

# Notices

## Regulatory Notices

- 13-01** Final Renewal Statements for Broker-Dealers, Investment Adviser Firms, Agents and Investment Adviser Representatives, and Branches; **Payment Deadline: February 1, 2013**
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## Information Notice

- 01/24/13** November 2012 Supplement to the Options Disclosure Document

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## BD and IA Renewals for 2013

### Final Renewal Statements for Broker-Dealers, Investment Adviser Firms, Agents and Investment Adviser Representatives, and Branches

Payment Deadline: February 1, 2013

#### Executive Summary

FINRA is issuing this *Notice* to help firms review, reconcile and respond to their Final Renewal Statements as well as view the reports that are currently available in Web CRD/IARD for the annual registration renewal process. The payment deadline is February 1, 2013.

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

#### Background & Discussion

##### Final Renewal Statements

On January 2, 2013, Final Renewal Statements and reports became available for viewing and printing in Web CRD/IARD. These statements reflect the final status of broker-dealer, registered representative, investment adviser firm, investment adviser representative, and branch registrations and/or notice filings as of December 31, 2012. Any adjustments in fees owed because of registration terminations, approvals, firm IA registrations, reporting status or notice filings subsequent to the Preliminary Renewal Statement are included in this final reconciled statement.

If the amount assessed on the Final Renewal Statement is greater than the amount assessed on the Preliminary Renewal Statement, the additional renewal fees are due by February 1, 2013. If the amount assessed on the Final Renewal Statement is less than the amount assessed on the Preliminary Renewal Statement, FINRA has issued a credit to the firm's Web CRD/IARD Daily Account.

#### January 2013

##### Notice Type

- ▶ Renewals

##### Suggested Routing

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

##### Key Topics

- ▶ IARD™
- ▶ Registration
- ▶ Renewals
- ▶ Web CRD®

##### Referenced Rules & Notices

- ▶ NTM 02-48

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

- ▶ Web CRD system processing fees;
- ▶ FINRA branch office fees;
- ▶ FINRA branch renewal processing fees;
- ▶ BATS Y-Exchange, Inc. (BATS-YX), BATS Z-Exchange, Inc. (BATS-ZX), BOX Options Exchange, LLC (BOX), C2 Options Exchange, Incorporated (C2), Chicago Board Options Exchange (CBOE), Chicago Stock Exchange (CHX), EDGA Exchange, Inc. (EDGA), EDGX Exchange, Inc.(EDGX), International Securities Exchange (ISE), National Stock Exchange (NSX), New York Stock Exchange (NYSE), NYSE MKT LLC (AMEX), NYSE Arca, Inc. (ARCA), NASDAQ OMX BX, Inc. (BX), NASDAQ OMX PHLX, Inc. (PHLX), NASDAQ Stock Exchange (NOX) maintenance fees;
- ▶ state agent renewal fees;
- ▶ state BD renewal fees;
- ▶ investment adviser firm and representative renewal fees, if applicable; and
- ▶ broker-dealer and/or investment adviser branch renewal fees.

FINRA must receive full payment of the Final Renewal Statement fees by February 1, 2013.

## Renewal Payment

A Final Renewal Statement that reflects a zero balance requires no further action by the firm. If you believe your firm overpaid and is due a renewal refund, please check your firm's Daily Account to verify FINRA transferred the overpayment. FINRA transferred all renewal overpayments to each firm's Daily Accounts on January 2, 2013. To request a refund check, please send an email to [finrarefunds@finra.org](mailto:finrarefunds@finra.org). The email must be sent by an appropriate firm signatory and include:

- ▶ the firm CRD Number;
- ▶ the amount of the refund requested; and
- ▶ the firm's daily account balance as verification.

If the Final Renewal Statement reflects an amount due, FINRA must receive payment no later than February 1, 2013. Firms have four payment options:

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

## Web CRD/IARD E-Pay

The Web CRD/IARD E-Pay application is accessible from the Final Renewal Statement and the [FINRA](#) or [IARD](#) websites. E-Pay allows a firm to make an electronic payment from a designated bank account to its Web CRD/IARD Renewal Account. Please note that in order for funds to be posted to a firm's Renewal Account by February 1, 2013, firms must submit payment electronically, no later than 8 p.m. Eastern Time (ET) on January 30, 2013.

## Wire Payment

A firm may wire full payment for its Final Renewal Statement by requesting its bank to initiate the wire transfer to “**BNY Mellon Financial Corporation.**” A firm should provide its bank the following information:

<b>Transfer funds to:</b>	BNY Mellon Financial Corporation
<b>ABA Number:</b>	031000037
<b>Beneficiary:</b>	FINRA
<b>FINRA Account Number:</b>	8-234-353
<b>Reference Number:</b>	Firm CRD number and “Renewals”

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

- ▶ Inform your bank to credit funds to the FINRA bank account and use only your firm's CRD Number and the word “Renewal” as a reference.
- ▶ Record the Confirmation Number of the wire transfer given to you by your bank. You will need this if you choose to call your bank later to confirm the wire transfer.
- ▶ Send your wire transfer by 2 p.m., ET. Your firm may confirm receipt by reviewing your Renewal Account online or calling the FINRA Gateway Call Center at (301) 869-6699 the following business day.

## Automatic Daily Account-to-Renewal Account Transfer

To facilitate payment of renewal fees, FINRA will automatically transfer funds from a firm's Daily Account to its Renewal Account beginning on January 11, 2013, through February 3, 2013, to cover outstanding fees assessed on Final Renewal Statements. FINRA will transfer funds only if a firm has sufficient funds available in its Daily Account to cover the full amount owed.

**Please Note:** If your firm does not want funds automatically transferred, ensure that FINRA receives your payment by January 10, 2013. Separately, if your firm wishes to transfer funds between affiliated firms, submit a [Web CRD/IARD Account Transfer Form](#) available on the FINRA website prior to the renewal deadline.

## Check

Please note that the separate renewal check payment address has been eliminated and all Web CRD/IARD check payments sent to FINRA are now only deposited into firms' Daily Accounts. If you mail a check to pay your firm's renewal fees, it will not be applied to your Renewal Account until January 11, 2013, when FINRA begins the automatic Daily Account-to-Renewal Account transfer noted above. For inclusion in the automatic transfer, please ensure that you have sufficient funds in your Daily Account to cover the total renewal fees due. If you would like your renewal payment to be applied before January 11, then you must pay using Web CRD/IARD E-Pay or with a wire transfer directly to your Renewal Account.

- ▶ Print and enclose a copy of the first page of your online Final Renewal Statement.
- ▶ Make checks payable to **FINRA** and write your firm's CRD Number on the memo line of the check.
- ▶ Processing of check payments may take up to two business days. Please account for mail delivery and payment processing time when sending payment.
- ▶ You can query Web CRD/IARD to verify that your check has been processed in the "Deposit Detail" of your Daily Account.
- ▶ Funds deposited into your firm's Daily Account will be transferred to your firm's Renewal Account as part of the automatic transfer process during the specified periods (January 11 - February 4, 2013).

## Check Payment Addresses

If your firm's accounting software (*e.g.*, Quicken, Quickbooks) stores vendor addresses, please update them for Web CRD/IARD check payments to the addresses shown below. Make sure you copy the appropriate address **exactly as it appears below**. If you exclude any of the information, it may delay the receipt of your payment.

US Mail	Express/Overnight Delivery
FINRA P.O. Box 7777-9995 Philadelphia, PA 19175-0001  (Note: This P.O. Box will not accept courier or overnight deliveries.)	FINRA/CRD Attn: 9995 500 Ross Street 154-0455 Pittsburgh, PA 15262  Provide the following phone number if one is required for the recipient: (301) 869-6699

## Renewal Reports

Renewal reports include all individual registrations renewed for 2013; however, they do not include registrations that were “pending approval” or “deficient” at year-end. Firms should examine their reports carefully to ensure that all registration approvals are correct. FINRA also suggests that firms include these reports in firms’ permanent records.

- ▶ **Firm Renewal Report:** This report lists all renewed personnel with FINRA and participating regulators. Individuals whose registrations are “approved” with any of these regulators during November and December will be included in this report, while registrations that are still pending or deficient will not be included. Firms should use this report to reconcile their records for renewal purposes.
- ▶ **Branches Renewal Report:** This report lists each branch registered with FINRA and other regulators that renew branches registered with them through Web CRD/IARD for which the firm was assessed a fee. Firms should use this report to reconcile their records for renewal purposes.

## Discrepancies

If a firm finds any discrepancies between its records and those maintained on Web CRD/IARD, the firm must report the discrepancy to FINRA. Firms must report all discrepancies by February 1, 2013. Copies of appropriate documentation from the firm’s Web CRD/IARD queues, such as a Web CRD-generated notice of termination, notification of deficient condition or notice of approval, should be readily available upon request by FINRA. Documentation should be mailed to:

**FINRA**  
Registration Management  
9509 Key West Ave  
Rockville, MD 20850

The Renewal Program Bulletin contains detailed instructions to help firms complete the renewal process. This publication is available at [www.finra.org/renewals](http://www.finra.org/renewals).

## Recruitment Compensation Practices

### FINRA Requests Comment on a Proposed Rule to Require Disclosure of Conflicts of Interest Relating to Recruitment Compensation Practices

Comment Period Expires: March 5, 2013

#### Executive Summary

Many member firms offer significant financial incentives to recruit registered representatives to join their firms, yet these compensation arrangements are not disclosed to customers when they are asked to transfer their accounts to a representative's new firm. To address conflicts of interest relating to recruitment compensation practices, FINRA seeks comment on a proposed rule that would require specific disclosure by the recruiting member firm of the financial incentives a representative receives as part of his or her relationship with the new firm. The recruiting member firm would be required to provide the disclosure before a former retail customer of the representative makes a final determination to transfer an account to the new firm.

The text of the proposed rule can be found at [www.finra.org/notices/13-02](http://www.finra.org/notices/13-02).

Questions concerning this *Notice* should be directed to:

- ▶ Philip Shaikun, Associate Vice President, Office of General Counsel (OGC), at (202) 728-8451; and
- ▶ Erika Lazar, Assistant General Counsel, OGC, at (202) 728-8013.

