

# Notices

## Regulatory Notices

- 14-20** FINRA Revises the Product and Problem Codes Used for Reporting Customer Complaints and Filing Required Documents Online; **Implementation Date: October 1, 2014**
- 14-21** SEC Approves Amendments to Equity Trade Reporting and OATS Rules; Effective Dates: OATS: April 7, 2014; ORF: September 15, 2014; ADF and TRFs: (millisecond reporting): **September 29, 2014; ADF and TRFs (remaining amendments): First Quarter 2015**
- 14-22** SEC Approves Amendments to FINRA Rule 5110 to Permit Termination Fees and Rights of First Refusal; Provide an Exemption From the Filing Requirements for Certain Collective Investment Vehicles; **and Clarify the Electronic Filing Requirement; Effective Date: May 15, 2014**
- 14-23** FINRA Issues an Interpretation to Clarify the Classification and Trade Reporting of Certain “Hybrid” Securities to FINRA; **Effective Date: June 16, 2014**
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## Election Notice

- 05/06/14** Upcoming FINRA Board of Governors Election; Petitions for Candidacy **Due: June 20, 2014**

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## Reporting Requirements

### FINRA Revises the Product and Problem Codes Used for Reporting Customer Complaints and Filing Required Documents Online

Implementation Date: October 1, 2014

#### Executive Summary

Starting on October 1, 2014, firms must select revised and new product and problem codes when: (1) reporting information regarding written customer complaints alleging theft or misappropriation of funds or securities, or forgery; (2) reporting quarterly statistical and summary information regarding written customer complaints; and (3) completing the online form to file copies of required documents.

For purposes of reporting statistical and summary information regarding written customer complaints, the first quarterly report using the revised and new codes is due by January 15, 2015, which is the reporting deadline for customer complaints received during the fourth calendar quarter (October 1, 2014 through December 31, 2014).

The revised and new product and problem codes are provided in Attachment A.

Questions concerning this *Notice* should be directed to Anthony Cavallaro, Central Review Group, at (646) 315-7319.

#### Background & Discussion

FINRA Rule 4530 (Reporting Requirements) requires firms to report, among other events, written customer complaints alleging theft or misappropriation of funds or securities, or forgery.<sup>1</sup> The rule also requires firms to report quarterly statistical and summary information regarding written customer complaints.<sup>2</sup> All customer complaint information must be electronically reported to FINRA via an application on the FINRA Firm Gateway. In addition, the rule requires firms to file with FINRA copies of specified criminal and civil actions,<sup>3</sup> which firms have the option of filing online via a form on the Firm Gateway.<sup>4</sup>

#### May 2014

##### Notice Type

- ▶ Guidance

##### Suggested Routing

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

##### Key Topics

- ▶ Customer Complaints
- ▶ Filing Requirements
- ▶ Online Filing
- ▶ Product and Problem Code Changes
- ▶ Reporting Requirements

##### Referenced Rules & Notices

- ▶ FINRA Rule 2111
- ▶ FINRA Rule 4530
- ▶ NASD Rule 3070

Firms are required to select the appropriate product and problem code when reporting customer complaint information and when completing the online form to file copies of required documents. FINRA periodically reviews the product and problem codes to determine whether the codes need to be revised to provide more clarity and whether new categories need to be added. Based on this review, FINRA is revising the codes and adding new categories. FINRA is also making non-substantive technical and stylistic changes to the codes. The substantive changes are described below.

## Product Codes

FINRA is amending Code 10 – Money Markets, which was previously used for reporting allegations relating to money markets under NASD Rule 3070 (Reporting Requirements) (the predecessor to FINRA Rule 4530). As revised, firms must use Code 10 – Certificate of Deposit (CD) (coupon and zero CDs) if the matter relates to a CD, and Code 38 – Money Markets (*e.g.*, commercial paper, Banker’s Acceptance (BA), not money market funds) if the matter relates to money markets.

In addition, FINRA is adding the following new product codes:

- Code 46 Viatical Settlement**—The sale of a terminally ill policy owner’s existing life insurance policy to a third party for more than its cash surrender value, but less than its net death benefit. Such a sale provides the policy owner with a lump sum. The third party becomes the new owner of the policy, pays the monthly premiums, and receives the full benefit of the policy when the insured dies.
- Code 47 Private Securities**—Securities that are not registered; not listed on an exchange; and otherwise not publicly available for trade.
- Code 48 Non-Broker-Dealer Affiliate Product**—Such as banking and insurance instruments or services related to non-broker-dealer affiliate activity and not otherwise characterized by another Product Code.
- Code 49 Exchange-Traded Notes (ETNs)** —Senior, unsecured, unsubordinated debt security issued by an underwriting bank designed to provide investors access to the returns of various market benchmarks. ETNs do not actually own anything they are tracking. The note is backed by the credit of the underwriting bank that is promising to pay the amount reflected in the index, minus fees upon maturity.

