.

In addition, FINRA incorporates additional minor amendments to the FINRA Rule 6700 Series and FINRA Rule 7730, including renumbering and conforming the text of parallel reporting provisions in FINRA Rule 6730(a).

TAF

On March 4, 2011, the SEC approved amendments to Section 1 of Schedule A to the FINRA By-Laws to provide a method of calculating the TAF for ABS transactions based on the “reported value of the sale” of such securities. Although the method for calculating the TAF will differ among TRACE-Eligible Securities due to differences in how size (volume) is reported to TRACE and TRACE system differences, for all TRACE-Eligible Securities, ultimately, the TAF is assessed based on the size of the transaction.

Currently, when reporting the size (volume) of a transaction other than an ABS, the number of bonds is reported and the TRACE system, which is programmed to reflect that one bond equals \$1,000 par value, calculates the size (expressed as total par value) of the transaction (e.g., 10 bonds x \$1,000 = \$10,000). Based on this reporting structure, the TAF is assessed on a per-bond basis, which indirectly is an assessment based on size, as the number of bonds is a proxy for the size of a transaction in \$1,000 increments.

The revisions to Section 1 of Schedule A to the FINRA By-Laws provide a method of calculating the TAF for sales of ABS based on the “reported value of the sale” of the transaction. When a member reports a transaction in an ABS where the par value (or original principal value or original face value) *does not decrease* (or in some circumstances, increase) over time due to the amortization of assets underlying the security, the total par value is reported to TRACE (and not the number of bonds, even if ascertainable) as required under FINRA Rule 6730(d)(2), and the TAF is assessed based upon the total par value reported.⁵ However, the requirements to report the size (volume) of an ABS differ

if the security amortizes over time. In the sale of an ABS where the original face value (or original principal value) is anticipated to decrease (or increase) over time due to the amortization of assets underlying the security, such as in the sale of a mortgage-backed security, size (volume) is not specifically reported, but is calculated, and the TAF is assessed, by multiplying (a) the reported original face value times (b) the applicable Factor. The Factor is either reported by the member, or, in most cases, is incorporated in the TRACE system by FINRA and not reported by the member as provided in Rule 6730(d)(2).⁶ The rate is \$0.00000075 times the size of the transaction as reported to TRACE, with a maximum charge of \$0.75 per trade.

Effective Date

The changes to the TRACE rules, FINRA Rule 7730 and Section 1 of Schedule A to the FINRA By-Laws become effective on May 16, 2011 (the same day that the rule changes in the TRACE ABS filing become effective).

Endnotes

- 1 See Securities Exchange Act Release No. 64364 (April 28, 2011), 76 FR 25385 (May 4, 2011) (SEC Order Approving File No. SR-FINRA-2011-012).
- 2 See Securities Exchange Act Release No. 64041 (March 4, 2011), 76 FR 13248 (March 10, 2011) (SEC Order Approving File No. SR-FINRA-2011-004).
- 3 See Securities Exchange Act Release No. 61566 (February 22, 2010), 75 FR 9262 (March 1, 2010) (SEC Order Approving File No. SR-FINRA-2009-065) (TRACE ABS filing).
- 4 See Securities Exchange Act Release No. 63223 (November 1, 2010), 75 FR 68654 (November 8, 2010) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2010-054 to Extend the Operational Date of SR-FINRA-2009-065) and [Regulatory Notice 10-55](#) (October 2010).
- 5 For example, the size of a \$100,000 par value transaction in an ABS that does not amortize over time is reported to TRACE as \$100,000. In contrast, a corporate bond transaction of \$100,000 par value is reported to TRACE as 100 bonds. See FINRA Rule 6730(d)(2).
- 6 If an ABS amortizes over time, a member must report the Factor only if the Factor that the member uses to execute the transaction is not the most current Factor publicly available for the ABS at the Time of Execution. When the Factor is the most current Factor publicly available, the member is not required to report it because FINRA incorporates such Factors in the TRACE system. A member must always report the original face value. See FINRA Rule 6730(d)(2).

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Fidelity Bonds

SEC Approves Consolidated FINRA Rule Governing Fidelity Bonds

Effective Date: January 1, 2012

Executive Summary

The SEC approved FINRA's proposal to adopt a rule governing fidelity bonds¹ for the consolidated FINRA rulebook.² The new rule, FINRA Rule 4360, is based on NASD Rule 3020, taking into account certain requirements under NYSE Rule 319 and its Interpretation.³

The text of the new rule is set forth in Attachment A. The rule takes effect on January 1, 2012.

Questions regarding this *Notice* should be directed to:

- ▶ Susan DeMando Scott, Associate Vice President, Financial Operations Policy, at (202) 728-8411; or
- ▶ Erika L. Lazar, Counsel, Office of General Counsel, at (202) 728-8013.

Background & Discussion

FINRA Rule 4360 (Fidelity Bonds) updates and clarifies the fidelity bond requirements in NASD Rule 3020 and NYSE Rule 319 (and its Interpretation) and better reflects current industry practices. The requirements are set forth in detail below.

May 2011

Notice Type

- ▶ Consolidated FINRA Rulebook
- ▶ Rule Approval

Suggested Routing

- ▶ Compliance
- ▶ Finance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management

Key Topics

- ▶ Fidelity Bonds

Referenced Rules & Notices

- ▶ FINRA Rule 4360
- ▶ NASD Rule 3020
- ▶ NYSE Rule 319 and its Interpretation
- ▶ SEA Rule 15c3-1
- ▶ SEA Rule 17a-4

General Provision

FINRA Rule 4360 requires each member firm that is required to join the Securities Investor Protection Corporation (SIPC) to maintain blanket fidelity bond coverage with specified amounts of coverage based on the firm's net capital requirement, with certain exceptions.⁴ Such firms must maintain fidelity bond coverage that provides for per loss coverage without an aggregate limit of liability.⁵ Firms may apply for this level of coverage with any product that meets these requirements, including the Securities Dealer Blanket Bond (SDBB) or a properly endorsed Financial Institution Form 14 Bond (Form 14).⁶

Most fidelity bonds contain a definition of the term "loss" (or "single loss"), for purposes of the bond, which generally includes all covered losses resulting from any one act or a series of related acts. A payment by an insurer for covered losses attributed to a single loss does not reduce a firm's coverage amount for losses attributed to other, separate acts. A fidelity bond with an aggregate limit of liability caps a firm's coverage during the bond period at a certain amount if a loss (or losses) meets this aggregate threshold. FINRA believes that per loss coverage without an aggregate limit of liability provides firms with the most beneficial coverage since the bond amount cannot be exhausted by one or more covered losses, which means it will be available for future losses during the bond period.

A firm that does not qualify for a fidelity bond with per loss coverage and no aggregate limit of liability must maintain substantially similar fidelity bond coverage in compliance with all other provisions of the rule, provided that the firm maintains written correspondence from two insurance providers stating that the firm does not qualify for such coverage.⁷ The firm must retain such correspondence for the period specified by Exchange Act Rule 17a-4(b)(4).⁸

A firm's fidelity bond must provide against loss and have Insuring Agreements covering at least the following: fidelity, on premises, in transit, forgery and alteration, securities and counterfeit currency.⁹ These Insuring Agreements are defined in the fidelity bond forms available to firms. FINRA Rule 4360 modifies the descriptive headings for these Insuring Agreements, in part, from NASD Rule 3020(a)(1) and NYSE Rule 319(d) to align them with the headings in the current bond forms.¹⁰ In addition, FINRA Rule 4360 replaces the specific coverage provisions in the NASD and NYSE rules that permit less than 100 percent of coverage for certain Insuring Agreements (*i.e.*, fraudulent trading and securities forgery)¹¹ so that coverage for all Insuring Agreements must be equal to 100 percent of the firm's minimum required bond coverage.¹²

A firm's fidelity bond must include a cancellation rider providing that the insurer will use its best efforts to *promptly* notify FINRA in the event the bond is cancelled, terminated or substantially modified. FINRA Rule 4360 adopts the definition of "substantially modified" in NYSE Rule 319¹³ and incorporates NYSE Rule 319.12's standard that a firm must *immediately* advise FINRA in writing if its fidelity bond is cancelled, terminated or substantially modified.¹⁴

Minimum Required Coverage

Each firm subject to the rule must maintain, at a minimum, fidelity bond coverage for any person associated with the firm, except directors or trustees who are not performing acts within the scope of the usual duties of an officer or employee.¹⁵

A firm with a minimum net capital requirement that is less than \$250,000 must maintain minimum coverage of the greater of 120 percent of its required minimum net capital under Exchange Act Rule 15c3-1 or \$100,000.¹⁶ The \$100,000 minimum coverage requirement modifies the present minimum requirement of \$25,000. FINRA believes this increase is warranted since the NASD and NYSE fidelity bond rules have not been materially modified since their adoption more than 30 years ago. Although firms may experience a slight increase in costs for their premiums under the new rule, FINRA believes that the amendments to the fidelity bond minimum requirements are necessary to provide meaningful and practical coverage for losses covered by the bond.

Firms with a minimum net capital requirement of at least \$250,000 must use a table in FINRA Rule 4360 to determine their minimum fidelity bond coverage requirement.¹⁷ The table is a modified version of the tables in NASD Rule 3020(a)(3) and NYSE Rule 319(e)(i). The identical NASD and NYSE requirements for members that have a minimum net capital requirement that exceeds \$1 million have been retained in FINRA Rule 4360; however, the rule adopts the higher requirements in NYSE Rule 319(e)(i) for a member with a net capital requirement of at least \$250,000, but less than \$1 million.

The entire amount of a firm's minimum required coverage must be available for covered losses and may not be eroded by the costs an insurer may incur if it chooses to defend a claim. Specifically, any defense costs for covered losses must be in addition to a firm's minimum coverage requirements.¹⁸ A firm may include defense costs as part of its fidelity bond coverage, but only to the extent that it does not reduce its minimum required coverage under the rule.

Deductible Provision

FINRA Rule 4360 provides for an allowable deductible amount of up to 25 percent of the fidelity bond coverage purchased by a firm. Any deductible amount elected by the firm that is greater than 10 percent of the coverage purchased by the firm¹⁹ must be deducted from its net worth in the calculation of its net capital for purposes of Exchange Act Rule 15c3-1.²⁰ Like the legacy NASD and NYSE rules, if the firm is a subsidiary of another FINRA member firm, this amount may be deducted from the parent's rather than the subsidiary's net worth, but only if the parent guarantees the subsidiary's net capital in writing.²¹

Annual Review of Coverage

A member firm (including a firm that signs a multi-year insurance policy) must review, annually as of the yearly anniversary date of the issuance of its fidelity bond, the adequacy of its fidelity bond coverage and make any required adjustments to its coverage, as set forth in the rule.²² A firm's highest net capital requirement during the preceding 12-month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), is the basis for determining the firm's minimum required fidelity bond coverage for the succeeding 12-month period.²³ The "preceding 12-month period" includes the 12-month period that ends 60 days before the yearly anniversary date of a firm's fidelity bond to provide the firm time to determine its required fidelity bond coverage by the anniversary date of the bond.

A firm that has only been in business for one year and elected the aggregate indebtedness ratio for calculating its net capital requirement may use, solely for the purpose of determining the adequacy of its fidelity bond coverage for its second year, the 15 to 1 ratio of aggregate indebtedness to net capital in lieu of the 8 to 1 ratio (required for broker-dealers in their first year of business) to calculate its net capital requirement. Notwithstanding the above, such member may not carry less minimum fidelity bond coverage in its second year than it carried in its first year.²⁴

Exemptions

FINRA Rule 4360 exempts from the fidelity bond requirements firms in good standing with a national securities exchange that maintain a fidelity bond subject to the requirements of such exchange that are equal to or greater than the requirements set forth in the rule.²⁵ Additionally, consistent with NYSE Rule Interpretation 319/01, FINRA Rule 4360 exempts from the fidelity bond requirements any firm that acts solely as a Designated Market Maker (DMM), floor broker or registered floor trader and does not conduct business with the public.²⁶

FINRA Rule 4360 does not maintain the exemption in NASD Rule 3020(e) for a one-person firm.²⁷ Historically, a sole proprietor or sole stockholder member was excluded from the fidelity bond requirements based upon the assumption that such firms were one-person shops and, therefore, could not obtain coverage for their own acts. FINRA has determined that these firms can and often do acquire fidelity bond coverage, even though it is currently not required, since all claims (irrespective of firm size) are likely to be paid or denied on a facts-and-circumstances basis. In addition, FINRA believes that each Insuring Agreement required by FINRA Rule 4360 has the potential to benefit a one-person firm.²⁸ Moreover, FINRA believes that requiring all SIPC member firms, regardless of size or structure, to maintain fidelity bond coverage promotes investor protection objectives and mitigates the effects of unforeseen losses.

Effective Date

FINRA Rule 4360 takes effect on January 1, 2012. Member firms subject to the rule (including a firm that signs a multi-year insurance policy) must have a fidelity bond in place as of January 1, 2012, that meets all of the requirements set forth in FINRA Rule 4360. Firms should contact their fidelity bond insurance providers in advance of the effective date of the rule to ensure that necessary updates to their policies are in place as of the effective date.

Endnotes

- 1 See Securities Exchange Act Release No. 63961 (February 24, 2011), 76 FR 11542 (March 2, 2011) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-059).
- 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 4360 replaces NASD Rule 3020 and the corresponding provisions in NYSE Rule 319 and its Interpretation. Accordingly, effective January 1, 2012, NASD Rule 3020 and NYSE Rule 319 (and its Interpretation) will be deleted from the Transitional Rulebook.
- 4 See FINRA Rule 4360(a)(1).
- 5 See FINRA Rule 4360(a)(3).
- 6 Since 1982, firms electing to acquire coverage through the FINRA-sponsored Insurance Program (Sponsored Program) have been provided with the SDBB. It is the “default” insurance for FINRA member firms in that when a firm completes the application for the Sponsored Program, they are applying for the SDBB.
- 7 See FINRA Rule 4360.02.
- 8 FINRA has been advised by insurance industry representatives that the alternative coverage requirement is necessary for firms that, for example, have had a covered loss paid by an insurer within the past five years or firms that may present certain risk factors that would prevent an insurer from offering per loss coverage without an aggregate limit of liability.
- 9 See FINRA Rule 4360(a)(1)(A)–(F).