January 2013

#### Notice Type

- ▶ Request for Comment

#### Suggested Routing

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

#### Key Topics

- ▶ Compensation
- ▶ Conflicts of Interest
- ▶ Customer Account Transfers
- ▶ Disclosure

#### Referenced Rules & Notices

- ▶ FINRA Rule 4512

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 5, 2013.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:  
Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

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

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).<sup>2</sup>

## Background & Discussion

A number of securities firms offer enhanced compensation packages to induce registered representatives to move from one firm to another. These inducements typically take the form of some combination of upfront bonuses, forgivable loans, transition assistance and back-end production bonuses. Such financial incentives may amount to as much as two to three times the commissions and fees produced by a representative in the previous year.<sup>3</sup> FINRA understands that currently the prominent factor in structuring recruitment compensation packages or transition assistance is the representative's "trailing twelve," *i.e.*, the most recent 12-month gross production or revenue.

These recruitment programs raise conflicts of interest that often are not disclosed when registered representatives encourage former customers to move to their new firm. Instead, many representatives typically address only the platform, products and services of the new firm. To inform customers of the conflicts raised by recruitment packages, FINRA is requesting comment on a proposed rule to require detailed disclosure of the recruitment incentives provided to a registered representative in conjunction with a move to a new firm.

## Enhanced Compensation Packages

In general, enhanced compensation packages offered to recruit a representative to leave one firm and join another provide an additional and significant layer of compensation on top of the commission payout grid compensation that the representative receives based on production at the new firm. The disclosure proposal applies only to that additional layer of compensation. The amount and structure of these additional arrangements depend on multiple factors, including the firm from which the representative is transferring, the representative's book of business, and the representative's years of service. Most recruitment compensation is calculated based on the representative's trailing production at the previous firm. Recruitment compensation packages also may depend on the business model of the firm offering the package.

Incentives at some firms appear to tend toward transition assistance, which may include moving expenses, leasing space, furniture, staff and termination fees associated with moving accounts. Other firms offer an upfront bonus that takes the form of a one-time signing bonus or a forgivable loan, based on a percentage of the representative's trailing twelve. To encourage an extended commitment to the new firm, some firms offer representatives a combination of a forgivable loan and an annual bonus in which the representative signs a promissory note for an upfront loan and receives an annual bonus that equals the annual installment due on the loan at the time the loan payment is due.<sup>4</sup> Firms also may offer a bonus based on a percentage of assets brought over from the representative's former firm, or bonuses (or bonus and loan combination packages) based on the representative's production of new business at the new firm, which are known as "back-end" or "production" bonuses, structured to encourage a representative to remain at the new firm.

## Concerns Regarding Enhanced Compensation Packages

Enhanced compensation packages offered to recruit representatives have been the subject of regulatory concern in the past. SEC Chairman Schapiro identified potential conflicts raised by recruitment compensation practices in 2009 in an open letter to broker-dealer CEOs.<sup>5</sup> The letter noted that:

Some types of enhanced compensation practices may lead registered representatives to believe that they must sell securities at a sufficiently high level to justify special arrangements that they have been given. Those pressures may in turn create incentives to engage in conduct that may violate obligations to investors. For example, if a registered representative is aware that he or she will receive enhanced compensation for hitting increased commission targets, the registered representative could be motivated to churn customer accounts, recommend unsuitable investment products or otherwise engage in activity that generates commission revenue but is not in investors' interest.

FINRA understands that in response to the 2009 letter, for a time many firms restructured recruitment compensation arrangements to avoid incentivizing such activities. While there may be legitimate business rationales for offering enhanced compensation and transition assistance to registered persons, these practices continue to raise conflicts of interest.<sup>6</sup> The proposed rule focuses on the undisclosed conflict that representatives have received lucrative financial incentives, often based on trailing production, to move firms, and customers that are solicited to follow their representatives are not directly notified of these practices. FINRA believes that customers would benefit from knowing the incentives that may have led their representative to change firms before they transfer an account to a new firm. Therefore, the proposed rule would provide transparency to customers at the previous firm before they contract to transfer their accounts to the representative's new firm.

## Proposal

FINRA believes that customers would benefit from being told the material conflicts arising from a registered person being paid recruiting incentives to change firms. To that end, FINRA requests comment on a proposed rule that would require a member firm (recruiting member) that provides, or has agreed to provide, to a registered person enhanced compensation in connection with the transfer to the recruiting member of the securities employment (or association) of the registered person from another financial services industry firm (previous firm) to disclose, for one year following the date the registered person associates with the recruiting member, the details of such enhanced compensation to any former customer with an account assigned to the registered person at the previous firm who (1) is individually contacted by the recruiting member or registered person, either orally or in writing, regarding the transfer of the securities employment (or association) of the registered person to the recruiting member; or (2) seeks to transfer an account from the previous firm to a broker-dealer account assigned to the registered person with the recruiting member.

The proposal would require disclosure of the details of enhanced compensation to be made orally or in writing at the time of first individualized contact by the recruiting member or registered person with the former customer after the registered person has terminated his or her association with the previous firm. If such disclosure is made orally, or if the customer seeks to transfer an account from the previous firm to a broker-dealer account assigned to the registered person with the recruiting member and no individualized contact with that customer has occurred (*e.g.*, the customer learns of the registered person's move from a general announcement or other sources), the recruiting member would be required to provide written disclosure to the customer with the account transfer approval documentation. The written disclosure must be clear and prominent, and must include information with respect to the timing, amount and nature of the enhanced compensation arrangement. For example, a general disclosure in small type that a registered person received an unspecified bonus in connection with his or her employment at a new firm would not be sufficient under the proposal.

For purposes of the proposed rule, the term “enhanced compensation” means compensation paid in connection with the transfer of securities employment (or association) to the recruiting member other than the compensation normally paid by the recruiting member to its established registered persons. Enhanced compensation includes but is not limited to signing bonuses, upfront or back-end bonuses, loans, accelerated payouts, transition assistance and similar arrangements, paid in connection with the transfer of securities employment (or association) to the recruiting member. It would not include, for example, the receipt of a higher payout at the recruiting member that was not otherwise related to the transfer of securities employment (or association). In addition, for purposes of the proposed rule, the term “financial services industry” means any industry regulated by the SEC, Commodity Futures Trading Commission, state securities authorities, federal or state banking authorities, state insurance authorities, or substantially equivalent foreign regulatory authorities.

The proposed rule would exclude disclosure to customer accounts that meet the definition of an institutional account pursuant to FINRA Rule 4512(c), except any natural person or a natural person advised by a registered investment adviser.<sup>7</sup> Furthermore, a member would not be required to disclose enhanced compensation in an amount less than \$50,000. The *de minimis* exception for enhanced compensation under \$50,000 is intended to allow firms to offset a registered person’s ordinary costs in the transition process, since such compensation does not raise the same degree of conflicts of interest as more lucrative enhanced compensation arrangements.

## Request for Comment

In addition to generally requesting comments, FINRA specifically requests comment regarding whether the proposed rule should:

- ▶ require written disclosure at first individualized contact in all instances, rather than allowing oral disclosure at this point;
- ▶ apply to all customers recruited by the transferring registered person during the year after transfer;
- ▶ apply to any new broker-dealer account assigned to the registered person with the recruiting member opened by a former customer of the registered person in addition to accounts transferring from the previous firm;
- ▶ require the registered person to disclose the details of any enhanced compensation to be received in connection with a transfer of securities employment (or association) to a recruiting member to any customer individually contacted by the registered person regarding such transfer *while the registered person is still at the previous firm*;

- ▶ include a requirement that a customer affirm receipt of the disclosure at or before account opening at the new firm. FINRA is interested, in particular, in the potential for such a requirement to delay the account opening process in a manner that could disadvantage customers;
- ▶ apply to a time period different from the proposed one year following the date the registered person associates with the recruiting member;
- ▶ establish an amount different from the proposed \$50,000 for a *de minimis* exception; or
- ▶ apply an alternative approach that would require a general upfront disclosure by the recruiting member or registered person that the registered person is receiving, or will receive, material enhanced compensation in connection with the transfer of securities employment (or association) to the recruiting member and that additional specific information regarding the details of such compensation is available at a specified location on its website or upon request.

FINRA also specifically requests comments on the economic impact and expected beneficial results of the proposed rule.

- ▶ What direct costs for the recruiting member will result from the rule?
- ▶ What indirect costs will arise for the recruiting member or its transferring persons?
- ▶ What benefits would result for individual investors and their agents? How extensive are these benefits?
- ▶ Are the costs imposed by the rule warranted by the potential harm to customers arising from the payment by member firms of recruitment compensation to incentivize representatives to change firms without disclosure of such incentives to transferring customers?
- ▶ Is the proposed rule well designed to reduce conflicts related to recruitment compensation practices?
- ▶ How will the rule change business practices and competition among firms with respect to recruiting and compensation practices? Will these impacts differentially affect small or specialized broker-dealers?
- ▶ What second order impacts could result?

We request quantified comments where possible.

## Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See [Notice to Members 03-73](#) (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the [Federal Register](#). Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
3. See, e.g., J. Horowitz, [What Meltdown? Broker Bidding Wars Are Back](#), Reuters, April 11, 2012.
4. For example, a recruiting member may offer a representative a combination loan and bonus agreement where the representative signs a promissory note for \$900,000 with a term of nine years. The representative receives the loan up front and is expected to pay nine annual installments of \$100,000 plus interest until maturity. On the date the annual installment is due on the loan, the member firm pays the representative a bonus in the exact amount of the loan payment due, including principal and interest.
5. See [Open Letter to Broker-Dealer CEOs from SEC Chairman Mary L. Schapiro](#), dated August 31, 2009.
6. FINRA notes that we are currently discussing with several major firms how they identify and manage conflicts of interest. See [Targeted Examination Letters Re: Conflicts of Interest](#) (July 2012).
7. FINRA Rule 4512(c) defines institutional account to mean the account of (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (3) any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

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## Communications With the Public

### FINRA Provides Guidance on New Rules Governing Communications With the Public

FINRA staff has received a number of questions since it published [Regulatory Notice 12-29](#), which announced SEC approval of FINRA's new rule on communications with the public. The new communications rules become effective February 4, 2013. To provide additional guidance on compliance with the new rules, FINRA has published a set of [questions and answers](#) on the Advertising Regulation page on the FINRA website.

Questions concerning this *Notice* should be directed to:

- ▶ Thomas A. Pappas, Vice President and Director, Advertising Regulation, at (240) 386-4553; or
- ▶ Joseph P. Savage, Vice President and Counsel, Investment Companies Regulation, at (240) 386-4534.