## Problem Codes

FINRA is revising the description of Code 04 – Suitability to reflect the requirements of FINRA Rule 2111 (Suitability). In addition, FINRA is revising the title and description of Code 63 from “Poor Service – Where the customer alleges that service from the firm or any of its employees was inadequate and/or unsatisfactory (*e.g.* failure to return phone calls, rudeness, lack of administrative attention to the account, etc.)” to “Service Issues – Allegations concerning inadequate or unsatisfactory service from the firm or any of its employees.”

FINRA is also adding the following new problem codes:

- Code 13 Selling Away**—Allegations concerning the RR engaging in a securities transaction outside the scope of his or her relationship with the firm and without the knowledge or approval of the firm.
- Code 14 Outside Business Activities**—Allegations concerning the RR engaging in an undisclosed business activity (other than a securities transaction) outside the scope of his or her relationship with the firm (*e.g.*, employment with another entity without the knowledge of the firm).
- Code 33 Non-Broker-Dealer Affiliate Activity**—Non-Broker-Dealer Affiliate activity not otherwise characterized by another Problem Code.
- Code 68 Firm Policy**—Allegations concerning a customer’s dissatisfaction with the RR or the firm as a result of a firm policy or procedure (that is not otherwise better characterized by another Problem Code).

## Availability of the Revised and New Codes

The revised and new product and problem codes are provided in Attachment A and are also available on [FINRA’s website](#).

## Endnotes

1. See FINRA Rule 4530(a)(1)(B).
2. See FINRA Rule 4530(d). Firms must report this information by the 15th calendar day of the month following the end of each calendar quarter (e.g., by April 15 for the first quarter). The statistics that firms report provide FINRA with important regulatory information that assists with the timely identification of potential sales practice and operational issues.
3. See FINRA Rule 4530(f).
4. See FINRA Rule 4530(g). Firms also have the option of filing the documents required under FINRA Rule 4530(f) via mail or email.

## FINRA Rule 4530 Product Codes

Select the most prominent in the complaint from the following codes:

- 00 Miscellaneous**
- 01 Equity-Listed** (common and preferred stock)
- 02 Debt-Corporate** (not asset-backed, includes convertible, corporate and zeros)
- 03 Debt-U.S. Government/U.S. Government Agency/U.S. Government Zeros and U.S. Zero Receipts** (*e.g.*, Treasury Investors Growth Receipt (TIGR), Certificate of Accrual on Treasury Securities (CATS)).
- 04 Commodities/Futures** (except commodity options and financial futures)
- 05 Commodity Options**
- 06 Options** (except index)
- 07 Index Options**
- 08 Insurance** (not annuities)
- 09 Mutual Funds** (open-ended, includes money market funds)
- 10 Certificate of Deposit (CD)** (coupon and zero CDs)
- 11 Unit Investment Trusts (UITs)** (corporate, government and municipal defined asset funds)
- 12 Direct Investments** (limited partnerships, etc.)
- 13 Financial Futures**
- 14 Equity-OTC** (common and preferred stock, new issue)
- 15 Debt-Municipal** (bonds, notes and zeros, not Municipal Investment Trusts (MITs))
- 16 Debt-Asset Backed** (Collateralized Mortgage Obligations (CMOs), credit card receivables, etc.)
- 17 Managed/Wrap Accounts** (in-house money manager)\*\*
- 18 No Product**
- 19 Managed/Wrap Accounts** (outside money manager)\*\*
- 20 Variable Annuities** – A variable annuity is an insurance company contract that allows the owner to elect to receive immediate or future periodic payments. A variable annuity is purchased, either with a lump sum or over time, with premiums allocated among various, separate account funds offered in the annuity contract. During the accumulation phase, the rate of return and the contract fund value on a variable annuity fluctuates with the performance of the underlying investments in the separate account funds, sometimes called investment portfolios or subaccounts.