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Endnotes continued

- 10 FINRA has been advised by insurance industry representatives that the rule change does not substantively change what is required to be covered by the bond. For example, previous versions of the SDBB and Form 14 included a separate Insuring Agreement for misplacement; however, in the current versions of the bonds, this coverage is included in both “on premises” and “in transit” coverage.
- 11 See NASD Rule 3020(a)(4) and (a)(5), and NYSE Rule 319(d)(ii)(B) and (C), and (e)(ii)(B) and (C).
- 12 Firms may elect to carry additional, optional Insuring Agreements not required by FINRA Rule 4360 for an amount less than 100 percent of the minimum required bond coverage.
- 13 FINRA Rule 4360.01 defines the term “substantially modified” as “any change in the type or amount of fidelity bonding coverage, or in the exclusions to which the bond is subject, or any other change in the bond such that it no longer complies with the requirements of this Rule.”
- 14 See FINRA Rule 4360(a)(2) and (e).
- 15 See FINRA Rule 4360(b)(2).
- 16 See FINRA Rule 4360(b)(1).
- 17 See FINRA Rule 4360(b)(1).
- 18 See FINRA Rule 4360(b)(3).
- 19 FINRA notes that a firm may elect, subject to availability, a deductible of less than 10 percent of the coverage purchased.
- 20 FINRA Rule 4360 eliminates the current concept of an “excess deductible” linked to a member firm’s required *minimum* bond requirement in NASD Rule 3020 and bases such deduction from net worth on coverage purchased by the firm.
- 21 See FINRA Rule 4360(c).
- 22 See FINRA Rule 4360(d)(1).
- 23 See FINRA Rule 4360(d)(2).
- 24 See FINRA Rule 4360(d)(3).
- 25 See FINRA Rule 4360(f)(1)(A). In general, the notification provisions of the corresponding exchange rules (*i.e.*, cancellation rider and notification upon cancellation, termination or substantial modification of the bond) require notification to the respective exchange rather than to FINRA. Accordingly, the practical effect for a firm that avails itself of the exemption is that such firm must maintain a fidelity bond subject to the same or greater requirements as in FINRA Rule 4360; however, such firm would be exempt from the requirement that FINRA be notified of changes to the bond and would alternatively comply with the notification provisions of the respective exchange.
- 26 See FINRA Rule 4360(f)(1)(B). See also Securities Exchange Act Release No. 58845 (October 24, 2008), 73 FR 64379 (October 29, 2008) (Order Approving File No. SR-NYSE-2008-46). In this rule filing, the role of the specialist was altered in certain respects and the term “specialist” was replaced with the term “Designated Market Maker.”
- 27 A one-person member (that is, a firm owned by a sole proprietor or stockholder that has no other associated persons, registered or unregistered) has no “employees” for purposes of NASD Rule 3020, and therefore such a firm currently is not subject to the fidelity bonding requirements. Conversely, a firm owned by a sole proprietor or stockholder that has other associated persons has “employees” for purposes of NASD Rule 3020, and currently is, and will continue to be, subject to the fidelity bonding requirements.

Endnotes continued

- 28 Insuring Agreement A – Fidelity is premised on the acts of an “employee” of the insured, which is currently broadly defined in the SDBB to include, among others, an officer or other employee of the insured, while employed in, at or by any of the insured’s offices or premises, an attorney retained by the insured while performing legal services for the insured and any natural person performing acts coming within the scope of the usual duties of an officer or employee of the insured, including any persons provided by an employment contractor. Based on this definition, FINRA believes that while a sole proprietor or sole stockholder may not have other associated persons or registered persons, it may have “employees” for purposes of a fidelity bond and therefore may benefit from Fidelity coverage (*e.g.*, outside counsel). Insuring Agreements B through F in FINRA Rule 4360 (*i.e.*, those covering property losses on premises or in transit, forgery and alteration, securities and counterfeit currency) are premised on losses suffered by the insured that are not limited to the acts of an “employee.”

ATTACHMENT A

Below is the text of the new FINRA rule.

* * * * *

4360. Fidelity Bonds

(a) General Provision

(1) Each member required to join the Securities Investor Protection Corporation shall maintain blanket fidelity bond coverage which provides against loss and has Insuring Agreements covering at least the following:

- (A) Fidelity
- (B) On Premises
- (C) In Transit
- (D) Forgery and Alteration
- (E) Securities
- (F) Counterfeit Currency

(2) The fidelity bond must include a cancellation rider providing that the insurance carrier will use its best efforts to promptly notify FINRA in the event the bond is cancelled, terminated or substantially modified.

(3) A member's fidelity bond must provide for per loss coverage without an aggregate limit of liability.

(b) Minimum Required Coverage

(1) A member with a net capital requirement of less than \$250,000 must maintain minimum fidelity bond coverage for all Insuring Agreements required by paragraph (a) of this Rule of the greater of (A) 120% of the member's required net capital under SEA Rule 15c3-1 or (B) \$100,000. A member with a net capital requirement of \$250,000 or more must maintain minimum fidelity bond coverage for all Insuring Agreements required by paragraph (a) of this Rule in accordance with the following table:

Net Capital Requirement under SEA Rule 15c3-1	Minimum Coverage
250,000 – 300,000	600,000
300,001 – 500,000	700,000
500,001 – 1,000,000	800,000
1,000,001 – 2,000,000	1,000,000
2,000,001 – 3,000,000	1,500,000
3,000,001 – 4,000,000	2,000,000
4,000,001 – 6,000,000	3,000,000
6,000,001 – 12,000,000	4,000,000
12,000,001 and above	5,000,000

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

(3) Any defense costs for covered losses must be in addition to the minimum coverage requirements as set forth in paragraph (b)(1) of this Rule.

(c) Deductible Provision

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

(d) Annual Review of Coverage

(1) A member, including a member that signs a multi-year insurance policy, shall, annually as of the yearly anniversary date of the issuance of the fidelity bond, review the adequacy of its coverage and make any required adjustments, as set forth in paragraphs (d)(2) and (d)(3) of this Rule.

(2) A member's highest net capital requirement during the preceding 12-month period, based on the applicable method of computing net capital (dollar minimum, aggregate indebtedness or alternative standard), shall be used as the basis for determining the member's required minimum fidelity bond coverage for the succeeding 12-month period. For the purpose of this paragraph, the "preceding 12-month period" shall include the 12-month period that ends 60 days before the yearly anniversary date of a member's fidelity bond.

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

(e) Notification of Change

A member shall immediately advise FINRA in writing if its fidelity bond is cancelled, terminated or substantially modified.

(f) Exemptions

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

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

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

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

• • • Supplementary Material: -----

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

.02 Alternative Coverage. A member that does not qualify for blanket fidelity bond coverage as required by paragraph (a)(3) of this Rule shall maintain substantially similar fidelity bond coverage in compliance with all other provisions of this Rule, provided that the member maintains written correspondence from two insurance providers stating that the member does not qualify for the coverage required by paragraph (a)(3) of this Rule. The member must retain such correspondence for the period specified by SEA Rule 17a-4(b)(4).

Promissory Note Proceedings

Arbitration Panel Composition for Promissory Note Disputes

Effective Date: June 6, 2011

Executive Summary

Effective June 6, 2011, FINRA will appoint chair-qualified public arbitrators to panels resolving promissory note disputes instead of appointing chair-qualified public arbitrators also qualified to resolve statutory discrimination claims.¹

The amendments apply to all promissory note proceedings in which FINRA has not sent lists of arbitrators to the parties as of the effective date. The text of the amendments is set forth in Attachment A.

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 (DR), at (212) 858-4307 or richard.berry@finra.org; or
- ▶ Margo A. Hassan, Assistant Chief Counsel, DR, at (212) 858-4481 or margo.hassan@finra.org.

Background & Discussion

In 2009, FINRA implemented new procedures to expedite the administration of cases that solely involve a brokerage firm's claim that an associated person failed to pay money owed on a promissory note.² Under the procedures, FINRA appoints a single chair-qualified public arbitrator from the roster of arbitrators approved to hear statutory discrimination claims (a statutory discrimination-qualified arbitrator)³ to resolve the dispute.⁴ These specially qualified arbitrators are public chair-qualified arbitrators who also are attorneys familiar with employment law and have at least ten years of legal experience. In addition, they may not have represented primarily the views of employers or of employees within the last five years. FINRA proposed using statutory discrimination qualified arbitrators because of the depth of their experience and their familiarity with employment law.

May 2011

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal

Registered Representatives

- ▶ Key Topics
- ▶ Arbitration
- ▶ Associated Person
- ▶ Code of Arbitration Procedure
- ▶ Promissory Note

Referenced Rules & Notices

- ▶ Notice 09-48
- ▶ Rule 12400 (c)
- ▶ Rule 13802
- ▶ Rule 13806

Since implementing the new procedures, FINRA found that promissory note cases did not require such extensive experience or depth of knowledge. In a majority of completed cases, arbitrators decided the case on the pleadings and the respondent broker did not appear. In addition, the number of promissory note cases has more than doubled in the past two years. As a result of this substantial increase, it became more difficult to appoint panels in these cases using only statutory discrimination-qualified arbitrators. Therefore, FINRA amended the Code of Arbitration Procedure for Industry Disputes (Industry Code) to provide that FINRA will appoint a chair-qualified public arbitrator to a panel resolving a promissory note dispute instead of appointing a statutory discrimination qualified arbitrator. Chair-qualified arbitrators have completed chair training and are attorneys who have served through award on at least two cases, or, if not attorneys, are arbitrators who have served through award on at least three cases.⁵ The rule amendments ensure that FINRA has a sufficient number of qualified arbitrators readily available to resolve these matters.

Effective Date

The amendments to the Industry Code are effective on June 6, 2011, and apply to all promissory note proceedings in which FINRA has not sent lists of arbitrators to the parties.

Endnotes

- 1 See Securities Exchange Act Rel. No. 64226 (April 7, 2011), 76 Federal Register 20741 (April 13, 2011) and Rel. No. 64226A (April 13, 2011), 76 Federal Register 21932 (April 19, 2011) (File No. SR-FINRA 2011-005).
- 2 See Securities Exchange Act Rel. No. 34-60132 (June 17, 2009), 74 FR 30191 (June 24, 2009) (File No. SR-FINRA-2009-015). FINRA announced implementation of New Rule 13806 (Promissory Note Proceedings) in [Regulatory Notice 09-48](#). The effective date was September 14, 2009.
- 3 See Rule 13802(c)(3).
- 4 Under Rule 13806, if an associated person does not file an answer, or files an answer but does not assert any counterclaims or third party claims, regardless of the amount in dispute, a single statutory discrimination-qualified arbitrator decides the case. If an associated person files a counterclaim or third-party claim, FINRA bases panel composition on the amount of the counterclaim or third-party claim. For counterclaims and third-party claims that are not more than \$100,000, FINRA appoints a single statutory discrimination-qualified arbitrator. For counterclaims and third-party claims of more than \$100,000, FINRA appoints a three-arbitrator panel comprising a statutory discrimination-qualified arbitrator, a public arbitrator and a non-public arbitrator.
- 5 See Rule 12400(c).

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Attachment A

New language is underlined; deletions are in brackets.

Code of Arbitration Procedure for Industry Disputes

* * *

13806 Promissory Note Proceedings

(a) – (b) No change.

(c) Composition of Panel

(1) If the panel consists of one arbitrator, the arbitrator will be a public arbitrator [qualified to resolve a statutory discrimination claim as set forth in Rule 13802(c)(3)] selected from the chairperson roster described in Rule 12400(c) of the Code of Arbitration Procedure for Customer Disputes, unless the parties agree in writing otherwise.

(2) If the panel consists of three arbitrators, one arbitrator will be a public arbitrator [who meets the qualifications in Rule 13802(c)(3)] selected from the chairperson roster described in Rule 12400(c) of the Code of Arbitration Procedure for Customer Disputes, unless the parties agree in writing otherwise; one arbitrator will be selected from the roster of public arbitrators; and one arbitrator will be selected from the roster of non-public arbitrators. [The arbitrator who meets the criteria in Rule 13802(c)(3) will serve as the chairperson of the panel.]

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

(d) – (f) No change.

* * *

Motion Practice

Five-Day Period for Replies to Responses to Motions in Arbitration

Effective Date: June 6, 2011

Executive Summary

Effective June 6, 2011, a moving party (the party that makes the original motion in an arbitration) will have a five-day period to reply to a response to a motion.¹ This five-day period gives parties an opportunity to brief fully the issues in dispute, and ensures that arbitrators deciding a motion have all the motion papers before issuing a final decision.

The amendments to the Customer and Industry Codes of Arbitration Procedure (the Codes) apply to motions in all cases and are set forth in Attachment A.

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 (DR), at (212) 858-4307 or richard.berry@finra.org; or
- ▶ Margo A. Hassan, Assistant Chief Counsel, DR, at (212) 858-4481 or margo.hassan@finra.org.

Background & Discussion

The Codes specify time periods for a party to respond to a motion, including a motion to dismiss. They do *not* provide expressly for a moving party to reply to a response. FINRA staff observed that occasionally, the moving party submitted a reply to a response. FINRA's practice had been to forward the reply to the arbitrators, even when FINRA receives the reply after it has already sent the motion and response to the arbitrators. Since the Codes do not prescribe a time period for replying to responses to motions, there have been instances where arbitrators reviewed the motion papers and even ruled on a motion before receiving a moving party's reply. On June 21, 2010, FINRA

May 2011

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives

Key Topics

- ▶ Arbitration
- ▶ Codes of Arbitration Procedure
- ▶ Motions

Referenced Rules & Notices

- ▶ Rule 12206
- ▶ Rule 12503
- ▶ Rule 12504
- ▶ Rule 13206
- ▶ Rule 13503
- ▶ Rule 13504

revised its practice relating to replies to responses to motions and published [Notice to Parties—Time to Reply to Objections](#) on its website, stating that moving parties have five calendar days from receipt of a response to a motion to submit a reply to the response.

FINRA amended Rules 12206 and 13206 (Time Limits), Rules 12503 and 13503 (Motions), and Rules 12504 and 13504 (Motions to Dismiss) to provide a moving party with a five-day period to reply to a response to a motion. The amendments codify FINRA's current practice, as outlined in the Notice to Parties, and make it transparent. The amendments also provide parties with an opportunity to brief fully the issues in dispute, and ensure that arbitrators have all of the motion papers before issuing a final decision on the motion.