January 2013

#### Notice Type

- ▶ Consolidated Rulebook
- ▶ Guidance

#### Suggested Routing

- ▶ Advertising
- ▶ Compliance
- ▶ Investment Companies
- ▶ Legal
- ▶ Registered Representatives
- ▶ Research
- ▶ Senior Management

#### Key Topics

- ▶ Advertising
- ▶ Communications With the Public
- ▶ Referenced Rules & Notices
- ▶ FINRA Rule 2200 Series
- ▶ Regulatory Notice 12-29

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## Subpoenas and Orders to Appear or Produce Documents

### SEC Approves Amendments to Arbitration Codes Relating to Subpoenas and Orders to Direct the Appearance of Witnesses and Production of Documents Without Subpoenas

Effective Date: February 18, 2013

#### Executive Summary

The Customer and Industry Codes of Arbitration Procedure (Codes) provide arbitrators with the authority to issue subpoenas for the appearance of witnesses and the production of documents. The Codes also authorize arbitrators to order FINRA member firms and their employees and associated persons to produce documents and/or to appear as witnesses without using the subpoena process. The SEC approved amendments to the Codes which direct arbitrators, in most instances, to issue orders (arbitrator orders), instead of issuing subpoenas, when industry parties seek the appearance of witnesses or the production of documents from non-party firms or their employees or associated persons.

The amendments add procedures for non-parties to object to subpoenas and for parties and non-parties to object to arbitrator orders of production. They also standardize procedures under the Codes relating to service of motions for subpoenas and arbitrator orders; service of issued subpoenas and arbitrator orders; and time frames for responding to subpoenas and arbitrator orders, making them operationally consistent.<sup>1</sup>

The amendments are effective on February 18, 2013, for all motions filed on or after the effective date that request a subpoena under Rule 12512 or 13512, or an arbitrator order under Rule 12513 or 13513.

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

January 2013

#### Notice Type

- ▶ Rule Amendment

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives

#### Key Topics

- ▶ Arbitration
- ▶ Code of Arbitration Procedure
- ▶ Discovery
- ▶ Orders to Appear or Produce Documents
- ▶ Subpoenas

#### Referenced Rules & Notices

- ▶ Rule 12512
- ▶ Rule 12513
- ▶ Rule 13512
- ▶ Rule 13513

Questions concerning this *Notice* should be directed to:

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

## Background & Discussion

### Subpoenas

The Codes give arbitrators the authority to issue subpoenas to parties and non-parties. Subpoena Rules 12512 and 13512 set forth procedures for a party to make a motion for a subpoena. The subpoena rules also detail how a party may object to a subpoena and reply to an objection. Finally, the subpoena rules describe how parties must share documents produced under a subpoena.

The subpoena rules do not address who bears the production costs under a subpoena. In practice, arbitrators resolve disputes between parties, and between parties and non-parties, relating to costs associated with subpoenas. The subpoena rules do not provide a procedure for non-parties to object to subpoenas served upon them. As a matter of practice, FINRA permits non-parties to file objections to subpoenas. The objections may include a request for the arbitrators to determine who pays the costs of production.

### Arbitrator Orders

The Codes authorize arbitrators to order firms, their employees or their associated persons to produce documents and/or to appear as witnesses without using the subpoena process. Unlike the subpoena rules, Rules 12513 and 13513 (order rules) expressly address the costs relating to production by non-party firms and their employees/associated persons. The order rules provide that, unless the panel directs otherwise, the party requesting the appearance of witnesses or the production of documents from non-parties pays the reasonable costs of the appearance and/or production.

### Amendments to the Subpoena Rules

FINRA believes that a party firm's responsibility to reimburse a non-party firm (or its employees or associated persons) for production costs should be the same regardless of whether the party firm requests a subpoena or an arbitrator order. FINRA also believes that firms and associated persons are better served by requesting an arbitrator order. Arbitrator orders offer an efficient mechanism for obtaining the appearance of witnesses and production of documents from firms and their employees. While the Codes provide an enforcement mechanism for subpoenas and arbitrator orders,<sup>2</sup> typically, once an arbitrator issues a subpoena, non-compliance is handled away from the arbitration forum through the courts. However, non-compliance relating to an arbitrator order is handled by the arbitrators who are familiar with the case. Another advantage to using an arbitrator order is that arbitrator orders are not subject to the geographical limitations contained in subpoena statutes. Arbitrator orders are cost effective because forum users avoid the costs and risks associated with court proceedings.

Since the Codes provide a mechanism through the order rules for seeking production of documents and witnesses without resorting to the subpoena process, FINRA amended the subpoena rules to provide that unless circumstances dictate the need for a subpoena, arbitrators may not issue subpoenas to non-party firms and/or employees or associated persons of non-party firms at the request of party firms and/or employees or associated persons of party firms. The amendments state that if the arbitrators determine that the request for the appearance of witnesses or the production of documents should be granted, then the arbitrators should order the appearance of such persons or the production of documents from such persons or non-party firms under the order rules. An arbitrator might order a subpoena if, for example, a firm failed to produce documents pursuant to an arbitrator order, or if a former associated person of a firm has left the industry and the arbitrator believes that an order would not be effective.

The amendments add new Rules 12512(g) and 13512(g) to address costs when a party firm and/or employee or associated person requests a subpoena directed to a non-party firm and/or employee or associated person. Under the new rules, if an arbitrator issues a subpoena, the party firm requesting the subpoena shall pay the reasonable costs of the non-party's appearance and/or production, unless the panel directs otherwise.

Finally, the amendments add new Rules 12512(e) and 13512(e) to provide a mechanism for non-parties to object to a subpoena they receive. Under the new provisions, if a non-party receiving a subpoena objects to the scope or propriety of the subpoena, the non-party may, within 10 calendar days of service of the subpoena, file written objections with the director of Arbitration. The party that requested the subpoena may respond to the objections within 10 calendar days of receipt of the objections. These new provisions codify FINRA's current practice concerning non-party objections to subpoenas.

### Amendments to the Order Rules

As described above, the order rules authorize arbitrators to order firms, their employees, or their associated persons to produce documents and/or to appear as witnesses without using the subpoena process. The rules also provide that unless the panel directs otherwise, the party requesting the appearance of witnesses or the production of documents from non-parties pays the reasonable costs of the appearance and/or production.

FINRA amended the order rules to incorporate the procedures outlined in the subpoena rules for making, objecting to and serving motions. In addition, FINRA amended the order rules to provide for non-party objections to an arbitrator's order.

### Effective Date

The amendments are effective on February 18, 2013, for all motions filed on or after the effective date that request a subpoena under Rule 12512 or 13512, or an arbitrator order under Rule 12513 or 13513.

### Endnotes

1. See Securities Exchange Act Rel. No. 68404 (December 11, 2012), 77 Federal Register 74712 (December 17, 2012) (File No. SR-FINRA-2012-041).
2. IM-12000 states that it may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2010 for a member or a person associated with a member to fail to appear or to produce any document in his possession or control as directed pursuant to provisions of the Code (see Customer Code of Arbitration Procedure Part I – Interpretative Material, Definitions, Organization and Authority).

## ATTACHMENT A

New language is underlined; deletions are in brackets

### Customer Code

#### 12512. Subpoenas

(a) To the fullest extent possible, parties should produce documents and make witnesses available to each other without the use of subpoenas.

(1) Arbitrators shall have the authority to issue subpoenas for the production of documents or the appearance of witnesses.

(2) Unless circumstances dictate the need for a subpoena, arbitrators shall not issue subpoenas to non-party FINRA members and/or employees or associated persons of non-party FINRA members at the request of FINRA members and/or employees or associated persons of FINRA members. If the arbitrators determine that the request for the appearance of witnesses or the production of documents should be granted, the arbitrators should order the appearance of such persons or the production of documents from such persons or non-party FINRA members under Rule 12513.

(b) A party may make a written motion requesting that an arbitrator issue a subpoena to a party or a non-party. The motion must include a draft subpoena and must be filed with the Director, with an additional copy for the arbitrator. The requesting party must serve the motion and draft subpoena on each other party, at the same time and in the same manner as on the Director. The requesting party may not serve the motion or draft subpoena on a non-party.

(c) If a party receiving a motion and draft subpoena objects to the scope or propriety of the subpoena, that party shall, within 10 calendar days of service of the motion, file written objections with the Director, with an additional copy for the arbitrator, and shall serve copies on all other parties at the same time and in the same manner as on the Director. The party that requested the subpoena may respond to the objections within 10 calendar days of receipt of the objections. After considering all objections, the arbitrator responsible for deciding discovery-related motions shall rule promptly on the issuance and scope of the subpoena.

(d) If the arbitrator issues a subpoena, the party that requested the subpoena must serve the subpoena at the same time and in the same manner on all parties and, if applicable, on any non-party receiving the subpoena.

(e) If a non-party receiving a subpoena objects to the scope or propriety of the subpoena, the non-party may, within 10 calendar days of service of the subpoena, file written objections with the Director. The Director shall forward a copy of the written objections to the arbitrator and all other parties. The party that requested the subpoena may respond to the objections within 10 calendar days of receipt of the objections. After considering all objections, the arbitrator responsible for issuing the subpoena shall rule promptly on the objections.

~~[(e)]~~ (f) Any party that receives documents in response to a subpoena served on a non-party shall provide notice to all other parties within five days of receipt of the documents. Thereafter, any party may request copies of such documents and, if such a request is made, the documents must be provided within 10 calendar days following receipt of the request.

(g) If the arbitrators issue a subpoena to a non-party FINRA member and/or any employee or associated person of a non-party FINRA member at the request of a FINRA member and/or employee or associated person of a FINRA member, the party requesting the subpoena shall pay the reasonable costs of the non-party's appearance and/or production, unless the panel directs otherwise.

### **12513. Authority of Panel to Direct Appearances of Associated Person Witnesses and Production of Documents Without Subpoenas**

(a) Upon motion of a party, the panel may order the following without the use of subpoenas:

- The appearance of any employee or associated person of a member of FINRA; or
- The production of any documents in the possession or control of such persons or members.

(b) The motion must include a draft order and must be filed with the Director, with an additional copy for the arbitrator. The requesting party must serve the motion and draft order on each other party, at the same time and in the same manner as on the Director. The requesting party may not serve the motion or draft order on a non-party.

(c) If a party receiving a motion and draft order objects to the scope or propriety of the order, that party shall, within 10 calendar days of service of the motion, file written objections with the Director, with an additional copy for the arbitrator, and shall serve copies on all other parties at the same time and in the same manner as on the Director. The party that requested the order may respond to the objections within 10 calendar days

of receipt of the objections. After considering all objections, the arbitrator responsible for deciding discovery-related motions shall rule promptly on the issuance and scope of the order.