- 21 **Warrants/Rights**
- 22 **Real Estate Investment Trusts (REITS)**
- 23 **Employee/Employer Stock Option Plan** (not listed options)\*\*
- 24 **Equity-Foreign**
- 25 **Debt-Foreign**
- 26 **Exchange-Traded Funds (ETFs)**
- 27 **Single Stock Futures**
- 28 **529 Plans\*\***
- 29 **Hedge Funds**
- 30 **Private Placements** (*e.g.*, Private Investments in Public Equity Securities (PIPES), etc.)
- 31 **Promissory Notes**
- 32 **Mortgage** (pledged assets, reverse mortgage)
- 33 **Closed-End Funds**
- 34 **Cash Management Accounts** (*e.g.*, debit/credit card) \*\*
- 35 **Self-Directed Fee-Based Accounts** (non-managed) \*\*
- 36 **Contractual Plans/Systematic Investment Plans**
- 37 **Tenant in Common** (*e.g.*, 1031 Exchanges)
- 38 **Money Markets** (*e.g.*, commercial paper, Banker's Acceptance (BA), not money market funds)
- 39 **Auction Rate Securities – Municipal Debt**
- 40 **Auction Rate Securities – Corporate Debt**
- 41 **Auction Rate Securities – Closed-End Funds**
- 42 **Structured Products** – For the purpose of this reporting, structured products are investment instruments designed to facilitate a particular risk-return objective, the performance of which is based on one or more referenced asset, index, interest rate, or other market measure. Some structured products offer full protection of the principal invested, whereas others offer limited or no protection of the principal. Structured products may be listed on a securities exchange or traded in the over-the-counter market.
- 43 **Fixed Annuities** – A fixed annuity is an insurance contract that is purchased either in a lump sum or over time. A fixed annuity is credited with a fixed or set interest rate and allows the owner to elect to receive immediate or future periodic payments. The insurance company guarantees both earnings and principal.

- 44 Equity-Indexed Annuities** – An equity-indexed annuity is an insurance company product purchased either in a lump sum or with a series of payments. The insurance company credits the holder with a return that is based on performance of an equity index, such as the S&P 500 Composite Stock Price Index. The insurance company may guarantee a minimum return. After the accumulation period, the insurance company makes periodic payments under the terms of the contract or in a lump sum.
- 45 Life Settlements** – A life settlement is a financial transaction in which a policy owner sells an existing life insurance policy to a third party for more than the policy's cash surrender value, but less than the net death benefit.
- 46 Viatical Settlement** – The sale of a terminally ill policy owner's existing life insurance policy to a third party for more than its cash surrender value, but less than its net death benefit. Such a sale provides the policy owner with a lump sum. The third party becomes the new owner of the policy, pays the monthly premiums, and receives the full benefit of the policy when the insured dies.
- 47 Private Securities** – Securities that are not registered; not listed on an exchange; and otherwise not publicly available for trade.
- 48 Non-Broker-Dealer Affiliate Product** – Such as banking and insurance instruments or services related to non-broker-dealer affiliate activity and not otherwise characterized by another Product Code.
- 49 Exchange-Traded Notes (ETNs)** – Senior, unsecured, unsubordinated debt security issued by an underwriting bank designed to provide investors access to the returns of various market benchmarks. ETNs do not actually own anything they are tracking. The note is backed by the credit of the underwriting bank that is promising to pay the amount reflected in the index, minus fees upon maturity.

\*\* These account types are to be used when the allegations relate specifically to the type of account and not to an underlying security within the account.

## FINRA Rule 4530 Problem Codes

Select the most egregious allegation in the complaint from the following codes:

- 00 Miscellaneous (Sales Practice Only)** – “Sales Practice” only (“Non-Sales Practice” Miscellaneous code is “99”).
- 01 Misrepresentation** – Allegations concerning false or misleading statements, claims, comparisons or omissions of material fact. Includes, but is not limited to, assurances and guarantees that are part of either oral or written communications or correspondence from the Registered Representative (RR) to a customer or prospect (not research/trading/investment banker/issuer/sponsor material).
- 02 Unauthorized Trading** – Allegations concerning one or more transactions that were effected without the customer’s specific knowledge and approval. (Note: Not margin liquidation or dividend reinvestment type problems.)
- 03 Excessive Trading** – Allegations concerning trading that was controlled by the RR and was excessive given the size, frequency, and character of the account in which trading was done solely to generate commissions or other compensation with disregard to the customer’s investment objectives.
- 04 Suitability** – Allegations concerning an unsuitable recommended transaction or investment strategy involving a security or securities, including possible violations of, among others, the following main suitability obligations: reasonable-basis suitability (must perform reasonable diligence to understand the nature of the recommended security or investment strategy involving a security or securities, as well as the potential risks and rewards, and determine whether the recommendation is suitable for at least some investors based on that understanding); customer-specific suitability (must have a reasonable basis to believe that a recommendation of a security or investment strategy involving a security or securities is suitable for the particular customer based on the customer’s investment profile); and quantitative suitability (must have a reasonable basis to believe that a series of recommended securities transactions are not excessive where there is control over the account).
- 05 Failure to Follow Instructions** – Allegations concerning the RR’s failure to follow specific instructions from the customer’s proper power of attorney holder or authorized parties of corporate or other entity accounts.
- 06 Documentation** – Allegations concerning material inaccuracies, omissions, or failures to obtain or provide required documents.
- 07 Solicitation** – Allegations concerning improper solicitation of an account or a transaction.