Effective Date

The amendments to the Codes are effective on June 6, 2011, and apply to motions in all cases.

Endnotes

- 1 See Securities Exchange Act Rel. No. 64225 (April 7, 2011), 76 Federal Register 20757 (April 13, 2011) (File No. SR-FINRA-2011-006).

Attachment A

New language is underlined; deletions are in brackets

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

* * *

Customer Code

12206. Time Limits

(a) No Change.

(b) Dismissal under Rule

Dismissal of a claim under this rule does not prohibit a party from pursuing the claim in court. By filing a motion to dismiss a claim under this rule, the moving party agrees that if the panel dismisses a claim under this rule, the non-moving party may withdraw any remaining related claims without prejudice and may pursue all of the claims in court.

(1) Motions under this rule must be made in writing, and must be filed separately from the answer, and only after the answer is filed.

(2) Unless the parties agree or the panel determines otherwise, parties must serve motions under this rule at least 90 days before a scheduled hearing, and parties have 30 days to respond to the motion. Moving parties may reply to responses to motions. Any such reply must be made within 5 days of receipt of a response.

(3) – (10) No change.

(c) – (d) No change.

* * *

12503. Motions

(a) – (b) No change.

(c) Replying to Responses to Motions

Parties have 5 days from the receipt of a response to a motion to reply to the response unless the responding party agrees to an extension of time, or the Director or the panel decides otherwise. Replies to responses must be served directly on each other party, at the same time and in the same manner. Replies to responses must also be filed with the Director, with additional copies for each arbitrator, at the same time and in the same manner in which they are served on the parties.

[c] (d) Authority to Decide Motions

(1) – (5) No change.

* * *

12504. Motions to Dismiss**(a) Motions to Dismiss Prior to Conclusion of Case in Chief**

(1) Motions to dismiss a claim prior to the conclusion of a party's case in chief are discouraged in arbitration.

(2) Motions under this rule must be made in writing, and must be filed separately from the answer, and only after the answer is filed.

(3) Unless the parties agree or the panel determines otherwise, parties must serve motions under this rule at least 60 days before a scheduled hearing, and parties have 45 days to respond to the motion. Moving parties may reply to responses to motions. Any such reply must be made within 5 days of receipt of a response.

(4) - (11) No change.

(b) – (e) No change.

* * *

Industry Code

13206. Time Limits

(a) No change.

(b) Dismissal under Rule

Dismissal of a claim under this rule does not prohibit a party from pursuing the claim in court. By filing a motion to dismiss a claim under this rule, the moving party agrees that if the panel dismisses a claim under this rule, the non-moving party may withdraw any remaining related claims without prejudice and may pursue all of the claims in court.

(1) Motions under this rule must be made in writing, and must be filed separately from the answer, and only after the answer is filed.

(2) Unless the parties agree or the panel determines otherwise, parties must serve motions under this rule at least 90 days before a scheduled hearing, and parties have 30 days to respond to the motion. Moving parties may reply to responses to motions. Any such reply must be made within 5 days of receipt of a response.

(3) – (10) No change.

(c) – (d) No change.

* * *

13503. Motions

(a) – (b) No change.

(c) Replying to Responses to Motions

Parties have 5 days from the receipt of a response to a motion to reply to the response unless the responding party agrees to an extension of time, or the Director or the panel decides otherwise. Replies to responses must be served directly on each other party, at the same time and in the same manner. Replies to responses must also be filed with the Director, with additional copies for each arbitrator, at the same time and in the same manner in which they are served on the parties.

[c] (d) Authority to Decide Motions

(1) – (5) No change.

* * *

13504. Motions to Dismiss**(a) Motions to Dismiss Prior to Conclusion of Case in Chief**

(1) Motions to dismiss a claim prior to the conclusion of a party's case in chief are discouraged in arbitration.

(2) Motions under this rule must be made in writing, and must be filed separately from the answer, and only after the answer is filed.

(3) Unless the parties agree or the panel determines otherwise, parties must serve motions under this rule at least 60 days before a scheduled hearing, and parties have 45 days to respond to the motion. Moving parties may reply to responses to motions. Any such reply must be made within 5 days of receipt of a response.

(4) – (11) No change.

(b) – (e) No change.

* * *

Customer Order Protection

SEC Approves Consolidated FINRA Customer Order Protection Rule

Effective Date: September 12, 2011

Executive Summary

On February 11, 2011, the SEC approved new FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) for the consolidated FINRA rulebook (the Consolidated FINRA Rulebook).¹ Rule 5320 consolidates, updates and simplifies NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders).² Rule 5320 becomes effective on September 12, 2011.

Text of new FINRA Rule 5320 is available in the online FINRA Manual at www.finra.org/finramanual.³

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

Background and Discussion

On February 11, 2011, the SEC approved a proposed rule change consolidating, updating and simplifying NASD IM-2110-2 (Trading Ahead of Customer Limit Order) and NASD Rule 2111 (Trading Ahead of Customer Market Orders) into FINRA Rule 5320 (Prohibition Against Trading Ahead of Customer Orders).⁴ FINRA Rule 5320 generally provides that a member firm that accepts and holds an order in an equity security from its own customer or a customer of another broker-dealer without immediately executing the order is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.⁵

May 2011

Notice Type

- ▶ Consolidated FINRA Rulebook
- ▶ New Rule

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Systems
- ▶ Trading and Market Making
- ▶ Training

Key Topics

- ▶ Limit Orders
- ▶ Manning Rule
- ▶ Market Orders
- ▶ Minimum Price-Improvement Standards
- ▶ NMS Stocks
- ▶ Order Protection
- ▶ OTC Equity Securities
- ▶ Rulebook Consolidation

Referenced Rules

- ▶ FINRA Rule 4512
- ▶ FINRA Rule 5320
- ▶ FINRA Rule 6420
- ▶ NASD IM-2110-2
- ▶ NASD Rule 2111
- ▶ NASD Rule 2320
- ▶ NASD Rule 3110
- ▶ NTM 95-43
- ▶ NTM 97-57
- ▶ NTM 05-51
- ▶ SEC Regulation NMS Rule 600

FINRA Rule 5320 applies to customer market and limit orders in securities that meet the definition of “OTC Equity Security” as defined in FINRA Rule 6420,⁶ as well as securities that meet the definition of “NMS stock” as defined in Rule 600 of SEC Regulation NMS.⁷ With respect to customer limit orders (marketable and non-marketable), as was the case with NASD IM-2110-2, new FINRA Rule 5320 includes minimum price improvement amounts that are necessary for a firm to execute an order on a proprietary basis when holding an unexecuted limit order in that same security, and not be required to execute the held limit order (unless an exception applies).⁸ The Supplementary Material to Rule 5320 provides several exceptions, including for large orders and orders from institutional accounts; a “no-knowledge” exception; and an exception for trades made to offset a customer odd-lot order or to correct a *bona fide* error.⁹

Large Orders and Institutional Account Exceptions

Rule 5320.01 generally continues to permit firms to negotiate terms and conditions on the acceptance of certain large-sized orders (orders of 10,000 shares or more and greater than \$100,000 in value) and orders from institutional accounts (as defined in NASD Rule 3110(c))¹⁰ that would permit firms to trade ahead of or along with such orders, provided that firms give clear and comprehensive written disclosure to such customer at account opening and annually thereafter that:

- a. discloses that the firm may trade proprietarily at prices that would satisfy the customer order, and
- b. provides the customer with a meaningful opportunity to opt in to the Rule 5320 protections with respect to all or any portion of its order.¹¹

In lieu of providing the written disclosure to customers at account opening and annually thereafter, Rule 5320.01 would permit firms to provide clear and comprehensive oral disclosure to, and obtain oral consent from, a customer on an order-by-order basis, provided that the firm documents who provided the consent and that the consent evidences the customer’s understanding of the terms and conditions of the order. When a customer has opted in to the Rule 5320 protections, a firm may still obtain consent on an order-by-order basis to trade ahead of or along with an order from that customer, provided that the firm documents who provided the consent and that the consent evidences the customer’s understanding of the terms and conditions of the order.

No-Knowledge Exception

Rule 5320.02 provides an exception for a firm's proprietary trading in NMS stocks where the proprietary trading unit does not have knowledge of the customer order. Specifically, if a firm implements and uses an effective system of internal controls—such as appropriate information barriers—that operate to prevent one trading unit from obtaining knowledge of customer orders held by a separate trading unit, those other trading units trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit.¹²

If a firm structures its order-handling practices in NMS stocks to permit its market-making desk to trade at prices that would satisfy customer orders held by a separate trading unit, the firm must disclose in writing to its customers, at account opening and annually thereafter, a description of the manner in which customer orders are handled by the firm and the circumstances under which it may trade proprietarily at its market-making desk at prices that would satisfy the customer order.

With respect to OTC Equity Securities, if a firm implements and uses an effective system of internal controls, such as appropriate information barriers, that operate to prevent a non-market-making trading unit from obtaining knowledge of customer orders held by a separate trading unit, the non-market-making trading unit trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit. The no-knowledge exception does not extend to the market-making desk for trading in OTC Equity Securities.

Odd Lot and Bona Fide Error Transaction Exceptions

The rule also provides an exception for firm proprietary trading made to offset a customer order that is in an amount less than a normal unit of trading (an “odd lot”). In addition, a transaction made to correct a *bona fide* error also is excepted. Firms are required to demonstrate and document the basis upon which a transaction meets the *bona fide* error exception.

Trading Outside Normal Market Hours

Supplementary Material .08 of Rule 5320 clarifies that the rule applies to a customer order at all times that the order is executable by the firm. Therefore, while firms generally may limit the life of a customer order to the period of normal market hours of 9:30 a.m. to 4:00 p.m. Eastern Time, if the customer and firm agree to the processing of the customer's order outside normal market hours, then the protections of this rule also apply to that customer's order outside of normal market hours.

FINRA Rule 5320 becomes effective on September 12, 2011.

Endnotes

- 1 See Securities Exchange Act Release No. 63895 (February 11, 2011); 76 FR 9386 (February 17, 2011) (Order Approving SR-FINRA-2009-090) (Approval Order). The current FINRA rulebook consists of (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The new FINRA Rules apply to all member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see [Information Notice 03/12/08](#) (Rulebook Consolidation Process).
- 2 Consistent with existing policy, where a provision of new FINRA Rule 5320 is not substantively different from NASD IM-2110-2 or NASD Rule 2111, previously issued interpretations generally will continue to apply (unless rescinded or updated by FINRA).
- 3 FINRA updates the rule text on its online *Manual* within two business days of SEC approval of changes to the rule text.
- 4 See Approval Order. FINRA understands that NYSE intends to file a proposed rule change to harmonize NYSE Rule 92 with the changes implemented in FINRA Rule 5320.
- 5 Rule 5320(b) provides that firms must have a written methodology in place governing the execution and priority of all pending orders that is consistent with the requirements of the rule and NASD Rule 2320 (Best Execution and Interpositioning). Firms also are required to ensure that their methodology is consistently applied.
- 6 “OTC Equity Security” means any equity security that is not an “NMS stock” as that term is defined in Rule 600(b)(47) of SEC Regulation NMS, provided, however, that the term “OTC Equity Security” does not include any restricted equity security. See FINRA Rule 6420(e).
- 7 A firm that is holding a customer order that is marketable and has not been immediately executed must make every effort to cross the order with any other order received by the firm on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent order is received by the firm and that is consistent with the terms of the orders. In the event that a firm is holding multiple orders on both sides of the market that have not been executed, the firm must make every effort to cross or otherwise execute the orders in a manner that is reasonable and consistent with the objectives of this rule and with the terms of the orders. A firm can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price. See Rule 5320.07.

- 8 See Rule 5320.06.
- 9 Rule 5320 also includes two additional exceptions, similar to existing provisions under NASD IM-2110-2 and NASD Rule 2111—specifically, a limited exception for riskless principal transactions and the intermarket sweep order exception. See Rule 5320.03 and .04.
- 10 As part of the Rulebook Consolidation Process, as of December 5, 2011, NASD Rule 3110(c) will become FINRA Rule 4512. See Securities Exchange Act Release No. 63784 (January 27, 2011); 76 FR 5850 (February 2, 2011) (Order Approving File No. FINRA-2010-052).
- 11 If a customer does not opt in to the Rule 5320 protections with respect to all or any portion of its order(s), the firm may reasonably conclude that the customer has consented to the firm trading a security on the same side of the market for its own account at a price that would satisfy the customer's order. Even if a customer does not opt in to the Rule 5320 protections, the firm's conduct must continue to be consistent with the guidance provided in [NTM 05-51](#) (August 2005) which, among other things, reminds firms that adherence to just and equitable principles of trade as mandated by Rule 2010 "requires that members handle and execute any order received from a customer in a manner that does not disadvantage the customer or place the firm's financial interests ahead of those of its customer." See also NASD Rule 2320.
- 12 Firms should indicate the existence of these information barriers in information submitted to FINRA's Order Audit Trail System (OATS) in accordance with the OATS rules and the OATS Reporting Technical Specifications on FINRA's website at www.finra.org/OATS.

Know Your Customer and Suitability

New Implementation Date for and Additional Guidance on the Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations

Implementation Date: July 9, 2012

Executive Summary

On November 17, 2010, the Securities and Exchange Commission (SEC) approved FINRA's proposal to adopt rules governing know-your-customer and suitability obligations¹ for the consolidated FINRA rulebook.² On January 10, 2011, FINRA issued [Regulatory Notice 11-02](#), which provided guidance regarding the new rules and announced an implementation date. This *Notice* announces a new implementation date of July 9, 2012, and provides additional guidance in response to some recent industry questions and concerns.

Questions regarding this *Notice* should be directed to James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8270.