(d) If the arbitrator issues an order, the party that requested the order must serve the order at the same time and in the same manner on all parties and, if applicable, on any non-party receiving the order.

(e) If a non-party receiving an order objects to the scope or propriety of the order, the non-party may, within 10 calendar days of service of the order, file written objections with the Director. The Director shall forward a copy of the written objections to the arbitrator and all other parties. The party that requested the order may respond to the objections within 10 calendar days of receipt of the objections. After considering all objections, the arbitrator responsible for issuing the order shall rule promptly on the objections.

(f) Any party that receives documents in response to an order served on a non-party shall provide notice to all other parties within five days of receipt of the documents. Thereafter, any party may request copies of such documents and, if such a request is made, the documents must be provided within 10 calendar days following receipt of the request.

[(b)] (g) Unless the panel directs otherwise, the party requesting the appearance of witnesses by, or the production of documents from, non-parties under this rule shall pay the reasonable costs of the appearance and/or production.

## Industry Code

### 13512. Subpoenas

(a) To the fullest extent possible, parties should produce documents and make witnesses available to each other without the use of subpoenas.

(1) Arbitrators shall have the authority to issue subpoenas for the production of documents or the appearance of witnesses.

(2) Unless circumstances dictate the need for a subpoena, arbitrators shall not issue subpoenas to non-party FINRA members and/or employees or associated persons of non-party FINRA members at the request of FINRA members and/or employees or associated persons of FINRA members. If the arbitrators determine that the request for the appearance of witnesses or the production of documents should be granted, the arbitrators should order the appearance of such persons or the production of documents from such persons or non-party FINRA members under Rule 13513.

(b) A party may make a written motion requesting that an arbitrator issue a subpoena to a party or a non-party. The motion must include a draft subpoena and must be filed with the Director, with an additional copy for the arbitrator. The requesting party must serve the motion and draft subpoena on each other party, at the same time and in the same manner as on the Director. The requesting party may not serve the motion or draft subpoena on a non-party.

(c) If a party receiving a motion and draft subpoena objects to the scope or propriety of the subpoena, that party shall, within 10 calendar days of service of the motion, file written objections with the Director, with an additional copy for the arbitrator, and shall serve copies on all other parties at the same time and in the same manner as on the Director. The party that requested the subpoena may respond to the objections within 10 calendar days of receipt of the objections. After considering all objections, the arbitrator responsible for deciding discovery-related motions shall rule promptly on the issuance and scope of the subpoena.

(d) If the arbitrator issues a subpoena, the party that requested the subpoena must serve the subpoena at the same time and in the same manner on all parties and, if applicable, on any non-party receiving the subpoena.

(e) If a non-party receiving a subpoena objects to the scope or propriety of the subpoena, the non-party may, within 10 calendar days of service of the subpoena, file written objections with the Director. The Director shall forward a copy of the written objections to the arbitrator and all other parties. The party that requested the subpoena may respond to the objections within 10 calendar days of receipt of the objections. After considering all objections, the arbitrator responsible for issuing the subpoena shall rule promptly on the objections.

~~[(e)]~~ (f) Any party that receives documents in response to a subpoena served on a non-party shall provide notice to all other parties within five days of receipt of the documents. Thereafter, any party may request copies of such documents and, if such a request is made, the documents must be provided within 10 calendar days following receipt of the request.

(g) If the arbitrators issue a subpoena to a non-party FINRA member and/or any employee or associated person of a non-party FINRA member at the request of a FINRA member and/or employee or associated person of a FINRA member, the party requesting the subpoena shall pay the reasonable costs of the non-party's appearance and/or production, unless the panel directs otherwise.

### 13513. Authority of Panel to Direct Appearances of Associated Person Witnesses and Production of Documents Without Subpoenas

(a) Upon motion of a party, the panel may order the following without the use of subpoenas:

- The appearance of any employee or associated person of a member of FINRA; or
- The production of any documents in the possession or control of such persons or members.

(b) The motion must include a draft order and must be filed with the Director, with an additional copy for the arbitrator. The requesting party must serve the motion and draft order on each other party, at the same time and in the same manner as on the Director. The requesting party may not serve the motion or draft order on a non-party.

(c) If a party receiving a motion and draft order objects to the scope or propriety of the order, that party shall, within 10 calendar days of service of the motion, file written objections with the Director, with an additional copy for the arbitrator, and shall serve copies on all other parties at the same time and in the same manner as on the Director. The party that requested the order may respond to the objections within 10 calendar days of receipt of the objections. After considering all objections, the arbitrator responsible for deciding discovery-related motions shall rule promptly on the issuance and scope of the order.

(d) If the arbitrator issues an order, the party that requested the order must serve the order at the same time and in the same manner on all parties and, if applicable, on any non-party receiving the order.

(e) If a non-party receiving an order objects to the scope or propriety of the order, the non-party may, within 10 calendar days of service of the order, file written objections with the Director. The Director shall forward a copy of the written objections to the arbitrator and all other parties. The party that requested the order may respond to the objections within 10 calendar days of receipt of the objections. After considering all objections, the arbitrator responsible for issuing the order shall rule promptly on the objections.

(f) Any party that receives documents in response to an order served on a non-party shall provide notice to all other parties within five days of receipt of the documents. Thereafter, any party may request copies of such documents and, if such a request is made, the documents must be provided within 10 calendar days following receipt of the request.

(b) (g) Unless the panel directs otherwise, the party requesting the appearance of witnesses by, or the production of documents from, non-parties under this rule shall pay the reasonable costs of the appearance and/or production.

## Supplemental FOCUS Information

### FINRA Requests Comment on a Proposed Supplemental Schedule for Inventory Positions

Comment Period Expires: February 25, 2013

#### Executive Summary

FINRA Rule 4524 (Supplemental FOCUS Information) requires each firm, as FINRA shall designate, to file such additional financial or operational schedules or reports as FINRA may deem necessary or appropriate for the protection of investors or in the public interest as a supplement to the FOCUS Report. FINRA requests comment on one such proposed schedule, a supplemental schedule for inventory positions.

The text of the proposed supplemental schedule can be found at [www.finra.org/notices/13-05](http://www.finra.org/notices/13-05).

Questions concerning this *Notice* should be directed to:

- ▶ Kris Dailey, Vice President, Risk Oversight & Operational Regulation, at (646) 315-8434; or
- ▶ Matthew E. Vitek, Assistant General Counsel, Office of General Counsel, at (202) 728-8156.

#### Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by February 25, 2013.

Comments must be submitted through one of the following methods:

- ▶ emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ mailing comments in hard copy to:  
Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

#### January 2013

##### Notice Type

- ▶ Request for Comment

##### Suggested Routing

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

##### Key Topics

- ▶ FOCUS Reporting

##### Referenced Rules & Notices

- ▶ Rule 4524

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

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).<sup>2</sup>

## Background & Discussion

Pursuant to SEA Rule 17a-5, firms are required to file with FINRA reports concerning their financial and operational status using SEC Form X-17A-5, Financial and Operational Combined Uniform Single (FOCUS) Report. In general, SEA Rule 17a-5 requires firms that clear transactions or carry customer accounts to file a FOCUS Report Part II, and requires firms that do not clear transactions or carry customer accounts to file a FOCUS Report Part IIA. However, firms that calculate net capital using Appendix E to SEA Rule 15c3-1 file a FOCUS Report Part II CSE, rather than FOCUS Report Part II.

## Proposal

FINRA Rule 4524 (Supplemental FOCUS Information) requires each firm, as FINRA shall designate, to file such additional financial or operational schedules or reports as FINRA may deem necessary or appropriate for the protection of investors or in the public interest as a supplement to the FOCUS Report. Pursuant to Rule 4524, FINRA is proposing to adopt a supplemental schedule to the FOCUS Report that would provide more detailed information of inventory positions held by firms. The proposed Supplemental Inventory Schedule (SIS) is identical to the Aggregate Securities and OTC Derivative Positions schedule from the FOCUS Report Part II CSE.

The proposal requires the SIS to be filed by all firms with inventory positions as of the end of the FOCUS Report reporting period, except for firms that: (1) have inventory positions consisting only of U.S. Treasury securities or money market mutual funds; or (2) file FOCUS Report Part II CSE. A firm that has inventory positions consisting only of U.S. Treasury securities or money market mutual funds would need to affirmatively indicate through functionality on the eFOCUS system that no filing is required for the reporting period. The proposed SIS would be due 20 business days after the end of a firm's FOCUS reporting period.

The proposed SIS is intended to capture more details of a firm's long and short inventory positions than what is captured on the FOCUS Report Part II and IIA. For example, FOCUS Report Part II and IIA require total inventory of securities sold short to be reported in aggregate, providing no information on the types of securities sold short by firms. In addition, long inventory is reported in categories that aggregate securities with different market risk profiles (*e.g.*, the Corporate Obligations category on the FOCUS Report Part II and Debt Securities on the FOCUS Report Part IIA includes single name corporate bonds, private label mortgage-backed securities and foreign debt holdings). The proposed SIS would provide FINRA with greater insights into the market risk associated with firms' inventory positions, and would enable FINRA staff to assess the related impact on firms' liquidity and funding needs.

## Request for Comment

In addition to generally requesting comments, FINRA specifically requests comment on:

- ▶ whether firms that have inventory positions consisting only of U.S. Treasury securities should be exempt from the filing requirement; and
- ▶ whether there is a category of firms that should not be required to file the proposed SIS based upon a *de minimis* amount of inventory positions.

FINRA believes that the economic impact associated with completion of the proposed SIS would be minimal because the required information should be readily available to firms, as it is necessary for purposes of computing the haircut deductions required under the SEC's net capital rule. FINRA also believes that any operational burden imposed by the proposed SIS would be outweighed by the benefit to firms in allowing the staff to better understand a firm's market risk, which will lead to more focused and effective examinations. FINRA, however, specifically seeks comment on the economic impact of the proposed SIS, including costs incurred by a firm in determining whether it must file the SIS for each reporting period, completing the SIS and filing the schedule with FINRA. We request quantified comments where possible.

Following FINRA's receipt of comments on the proposed SIS in response to this *Notice*, in accordance with the requirements of Rule 4524, FINRA will file the proposed SIS with the SEC pursuant to Section 19(b) of the SEA.

## Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See [\*Notice to Members 03-73\*](#) (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.