- 08 **Misappropriation/Forgery** – Allegations concerning theft or misappropriation of funds or securities or forgery. (Note: Not dividend reinvestment, customer checking/debit card activity or routine transfer instructions problems.)
- 09 **Communications with the Public** – Allegations concerning false or misleading statements, claims, comparisons, or material omissions in communications or correspondence to a customer or prospect (including flyers, retail communications, sales materials and advertisements prepared by the RR).
- 10 **Disclosure of Fees** – Allegations concerning the RR’s failure to advise or the RR’s incorrect advice of back-end fees associated with the product. (Includes Contingent Deferred Sales Charges (CDSC), surrender penalties, but not commissions or managed account fees.)
- 11 **Failure to Supervise** – Allegations concerning a sales practice violation involving the customer’s account or the RR and also a failure to supervise on the part of the named supervisor, such as the branch office manager, at the time the activity occurred.
- 12 **Poor Recommendation/Poor Advice** – Allegations concerning a recommendation to purchase, sell or exchange a security that constituted poor advice.
- 13 **Selling Away** – Allegations concerning the RR engaging in a securities transaction outside the scope of his or her relationship with the firm and without the knowledge or approval of the firm.
- 14 **Outside Business Activities** – Allegations concerning the RR engaging in an undisclosed business activity (other than a securities transaction) outside the scope of his or her relationship with the firm (e.g., employment with another entity without the knowledge of the firm).
- 20 **Research** – Allegations concerning a transaction(s) that was made based upon a firm’s research opinion that allegedly contained a material misstatement(s) or the omission of a material fact(s) communicated to the RR/customer. (This will usually be coded as a “Firm” vs. “RR” problem.)
- 21 **Product Origination/Investment Banking** – Allegations concerning a transaction(s) that was based on investment banking/issuer/sponsor disclosure(s) that allegedly lacked “due diligence” in that such disclosure(s) contained a material misstatement(s) or the omission of a material fact(s) communicated to the RR/customer. (This will usually be coded as a “Firm” vs. “RR” problem.)
- 22 **Trading** – Allegations concerning a transaction(s) that was based on a Trading Department (or support staff) disclosure(s) that contained a material misstatement(s) or the omission of a material fact(s) relating to secondary market conditions or security feature communicated to the RR/customer. (This will usually be coded as a “Firm” vs. “RR” problem.)

- 23 Poor Performance** – Allegations concerning the poor performance of the customer’s account, but does not allege any specific sale practice violations against the RR or attribute damages to a research analyst recommendation. (Not otherwise reportable under Sales Practice Codes 20, 21 or 22.)
- 24 Managed Accounts** – Allegations concerning the practice of an in-house or outside money manager. (Not to be used when the RR is the money manager and allegations are of a sales practice nature against the RR.)
- 25 Marketing/Sales Literature** – Allegations concerning false or misleading statements, claims, comparisons or material omissions found in *retail communications*, advertisements, sales literature and other written firm communications. (Not research trading/investment banking/issuer/sponsor materials.)
- 26 Regulation B** – Allegations concerning a denial of credit on the basis of race, color, religion, national origin, sex, marital status, age, receipt of income from public assistance programs or good faith exercise of any rights under the Consumer Credit Protection Act (CCPA) (Usually coded as a “firm vs. RR” problem.)
- 27 Regulation E** – Allegations concerning a failure by the firm to comply with Regulation E – the Electronic Transfer Act. (Usually coded as a “firm vs. RR” problem.)
- 28 Regulation S-P** – Allegations concerning a failure by the firm to comply with Regulation S-P, which was adopted to implement Title V of the Gramm-Leach-Bliley Act. Pursuant to Regulation S-P, a financial institution must:
- ▶ Disclose to customers - on an initial and annual basis - its policies for collecting and sharing a customer’s non-public personal information with affiliated and nonaffiliated third parties;
  - ▶ Provide the Firm’s customers with the ability to “opt out” of certain disclosures of their non-public personal information to non-affiliated third parties, with certain exceptions; and
  - ▶ State the financial institution’s security standards to protect a customer’s nonpublic personal information. (Usually coded as a “firm vs. RR” problem.)
- 29 Third Party/Anonymous** – Allegations received by an unauthorized third party or anonymous source. (Note: If the firm received authorization from the customer subsequent to the receipt of a third party/anonymous complaint, it is obligated to file an amendment via the Firm Gateway application within 45 days of receipt of the authorization to identify the true problem code.)
- 30 Complaints Referred to Previous Employer** – Allegations received by a firm against a current or previously employed RR regarding activities that occurred at the RR’s former employer firm.