Background

New FINRA Rule 2090 (Know Your Customer) requires firms to “use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer....” The rule explains that essential facts are “those required to (a) effectively service the customer’s account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.”³

May 2011

Notice Type

- ▶ Consolidated FINRA Rulebook
- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Know Your Customer
- ▶ Suitability

Referenced Rules & Notices

- ▶ Bank Secrecy Act
- ▶ FINRA Rule 2090
- ▶ FINRA Rule 2111
- ▶ FINRA Rule 2130
- ▶ FINRA Rule 2264
- ▶ FINRA Rule 2270
- ▶ NTM 04-89
- ▶ NTM 05-26
- ▶ Regulatory Notice 09-31
- ▶ Regulatory Notice 11-02
- ▶ SEA Rule 17a-3

New FINRA Rule 2111 (Suitability) requires that a firm or associated person “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile.”⁴

In general, the new FINRA rules retain the core features of the previous NASD and NYSE rules covering the same subject areas and codify well-settled interpretations of those rules. A few aspects of the FINRA rules, however, have created new or modified obligations. Numerous firms asked that FINRA delay the implementation date to allow more time to prepare new or update current procedures, modify automated systems, and educate their associated persons regarding compliance with the new or modified requirements. Given these concerns and the significance of the rules to both the industry and the public, FINRA believes it is appropriate to provide firms with a reasonable extension of the implementation date to comply with the new or modified requirements. Accordingly, FINRA filed with the SEC a rule change effective immediately to delay the rules’ implementation date until July 9, 2012.⁵

Discussion

A number of firms have asked FINRA to provide additional guidance to assist them in preparing to comply with the new rules. The most frequently asked questions and FINRA’s answers are discussed below.⁶ FINRA reiterates, however, that many of the obligations under the new rules are the same as those under the predecessor rules and interpretations of those rules. FINRA emphasizes that existing guidance and interpretations regarding know-your-customer and suitability obligations continue to apply to the extent that they are not inconsistent with the new rules.

Know Your Customer

- Q1. Does the know-your-customer obligation to “understand the authority of each person acting on behalf of the customer” require a firm to know more than the names of the persons acting on behalf of the customer?**
- A1.** Rule 2090 generally requires a member firm to know the names of any persons authorized to act on behalf of a customer and any limits on their authority that the customer establishes and communicates to the member firm. FINRA understands, however, that some member firms may decide as a business practice to accept only those customers that do not qualify the scope of authority of persons acting on the customers’ behalf in their dealings with the member firms.

Suitability

Firms' questions regarding the new suitability rule have focused on information-gathering requirements in relation to a customer's investment profile, the scope of the term "strategy," and reasonable-basis obligations.

Customer's Investment Profile

- Q2. Does a firm have to update all customer-account documentation by the suitability rule's implementation date to capture the new "customer investment profile" factors (age, investment experience, time horizon, liquidity needs and risk tolerance) that were added to the existing list (other holdings, financial situation and needs, tax status and investment objectives)?⁷**
- A2.** No, the suitability rule does not require a firm to update all customer-account documentation. The rule requires that a broker seek to obtain⁸ and consider relevant customer-specific information when making a recommendation. Although a firm has a general obligation to evidence compliance with applicable FINRA rules, aside from the situation where a firm determines not to seek certain information (addressed in Question 3 below),⁹ Rule 2111 does not include any explicit documentation requirements.¹⁰ The suitability rule allows firms to take a risk-based approach with respect to documenting suitability determinations. For example, the recommendation of a large-cap, value-oriented equity security generally would not require written documentation as to the recommendation. In all cases, the suitability rule applies to recommendations, but the extent to which a firm needs to evidence suitability generally depends on the complexity of the security or strategy in structure and performance and/or the risks involved. Compliance with suitability obligations does not necessarily turn on documentation of the basis for the recommendation. However, firms should understand that, to the degree that the basis for suitability is not evident from the recommendation itself, FINRA examination and enforcement concerns will rise with the lack of documentary evidence for the recommendation. In addition, documentation by itself does not cure an otherwise unsuitable recommendation.
- Q3. Would a firm violate the suitability rule if it makes recommendations to customers for whom it has not obtained all of the customer-specific information listed in FINRA Rule 2111(a)?**
- A3.** The essential requirement of this provision is that the member firm or associated person exercise "reasonable diligence" to ascertain the customer's investment profile. In most instances, asking a customer for the information would constitute reasonable diligence. When customer information is unavailable despite a firm's reasonable diligence, however, the firm must carefully consider whether it has a sufficient understanding of the customer to properly evaluate the suitability of the

recommendation. While the rule lists some of the aspects of a typical investment profile, not every factor may be relevant to all situations. Indeed, Supplementary Material .04 states that a member need not seek to obtain and analyze all of the factors if it “has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer’s investment profile in light of the facts and circumstances of the particular case.” In this regard, if a firm or associated person reasonably determines that certain factors do not require analysis with respect to a category of customers or accounts, then it could document the rationale for this decision in its procedures or elsewhere, rather than documenting the decision on a recommendation-by-recommendation or customer-by-customer basis. For example, a firm may conclude that age is irrelevant regarding all customers that are entities or liquidity needs are irrelevant regarding all customers for whom only liquid securities will be recommended.

The absence of some customer information that is not material under the circumstances generally should not affect a firm’s ability to make a recommendation. To meet its suitability obligations, a firm must obtain and analyze enough customer information to have a reasonable basis to believe the recommendation is suitable. The significance of specific types of customer information generally will depend on the facts and circumstances of the particular case, including the nature and characteristics of the product or strategy at issue.

Q4. How does FINRA define the terms “liquidity needs,” “time horizon” and “risk tolerance” for purposes of the suitability rule?

- A4.** FINRA Rule 2111 does not define the terms. As a general matter, these terms are to be understood commensurate with their meaning in financial analysis. FINRA, however, offers the following guidelines:
- ▶ **Liquidity Needs:** The extent to which a customer desires the ability or has financial obligations that dictate the need to quickly and easily convert to cash all or a portion of an investment or investments without experiencing significant loss in value from, for example, the lack of a ready market, or incurring significant costs or penalties.¹¹
 - ▶ **Time Horizon:** “[T]he expected number of months, years, or decades [a customer plans to invest] to achieve a particular financial goal.”¹²
 - ▶ **Risk Tolerance:** A customer’s “ability and willingness to lose some or all of [the] original investment in exchange for greater potential returns.”¹³

FINRA recognizes that there can be an inverse relationship between an investment time horizon and liquidity needs in that the longer a customer's time horizon, the less the need for liquidity. However, a customer may have a long time horizon, but also may need or want to invest all or a portion of his or her portfolio in liquid assets to pay for unexpected expenses or take advantage of unforeseen opportunities. Furthermore, although customers with a long time horizon generally may be in a position to seek greater returns by taking on greater risk because they "can wait out slow economic cycles and the inevitable ups and downs of" the markets,¹⁴ that is not always the case. Some customers with long time horizons may not desire to take on such risk and others, because of considerations outside their time horizons, are unable to do so.

- Q5. Can a customer with multiple accounts at a single firm have different investment profiles or investment-profile factors (e.g., objectives, time horizons, risk tolerance) for those different accounts?**
- A5.** A customer could proceed in such a manner, but a firm should evidence the customer's intent to use different investment profiles or investment-profile factors for the different accounts. Nothing in this guidance, however, relieves a firm from having to ensure that the investment profiles or factors accurately reflect the customer's decisions. In addition, where a firm allows a customer to use different investment profiles or factors for different accounts rather than using a single customer profile for all of the customer's accounts, a firm could not borrow profile factors from the different accounts to justify a recommendation that would not be appropriate for the account for which the recommendation was made.
- Q6. Does a firm have to use the exact rule terminology when seeking to obtain customer-specific information?**
- A6.** No. FINRA is aware that some firms currently ask customers for relevant information without using the exact rule terminology or separately designating factors (e.g., investment objectives that include a risk-tolerance component that is not separately labeled as such). Firms may continue to use such approaches. Firms must attempt to obtain and analyze relevant customer-specific information. Although firms should be capable of explaining how they are doing so and, where appropriate, evidencing that they are doing so, the rule does not dictate use of a specific method or process or of particular terminology.

Strategies**Q7. What is the scope of the term “strategy” as used in FINRA Rule 2111?**

- A7.** The rule explicitly states that the term “strategy” should be interpreted broadly.¹⁵ The rule would cover a recommended investment strategy regardless of whether the recommendation results in a securities transaction or even references a specific security or securities. For instance, the rule would cover a recommendation to purchase securities using margin¹⁶ or liquefied home equity¹⁷ or to engage in day trading,¹⁸ irrespective of whether the recommendation results in a transaction or references particular securities.

The term also would capture an *explicit* recommendation to *hold* a security or securities.¹⁹ While a decision to hold might be considered a passive strategy, an explicit recommendation to hold does constitute the type of advice upon which a customer can be expected to rely. An explicit recommendation to hold is tantamount to a “call to action” in the sense of a suggestion that the customer stay the course with the investment. The rule would apply, for example, when an associated person meets with a customer during a quarterly or annual investment review and explicitly advises the customer not to sell any securities in or make any changes to the account or portfolio. The rule, however, would not cover an implicit recommendation to hold.²⁰ The rule, for instance, would not apply where an associated person remains silent regarding, or refrains from recommending the sale of, securities held in an account. That is true regardless of whether the associated person previously recommended the purchase of the securities, the customer purchased them without a recommendation, or the customer transferred them into the account from another firm where the same or a different associated person had handled the account.²¹

Q8. What is the nature of the obligation under the suitability rule created by a hold recommendation?

- A8.** The new rule does not change the longstanding application of the suitability rule on a recommendation-by-recommendation basis. In general, the focus remains on whether the recommendation was suitable at the time when it was made. Absent an agreement, course of conduct or unusual fact pattern that might alter the normal broker-customer relationship, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations.²²

Q9. What is the scope of the provision in Supplementary Material .03 that excludes from the rule's coverage certain types of strategy-related communications that are educational in nature?²³

A9. What could be considered a "safe-harbor" provision in Supplementary Material .03 is limited in scope. Firms seeking to rely on the provision should take a conservative approach to determining whether a particular communication is eligible for such treatment. Any significant variation from the list in the safe-harbor provision would be subject to regulatory scrutiny. It is important to note, however, that the suitability rule would not apply to a firm's explanation of a strategy falling outside the safe-harbor provision if a reasonable person would not view the communication as a recommendation. Accordingly, the suitability rule would cover a firm's recommendation that a customer purchase securities using margin, whereas the rule generally would not cover a firm's brochure that simply explains the risks and benefits of margin without suggesting that the customer take action.²⁴

Q10. For purposes of the suitability rule, how should a firm document recommendations to hold in particular and recommendations of strategies more generally?

A10. As discussed above, aside from the instances when a firm determines not to seek certain information (addressed in Question 3), FINRA Rule 2111 does not impose explicit documentation requirements. Each firm has a general obligation to evidence compliance with applicable FINRA rules. A firm may use a risk-based approach to evidencing compliance with the suitability rule. In that context, a firm may want to focus on hold recommendations involving securities that by their nature or due to particular circumstances could be viewed as having a shorter-term investment component, that have a periodic reset or similar mechanism that could alter the product's character over time, that are particularly susceptible to changes in certain market conditions, or that are otherwise potentially risky to hold at the time when the recommendations are made. A risk-based approach also may lead a firm to pay particular attention to hold recommendations where, at the time the recommendation is made, a customer's account has a heavy concentration in a particular security or industry sector or the security or securities in question are inconsistent with the customer's investment profile.²⁵ The same approach applies to other recommended strategies. In general, the more complex and risky the strategy, the more the firm using a risk-based approach should focus on the recommendation.

In regard to the type or form of documentation that may be needed, the facts and circumstances must inform that decision. Consistent with the discussions above, however, the complexity of and risks associated with a particular security or strategy likely will impact the level of documented analysis that is appropriate.

Reasonable-Basis Suitability

Q11. For purposes of compliance with the reasonable-basis obligation,²⁶ is it sufficient that a firm’s “product committee,” which conducts due diligence on products, has approved a product for sale?

A11. Although due diligence reviews by such committees can be extremely beneficial,²⁷ a firm’s approval of a product for sale does not necessarily mean that an associated person has complied with the reasonable-basis obligation. Reasonable-basis suitability has two main components: a broker must (1) perform reasonable diligence to understand the potential risks and rewards associated with a recommended security or strategy and (2) determine whether the recommendation is suitable for at least some investors based on that understanding. A broker can violate reasonable-basis suitability under either prong of the test. That is, even if a firm’s product committee has approved a product for sale, an individual broker’s lack of understanding of a recommended product or strategy could violate the obligation, notwithstanding that the recommendation is suitable for some investors.²⁸

A firm should educate its associated persons on the potential risks and rewards of the products that the firm permits them to recommend. In general, an associated person may rely on a firm’s fair and balanced explanation of the potential risks and rewards of a product. However, if the associated person remains uncertain about the potential risks and rewards of a product or has reason to believe that the firm failed to address a particular issue or has done so in an incomplete or inaccurate manner, then the associated person would need to engage in further inquiry before recommending the product.

Endnotes

- 1 See Securities Exchange Act Release No. 63325 (November 17, 2010), 75 FR 71479 (November 23, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039).
- 2 The current FINRA rulebook consists of (1) FINRA rules; (2) NASD rules; and (3) rules incorporated from NYSE (NYSE rules). While the NASD rules generally apply to all FINRA member firms, the NYSE rules apply only to those members of FINRA that also are members of the NYSE. 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, March 12, 2008](#) (Rulebook Consolidation Process).
- 3 FINRA Rule 2090.01.

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- 4 FINRA Rule 2111(a).
- 5 See Securities Exchange Act Release No. 64260 (April 8, 2011), 76 FR 20759 (April 13, 2011) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Delay the Implementation Date of FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability)); File No. SR-FINRA-2011-016).
- 6 Nothing in this guidance shall be construed as altering in any manner a member firm's obligations under other applicable federal securities laws or FINRA rules, including SEA Rule 17a-3 and the Bank Secrecy Act, 31 U.S.C. §§ 5311, *et seq.*
- 7 See FINRA Rule 2111(a).
- 8 The term "obtained," as used in the rule's information-gathering section, does not require a firm to document the information in all instances.
- 9 See FINRA Rule 2111.04 (explaining that a firm that decides not to seek to obtain and analyze information about a customer-specific factor must document its reasonable basis for believing that the factor is not a relevant consideration).
- 10 FINRA notes that there are SEC and other FINRA rules that explicitly require specific types of documentation. See, e.g., SEA Rule 17a-3(a)(17)(i) (A) (discussing "books and records" requirements for certain account information, including, among other things, date of birth, employment status, annual income, net worth and investment objectives, regarding an account with a natural person as a customer). See also *supra* note 6.
- 11 For purposes of considering liquidity needs in the context of FINRA Rule 2111, examples of possible liquid investments include money market funds, Treasury bills and many blue-chip stocks, exchange-traded funds and mutual funds. FINRA emphasizes, however, that a high level of liquidity does not, in and of itself, mean that the recommended product is suitable for all customers. For instance, some relatively liquid products can be complex and/or risky and therefore unsuitable for some customers. See, e.g., [Regulatory Notice 09-31](#) (June 2009) (reminding firms of their sales-practice obligations relating to leveraged and inverse exchange-traded funds).
- 12 See www.sec.gov/investor/pubs/assetallocation.htm.
- 13 *Id.*
- 14 *Id.*
- 15 See FINRA Rule 2111.03.
- 16 For certain requirements related to margin, see FINRA Rule 2264.
- 17 See [Notice to Members \(NTM\) 04-89](#) (December 2004) (reminding firms that "recommending liquefying home equity to purchase securities may not be suitable for all investors and that [firms] should perform a careful analysis to determine whether liquefying home equity is a suitable strategy for an investor").
- 18 For certain requirements related to day trading, see FINRA Rules 2130 and 2270.
- 19 See FINRA Rule 2111.03.