## FINRA's Information and Testimony Requests

### SEC Approves Amendments to Rule 8210

Effective Date: February 25, 2013

#### Executive Summary

The SEC approved amendments to FINRA Rule 8210<sup>1</sup> to:

- ▶ clarify the scope of FINRA's authority under Rule 8210 to inspect and copy the books, records and accounts of member firms, associated persons and persons subject to FINRA's jurisdiction;
- ▶ specify the method of service for certain unregistered persons under the rule; and
- ▶ authorize service of requests under the rule on attorneys who are representing firms, associated persons or persons subject to FINRA's jurisdiction.

The text of the amended rule, including Supplementary Material, is set forth in Attachment A. The amendments are effective on February 25, 2013.

Questions concerning this *Notice* should be directed to:

- ▶ Alan Lawhead, Vice President and Director, Appellate Group, at (202) 728-8853; or
- ▶ Matthew E. Vitek, Assistant General Counsel, Office of General Counsel, at (202) 728-8156.

January 2013

#### Notice Type

- ▶ Rule Amendment

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

#### Key Topics

- ▶ Information and Testimony
- ▶ Inspection and Copying of Books and Records

#### Referenced Rules & Notices

- ▶ FINRA Rule 8210
- ▶ NTM 99-77

## Background & Discussion

FINRA Rule 8210 grants FINRA staff and adjudicators authority to inspect and copy the books, records and accounts of member firms, associated persons and other persons over whom FINRA has jurisdiction. The SEC's approval of FINRA's proposed rule change means the amended rule now specifies that FINRA staff and adjudicators have the right to inspect and copy information in the "possession, custody or control" of the member firm, associated person or person over whom FINRA has jurisdiction. FINRA added the phrase "possession, custody or control" to link this concept to the existing body of case law that has defined possession, custody or control as used in Rule 34 of the Federal Rules of Civil Procedure. For example, in using the word "control," the amended rule requires firms, associated persons and other persons over whom FINRA has jurisdiction to provide records that they have the legal right, authority or ability to obtain upon demand.<sup>2</sup> FINRA also added Supplementary Material .01 to address what books, records and accounts are covered by the rule. The broad scope of books, records and accounts covered by the rule includes records relating to a FINRA investigation of outside business activities, private securities transactions, and possible violations of just and equitable principles of trade, other FINRA rules, MSRB rules and the federal securities laws.<sup>3</sup> The Supplementary Material further indicates that all aspects of the relationship between a broker-dealer and its associated persons are potentially the subject of a Rule 8210 request.

The amended rule addresses how FINRA staff or an adjudicator serves a Rule 8210 request on an associated but unregistered person.<sup>4</sup> The Central Registration Depository (CRD<sup>®</sup>) generally does not contain addresses for unregistered persons.<sup>5</sup> The amended rule therefore allows service at a business address or a home address. FINRA will send a Rule 8210 request to a firm's business address when an unregistered person is associated with the firm. FINRA will personally serve an unregistered person who is not currently associated with a firm.<sup>6</sup>

The amended rule allows FINRA to serve a Rule 8210 request on the attorney for a member firm, associated person or person subject to FINRA's jurisdiction. The amended rule provides that, if FINRA staff or an adjudicator knows that a firm, associated person or person subject to FINRA's jurisdiction is represented by counsel regarding the matter in question, notice of a Rule 8210 request will be provided to counsel rather than to the client. It is accordingly the responsibility of a firm, associated person or person subject to FINRA's jurisdiction to communicate clearly to FINRA staff when they are being represented by an attorney in responding to a Rule 8210 request. When FINRA sends a Rule 8210 request to counsel, counsel receives it as the authorized agent for the firm, associated person or person subject to FINRA's jurisdiction. In this situation, service of the request on counsel is treated the same as service on the client.

## Endnotes

1. See Securities Exchange Act Release No. 68386 (Dec. 7, 2012), 77 FR 74253 (Dec. 13, 2012) (Order Approving Proposed Rule Change; File No. SR-FINRA-2009-060).
2. See *Camden Iron & Metal v. Marubeni Am. Corp.*, 138 F.R.D. 438, 441 (D.N.J. 1991) (“Federal courts construe ‘control’ very broadly”).
3. In a 2006 opinion, the SEC expressed skepticism regarding FINRA’s argument that an associated person was required to provide documents because they were in his possession and control. See *Jay Alan Ochanpaugh*, Exchange Act Release No. 54363, 2006 SEC LEXIS 1926, at \*19 (Aug. 25, 2006). The SEC accepted, for the purpose of its decision, that a “possession and control” standard applied, but concluded that “[FINRA] has not met its burden of proof to meet even that standard.” *Id.* 2006 SEC LEXIS 1926, at \*22. By adding the phrase “possession, custody or control,” the amended rule removes this uncertainty identified in the *Ochanpaugh* opinion.
4. All associated persons are not necessarily registered persons. FINRA’s By-Laws define “associated person of a member” or “person associated with a member” as: “(1) a natural person who is registered or has applied for registration under the Rules of the Corporation; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the Corporation under these By-Laws or the Rules of the Corporation; and (3) for purposes of Rule 8210, any other person listed in Schedule A of Form BD of a member”. See FINRA By-Laws, Art. I (rr).
5. The amended rule therefore does not rely on an unregistered person to update CRD with his or her current address. Firms and registered persons, in contrast, have an affirmative duty to update CRD with their current address for at least two years after they have had their registration terminated. See *Notice to Members 99-77* (Sept. 1999).
6. The amended rule provides that notice will be deemed received by the associated person upon personal service, as specified in FINRA Rule 9134(a)(1).

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## Attachment A

Below is the text of the amended FINRA Rule 8210. New language is underlined.

\* \* \* \* \*

### 8200. INVESTIGATIONS

#### 8210. Provision of Information and Testimony and Inspection and Copying of Books

##### (a) Authority of Adjudicator and FINRA Staff

For the purpose of an investigation, complaint, examination, or proceeding authorized by the FINRA By-Laws or rules, an Adjudicator or FINRA staff shall have the right to:

(1) require a member, person associated with a member, or any other person subject to FINRA's jurisdiction to provide information orally, in writing, or electronically (if the requested information is, or is required to be, maintained in electronic form) and to testify at a location specified by FINRA staff, under oath or affirmation administered by a court reporter or a notary public if requested, with respect to any matter involved in the investigation, complaint, examination, or proceeding; and

(2) inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in the investigation, complaint, examination, or proceeding that is in such member's or person's possession, custody or control.

(b) through (c) No Change.

##### (d) Notice

A notice under this Rule shall be deemed received by the member or currently or formerly registered person to whom it is directed by mailing or otherwise transmitting the notice to the last known business address of the member or the last known residential address of the person as reflected in the Central Registration Depository. With respect to a person who is currently associated with a member in an unregistered capacity, a notice under this Rule shall be deemed received by the person by mailing or otherwise transmitting the notice to the last known business address of the member as reflected in the Central Registration Depository. With respect to a person subject to FINRA's jurisdiction who was formerly associated with a member in an unregistered capacity, a notice under this Rule shall be deemed received by the person upon personal service, as set forth in Rule 9134(a)(1). If the Adjudicator or FINRA staff responsible for mailing or otherwise transmitting the notice to the member or person has actual knowledge that the address in the Central Registration Depository is out of date or inaccurate, then a copy of the notice shall be mailed or otherwise transmitted to:

(1) the last known business address of the member or the last known residential address of the person as reflected in the Central Registration Depository; and

(2) any other more current address of the member or the person known to the Adjudicator or FINRA staff who is responsible for mailing or otherwise transmitting the notice.

If the Adjudicator or FINRA staff responsible for mailing or otherwise transmitting the notice to the member or person knows that the member or person is represented by counsel regarding the investigation, complaint, examination, or proceeding that is the subject of the notice, then the notice shall be served upon counsel by mailing or otherwise transmitting the notice to the counsel in lieu of the member or person, and any notice served upon counsel shall be deemed received by the member or person.

(e) through (g) No Change.

• • • Supplementary Material: -----

**.01 Books and Records Relating to Investigations.** This rule requires FINRA members, associated persons and persons subject to FINRA's jurisdiction to provide FINRA staff and adjudicators with requested books, records and accounts. In specifying the books, records and accounts "of such member or person," paragraph (a) of the rule refers to books, records and accounts that the broker-dealer or its associated persons make or keep relating to its operation as a broker-dealer or relating to the person's association with the member. This includes but is not limited to records relating to a FINRA investigation of outside business activities, private securities transactions or possible violations of just and equitable principles of trade, as well as other FINRA rules, MSRB rules, and the federal securities laws. It does not ordinarily include books and records that are in the possession, custody or control of a member or associated person, but whose bona fide ownership is held by an independent third party and the records are unrelated to the business of the member. The rule requires, however, that a FINRA member, associated person, or person subject to FINRA's jurisdiction must make available its books, records or accounts when these books, records or accounts are in the possession of another person or entity, such as a professional service provider, but the FINRA member, associated person or person subject to FINRA's jurisdiction controls or has a right to demand them.

\* \* \* \* \*

## Markups, Commissions and Fees

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

Comment Period Expires: April 1, 2013

#### Executive Summary

As part of the process to develop a new, consolidated rulebook (the Consolidated FINRA Rulebook),<sup>1</sup> FINRA is requesting comment on proposed FINRA rules governing markups, markdowns, commissions and fees. FINRA initially sought comment on the proposed rules in [Regulatory Notice 11-08](#). In response to the comments received, FINRA is proposing several changes to the proposed rules. These changes include, among other things, amendments to: (1) retain the 5% markup policy in NASD IM-2440-1 (Mark-Up Policy); (2) revise certain of the relevant factors used to determine the reasonableness of markups and commissions; (3) eliminate the requirement to provide commission schedules for equity securities transactions to retail customers; and (4) extend the proposed markup rules to transactions in certain government securities. This *Notice* requests comment on the revised proposal.

The text of the proposed rules can be found at [www.finra.org/notices/13-07](http://www.finra.org/notices/13-07).

Questions regarding this *Notice* should be directed to:

- ▶ Sharon Zackula, Associate Vice President & Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8985; and
- ▶ Erika Lazar, Assistant General Counsel, OGC, at (202) 728-8013.