- 31 **Other Theft / Forgery** – Allegations concerning theft or misappropriation of funds or securities or forgery against someone other than a RR of the firm.
- 32 **Identity Theft** – Allegations concerning improper use of a customer’s social security number or other non-public personal identity information by unauthorized individuals or entities.
- 33 **Non-Broker-Dealer Affiliate Activity** – Non-Broker-Dealer Affiliate activity not otherwise characterized by another Problem Code.
- 40 **Miscellaneous** – Firm related complaints only. Non sales practice miscellaneous code is 99. Sales practice miscellaneous code is 00.
- 50 **Transfer of Accounts** – Allegations concerning full or partial transfer of a customer’s account between broker-dealers. Includes both ACATS and manual transfers and internal transfers between branches.
- 51 **Receipt or Delivery of Securities** – Allegations concerning receipt or delivery of any type of security from broker-dealer to a customer or vice versa. Includes lost certificates, delayed securities transfers, non-transferable securities or securities not in transfer because of a fail.
- 52 **Receipt or Disbursement of Funds** – Allegations concerning funds received from or disbursed to a customer. Includes checks generated automatically, such as monthly dividend checks, IRS distribution, etc.
- 53 **Dividend and Interest Problems** – Allegations concerning payments or charges of dividends or interest, including stock dividends. Does not include disbursement of automatic monthly dividend checks or margin interest dependencies.
- 54 **Margin Problems** – Allegations concerning margin, including account liquidations, margin call notification and margin interest discrepancies.
- 55 **Reorganization/Redemption** – Allegations concerning stock splits, tenders, mergers, bond/unit trust redemption and called bonds.
- 56 **Proxy/Prospectus** – Allegations concerning the delay or non-receipt of a proxy, prospectus or shareholder mailing by a customer.
- 57 **Execution** – Allegations concerning non-execution, price discrepancy, delay in entry or report and delay in mutual fund purchases and redemptions.
- 58 **Statements/Confirms** – Allegations concerning physical characteristics and presentation of statements/confirms, failure to receive statement/confirms, and questions regarding the reported price, value of, or failure to, value a security.
- 59 **Tax Reporting** – Allegations concerning tax reporting to, or on behalf of, a customer. Includes 1099, TEFRA withholding, K-1, W2-p, 5498 and Year-to-Date information appearing on monthly statements as well as any other tax reporting forms.

- 60 **Fees and Commissions** – Allegations concerning customary fees (custodial, administrative), service charges (bounced checks, lost certificate, replacement, etc.) and commissions/markups (markdowns) and wrap fees.
- 61 **Account Administration and Processing** – Allegations concerning daily activity in a customer’s account (e.g., trade corrections, journal entries, un-invested credit balances, and erroneous or missing positions in account).
- 62 **On-Line Trading** – Allegations concerning trading initiated by a customer on-line, (including non-execution, price discrepancy, delays in execution and delays in trade confirmation).
- 63 **Service Issues** – Allegations concerning inadequate or unsatisfactory service from the firm or any of its employees.
- 64 **PATRIOT Act Liquidation** – Allegations concerning the liquidation of an account due to the firm’s inability to confirm the customer’s identity per Section 326 of the PATRIOT Act or failure to obtain foreign bank certifications per Sections 313 and 319(b) of the PATRIOT Act.
- 65 **Account Administration and Processing** – Account Opening – Allegations concerning problems establishing a new account (e.g., delays in opening account, and issues with account type and documentation).
- 66 **Account Administration and Processing** – Account Maintenance – Allegations concerning non-transaction-related problems with existing accounts (e.g., address changes, investment objective changes, title changes and account closing issues).
- 67 **On-Line Issues** – Allegations concerning access and functionality of a firm’s online system (connectivity and navigation).
- 68 **Firm Policy** – Allegations concerning a customer’s dissatisfaction with the RR or the firm as a result of a firm policy or procedure (that is not otherwise better characterized by another Problem Code).
- 99 **Miscellaneous (Non-Sales Practice Only)** – “Non-Sales Practice” only (“Sales Practice” Miscellaneous code is “00”).