- 20 See FINRA Rule 2111.03. In limited circumstances, FINRA and the SEC have recognized that certain actions constitute implicit recommendations that can trigger suitability obligations. For example, FINRA and the SEC have held that associated persons who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule. See, e.g., *Rafael Pinchas*, 54 S.E.C. 331, 341 n.22 (1999) ("Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of the NASD rules."); *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11 (1992) (stating that transactions a broker effects for a discretionary account are implicitly recommended). Although such holdings continue to act as precedent regarding those issues, the new rule does not broaden the scope of *implicit* recommendations. The new rule does not apply to *implicit* recommendations to *hold*.
- 21 Firms also have asked whether the absence of a sell order in a discretionary account amounts to an implicit hold recommendation covered by the rule. *To the extent that a customer account at a broker-dealer can be discretionary under applicable federal securities laws*, the suitability rule generally would not apply where a firm refrains from selling a security. The rule states that it applies to *explicit* recommendations to hold. See FINRA Rule 2111.03. Unless the facts indicate that an associated person's failure to sell securities in a discretionary account was intended as or tantamount to an explicit recommendation to hold, FINRA would not view the associated person's inaction or silence in such circumstances as a recommendation to hold the securities for purposes of the suitability rule.
- 22 Similarly, and as noted previously, the absence of a recommendation to sell would not amount to a hold recommendation subject to the rule.
- 23 See FINRA Rule 2111.03.
- 24 [Regulatory Notice 11-02](#) (January 2011) discusses several guiding principles that are relevant to determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule.
- 25 As discussed in Question 8 above, absent an agreement, course of conduct or unusual fact pattern that might alter the normal broker-customer relationship, a hold recommendation would not create an ongoing duty to monitor and make subsequent recommendations.
- 26 See FINRA Rule 2111.05(a).
- 27 See, e.g., [NTM 05-26](#) (April 2005) (recommending best practices for reviewing new products).
- 28 See FINRA Rule 2111.05(a). This position is consistent with requirements under the previous suitability rule. In *Dep't of Enforcement v. Siegel*, for instance, FINRA's National Adjudicatory Council explained that a "recommendation may lack 'reasonable-basis' suitability if the broker: (1) fails to understand the transaction, which can result from, among other things, a failure to conduct a reasonable investigation concerning the security; or (2) recommends a security that is not suitable for any investors." *Dep't of Enforcement v. Siegel*, No. C05020055, 2007 NASD Discip. LEXIS 20, at *38 (NAC May 11, 2007), *aff'd*, Exchange Act Release No. 58737, 2008 SEC LEXIS 2459 (Oct. 6, 2008), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir. 2010), *cert. denied*, 2010 U.S. LEXIS 4340 (May 24, 2010).

Financial Responsibility

SEC Approves Consolidated Financial Responsibility and Related Operational Rules

Effective Date: August 1, 2011

Executive Summary

The SEC approved FINRA's proposed rule change¹ to adopt a set of financial responsibility and related operational rules for the consolidated rulebook (the Consolidated FINRA Rulebook).² FINRA Rules 4150, 4311, 4522 and 4523 are new consolidated rules governing financial responsibility as well as certain operational and contractual requirements of members. The new rules are based in part on, and replace, provisions in the NYSE and NASD Rules.³

The text of the new rules is set forth in Attachment A. The questionnaire that FINRA is specifying for use by carrying firms pursuant to new FINRA Rules 4311(b)(3) and 4311.02 is in Attachment B.⁴

Questions regarding this *Notice* should be directed to:

- ▶ Kris Dailey, Vice President, Risk Oversight & Operational Regulation (ROOR), at (646) 315-8434;
- ▶ Susan DeMando Scott, Associate Vice President, Financial Operations Department, at (202) 728-8411; or
- ▶ Adam H. Arkel, Assistant General Counsel, Office of General Counsel, at (202) 728-6961.

Background

New FINRA Rules 4150, 4311, 4522 and 4523, in combination with the consolidated financial responsibility rules that the SEC approved in November 2009,⁵ enhance FINRA's authority to execute effectively its financial and operational surveillance and examination programs. Consistent with the approach that FINRA discussed in SR-FINRA-2008-067 and [Regulatory Notice 09-71](#), many of the requirements set forth in the new rules are substantially the same as requirements found in current rules and, where appropriate, are tiered to apply only to carrying or clearing firms, or to

May 2011

Notice Type

- ▶ Consolidated Rulebook
- ▶ New Rules

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Capital Compliance
- ▶ Financial Responsibility
- ▶ Operational Rules

Referenced Rules & Notices

- ▶ FINRA Rule 4150
- ▶ FINRA Rule 4311
- ▶ FINRA Rule 4522
- ▶ FINRA Rule 4523
- ▶ NTM 94-07
- ▶ NYSE Information Memo 82-18
- ▶ NYSE Rule 322
- ▶ NYSE Rule 382
- ▶ NYSE Rule 416A
- ▶ NYSE Rule 440
- ▶ NYSE Rule Interpretations 382/01 through 382/05
- ▶ NYSE Rule Interpretation 409(a)/01
- ▶ NYSE Rule Interpretation 440.20/01
- ▶ NASD Rule 3230
- ▶ SEA Rule 15c3-1
- ▶ SEA Rule 15c3-3
- ▶ SEA Rule 17a-3
- ▶ SEA Rule 17a-4
- ▶ SEA Rule 17a-13
- ▶ Regulatory Notice 08-76
- ▶ Regulatory Notice 09-03
- ▶ Regulatory Notice 09-71
- ▶ Information Notice 03/12/08



firms that engage in certain specified activities.⁶ Certain provisions of the rules are new for FINRA members that are not Dual Members (non-NYSE members). Certain other provisions are new for both Dual Members and non-NYSE members alike.

Discussion

A. FINRA Rule 4150 (Guarantees by, or Flow Through Benefits for, Members)

FINRA Rule 4150(a), based in large part on NYSE Rule 322,⁷ requires that prior written notice be given to FINRA whenever a member guarantees, endorses or assumes, directly or indirectly, the obligations⁸ or liabilities of another person (including an entity).⁹ Paragraph (b) of the rule requires that prior written approval must be obtained from FINRA whenever any member receives flow through capital benefits in accordance with Appendix C of SEA Rule 15c3-1. Details of the rule's notice and prior approval requirements are included in Supplementary Material to the new rule (FINRA Rule 4150.01).

FINRA Rule 4150.02 provides that a member may at any time (*i.e.*, not just within the context of the prior written notice that the member provides or the prior written approval that the member seeks to obtain pursuant to the rule) be required to provide FINRA with information with respect to the arrangement, relationship and dealings with a person referred to in the rule.

FINRA Rule 4150.03 prohibits any member from entering into an arrangement described in the rule unless the member has the authority to make available promptly the books and records of the other person for inspection by FINRA in the United States. The rule provides that the books and records of the other person must be kept separately from those of the member.

With respect to persons referred to in the rule that are registered broker-dealers, FINRA Rule 4150.04 requires that the member furnish to FINRA copies of the person's FOCUS Reports simultaneous with their being filed with the person's designated examining authority (DEA). FINRA expects that members shall furnish the person's FOCUS Reports to FINRA on an ongoing basis (the member need not furnish the person's FOCUS Reports to FINRA if FINRA is the person's DEA). For persons that are not registered broker-dealers, the rule requires, in lieu of FOCUS Reports, submission of financial and operational statements, in such format and at such time periods as FINRA may require, sufficient to gauge the capital and operational effects of the arrangement or relationship on the member.

FINRA Rule 4150.05 provides that guarantees executed routinely in the normal course of business, such as trade guarantees, signature guarantees, endorsement of securities and the writing of options, are not subject to the requirements of the rule provided that, in regard to the guarantee of the writing of options, the transaction is appropriately recorded on the member's books and records in accordance with SEA Rule 17a-3(a)(10) and is reflected in its net capital computation pursuant to SEA Rule 15c3-1.

FINRA Rule 4150.06 provides that, within 30 days of the implementation date of the rule (*i.e.*, by August 31, 2011), each member must advise FINRA, in writing, of any guarantees, endorsements, assumptions of obligations/liabilities, or flow through capital benefits, in effect as of August 1, 2011 not having otherwise been reported, in writing, to the member's Regulatory Coordinator at FINRA.

B. FINRA Rule 4311 (Carrying Agreements)

New FINRA Rule 4311 is based on NASD Rule 3230 and NYSE Rule 382 (including NYSE Rule Interpretations 382/01 through 382/05 and 409(a)/01). The new rule governs the requirements applicable to members when entering into agreements for the carrying of any customer accounts in which securities transactions can be effected. Historically, the purpose of the NASD and NYSE rules upon which new FINRA Rule 4311 is based has been to ensure that certain functions and responsibilities are clearly allocated to either the introducing or carrying firm, consistent with the requirements of the SRO's and SEC's financial responsibility and other rules and regulations, as applicable.¹⁰ The new rule continues to serve that same purpose and, accordingly, contains many requirements that are substantially unchanged from NASD Rule 3230 and NYSE Rule 382. New FINRA Rule 4311 also codifies certain provisions that are new for non-NYSE members, or are new for both Dual Members and non-NYSE members alike. Following is a summary of the major provisions of the new rule.

FINRA Rule 4311(a)(1) prohibits a member, unless otherwise permitted by FINRA, from entering into an agreement for the carrying, on an omnibus or fully disclosed basis, of any customer account in which securities transactions can be effected (for purposes of Rule 4311, "customer account" or "account"), unless the agreement is with a carrying firm that is a FINRA member.¹¹ This is a new requirement for all members; however, the vast majority of carrying firms in the United States are FINRA members. New FINRA Rule 4311(a)(1) also includes a provision requiring that when an introducing firm acts as an intermediary for another introducing firm or firms (so-called "piggyback" or "intermediary clearing arrangements") for the purpose of obtaining clearing services from the carrying firm, the introducing firm must notify the carrying firm of the existence of the arrangement(s) with the other introducing firm(s) and disclose the identity of the firm(s). Based in large part on NYSE Rule Interpretation 382/05, the new rule further requires that each carrying agreement identify and bind every direct and indirect recipient of clearing services as a party to the agreement.

FINRA Rule 4311(b)(1), consistent with the requirements of NASD Rule 3230(e) and NYSE Rule 382(a), requires that the carrying firm submit to FINRA for prior approval any agreement for the carrying of accounts, whether on an omnibus or fully disclosed basis, before the agreement may become effective. The rule also provides that the carrying firm must also submit to FINRA for prior approval any material changes to an approved carrying agreement before the changes may become effective.¹² The rule codifies the practice under

NASD Rule 3230 of permitting use of pre-approved standardized forms of agreement, with the exception of agreements with parties that are not U.S.-registered broker-dealers. The rule requires a carrying firm to submit separately to FINRA for approval each carrying agreement with a non-U.S.-registered broker-dealer.¹³ This is a new requirement for non-NYSE members.

FINRA Rule 4311(b)(3) codifies the current practice under NYSE Rule 382 of requiring that as early as possible, but not later than 10 business days, prior to the carrying of any accounts of a new introducing firm (including the accounts of any piggyback or intermediary introducing firm(s)), the carrying firm must submit to FINRA a notice identifying each such introducing firm by name and CRD number and include such additional information as FINRA may require.¹⁴ This is a new requirement for non-NYSE carrying members, and permits FINRA to obtain additional information that enables it to evaluate the impact of the new carrying arrangement on the financial and operational condition of the member.

FINRA Rule 4311(b)(4) expressly requires each carrying firm to conduct appropriate due diligence with respect to any new introducing firm relationship. Such due diligence is expected to be conducted prior to the commencement of the relationship. The rule provides that such due diligence must assess the financial, operational, credit and reputational risk that such arrangement will have upon the carrying firm.¹⁵ The rule provides that FINRA, in its review of any arrangement, may in its discretion require specific items to be addressed by the carrying firm as part of the firm's due diligence requirement under the rule. The rule further provides that the carrying firm must maintain a record, in accord with the time frames prescribed by SEA Rule 17a-4(b), of the due diligence conducted for each new introducing firm.

FINRA Rule 4311(c)(1), based in part on NASD Rule 3230(a) and NYSE Rule 382(b), requires that each carrying agreement in which accounts are to be carried on a fully disclosed basis specify the responsibilities of each party to the agreement, including at a minimum the allocation of responsibilities set forth in paragraphs (c)(1)(A) through (c)(1)(I) and (c)(2) of the rule. Under federal securities regulations, the carrying firm is responsible for the safeguarding of the funds and securities held in the accounts that it carries. Consistent therewith, FINRA Rule 4311(c)(2) requires that each carrying agreement in which accounts are to be carried on a fully disclosed basis must expressly allocate to the carrying firm the responsibility for the safeguarding of funds and securities for the purposes of SEA Rule 15c3-3. Further, because FINRA believes that it is important to ensure the accuracy and integrity of customer account statements, FINRA Rule 4311(c)(2) requires that each carrying agreement in which accounts are to be carried on a fully disclosed basis must expressly allocate to the carrying firm the responsibility for preparing and transmitting statements of account to customers. The rule provides that the carrying firm may authorize the introducing firm to prepare and/or transmit such statements on the carrying firm's behalf with the prior written approval of FINRA.¹⁶ FINRA will review the circumstances of each such request and anticipates that such exceptions will be infrequent and may require additional time for review and approval of the carrying agreement than would otherwise be required.