#### January 2013

##### Notice Type

- ▶ Request for Comment
- ▶ Consolidated FINRA Rulebook

##### Suggested Routing

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

##### Key Topics

- ▶ 5% Policy
- ▶ Commissions
- ▶ Government Securities
- ▶ Markups and Markdowns
- ▶ Rulebook Consolidation
- ▶ Service Charges and Fees

##### Referenced Rules & Notices

- ▶ FINRA Rule 0150
- ▶ FINRA Rule 2010
- ▶ FINRA Rule 2111
- ▶ NASD IM-2310-3
- ▶ NASD IM-2440-1
- ▶ NASD IM-2440-2
- ▶ NASD Rule 2430
- ▶ NASD Rule 2440
- ▶ NYSE Rule 375 and Interpretation 375/01
- ▶ Regulatory Notice 11-08
- ▶ SEA Section 3
- ▶ SEA Section 19

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 1, 2013.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:  
Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

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

**Important Notes:** All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.<sup>2</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).<sup>3</sup>

## Background & Discussion

In [Regulatory Notice 11-08](#), FINRA sought comment on an initial proposal regarding proposed FINRA Rules 2121 (Fair Prices and Markups, Markdowns and Commissions) and 2122 (Markups and Markdowns for Transactions in Debt Securities, Except Municipal Securities) governing markups, markdowns and commissions (the proposed markup rules), and proposed FINRA Rule 2123 (Charges and Fees for Services Performed) governing fees. The proposed FINRA rules are derived from NASD Rule 2440 (Fair Prices and Commissions), NASD IM-2440-1 (Mark-Up Policy), NASD IM-2440-2 (Additional Mark-Up Policy for Transactions in Debt Securities, Except Municipal Securities), NASD Rule 2430 (Charges for Services Performed), and Incorporated NYSE Rule 375 (Missing the Market).<sup>4</sup> FINRA received 25 comment letters in response to [Regulatory Notice 11-08](#).<sup>5</sup> FINRA now seeks comments on a revised proposal.

## Differences Between the Initial and Revised Proposals

The significant differences between the initial proposal and the revised proposal are set forth below; however, interested parties should carefully read the proposed rule text for a complete and detailed understanding of the revised proposal.

- ▶ The revised proposal amends proposed FINRA Rule 2121 to:
  - ▶ retain the 5% policy and related concepts from NASD IM-2440-1. In the initial proposal, FINRA proposed to delete the 5% policy and all related statements;
  - ▶ establish a rebuttable presumption that a markup, markdown or commission in excess of 5 percent is unfair and unreasonable;
  - ▶ modify the “relevant factors” that member firms should take into consideration in determining the fairness of a markup, markdown or commission to provide additional guidance and, in some instances, expand the scope of the factor; and
  - ▶ delete previously proposed FINRA Rule 2121(e), a requirement that member firms provide commission schedule(s) for equity securities transactions to retail customers.
- ▶ The revised proposal amends proposed FINRA Rule 2122 to update the criteria applicable to eligible qualified institutional buyers (QIB) purchasing or selling non-investment grade debt securities, whose transactions are excluded under the markup rules. The amendments would incorporate the standards regarding institutional suitability in FINRA Rule 2111(Suitability), rather than NASD IM-2310-3, which has been superseded.<sup>6</sup>
- ▶ The revised proposal amends proposed FINRA Rule 2123 to provide additional examples of charges and fees that are subject to the rule and include natural persons advised by an investment adviser and other natural persons as “retail customers” for the purposes of the rule.
- ▶ Finally, the revised proposal includes an amendment to FINRA Rule 0150 (Application of Rules to Exempted Securities Except Municipal Securities) that extends the proposed markup rules to transactions in government securities as defined in Exchange Act Section 3(a)(42) (excluding U.S. Treasury securities as defined in FINRA Rule 6710(p)).

## Revised Proposal

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

Consistent with the initial proposal, FINRA proposes to consolidate and transfer NASD Rule 2440, NASD IM-2440-1 and NYSE Rule 375 to the Consolidated FINRA Rulebook as new FINRA Rule 2121. FINRA is proposing minor substantive changes to NASD Rule 2440 and NYSE Rule 375, and significant changes to NASD IM-2440-1.<sup>7</sup> As set forth in the initial proposal, FINRA proposes not to incorporate NYSE Rule Interpretation 375/01, which addresses the execution of an order when a member firm has missed the market, into the proposed markup rules.<sup>8</sup> The revised proposal includes additional substantive amendments to proposed FINRA Rule 2121, which are described in detail below.<sup>9</sup>

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

In general, NASD Rule 2440 requires that securities be sold to or purchased from customers at fair prices and, if a member firm acts as agent, be subject to fair commissions or commission-equivalent charges. Fairness is judged by the facts and circumstances of the particular transaction. NASD Rule 2440 also lists certain circumstances and factors that are relevant in determining a markup, markdown or commission.

Consistent with the initial proposal, FINRA proposes to transfer NASD Rule 2440 as proposed FINRA Rule 2121(a), subject to minor changes, to the Consolidated FINRA Rulebook. Proposed FINRA Rule 2121(a) requires, in any securities transaction, if a member firm acts as principal and buys for the member's account from its customer, or sells from the member's account to its customer, that the member firm must buy or sell at a price which is fair and reasonable, taking into consideration all relevant facts and circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that the member firm is entitled to remuneration. If a member firm acts as agent for the member's customer in any securities transaction, the member firm must not charge its customer more than a fair and reasonable commission, commission-equivalent fee, or service charge, taking into consideration all relevant facts and circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order, and the value of any service the member firm may have rendered by reason of its experience in and knowledge of such security and the market for the security.

## 2. Retaining the “5% Policy” and Related Concepts (Proposed FINRA Rule 2121(b)(1))

NASD IM-2440-1 addresses the 5% policy. The preamble to NASD IM-2440-1 states that the question of fair markups (or spreads) is one for which there is no definitive answer or single interpretation because a markup that may be considered fair in one transaction could be unfair in another transaction, based on the different circumstances of the two transactions. The preamble also refers to a 1943 survey of the FINRA (then NASD) membership, in which 71 percent of respondents indicated that transactions were executed with markups of 5 percent or less.<sup>10</sup> The Board of Governors then determined that in most transactions, markups of 5 percent or less would fall within the “fair and reasonable” standard and adopted the 5% policy as guidance. In addition, NASD IM-2440-1(a) provides several general considerations, including statements that the 5% policy is a guide and not a rule and that a markup pattern of 5 percent or even less may be considered unfair or unreasonable under the 5% policy.

In the initial proposal, FINRA proposed to delete the 5% policy and to provide “Markup Threshold Guidance” in a separate *Regulatory Notice*, which would set forth quantitative guidance regarding markup, markdown and commission thresholds that, if exceeded, would be subject to additional regulatory scrutiny. A majority of the comments received on the initial proposal opposed the elimination of the 5% policy.<sup>11</sup> These commenters stated that the 5% policy generally has been effective in regulating broker-dealers for over 70 years and eliminating it would reduce investor protection, harm investors, and be interpreted by unscrupulous industry members as an invitation to charge excessive or abusive markups and commissions. These commenters urged FINRA to retain the 5% policy (or a similar quantitative standard) in the proposed markup rules because it helps firms in establishing effective supervisory and compliance procedures and setting upper benchmarks applicable to almost all transactions (e.g., the 5% policy aids compliance personnel in surveillance efforts using automated tools, such as exception reports). The commenters also noted that it protects investors from excessive markups and commissions and assists them in challenging excessive markup and commission charges in arbitration and other proceedings. Several commenters suggested that the 5% policy should be revised to include an alternative quantitative standard if the current policy is outdated.

In light of the concerns raised by the comments on the initial proposal, FINRA proposes to retain the 5% policy as FINRA Rule 2121(b)(1).<sup>12</sup> Proposed FINRA Rule 2121(b)(1) incorporates the general considerations from NASD IM-2440-1(a) that the 5% policy is a guide, not a rule and that a markup pattern of 5 percent or less may be considered unfair or unreasonable under the 5% policy. In addition, proposed FINRA Rule 2121(b)(1) provides that when a member firm charges a markup, markdown or commission in excess of 5 percent, a presumption exists that it is unfair and unreasonable. A member firm may overcome the presumption by demonstrating that the markup, markdown or commission is fair and reasonable based on the relevant factors set forth in proposed FINRA Rule 2121(c),

which is based on NASD IM-2440-1(b). All relevant factors may be considered to determine if a member firm has rebutted the presumption; provided, however, the presumption may not be rebutted based solely on the member firm's disclosure to a customer of the firm's markup, markdown or commission (made in compliance with the revised disclosure requirements in proposed FINRA Rule 2121(c)(5)).

Notwithstanding the revised proposal to retain the 5% policy, FINRA recognizes that 5 percent is significantly higher than the average markup, markdown or commission currently charged by most member firms in customer transactions. Since 1943, advances in information and communication technologies, and member firms' front and back office technologies, have significantly reduced execution costs. As a result, markups, markdowns and commissions also have decreased in many investment products. In addition, customers generally have multiple execution options, and competition among market professionals has driven down the amount of markup, markdown or commission a member firm will charge. Accordingly, although proposed FINRA Rule 2121 would retain the 5% policy, member firms should not view the provision as establishing a specific ceiling or cap below which most markups, markdowns or commissions will not be viewed as excessive (or will not be questioned).

### **3. Other General Considerations (Proposed FINRA Rules 2121(b)(2) through (b)(5))**

Consistent with the initial proposal, the revised proposal transfers to FINRA Rule 2121(b) (General Considerations) the general considerations in NASD IM-2440-1(a)(2) and (a)(5) with minor changes. The revised proposal transfers NASD IM-2440-1(a)(3) and (c)(2) with clarifying changes that were not included in the initial proposal.<sup>13</sup>

- ▶ Proposed FINRA Rule 2121(b)(2), based on NASD IM-2440-1(a)(2), provides that a member firm may consider its expenses, but shall not justify markups, markdowns or commissions on the basis of expenses that are excessive.
- ▶ Proposed FINRA Rule 2121(b)(3), based on NASD IM-2440-1(a)(3), provides that the difference between the customer's price (including the markup or markdown) and the prevailing market price is the amount (or percentage) to be considered when determining if a member firm has dealt fairly with its customer in a principal transaction. Unless other bona fide, more credible evidence of the prevailing market price can be evidenced, for a markup, a member firm's own contemporaneous cost is the best indication of the prevailing market price of a security, and for a markdown, a member firm's own contemporaneous proceeds are the best indication of the prevailing market price of a security.
- ▶ Proposed FINRA Rule 2121(b)(4), based on NASD IM-2440-1(c)(2), provides that except in riskless principal trades or nearly contemporaneous trades in which a security is held in a member's inventory very briefly, if a member firm sells a security to a customer

from inventory, the amount of the markup would be determined on the basis of the markup over the bona fide representative current market price, and the profit or loss to the member firm from market appreciation or depreciation before, or after, the date of the transaction with the customer would not ordinarily enter into the determination of the amount or fairness of the markup.