## Equity Trade Reporting and OATS

### SEC Approves Amendments to Equity Trade Reporting and OATS Rules

**Effective Dates:** OATS: April 7, 2014; ORF: September 15, 2014; ADF and TRFs (millisecond reporting): September 29, 2014; ADF and TRFs (remaining amendments): First Quarter 2015

#### Executive Summary

The Securities and Exchange Commission (SEC) has approved amendments to FINRA rules governing the reporting of (i) over-the-counter (OTC) transactions in equity securities to the FINRA facilities;<sup>1</sup> and (ii) orders in NMS stocks and OTC equity securities to the Order Audit Trail System (OATS). The OATS amendments were implemented April 7, 2014, and the ORF amendments will be implemented September 15, 2014. The implementation date for the requirement relating to reporting in milliseconds to the ADF and TRFs is September 29, 2014. The implementation date for the remainder of the ADF and TRF amendments will be announced separately and will be during the first quarter of 2015.

The amended rule text is available in the online FINRA Manual.

Questions regarding this *Notice* may be directed to:

- ▶ Market Regulation Legal Section at (240) 386-5126;
- ▶ FINRA Market Operations at (866) 776-0800;
- ▶ FINRA Product Management at (866) 899-2107;
- ▶ FINRA's OATS Helpdesk at (800) 321-6273; or
- ▶ for legal or interpretive questions, Lisa Horrigan, Associate General Counsel, Office of General Counsel, at (202) 728-8190.

#### May 2014

##### Notice Type

- ▶ Rule Amendment

##### Suggested Routing

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

##### Key Topics

- ▶ Alternative Display Facility (ADF)
- ▶ Form T
- ▶ Intermarket Sweep Orders (outbound)
- ▶ NMS Stocks
- ▶ Non-Business Day Trades
- ▶ Order Audit Trail System (OATS)
- ▶ OTC Equity Securities
- ▶ OTC Reporting Facility (ORF)
- ▶ Prior Reference Price Transactions
- ▶ Step-Outs
- ▶ Stop Stock Transactions
- ▶ T+365 Trades
- ▶ Trade Reporting
- ▶ Trade Reporting Facilities (TRFs)

##### Referenced Rules & Notices

- ▶ FINRA Rules 6282, 6380A, 6380B, 6420, 6622, 7130, 7140, 7230A, 7230B, 7240A, 7240B, 7330, 7340 and 7440
- ▶ Regulatory Notice 11-03
- ▶ SEC Regulation NMS

## Background and Discussion

The SEC approved<sup>2</sup> amendments to FINRA rules relating to:

- ▶ reporting an additional time field for specified trades;
- ▶ expressing execution time in milliseconds when reporting to the FINRA facilities and OATS;
- ▶ linking reversal reports to the original trade;
- ▶ reporting trades executed on non-business days and trades that are more than one year old;
- ▶ using a new “step-in” indicator; and
- ▶ processing trades submitted to a FINRA facility for clearing.

### Reporting an Additional Time Field

FINRA rules currently require that trade reports submitted to the FINRA facilities include the time of trade execution, except where another time is expressly required by rule. Because of enhancements to FINRA facilities to accommodate more than one time entry for a single transaction report, the amendments require firms to reflect two times in reports of stop stock transactions, as defined for purposes of the FINRA trade reporting rules,<sup>3</sup> and transactions that reflect an execution price that is based on a prior reference point in time (PRP transactions). Specifically, firms must report (1) the time at which the parties agree to the stop stock price or the prior reference time (*i.e.*, the time currently required by FINRA rules), and (2) the actual time of execution.<sup>4</sup> Thus, for example, for stop stock transactions, if the parties agree to the stop stock price at 10:00 a.m. and the trade is executed at 11:00 a.m., the trade report would reflect times of 10:00 a.m. and 11:00 a.m. Similarly, for PRP transactions, if a firm executes a market-on-open order at 10:30 a.m., the trade report would reflect times of 9:30 a.m. (the time the market opened) and 10:30 a.m. Stop stock and PRP transactions that are reported more than 10 seconds following execution are marked late. Firms are reminded that if the trade is executed within 10 seconds of the time the parties agree to the stop stock price or within 10 seconds of the prior reference time, then firms should not use the designated modifier and report only the actual time of execution.