Based in part on NASD Rule 3230(g), NYSE Rule 382(c) and NYSE Rule Interpretation 382/03, FINRA Rule 4311(d) requires that each customer whose account is introduced on a fully disclosed basis must be notified in writing upon the opening of the account of the existence of the carrying agreement and the responsibilities allocated to each respective party. The carrying firm is responsible for the content of the notification to the customer. Further, the rule provides that the customer must be notified promptly and in writing in the event of any change to any of the parties to the agreement or any material change to the allocation of responsibilities thereunder. Supplementary Material to the rule (FINRA Rule 4311.05) provides that, for purposes of FINRA Rule 4311(d), notification to customers of a change to any of the parties to the carrying agreement is not required in instances where, consistent with applicable FINRA rules and the federal securities laws, such customers' accounts are being transferred pursuant to:

- a. ACATS using an authorized Transfer Instruction Form (TIF); or
- b. a process outside of ACATS where notification to customers is provided by means of an alternative mechanism such as affirmative or negative response letters.

Consistent with NYSE Rule Interpretation 382/03, FINRA Rule 4311(e) requires that each carrying agreement expressly state that to the extent a particular responsibility is allocated to one party, the other party or parties will supply to the responsible organization all appropriate data in their possession pertinent to the proper performance and supervision of that responsibility. This is a new requirement for non-NYSE members.

Based in large part on NASD Rule 3230(d) and NYSE Rule 382(f), FINRA Rule 4311(f) provides that a carrying agreement may authorize an introducing firm to issue negotiable instruments directly to its customers on the carrying firm's behalf, using instruments for which the carrying firm is the maker or drawer, provided that the parties comply with SEA Rule 15c3-3 and further that the introducing firm represents to the carrying firm in writing that the introducing firm maintains, and will enforce, supervisory policies and procedures with respect to such negotiable instruments that are satisfactory to the carrying firm.

The provisions of FINRA Rule 4311(g)(1) and (h) generally address the obligations of the parties to provide the referenced information, such as any written customer complaints and exception reports, to each other and/or to FINRA and are based upon existing NASD and NYSE rule provisions. (Note that the July 1 deadline set forth in paragraph (h)(2) of the new rule differs from the current requirement (no later than July 31) specified by the corresponding NASD and NYSE rule provisions.) FINRA Rule 4311(g)(2) provides that, upon a showing of good cause, FINRA, at its discretion, may exclude certain carrying firms from the requirements of FINRA Rule 4311(g)(1) in instances where the introducing firm is an affiliated entity of the carrying firm. This provision is based upon NASD Rule 3230(b)(3) but is not contained in NYSE Rule 382.

FINRA Rule 4311(i) is based largely on NASD Rule 3230(h) and does not have a corresponding provision to NYSE Rule 382. The new rule provides that all carrying agreements must require each introducing firm to maintain its proprietary and customer accounts, and the proprietary and customer accounts of any introducing firm for which it is acting as an intermediary in obtaining clearing services from the carrying firm, in such a manner as to enable the carrying firm and FINRA to specifically identify the proprietary and customer accounts belonging to each introducing firm. Consistent with NASD Rule 3230(h), the requirements of FINRA Rule 4311(i) apply only to intermediary clearing arrangements that are established on or after February 20, 2006 (the date this requirement as set forth in NASD Rule 3230(h) became effective).

C. FINRA Rule 4522 (Periodic Security Counts, Verifications and Comparisons)

FINRA Rule 4522(a), based in large part on NYSE Rule 440.10, requires each member that is subject to the requirements of SEA Rule 17a-13 to make the counts, examinations, verifications, comparisons and entries set forth in SEA Rule 17a-13. FINRA Rule 4522(b), again based in large part on NYSE Rule 440.10, requires each carrying or clearing member subject to SEA Rule 17a-13 to make more frequent counts, examinations, verifications, comparisons and entries where prudent business practice would so require. Each such carrying or clearing member is required to receive position statements no less than once per month with respect to securities held by clearing corporations, other organizations or custodians and, at least once per month, reconcile all such securities and money balances by comparison of the clearing corporations' or custodians' position statements to the member's books and records. The carrying or clearing member must promptly report any differences to the contra organization, and both the contra organization and the member firm must promptly resolve the differences. Where there is a higher volume of activity, the rule provides that good business practice may require a more frequent exchange of statements and performance of reconciliations. The rule further requires that no later than seven business days after each security count, the carrying or clearing member must enter any unresolved differences into a "Difference" account for that security count.

NASD rules do not have a provision that corresponds to NYSE Rule 440.10. Accordingly, the requirements of FINRA Rule 4522(b) are new to non-NYSE carrying or clearing members that are subject to the requirements of SEA Rule 17a-13.¹⁷

D. FINRA Rule 4523 (Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts)

FINRA Rule 4523, based in large part on NYSE Rule 440.20, is intended to help assure the accuracy of each member's books and records and includes supervisory measures for their implementation. Paragraph (a) of the new rule requires that each member must designate an associated person to be responsible for each general ledger bookkeeping account and account of like function used by the member, and that the associated person must control

and oversee entries into each such account and determine that the account is current and accurate as necessary to comply with all applicable FINRA rules and federal securities laws governing books and records and financial responsibility requirements. The rule requires that a supervisor must, as frequently as is necessary considering the function of the account but, in any event, at least monthly, review each account to determine that it is accurate and that any items that are aged or uncertain as to resolution are promptly identified for research and possible transfer to a suspense account(s).

FINRA Rule 4523(b) requires that each carrying or clearing member must maintain a record of the name of each individual assigned primary and supervisory responsibility for each account as required by paragraph (a) of the rule. All records made pursuant to Rule 4523(b) must be preserved for a period of not less than six years (the period set forth in SEA Rule 17a-4(a)).

FINRA Rule 4523(c) provides that each member must record, in an account that must be clearly identified as a suspense account, money charges or credits and receipts or deliveries of securities whose ultimate disposition is pending determination. The rule requires that a record be maintained of all information known with respect to each item so recorded. Again, all records made pursuant to FINRA Rule 4523(c) must be preserved for a period of not less than six years (the period set forth in SEA Rule 17a-4(a)).

Supplementary Material to the new rule (FINRA Rule 4523.01) provides that, for the purposes of paragraphs (a) and (b) of the rule, members with only one associated person may assign primary and supervisory responsibility for each account to that associated person, subject to applicable registration requirements. Further, the Supplementary Material provides that members of limited size and resources that have more than one associated person may seek FINRA's prior written approval to assign primary and supervisory responsibility for each account to the same associated person. Further, for purposes of clarification, FINRA Rule 4523.02 provides that, for purposes of FINRA Rule 4523, all requirements that apply to a member that clears or carries customer accounts shall also apply to any member that, operating pursuant to the exemptive provisions of SEA Rule 15c3-3(k)(2)(i), either clears customer transactions pursuant to such exemptive provisions or holds customer funds in a bank account established thereunder.

NASD rules do not have a provision that corresponds to NYSE Rule 440.20. Accordingly, the requirements of new FINRA Rule 4523 are new to non-NYSE members.

Endnotes

- 1 See Securities Exchange Act Release No. 63999 (March 1, 2011), 76 FR 12380 (March 7, 2011) (Order Granting Approval to Proposed Rule Change; File No. SR-FINRA-2010-061).
- 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 Effective August 1, 2011, NYSE Rules 322, 382, 440.10 and 440.20 and NYSE Rule Interpretations 382/01 through 382/05, 409(a)/01 and 440.20/01 and NASD Rule 3230 will be deleted from the Transitional Rulebook.
- 4 See note 14 below.
- 5 The consolidated financial responsibility rules went into effect on February 8, 2010. See Securities Exchange Act Release No. 60933 (November 4, 2009), 74 FR 58334 (November 12, 2009) (Order Granting Approval to Proposed Rule Change; File No. SR-FINRA-2008-067). See also [Regulatory Notice 09-71](#) (December 2009) (SEC Approves Consolidated FINRA Rules Governing Financial Responsibility); [Regulatory Notice 09-03](#) (January 2009) (Financial Responsibility and Related Operational Rules).
- 6 For purposes of the new rules—like the consolidated financial responsibility rules that went into effect pursuant to SR-FINRA-2008-067—FINRA has specified in the rule text where appropriate that all requirements that apply to a member that clears or carries customer accounts also apply to any member that, operating pursuant to the exemptive provisions of SEA Rule 15c3-3(k)(2)(i), either clears customer transactions pursuant to such exemptive provisions or holds customer funds in a bank account established thereunder. For further background, see 74 FR 58334. See also new FINRA Rule 4523.02 and further discussion in this *Notice*.
- 7 NASD rules do not have a provision that corresponds to NYSE Rule 322. Accordingly, the requirements of new FINRA Rule 4150 are new to non-NYSE members.
- 8 The term “obligations” includes financial obligations, as well as other obligations that may have a financial impact on a member, such as performance obligations.
- 9 For purposes of the new rules, all references to “persons” include entities.
- 10 See, e.g., [Notice to Members 94-07](#) (February 1994) (SEC Approves New NASD Rule Relating to the Obligations and Responsibilities of Introducing and Clearing Firms) and [NYSE Information Memo 82-18](#) (March 1982) (Carrying Agreements – Amendments to Rules 382 and 405).
- 11 Because carrying firms generally are FINRA members, FINRA expects requests to enter into carrying agreements with firms that are not FINRA members to be infrequent.

- 12 New FINRA Rule 4311.01 includes guidance as to what constitutes a material change for purposes of paragraph (b)(1) of the rule. Specifically, material changes include, but are not limited to, changes to: the allocation of responsibilities required by the rule; termination clauses applicable to the introducing firm; any terms or provisions affecting the liability of the parties; and the parties to the agreement, including, for example, the addition of a new party to the agreement, such as a “piggyback” arrangement, a new carrying firm or a new introducing firm, but not including a termination of the agreement. (However, as explained in [Regulatory Notice 08-76](#) (December 2008) (Reporting Clearing Arrangements), under NYSE Rule 416A carrying firms that are Dual Members are required to update their Firm Clearing Arrangement Form information on an ongoing basis no later than 30 days after the information has changed. FINRA expects to extend this requirement to all carrying firms later as part of the rulebook consolidation process.)
- 13 New FINRA Rule 4311(a)(2) expressly permits a carrying firm to enter into a carrying agreement for the carrying of the customer accounts of a person other than a U.S. registered broker or dealer, subject to the conditions set forth in the rule.
- 14 FINRA Rule 4311.02 provides that, for purposes of the notice requirement of paragraph (b)(3) of the rule, the carrying firm must submit a questionnaire in such form as to be specified by FINRA, which may be updated from time to time as FINRA deems necessary. (The questionnaire that FINRA is specifying for use by carrying firms pursuant to FINRA Rules 4311(b)(3) and 4311.02 is in Attachment B.)
- 15 New FINRA Rule 4311.03 provides that the due diligence may include, without limitation, inquiry by the carrying firm into the introducing firm’s business model and product mix, proprietary and customer positions, FOCUS and similar reports, audited financial statements and complaint and disciplinary history.
- 16 Supplementary Material (FINRA Rule 4311.04) reminds members that, for purposes of paragraphs (c)(1)(F) and (c)(2) of the new rule, receipt and delivery of customers’ funds and securities and the safeguarding of such funds and securities must comply with the requirements of the SEC’s financial responsibility rules, in particular SEA Rule 15c3-3, and applicable SEC guidance.
- 17 Note that the rule by its terms does not apply to members that are exempt from SEA Rule 17a-13.

ATTACHMENT A

Below is the text of new FINRA Rules 4150, 4311, 4522 and 4523.

* * * * *

4150. Guarantees by, or Flow Through Benefits for, Members

(a) Prior written notice shall be given to FINRA whenever any member guarantees, endorses or assumes, directly or indirectly, the obligations or liabilities of another person.

(b) Prior written approval must be obtained from FINRA whenever any member receives flow through capital benefits in accordance with Appendix C of SEA Rule 15c3-1.

• • • Supplementary Material: -----

.01 Financial and Operational Impact. The written notice required by paragraph (a) of this Rule shall be given to FINRA at least 10 business days prior to entering into such arrangement or relationship with another person. Both the written notice required by paragraph (a) of this Rule and the request for approval under paragraph (b) of this Rule shall include the address and general nature of business conducted by such person, a description of the relationship or arrangement between the parties, details regarding the capitalization of such person (including the percentage of ownership or profits by the member), as well as the actual and potential effect of the arrangement or relationship on the member's capital (including net capital) and operations and such other information as FINRA may require. A request for approval under paragraph (b) of this Rule shall further include an opinion of counsel where such is required in conformity with Appendix C of SEA Rule 15c3-1.

.02 Member Dealings. A member may at any time be required to provide FINRA with information with respect to the arrangement, relationship and dealings with a person referred to in this Rule.

.03 Books and Records. No member shall enter into an arrangement described in this Rule unless it has the authority to make available promptly the books and records of such other person for inspection by FINRA in the United States. The books and records of such person shall be kept separately from those of the member.

.04 FOCUS Reporting Requirements. For persons referred to in this Rule that are registered broker-dealers, the member shall furnish to FINRA copies of such person's FOCUS Reports simultaneous with their being filed with the person's designated examining authority. For persons referred to in this Rule that are not registered broker-dealers, FINRA requires, in lieu of FOCUS, submission of financial and operational statements, in such format and at such time periods as may be required by FINRA, sufficient to gauge the capital and operational effects of the arrangement or relationship.

.05 Routine Guarantees. Guarantees executed routinely in the normal course of business such as trade guarantees, signature guarantees, endorsement of securities and the writing of options, are not subject to the requirements of this Rule provided that, in regard to the guarantee of the writing of options, the transaction is appropriately recorded on the member's books and records in accordance with SEA Rule 17a-3(a)(10) and is reflected in its net capital computation pursuant to SEA Rule 15c3-1.

.06 Guarantees Already in Effect. Within 30 days of August 1, 2011, each member shall advise FINRA, in writing, of any guarantees, endorsements, assumptions of obligations/liabilities, or flow through capital benefits, in effect as of August 1, 2011 not having otherwise been reported, in writing, to the appropriate Regulatory Coordinator.