- ▶ Proposed FINRA Rule 2121(b)(5), based on NASD IM-2440-1(a)(5), provides that a determination of the fairness of a markup, markdown or commission must be based on a consideration of all the relevant factors, of which the percentage of markup, markdown or commission is only one.

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

In the initial proposal, FINRA proposed to transfer as FINRA Rule 2121(c) (Relevant Factors) the non-exclusive list of seven relevant factors in NASD IM-2440-1(b) that a member firm should take into consideration in determining if a markup, markdown or commission is fair and reasonable. FINRA now proposes minor changes to three of the factors to provide additional guidance and, in some cases, to expand the scope of the factor:

- ▶ In the initial proposal, FINRA Rule 2121(c)(2) (The Availability of the Security in the Market), based on NASD IM-2440-1(b)(2), stated that, in the case of an inactive security, the effort and cost of buying or selling the security, or any other unusual circumstances connected with its acquisition or sale, may be a factor in determining the amount (or percentage) of the markup, markdown or commission. The revised proposal expands this provision to provide that the effort and cost of buying or selling a security may be a factor in determining the amount (or percentage) of a markup, markdown or commission if a security is difficult to locate or source, is inactive or infrequently traded, is subject to market liquidity restraints relative to the size of the transaction sought to be executed, or if there are unusual circumstances connected with a security's acquisition or sale, *e.g.*, the security is acquired through a foreign intermediary.
- ▶ In the initial proposal, FINRA Rule 2121(c)(4) (The Amount of Money Involved in a Transaction), based on NASD IM-2440-1(b)(4), stated that a transaction that involves a small amount of money may warrant a higher percentage of markup, markdown or commission to cover expenses of handling. The revised proposal adds language to provide that a transaction that involves a large amount of money may warrant a lower percentage of markup, markdown or commission where the expenses of handling the transaction do not rise by virtue of the size of the transaction.
- ▶ In the initial proposal, FINRA Rule 2121(c)(5) (Disclosure), based on NASD IM-2440-1(b)(5), stated that where a member discloses the amount of the commission charged in an agency transaction, or the markup or markdown made in a principal transaction, to a customer before the transaction is effected, such disclosure may be considered in determining if a member deals fairly with a customer. The revised proposal clarifies that for disclosure to be considered in determining if a member deals fairly with a

customer, a member firm must disclose the total dollar amount and percentage of the commission charged in an agency transaction, or the total dollar amount and percentage of markup or markdown made in a principal transaction to a customer before the transaction is effected. Consistent with the initial proposal, disclosure itself does not justify a markup, markdown or commission that is unfair or unreasonable in light of all other relevant facts and circumstances surrounding the transaction.

Consistent with the initial proposal, FINRA proposes to transfer to FINRA Rule 2121(c) the following four factors with minor, stylistic changes:

- ▶ NASD IM-2440-1(b)(1) would transfer as proposed FINRA Rule 2121(c)(1) (The Type of Security Involved);
- ▶ NASD IM-2440-1(b)(3) would transfer as proposed FINRA Rule 2121(c)(3) (The Price of the Security);
- ▶ NASD IM-2440-1(b)(6) would transfer as proposed FINRA Rule 2121(c)(6) (The Pattern of Markups); and
- ▶ NASD IM-2440-1(b)(7) would transfer as proposed FINRA 2121(c)(7) (The Nature of the Member's Business).

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

Consistent with the initial proposal, FINRA Rule 2121(d) provides that FINRA Rule 2121 is not applicable to: (1) the sale of securities where a prospectus or offering circular must be delivered and the securities are sold at the specific public offering price, based on NASD IM-2440-1(d); and (2) a transaction in a non-investment grade debt security with a QIB that meets the conditions set forth in proposed FINRA Rule 2122(b)(9), which is described below.

#### **6. Deletion of the "Proceeds Provision"**

When a customer sells one security and buys a second security at the same time, using the proceeds of the securities position liquidated to pay for the second position, the "proceeds provision" in NASD IM-2440-1(c)(5) requires that both trades be treated as a single transaction for markup, markdown and commission purposes, with the result that the total remuneration for both transactions generally cannot exceed the remuneration amount for a single transaction. Consistent with the initial proposal, FINRA proposes not to incorporate the proceeds provision in NASD IM-2440-1(c)(5) in the proposed markup rules.

FINRA received eight comment letters opposing the elimination of the proceeds provision and two comment letters in favor of eliminating it.<sup>14</sup> The commenters that opposed deleting the proceeds provision stated that the provision prevents member firms from “double dipping,” serves as a deterrent to churning and, if deleted, would encourage unscrupulous broker-dealers to engage in serial transactions to generate maximum commission income. Some of the commenters suggested that FINRA clarify the proceeds provision, or provide guidance, instead of deleting it.

FINRA has carefully considered the comments and continues to believe that the proceeds provision should not be incorporated in the proposed markup rules because it includes a standard that is not susceptible to consistent and fair application.<sup>15</sup> In FINRA’s view, the more practical approach is to determine transaction remuneration on a fair basis for each transaction and to address the commenters’ concerns by continuing to monitor accounts for possible churning and other fraudulent trading, or trading that is in violation of just and equitable principles of trade.

#### **7. Deletion of Initial Proposal Regarding Commission Schedules (Proposed FINRA Rule 2121(e))**

FINRA Rule 2121(e) in the initial proposal added a new requirement to the markup rules regarding transaction-based remuneration. In general, the proposed provision required member firms to establish and make available to retail customers the schedule(s) of standard commission charges for transactions in equity securities with retail customers. Commenters on the initial proposal objected to the new requirement stating, among other things, that the requirement would be duplicative of information currently provided to customers, commissions vary widely by account type, posting commission schedules would set a floor instead of fostering competition, and posting commission schedules would be counter-productive in this era of negotiated commissions.<sup>16</sup> In light of the commenters’ concerns, FINRA proposes to delete the proposed requirement.

#### **8. Notice of “Missing the Market” and Consent to Commission Charge (Proposed FINRA Rule 2121(e))**

In the initial proposal, FINRA proposed to incorporate NYSE Rule 375 as proposed FINRA Rule 2121(f) (Notice of “Missing the Market” and Consent to Commission Charge) with minor changes in the Consolidated FINRA Rulebook. In the revised proposal, the provision is renumbered as proposed FINRA Rule 2121(e) and, consistent with the initial proposal, provides that a member firm that accepts an order for execution as agent and, by reason of neglect to execute the order or otherwise, trades with the customer as principal, shall not charge the customer a commission, without the knowledge and consent of the customer.<sup>17</sup>

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

NASD IM-2440-2 addresses: (1) additional standards applicable to the determination of a markup or a markdown in a transaction with a customer in a debt security; (2) the procedures to identify prevailing market price; (3) the role of the dealer's contemporaneous cost in determining prevailing market price; and (4) characteristics of "similar securities" and the role of similar securities in determining a markup or a markdown. In the initial proposal, FINRA proposed to transfer NASD IM-2440-2 to the Consolidated FINRA Rulebook as proposed FINRA Rule 2122 without significant changes.<sup>18</sup> FINRA now proposes to incorporate the following additional amendments.

In proposed FINRA Rule 2122(b)(5) and proposed FINRA Rule 2122(b)(6), based on NASD IM-2440-2(b)(5) and (b)(6), FINRA proposes to clarify several statements in the existing provisions that apply when a dealer looks to alternative measures to determine the prevailing market price of a security that the dealer purchases from, or sells to, a customer.

In the initial proposal, FINRA Rule 2122(b)(9), based on NASD IM-2440-2(b)(9), provided that member firms engaged in customer transactions that meet the following conditions are not subject to the requirements governing markups and markdowns for such transactions: (1) the transaction is effected with a QIB;<sup>19</sup> (2) the transaction involves a non-investment grade debt security;<sup>20</sup> and (3) the dealer has determined, after considering the factors set forth in NASD IM-2310-3 (Suitability Obligations to Institutional Customers), that the QIB has the capacity to evaluate independently the investment risk and, in fact, is exercising independent judgment in deciding to enter into the transaction. The revised proposal updates the third criterion in proposed FINRA Rule 2122(b)(9) to delete references to NASD IM-2310-3, which was rescinded on July 9, 2012, align the criterion with the standards regarding institutional suitability in FINRA Rule 2111(Suitability), which took effect on July 9, 2012,<sup>21</sup> and expand the standards to apply to an authorized agent of a QIB.

Specifically, under the revised proposal, the third criterion requires that a dealer have a reasonable basis to believe that a QIB purchasing or selling a non-investment grade debt security is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities, and the QIB affirmatively must indicate that it is exercising independent judgment in deciding to enter into the transaction. In addition, if a QIB has delegated decision-making authority to an agent, such as an investment adviser or a bond trust department, the factors would be applied to the agent.

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

NASD Rule 2430 requires that charges and fees for services must be reasonable and not unfairly discriminate among customers, and it applies to all charges and fees for services provided by a member firm that are not related to the execution of a transaction.

In the initial proposal, and as described in more detail in [Regulatory Notice 11-08](#), FINRA proposed to adopt NASD Rule 2430 as FINRA Rule 2123 (Charges and Fees for Services Performed) in the Consolidated FINRA Rulebook with a significant change to require member firms to establish and make available to retail customers their schedule(s) of standard charges and fees for services. The initial proposal defined a retail customer as a customer that does not qualify as an “institutional account” as defined in Rule 4512(c).<sup>22</sup> The revised proposal makes two changes to proposed FINRA Rule 2123.

The revised proposal provides in proposed FINRA Rule 2123(a) additional examples of charges and fees for miscellaneous services performed that are subject to the proposed rule, including charges and fees for setting up a new account, research, customer portfolio analysis, tax advice and calculation of required minimum distribution. In addition, the revised proposal modifies the definition of a “retail customer” in proposed FINRA Rule 2123(b), which requires that disclosures regarding charges and fees be made to retail customers. Under the modified definition, a retail customer would mean a customer that does not qualify as an “institutional account” as defined in Rule 4512(c), except any natural person or any natural person advised by a registered investment adviser.