In addition, the amendments require firms to include two times when reporting block transactions using the exception for Intermarket Sweep Orders (ISOs) (outbound) under SEC Rule 611 (Order Protection Rule) of Regulation NMS if the time the firm routed the ISOs is different from the execution time.<sup>5</sup> Specifically, firms must report the time that all material terms of the transaction are known in the “execution time” field, as they do today. In the new time field (*i.e.*, the reference or “ISO time” field), if different from the execution time, firms should report the time they used to determine the ISOs, if any, to route to any better-priced protected quotations (sometimes referred to as the time the firm takes a

“snapshot” of the market).<sup>6</sup> Firms are reminded that, to comply with SEC Rule 611(b)(6), SEC staff has stated that firms need to use an automated system that is capable of ascertaining current protected quotations and simultaneously routing the necessary ISOs.<sup>7</sup> Thus, FINRA would expect the “snapshot” time and the time that ISOs are routed to be the same. To the extent that these times differ, or where multiple ISOs are routed and the route times differ, using the “snapshot” time in all instances will eliminate any confusion regarding which time to report.

### Expressing Time in Milliseconds (Trade Reporting and OATS)

FINRA trade reporting rules require firms to report execution time to the FINRA facilities in terms of hours, minutes and seconds (*i.e.*, HH:MM:SS).<sup>8</sup> Similarly, the OATS rules require firms to record order event times in hours, minutes and seconds.<sup>9</sup> Pursuant to the amendments, firms must express time in milliseconds (*i.e.*, HH:MM:SS:mmm) when reporting trades to the FINRA facilities or order information to OATS, if the firm’s system captures time in milliseconds.<sup>10</sup> However, firms are not required to capture time in milliseconds and are permitted to continue to report time in seconds, if their systems do not capture milliseconds. FINRA notes that if a firm’s system, such as an alternative trading system, captures time in milliseconds, then that system is expected to be capable of reporting in milliseconds. FINRA also notes that as technology advances, FINRA would expect to see over time an increasing percentage of firms both capturing milliseconds and making submissions to the FINRA facilities and OATS reflecting time in milliseconds.

In addition, if a firm submits multiple reports for the same event (*e.g.*, a trade report and an OATS Execution Report), FINRA would expect the time stamps to be both to the second or both to the millisecond, but not one to the second and one to the millisecond. For example, where the firm is reporting execution time in milliseconds, FINRA would match the execution time on the firm’s OATS Execution Report and on its corresponding trade report at the millisecond (not second) level and the time stamps on the two reports must be identical.<sup>11</sup> Thus, firms may need to update their systems for OATS reporting to reflect the fact that other systems in the firm use milliseconds so that the times those systems use (if in milliseconds) are accurately reflected in the firm’s OATS reports. As noted above, the amendments do not require firms to use milliseconds or update existing systems to use milliseconds; however, to the extent a firm’s system uses milliseconds, those timestamps should be to the millisecond when they are reported to OATS.

FINRA further notes that the determination whether a trade has been reported late (*i.e.*, outside the 10-second reporting window under FINRA rules) remains at the second level for firms that report execution time in seconds, and for firms that report time in milliseconds, the determination is made at the millisecond level. Thus, for example, a trade with an execution time of 10:01:00 must be reported no later than 10:01:10, and a trade with an execution time of 10:01:00:999 must be reported no later than 10:01:10:999.

### Linking Reversal Reports to the Original Trade

FINRA rules require that if a trade that was previously reported to FINRA is cancelled or reversed, firms must report the cancellation or reversal to the same FINRA facility to which the trade was originally reported<sup>12</sup> and must do so within the time frames set forth in the rules.<sup>13</sup> The amendments require firms to identify the original trade in the reversal report by including the control number the FINRA facility generated and report date for the original trade report.<sup>14</sup> In accordance with system requirements, the control number field is a required field for all reports of reversals and if it is not populated, then the report will be rejected. However, FINRA will validate the control number only where the original trade was executed after implementation of the amendments. Accordingly, when reversing trades executed prior to implementation, firms are not required to provide an actual control number and instead may insert a “dummy” number to populate the required field.

Firms must maintain sufficient records to enable them to identify the control number and report date for any trades that they reverse, to the extent such information cannot be obtained from the data retained by the FINRA facility.<sup>15</sup>

### Reporting Non-business Day Trades and T+365 Trades

Pursuant to the amendments, firms are required to report trades executed on non-business days (*i.e.*, weekends and holidays) and trades reported more than 365 days after trade date (T+365) to a FINRA facility. (Today these trades are reported on Form T through FINRA’s Firm Gateway.) Non-business day trades and T+365 trades are assessed regulatory fees under Section 3 of Schedule A to the FINRA By-Laws (Section 3)<sup>16</sup> and are not submitted to clearing by the FINRA facility<sup>17</sup> or disseminated.