* * * * *

4311. Carrying Agreements

(a) (1) Unless otherwise permitted by FINRA, a member shall not enter into an agreement for the carrying, on an omnibus or fully disclosed basis, of any customer account in which securities transactions can be effected ("customer account" or "account"), unless such agreement is with a carrying firm that is a FINRA member. An introducing firm that acts as an intermediary for another introducing firm(s) for the purpose of obtaining clearing services from the carrying firm must notify such carrying firm of the existence of such arrangement(s) and the identity of the other introducing firm(s). Each such carrying agreement(s) shall identify and bind every direct and indirect recipient of clearing services as a party thereto.

(2) A carrying firm may enter into a carrying agreement(s) for the carrying of the customer accounts of a person other than a U.S. registered broker or dealer, subject to the conditions set forth in this Rule.

(b) (1) The carrying firm shall submit to FINRA for prior approval any agreement for the carrying of accounts, whether on an omnibus or fully disclosed basis, before such agreement may become effective. The carrying firm also shall submit to FINRA for prior approval any material changes to an approved carrying agreement before such changes may become effective.

(2) A carrying firm may use a standardized form of agreement that has been approved by FINRA pursuant to paragraph (b)(1) of this Rule, to enter into new carrying arrangements with other U.S. registered brokers or dealers, without the re-submission and re-approval of such agreement. However, a carrying firm must submit to FINRA for approval each carrying agreement that includes a party that is not a U. S. registered broker or dealer.

(3) As early as possible, but not later than 10 business days, prior to the carrying of any accounts of a new introducing firm (including the accounts of any introducing firm(s) for which a new or existing introducing firm is acting as an intermediary in obtaining clearing services from the carrying firm) the carrying firm shall submit to FINRA a notice identifying each such introducing firm by name and CRD number and shall include such additional information as FINRA may require.

(4) Each carrying firm shall conduct appropriate due diligence with respect to any new introducing firm relationship to assess the financial, operational, credit and reputational risk that such arrangement will have upon the carrying firm. FINRA, in its review of any arrangement, may in its discretion require specific items to be addressed by the carrying firm as part of such firm's due diligence requirement under this Rule. The carrying firm shall maintain a record, in accordance with the timeframes prescribed by SEA Rule 17a-4(b), of the due diligence conducted for each new introducing firm.

(c) (1) Each carrying agreement in which accounts are to be carried on a fully disclosed basis shall specify the responsibilities of each party to the agreement, including at a minimum the allocation of the responsibilities set forth in paragraphs (c)(1)(A) through (I) and (c)(2) of this Rule. The allocation of such responsibilities shall be subject to approval by FINRA pursuant to paragraph (b)(1) of this Rule.

- (A) Opening and approving accounts.
- (B) Acceptance of orders.
- (C) Transmission of orders for execution.
- (D) Execution of orders.
- (E) Extension of credit.
- (F) Receipt and delivery of funds and securities.
- (G) Preparation and transmission of confirmations.
- (H) Maintenance of books and records.
- (I) Monitoring of accounts.

(2) Each carrying agreement in which accounts are to be carried on a fully disclosed basis shall expressly allocate to the carrying firm the responsibility for the safeguarding of funds and securities for the purposes of SEA Rule 15c3-3 and for preparing and transmitting statements of account to customers. However, the carrying firm may authorize the introducing firm to prepare and/or transmit statements of account to customers on the carrying firm's behalf with the prior written approval of FINRA.

(d) Each customer whose account is introduced on a fully disclosed basis shall be notified in writing upon the opening of the account of the existence of the carrying agreement and the responsibilities allocated to each respective party. The carrying firm shall be responsible for the content of such notification to the customer. The customer shall be notified promptly and in writing in the event of any change to any of the parties to the agreement or any material change to the allocation of responsibilities thereunder.

(e) Each carrying agreement shall expressly state that to the extent that a particular responsibility is allocated to one party, the other party or parties will supply to the responsible organization all appropriate data in their possession pertinent to the proper performance and supervision of that responsibility.

(f) A carrying agreement may authorize an introducing firm to issue negotiable instruments directly to its customers on the carrying firm's behalf, using instruments for which the carrying firm is the maker or drawer, provided that the parties comply with SEA Rule 15c3-3 and further that the introducing firm represents to the carrying firm in writing that such introducing firm maintains, and will enforce, supervisory policies and procedures with respect to the issuance of such negotiable instruments that are satisfactory to the carrying firm.

(g) (1) Each carrying agreement shall expressly authorize and direct the carrying firm to:

(A) furnish promptly to the introducing firm and the introducing firm's designated examining authority (or, if none, to its appropriate regulatory agency or authority) any written customer complaint received regarding the conduct of the introducing firm or firms and its associated persons; and

(B) notify the complaining customer, in writing, that it has received the complaint and that such complaint has been furnished to the introducing firm and its designated examining authority (or, if none, to its appropriate regulatory agency or authority).

(2) Upon a showing of good cause, FINRA, at its discretion, may exclude certain carrying firms from the requirements of paragraph (g)(1) in instances where the introducing firm is an affiliated entity of the carrying firm.

(h) (1) At the commencement of the agreement and annually thereafter, the carrying firm must furnish to each of its introducing firms a list of all reports (e.g., exception reports) available to assist the introducing firm with the responsibilities allocated to it pursuant to the carrying agreement. The introducing firm must promptly request of the carrying firm, in writing, those offered reports that it requires.

(2) No later than July 1 of each year, the carrying firm shall notify the introducing firm's chief executive and chief compliance officer(s) in writing of the list of reports offered to, requested by and supplied to the introducing firm as of the date of the notice. A copy of this written notice must at the same time be provided to the introducing firm's designated examining authority (or if none, to its appropriate regulatory agency or authority).

(3) The carrying firm shall maintain as part of its books and records those reports requested by and supplied to the introducing firm. The carrying firm may satisfy the requirements of this paragraph by furnishing, upon request of the introducing firm's designated examining authority (or if none, to its appropriate regulatory agency or authority):

(A) a re-created copy of the report originally produced; or

(B) the format of the report and the applicable data elements contained in the original report.

(4) Upon a showing of good cause, FINRA, at its discretion, may exclude certain carrying firms from the requirements of this paragraph (h) in instances where the introducing firm is an affiliated entity of the carrying firm.

(i) All carrying agreements shall require each introducing firm to maintain its proprietary and customer accounts, and the proprietary and customer accounts of any introducing firm for which it is acting as an intermediary in obtaining clearing services from the carrying firm, in such a manner as to enable the carrying firm and FINRA to specifically identify the proprietary and customer accounts belonging to each introducing firm. The requirements of this paragraph (i) shall apply to intermediary clearing arrangements that are established on or after February 20, 2006.

••• [Supplementary Material](#) -----

.01 Material Changes. For purposes of paragraph (b)(1) of this Rule, material changes include, but are not limited to, changes to: (a) the allocation of responsibilities required by this Rule; (b) termination clauses applicable to the introducing firm; (c) any terms or provisions affecting the liability of the parties; and (d) the parties to the agreement (including, for example, the addition of a new party to the agreement, such as a "piggyback" arrangement, a new carrying firm or a new introducing firm, but not including a termination of the agreement).

.02 Notice of New Introducing Firm Arrangement. For purposes of the notice requirements of paragraph (b)(3) of this Rule, the carrying firm shall submit a questionnaire in such form as to be specified by FINRA in a Regulatory Notice, which questionnaire may be updated from time to time as FINRA deems necessary.

.03 Due Diligence. For purposes of paragraph (b)(4) of this Rule, the carrying firm's due diligence may include, without limitation, inquiry by the carrying firm into the introducing firm's business model and product mix, proprietary and customer positions, FOCUS and similar reports, audited financial statements and complaint and disciplinary history.

.04 Allocation of Responsibilities. For purposes of paragraphs (c)(1)(F) and (c)(2) of this Rule, members are reminded that receipt and delivery of customers' funds and securities and the safeguarding of such funds and securities must comply with the requirements of the SEC's financial responsibility rules, in particular SEA Rule 15c3-3, and applicable SEC guidance.

.05 Notice to Customers. For purposes of paragraph (d) of this Rule, notification to customers of a change to any of the parties to the carrying agreement is not required in instances where, consistent with applicable FINRA rules and the federal securities laws, such customers' accounts are being transferred pursuant to: (a) ACATS using an authorized Transfer Instruction Form (TIF); or (b) a process outside of ACATS where notification to customers is provided by means of an alternative mechanism such as affirmative or negative response letters.

* * * * *

4522. Periodic Security Counts, Verifications and Comparisons

(a) Each member that is subject to the requirements of SEA Rule 17a-13 shall make the counts, examinations, verifications, comparisons and entries set forth in SEA Rule 17a-13.

(b) Each carrying or clearing member subject to the requirements of SEA Rule 17a-13 shall make more frequent counts, examinations, verifications, comparisons and entries where prudent business practice would so require. In addition, each such carrying or clearing member shall:

(1) Receive position statements as frequently as good business practice requires, but no less than once per month with respect to securities held by clearing corporations, other organizations or custodians. Each such member shall at least once per month reconcile all such securities and money balances by comparison of

the clearing corporations' or custodians' position statements to the member's books and records and promptly report differences to the contra organization and such differences shall be promptly resolved by both. Where there is a higher volume of activity, good business practice may require a more frequent exchange of statements and their reconciliation; and

(2) At a maximum of seven business days after each security count, enter all unresolved differences into a "Difference" account, for that security count. The Difference account shall identify the unverified securities and reflect the number of shares or principal amount long or the number of shares or principal amount short of each security difference and the date of the security count that disclosed such difference. Thereafter, any adjustment of a difference position shall be made by entry into such account.

4523. Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts

(a) Each member shall designate an associated person who shall be responsible for each general ledger bookkeeping account and account of like function used by the member and such associated person shall control and oversee entries into each such account and shall determine that the account is current and accurate as necessary to comply with all applicable FINRA rules and federal securities laws governing books and records and financial responsibility requirements. A supervisor shall, as frequently as is necessary considering the function of the account but, in any event, at least monthly, review each account to determine that it is current and accurate and that any items that become aged or uncertain as to resolution are promptly identified for research and possible transfer to a suspense account(s).

(b) Each carrying or clearing member shall maintain a record of the names of the associated persons assigned primary and supervisory responsibility for each account as required by paragraph (a) of this Rule. All records made pursuant to this paragraph (b) shall be preserved for a period of not less than six years.

(c) Each member must record, in an account that shall be clearly identified as a suspense account, money charges or credits and receipts or deliveries of securities whose ultimate disposition is pending determination. A record must be maintained of all information known with respect to each item so recorded. Such suspense accounts include, but are not limited to, DK fails, unidentified fails, unallocable securities receipts versus

payment, returned deliveries, and any other receivable or payable (money or securities) “suspended” because of doubtful ownership, collectibility or deliverability. To the extent that suspense items can be distinguished by type, separate accounts may be used provided that the word “suspense” is made a prominent part of the account title. All records made pursuant to this paragraph shall be preserved for a period of not less than six years.

• • • Supplementary Material -----

.01 Supervisory Responsibility. For the purposes of paragraphs (a) and (b) of this Rule, each member with only one associated person may assign primary and supervisory responsibility for each account to that associated person, subject to applicable registration requirements. Members of limited size and resources that have more than one associated person may seek FINRA’s prior written approval to assign primary and supervisory responsibility for each account to the same associated person.

.02 Members Operating Pursuant to the Exemptive Provisions of SEA Rule 15c3-3(k)(2)(i). For purposes of this Rule, all requirements that apply to a member that clears or carries customer accounts shall also apply to any member that, operating pursuant to the exemptive provisions of SEA Rule 15c3-3(k)(2)(i), either clears customer transactions pursuant to such exemptive provisions or holds customer funds in a bank account established thereunder.

* * * * *

Attachment B: Carrying Firm Questionnaire

Questionnaire to be submitted by the carrying firm prior to the carrying of any accounts of a new introducing firm(s) (including omnibus firms whose accounts are to be carried by the carrying firm) ("correspondents") pursuant to FINRA Rules 4311(b)(3) and 4311.02. The completed questionnaire shall be sent to the carrying firm's Regulatory Coordinator at FINRA no later than 10 business days prior to the carrying of any accounts of a new correspondent.

If using a pre-approved form of carrying agreement pursuant to FINRA Rule 4311(b)(2), please specify form and date of FINRA's approval of such form:

Section I: Correspondent Profile

1. Name of correspondent: _____
2. Is the correspondent acting as an intermediary introducing firm for any other introducing firm(s) that is a party(ies) to the carrying agreement?
 - Yes** If yes, please list the names of the other introducing firms and provide separate correspondent profile questionnaires for each:

 - No**
3. Is the correspondent a FINRA member?
 - Yes** (if yes, please skip to Question 4)
 - No** If no, please provide the following information:
 - Is the proposed correspondent a US-registered broker-dealer?
 - Yes** If yes, please provide its SEC Registration No.: _____
 - No** If no, please list the foreign jurisdiction(s) in which the correspondent operates: _____

4. Method of Conversion of Accounts:
 - ACATS? **Yes**
 No
 - Bulk Transfer?
 - Yes** If yes, expected conversion date: _____
 - No**
 - Name of Delivering Broker: _____
 - Other? Please specify: _____

5. Amount of clearing deposit collected from correspondent \$ _____

6. Is this an arrangement for the carrying of an omnibus account(s)?

Yes (If yes, please skip to Question 8)

No

7. Approximate number of retail accounts: _____ Institutional accounts: _____

8. Expected correspondent customer:

Debit balances: \$ _____

Credit balances: \$ _____

9. Customer Business Mix: (Please indicate approximate number of monthly tickets):

Listed equities _____ Asset Backed Securities _____

Unlisted equities _____ Commodities _____

Municipals _____ Options _____

Governments _____ Other (please specify

Corporate Bonds _____ type(s) of product(s) _____

10. Does the correspondent engage in proprietary trading activities to be cleared and/or carried by the firm? If yes, please specify trading strategies (e.g., market making, speculative trading, customer facilitation, risk arbitrage, statistical arbitrage, etc.) and indicate products traded below:

Trading strategies engaged in: _____

Listed equities _____ Asset Backed Securities _____

Unlisted equities _____ Commodities _____

Municipals _____ Options _____

Governments _____ Other (please specify

Corporate Bonds _____ type(s) of product(s) _____

11. Will the correspondent be provided the following special margin privileges and/or have special margin requirements been established for the correspondent's customer and/or proprietary accounts?