### D. Application of the Proposed Markup Rules to Transactions in Government Securities (FINRA Rule 0150)

FINRA Rule 0150(c) enumerates the FINRA and NASD rules that apply to transactions in, and business activities relating to, exempted securities, except municipal securities, conducted by member firms. The rule does not include the current markup rules<sup>23</sup> and, in general, cases alleging excessive markups, markdowns or commissions in transactions in exempted securities, other than municipal securities, are brought under FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).<sup>24</sup>

In the revised proposal, FINRA proposes to amend FINRA Rule 0150 (Application of Rules to Exempted Securities Except Municipal Securities) to extend the proposed markup rules to transactions in government securities (as defined in Exchange Act Section 3(a)(42)), except U.S. Treasury securities (as defined in FINRA Rule 6710(p)).<sup>25</sup> Extension of the proposed markup rules to transactions in government securities is consistent with action contemplated since the SEC’s 1996 Approval Order, approving the application of certain FINRA (then NASD) rules to transactions in exempted securities, other than municipal securities.<sup>26</sup> In addition, FINRA collects extensive information about government securities (*i.e.*, agency debentures and agency asset-backed securities), other than U.S. Treasury securities, in TRACE trade reports, and actively surveils the markets in such securities.

## Market Makers

FINRA notes that proposed FINRA Rules 2121 and 2122 (like the current markup rules) do not address a market maker's allowance, subject to the limitations in regulation, to capture the trading spread between the bid and the ask prices and nothing in proposed FINRA Rules 2121 and 2122 affects that body of law and regulation.

## Endnotes

1. The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see [Information Notice 03/12/08](#) (Rulebook Consolidation Process). For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.
2. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See [Notice to Members 03-73](#) (November 2003) (NASD Announces Online Availability of Comments) for more information.
3. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
4. NASD Rule 2440, NASD IM-2440-1, and NASD IM-2440-2 govern markups, markdowns and commissions in transactions with customers. Fees or charges that are not transaction-related (e.g., charges for safekeeping or collecting dividends or interest for a customer) are governed by NASD Rule 2430 (Charges for Services Performed). NYSE Rule 375 (Missing the Market) addresses instances where, by reason of neglect to execute the order or otherwise, a member firm takes or supplies for its own account the securities named in the order. The rules are summarized in [Regulatory Notice 11-08](#).
5. The comments received in response to [Regulatory Notice 11-08](#) are available on FINRA's website at [www.finra.org/notices/11-08](http://www.finra.org/notices/11-08).
6. FINRA Rule 2111 took effect on July 9, 2012, and superseded NASD Rule 2310 (Recommendations to Customers (Suitability)), NASD IM-2310-1 (Possible Application of SEC Rules 15g-1 through 15g-9), NASD IM-2310-2 (Fair Dealing with Customers), and NASD IM-2310-3 (Suitability Obligations to Institutional Customers).
7. NASD Rule 2440, NASD IM-2440-1 and NYSE Rule 375 would be deleted with the adoption of proposed FINRA Rule 2121.

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8. As discussed in more detail in [Regulatory Notice 11-08](#), FINRA would delete NYSE Rule Interpretation 375/01, which provides that a member firm that has “missed the market” should contact the customer, inform the customer of the circumstances and permit the customer to choose one of two ways that the member firm then will use to fill the order.
9. This *Notice* does not address certain amendments discussed in [Regulatory Notice 11-08](#) that are not changing under the revised proposal. For example, consistent with the initial proposal, FINRA proposes several conforming changes to FINRA Rule 2121 to add the term “reasonable” when referring to markups, markdowns and commissions that must be “fair” to incorporate the more widely used phrase “fair and reasonable.”
10. The results are based on the 82 percent of the membership that responded to the survey.
11. *See, e.g.*, Law Office of Scott T. Beall (Beall), Law Office of Steve A. Buchwalter, P.C. (Buchwalter), Churchill Financial, LLC (Churchill), Compliance-by-Proxy (CBP), Cornell Securities Law Clinic (Cornell), Barry D. Estell (Estell), William Gladden (Gladden), Ledbetter & Associates P.A. (Ledbetter), North American Securities Administrators Association (NASAA), Public Investors Arbitration Bar Association (PIABA), Jeffrey R. Sonn, Esq. (Sonn), St. John’s School of Law Clinic (St. John’s), and Wells Fargo Advisors (WFA). Six commenters favored retiring the 5% policy. *See* letters from Securities Industry and Financial Markets Association (SIFMA), Financial Services Institute (FSI), Cambridge Investment Research (Cambridge), JW Korth, Moloney Securities, Inc. (Moloney), and National Planning Holdings, Inc. (NPH). However, three of the commenters, SIFMA, FSI and Cambridge, stated that the 5% policy should not be withdrawn unless FINRA provided to the membership, before or at the same time, the “Markup Threshold Guidance” or similar guidance.
12. In light of the proposal to retain the 5% policy, FINRA does not intend at this time to provide “Markup Threshold Guidance” in a separate *Regulatory Notice*.
13. FINRA Rule 2121(b)(1) through (b)(4) as initially proposed would be renumbered, respectively, as proposed FINRA Rule 2121(b)(2) through (b)(5).
14. *See* letters from Beall, Buchwalter, Cornell, Estell, Gladden, Ledbetter, NASAA, and PIABA opposing the deletion of the proceeds provision. *See* letters from SIFMA and Roberts & Ryan Investments, Inc. (R&R) in favor of deleting the provision.
15. For example, it is not always clear when two transactions occurring close in time are related (the two transactions may represent unrelated investment decisions) or how close in time transactions must be to be considered “proceeds” transactions. In addition, the proceeds provision may not be applied when a customer decides to sell a position at one member firm and purchase a position at another member firm.
16. *See, e.g.*, letters from Cambridge, CBP, Churchill, FSI, Moloney, NPH, Regal Bay Investment Groups, R&R, SIFMA, and WFA opposing the requirement to provide equity commission schedules to retail customers; letter from Juanita D. Hanley noting certain limitations of the proposed requirement; and letters from Cornell, St John’s, NASAA, and Sonn supporting the proposed requirement.

17. Proposed FINRA Rule 2121(e) would be a new requirement for former NASD-only members. As discussed in the initial proposal, FINRA proposes to transfer these requirements because there are no similar requirements in the NASD markup rules regarding whether, and under what circumstances, a member firm may charge a commission if a member “misses the market.”
18. NASD IM-2440-2 would be deleted with the adoption of FINRA Rule 2122.
19. See 17 CFR § 230.144A(a)(1).
20. For the purpose of the rule, the proposal would adopt the definition of “non-investment grade debt security” in NASD IM-2440-2(b)(9) with no change.
21. See *supra* note 6.
22. NASD Rule 2430 would be deleted with the adoption of FINRA Rule 2123. See [Regulatory Notice 11-08](#). See also [Notice to Members 92-11](#) (Fees and Charges for Services).
23. This is largely for historical reasons. The Government Securities Act Amendments of 1993 (GSAA) eliminated the statutory limitations on NASD’s authority to apply sales practice rules to transactions in exempted securities, except municipal securities. NASD undertook to review the specific application of certain of its rules, including the NASD markup rules then in effect (Rules 2440 and IM-2440-1), to the government securities market. See [Notice to Members 96-66](#) (October 1996). NASD IM-2440-2 (the debt markup interpretation) – approved in 2007 – had not been adopted at the time FINRA Rule 0150 (then NASD Rule 0116) went into effect. See Securities Exchange Act Release No. 44631 (July 31, 2001), 66 FR 41283 (August 7, 2001) (Order Approving File No. SR-NASD-2000-038 (NASD Rule 0116)); see also Securities Exchange Act Release No. 55638 (April 16, 2007), 72 FR 20150 (April 23, 2007) (Order Approving File No. SR-NASD-2003-141 (NASD IM-2440-2)).
24. In [Notice to Members 96-66](#), FINRA noted that actions for conduct generally encompassed by the NASD markup rules, among others, in the government securities market may be brought under FINRA Rule 2010. See also Securities Exchange Act Release No. 37588 (August 20, 1996), 61 FR 44100 (August 27, 1996) (Order Approving File No. SR-NASD-95-39) (1996 Approval Order).
25. “U.S. Treasury security” is defined in FINRA Rule 6710(p) to mean a security issued by the U.S. Department of the Treasury to fund the operations of the federal government or to retire such outstanding securities.
26. See *supra* note 24, the 1996 Approval Order at 61 FR 44104.

# Information Notice

## November 2012 Supplement to the Options Disclosure Document

The SEC approved the November 2012 [supplement](#) to the Options Disclosure Document (ODD).<sup>1</sup> The ODD contains general disclosures on the characteristics and risks of trading standardized options. The November 2012 supplement amends the ODD disclosure to accommodate adjustments for cash dividends and distributions for options overlying less than 100 shares. Among other things, this change will help to ensure that mini options<sup>2</sup> are adjusted when the corresponding standard-sized options are adjusted. Specifically, the November 2012 Supplement would make clear that no adjustment will normally be made for any cash dividend or distribution that amounts to less than \$0.125 per underlying share. In addition, for contracts originally listed with a unit of trading larger than 100 shares, the November 2012 Supplement will continue to provide that no adjustment normally would be made for any cash dividend or distribution that amounts to less than \$12.50 per contract. As with other supplements to the ODD, this should be read in conjunction with the current ODD, [Characteristics and Risks of Standardized Options](#).

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

January 24, 2013

### Suggested Routing

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

### Key Topics

- ▶ Mini Options
- ▶ Options
- ▶ Options Disclosure Document

### Referenced Rules & Notices

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

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

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

FINRA reminds firms that they may electronically transmit documents that they are required to furnish to customers under FINRA rules, including the ODD and supplements thereto, provided the firm adheres to the standards contained in the May 1996 and October 1995 Securities Exchange Commission Releases,<sup>4</sup> and as discussed in [Notice to Members 98-3](#). Firms may also transmit the ODD and supplements to customers who have consented to electronic delivery through the use of a hyperlink.

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

## Endnotes

1. See Securities Exchange Act Release No. 68368 (December 6, 2012) 77 FR 74043 (December 12, 2012).
2. In September 2012, the SEC approved proposed rule changes that permitted the International Securities Exchange, LLC and NYSE Arca, Inc. to list and trade mini options overlying 10 shares of SPDR S&P 500 ETF, Apple Inc., SPDR Gold Trust, Google Inc. and Amazon.com, Inc. See Securities Exchange Act Release No. 67948 (September 28, 2012), 77 FR 60735 (October 4, 2012) (SR-NYSEArca-2012-64 and SR-ISE-2012-58).
3. 17 CFR 240.9b-1.
4. See Securities Act Release No. 7288 (May 9, 1996) 61 FR 24644 (May 15, 1996) and Securities Act Release No. 7233 (October 6, 1995) 60 FR 53458 (October 13, 1995).
5. See Securities Act Release No. 58738 (October 6, 2008) 73 FR 60371 (October 10, 2008).