If yes, please specify by completing a. – d. below:

a. **Portfolio Margining:** Proprietary Accounts: Yes No

Customer Accounts: Yes No

b. **Day Trading:** Proprietary Accounts: Yes No

Customer Accounts: Yes No

c. **Special house requirements:** Proprietary Accounts: Yes No

Customer Accounts: Yes No

d. **Other (specify):** _____

12. Has a Proprietary Accounts of Introducing Brokers (PAIB) agreement been executed with the correspondent?

Yes

No If no, please explain. _____

Section II: Correspondent Risk Management

Please respond to the following questions as they apply to the proposed correspondent relationship.

Please note that FINRA Rule 4311(b)(4) requires that each carrying firm shall conduct appropriate due diligence with respect to any new introducing firm relationship to assess the financial, operational, credit and reputational risk that such arrangement will have upon the carrying firm. The questions below are representative of the type of reviews FINRA expects firms to conduct as part of their correspondent due diligence performed in accordance with this rule. However, the firm is expected to assess the extent of the review required for each correspondent and perform additional reviews as it deems necessary. Please note that a record of the due diligence conducted for each new introducing firm must be maintained by the carrying firm in accordance with the timeframes prescribed by Exchange Act Rule 17a-4(b).

1. Has a review been conducted of the correspondent's business mix and customer account activities? Yes No NA

Election Notice

Board Election

Upcoming FINRA Board of Governors Election of a Small Firm and Large Firm Governor

Executive Summary

The annual meeting of FINRA firms will take place on or about Wednesday, August 3, 2011, to elect one Small Firm Governor and one Large Firm Governor on the FINRA Board of Governors (FINRA Board).

A formal notice of the meeting, including the precise date, time and location, will be mailed to executive representatives on or about June 29, 2011.

Eligible individuals who were not nominated for election to the FINRA Board by the Nominating Committee for the Large Firm seat—and eligible individuals for the Small Firm seat—may be included on the ballot for the election of governors by following the petition procedures set forth in the By-Laws and as further described in this *Election Notice*.

Note: FINRA distributed this *Notice* electronically to the executive representative of each FINRA firm and it is posted online at www.finra.org/Notices/Election/050311. Executive representatives should circulate this *Notice* to their firms' branch managers.

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

- ▶ Marcia E. Asquith, Senior Vice President and Corporate Secretary, at (202) 728-8949; or
- ▶ T. Grant Callery, Executive Vice President and General Counsel, at (202) 728-8285.

May 3, 2011

Suggested Routing

- ▶ Executive Representatives
- ▶ Senior Management

Composition of the Board

The FINRA Board consists of 22 members,¹ including:

- ▶ the Chief Executive Officer of FINRA;
- ▶ eleven Public Governors;
- ▶ one Floor Member Governor;
- ▶ one Independent Dealer/Insurance Affiliate Governor;
- ▶ one Investment Company Affiliate Governor;
- ▶ three Small Firm Governors;
- ▶ one Mid-Size Firm Governor; and
- ▶ three Large Firm Governors.

Of the 22 Board members, the Public, Floor Member, Independent Dealer/Insurance Affiliate and Investment Company Affiliate Governors are appointed by the FINRA Board from candidates recommended by the Nominating Committee (the “Appointed Governors”).

The Nominating Committee also may nominate individuals to run for election for the seven elected governor seats that comprise the three Small Firm Governors, one Mid-Size Firm Governor and three Large Firm Governors (the “Elected Governors”).

To be eligible to serve, Large Firm Governors must be registered with Large Firms, Small Firm Governors must be registered with Small Firms and the Mid-Size Firm Governor must be registered with a Mid-Size Firm. In order for the Board to maintain compliance with the compositional requirements of the FINRA Board set forth in the FINRA By-Laws, the seven Elected Governors have a continuing obligation to satisfy the firm-size classification throughout the entire term for which the governor is elected. Pursuant to Article I of FINRA’s By-Laws, firm sizes are defined as follows:

- ▶ a Large Firm is defined as a firm that employs 500 or more registered persons;²
- ▶ a Mid-Size Firm is defined as a firm that employs at least 151 and no more than 499 registered persons;³ and
- ▶ a Small Firm is defined as a firm that employs at least one and no more than 150 registered persons.⁴

Terms and Term Limits

As of the 2010 annual meeting, the Appointed Governors and the Elected Governors were staggered into three classes,⁵ with the first class of governors (Appointed or Elected) holding office until the first succeeding annual meeting of FINRA firms, the second class of governors holding office until the second succeeding annual meeting and the third class of governors holding office until the third succeeding annual meeting, or until a successor is duly appointed or elected (as the case may be) and qualified, or until death, resignation, disqualification or removal.

At each subsequent annual meeting, governors will be appointed or elected for a term of three years to replace those whose terms expire. Governors may not serve more than two consecutive terms. If a governor is elected or appointed to fill a vacancy of such a governor position for a term of less than one year, the governor may serve up to two consecutive terms following the expiration of the governor's initial term.

The By-Laws expressly provide that the term of office of a governor shall terminate immediately upon a determination by the Board, by a majority vote of the remaining governors, that the governor no longer satisfies the classification for which the governor was elected. Individuals seeking nomination for election as a Large Firm, Small Firm or Mid-Size Firm Governor also have an obligation to satisfy the firm-size classification on the date the petition is circulated, the date the petition is certified by the Corporate Secretary and date of the annual meeting. Individuals who fail to meet this requirement will be disqualified from election.

FINRA Nominating Committee Nominees

Pursuant to Article VII, Section 9 of the FINRA By-Laws, the FINRA Nominating Committee has nominated Sallie L. Krawcheck, Bank of America, as its Large Firm Governor nominee (see attached profile).

With respect to the Small Firm Governor seat, the Nominating Committee determined it would not nominate a candidate for election in 2011. Instead, any eligible candidates who obtain the requisite number of petitions will be included on the ballot.

Petition Process for Additional Candidates

Pursuant to Article VII, Section 10 of FINRA's By-Laws, a person who has not been nominated for election to the FINRA Board by the Nominating Committee may be included on the ballot for the election of governors if:

- (a) within 45 days after the date of this Election Notice, such person presents to the Secretary of FINRA petitions in support of such nomination, duly executed by at least three percent of FINRA member firms entitled to vote for such nominee's election. If, however, a candidate's name appears on a petition in support of more than one nominee, the petition must be endorsed by 10 percent of FINRA member firms entitled to vote for such nominees' election; and
- (b) the Secretary certifies that such petitions have been duly executed by the executive representatives of the requisite number of FINRA member firms entitled to vote for such person's election, and the person being nominated satisfies the classification of the governorship to be filled based on the information provided by the person as is reasonably necessary for the Secretary to make the certification.

As of close of business on Monday, May 2, 2011, the number of FINRA Small Firms was 4,189 and the number of Large Firms was 173.

Firms may only endorse one petitioner for the same firm size seat as their own.

The petition must identify the seat for which he or she is seeking to be nominated. The petitioner must submit sufficient information to determine the person's status with respect to the category for which he or she is petitioning to be nominated. The petitioner must also provide information sufficient for the Corporate Secretary to determine that the petitions are duly executed by the executive representatives of the requisite number of applicable size firm members. In addition, to assist in the process of verifying petitions, FINRA requests that all petitions submitted be dated by their signatory. **Petitions must be submitted no later than Friday, June 17, 2011.**

The names of persons obtaining the requisite number of valid petitions will be included on the appropriate proxy mailed to eligible firms in advance of the annual meeting.

Voting Eligibility

A proxy will be mailed, along with the notice of the annual meeting, to the executive representative on record at each eligible FINRA firm prior to the annual meeting.

Firms are eligible to vote for the nominees who are running for seats that are in the same size category as their own firm. Therefore, Small Firms and Large Firms may vote only for the candidates running for the seats reserved for their firm size.

FINRA will verify the size of each firm on the day the proxies are mailed. Each firm eligible to vote will receive a proxy containing the nominees for their voting class.

Endnotes

- 1 See Article Eight, paragraph (b) of the Restated Certificate of Incorporation of FINRA; Article VII, Section 4 of the FINRA By-Laws.
- 2 See Article I (y) of the FINRA By-Laws.
- 3 See Article I (cc) of the FINRA By-Laws.
- 4 See Article I (ww) of the FINRA By-Laws.
- 5 The By-Laws specified that, with respect to the Elected Governors, the first class of governors includes one Large Firm Governor and one Small Firm Governor; the second class includes one Large Firm Governor, one Mid-Size Firm Governor and one Small Firm Governor; and the third class includes one Large Firm Governor and one Small Firm Governor. See Article VII, Sec. 5 of FINRA's By-Laws.

Attachment A

Profile of Nominating Committee Nominee for Elected Large Firm Governor Seat

Sallie L. Krawcheck is president of Global Wealth & Investment Management for Bank of America. Global Wealth & Investment Management provides comprehensive wealth management to high net worth clients around the world. It also provides retirement and benefit plan services, philanthropic management and asset management to individuals and institutions. Prior to joining Bank of America, Ms. Krawcheck was chief executive officer and chairman for Citi Global Wealth Management, responsible for the Citi Private Bank, Citi Smith Barney and Citi Investment Research. During her time at Citi, she was also a member of the senior leadership committee and executive committee. Ms. Krawcheck joined Citi in October 2002 as chairman and chief executive officer of Smith Barney, where she oversaw the global management of the Smith Barney and Citi Investment Research businesses. In 2004, she was appointed chief financial officer and head of strategy for Citigroup Inc. Prior to joining Citi, Ms. Krawcheck was chairman and chief executive officer of Sanford C. Bernstein & Company. Among other honors, Ms. Krawcheck has been listed eight times as one of *Fortune's* "Most Powerful Women" in business, and *U.S. Banker* ranked her first on its list of "25 Women to Watch" in 2009 and fourth on its "25 Most Powerful Women in Banking" list in 2010. And she has been recognized as one of *TIME* magazine's "Global Business Influentials." Ms. Krawcheck attended the University of North Carolina at Chapel Hill on the Morehead Scholarship and graduated in 1987 with academic honors and a Bachelor of Arts. In 1992, she received an MBA from Columbia University. She is a member of the Bretton Woods Committee and on the board of directors at The University of North Carolina at Chapel Hill Foundations, Inc. and Carnegie Hall. She also is on the board of overseers of Columbia University Business School and the board of trustees for The Economic Club of New York.

Trade Reporting Notice

Reporting Asset-Backed Securities to the Trade Reporting and Compliance Engine (TRACE)

Executive Summary

Although firms have up to two business days (T + 1) to report transactions in Asset-Backed Securities (ABS) under the TRACE transaction reporting rules that become effective on May 16, 2011, FINRA requests that firms report transactions in ABS as soon as practicable after the execution of a transaction and throughout the trading day.

Discussion

FINRA's TRACE rules provide for the reporting of transactions in TRACE-Eligible Securities to TRACE. Effective May 16, 2011, ABS are TRACE-Eligible Securities, and firms must begin reporting transactions in ABS to TRACE.¹

Initially, FINRA proposed that firms report transactions in ABS no later than the close of the TRACE System on the date of trade (T), with certain exceptions. In response to firm concerns about the difficulties of submitting transaction information on certain more complex ABS transactions, FINRA proposed and the SEC approved a Pilot Program to allow more time for reporting such ABS transactions to TRACE during the first six months of reporting, which gives firms more flexibility (an additional day) for timely reporting. Specifically, during the Pilot Program, FINRA Rule 6730 permits transactions in ABS executed on a business day to be reported no later than the next business day (T+1) during TRACE System Hours.² Upon expiration of the Pilot Program, most transactions in ABS must be reported the day of execution during TRACE System Hours to be timely reported.³

May 10, 2011

Key Topic(s)

- ▶ Asset-Backed Securities
- ▶ Delayed Reporting
- ▶ Securitized Products
- ▶ TRACE-Eligible Securities
- ▶ Transaction Reporting

Referenced Rules & Notices

- ▶ Regulatory Notice 11-20
- ▶ FINRA Rule 6730

FINRA's TRACE system is designed to accept transaction reports throughout the trading day. FINRA has become aware that certain firms may queue ABS transaction reports and report such transactions at or near the close of the permissible reporting time period (*i.e.*, on T + 1 during the Pilot Program and trade date after the expiration of the Pilot Program). If a number of firms adopt such ABS trade reporting practices, FINRA is concerned that system capacity issues may cause delays in processing ABS transaction reports, and, in some instances, may result in firms being unable to report timely. To prevent such system problems, FINRA requests that firms report trades in ABSs as soon as practicable and throughout the course of the trading day rather than queuing such reports until the end of the reporting time period. If firms do not voluntarily report in this manner, it may become necessary to amend FINRA Rule 6730(a)(3) specifically to require that firms report "as soon as practicable" in all cases.

Endnotes

- 1 The SEC approved amendments to the TRACE rules that define ABS as TRACE-Eligible Securities, require firms to report transactions in ABS to the TRACE system and establish other requirements related to ABS, which FINRA proposed in three rule filings. *See* Securities Exchange Act Release No. 64364 (April 28, 2011), 76 FR 25385 (May 4, 2011) (SEC Order Approving SR-FINRA-2011-012); Securities Exchange Act Release No. 64041 (March 4, 2011), 76 FR 13248 (March 10, 2011) (SEC Order Approving File No. SR-FINRA-2011-004); and Securities Exchange Act Release No. 61566 (February 22, 2010), 75 FR 9262 (March 1, 2010) (SEC Order Approving SR-FINRA-2009-065). *See also* [*Regulatory Notice 11-20*](#) (May 2011). The amendments become effective May 16, 2011.
- 2 FINRA Rule 6730(a)(3) (A)(i), effective May 16, 2011.
- 3 Specifically, after the Pilot Program has expired, transactions in ABSs executed on a business day at or after 12:00:00 a.m. Eastern Time through 5:00:00 p.m. Eastern Time must be reported the same day during TRACE System Hours. *See* FINRA Rule 6730(a)(3)(A)(ii). However, if a transaction is executed after 5:00:00 p.m. Eastern Time on a business day or on a non-business day, the transaction is timely reported if reported the next business day. *See* FINRA Rule 6730(a)(3)(B).