In addition, firms must report non-business day trades on an “as/of” basis by 8:15 a.m. the next business day following execution with the unique trade report modifier to denote their execution outside normal market hours; trades not reported by 8:15 a.m. are marked late.<sup>18</sup> Thus, for example, a trade executed on Saturday must be reported by 8:15 a.m. the following Monday (since the FINRA facilities are not open on Saturday to accept the trade report), and if the trade is not reported by that time, it is marked late. All T+365 trades are reported on an “as/of” basis and are marked late.

### Using a New “Step-in” Indicator

Today, firms can effectuate a “step-out”<sup>19</sup> by submitting a clearing-only report to a FINRA facility, and FINRA rules prohibit firms from submitting to a FINRA facility any non-tape report (including but not limited to reports of step-outs) associated with a previously executed trade that was not reported to that FINRA facility.<sup>20</sup> For every step-out, one firm is stepping out of (or transferring) the position and the other firm is stepping into (or receiving) the position. Pursuant to the amendments, where both sides are submitting a clearing-only report to effectuate a step-out, the firm transferring out of the position must report a step-out and the firm receiving the position must report a step-in. FINRA notes that

the FINRA facilities that offer matching, such as the ORF, will match corresponding “step-out” and “step-in” submissions; the system will not match two “step-in” or two “step-out” submissions.<sup>21</sup> Firms are reminded that they should not use the step-out and step-in indicators when reporting a riskless principal or agency “flip,” both of which entail a change in beneficial ownership and must be reported to FINRA where specified by rule.

### Processing Trades Submitted for Clearing

When firms use the trade acceptance and comparison functionality of a FINRA facility, the reporting party reports the trade and the contra party subsequently either accepts or declines the trade.<sup>22</sup> The amendments clarify that rather than being purged from the system at the end of trade date processing, trades that have been declined by the contra party are carried over and remain available for cancellation or correction by the reporting party or subsequent acceptance by the contra party.<sup>23</sup> Thus, for example, if Firm A, as the contra party, erroneously declines the trade report Firm B submits, Firm A could accept the previously declined trade up to T+1.<sup>24</sup>

Declined trades that are carried over will not be available for the automatic lock-in process described in the rules and will not be sent to clearing unless the parties take action. Firms are reminded that the reporting firm must cancel a declined trade that was previously reported for dissemination purposes to have the trade removed from the tape, *i.e.*, the system does not remove the trade automatically from the tape.<sup>25</sup>

In addition, the amendments reorganized FINRA rules relating to locking in trades for clearing and clarified that trades that are T+22 or older that remain open are carried over, but are not subject to the automatic lock-in process.<sup>26</sup> (Today such T+22 trades are purged from the system, although firms may subsequently resubmit them.)

### Implementation

FINRA will implement the amendments as follows:

- ▶ **OATS:** As previously announced, the amendments to the OATS rules were implemented on Monday, April 7, 2014.<sup>27</sup>
- ▶ **OTC Reporting Facility:** The amendments to the ORF rules will be implemented upon migration of the ORF to the new technology platform on Monday, September 15, 2014. Firms should refer to the [ORF Forms & Documentation](#) page for updated ORF technical specifications.
- ▶ **Alternative Display Facility, FINRA/Nasdaq TRF and FINRA/NYSE TRF:** The implementation date for the requirement relating to reporting in milliseconds to the ADF and TRFs is Monday, September 29, 2014. The implementation date for the remainder of the ADF and TRF amendments has not been set and will be extended beyond the September 30, 2014, date, proposed in SR-FINRA-2013-050, to the first quarter of 2015. Separate notice will be provided once the ADF and TRF implementation date has been set.

## Endnotes

1. Specifically, the FINRA facilities are the Alternative Display Facility (ADF) and the Trade Reporting Facilities (TRFs), to which firms report OTC transactions in NMS stocks; and the OTC Reporting Facility (ORF), to which firms report transactions in OTC equity securities, as defined in FINRA Rule 6420 (*i.e.*, equity securities that are not NMS stocks), as well as transactions in restricted equity securities, as defined in FINRA Rule 6420, effected pursuant to Securities Act Rule 144A.
2. See Securities Exchange Act Release No. 71623 (February 27, 2014), 79 FR 12558 (March 5, 2014) (Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1; File No. SR-FINRA-2013-050).
3. “Stop stock transaction” means a transaction resulting from an order in which a firm and another party agree that the order will be executed at a stop stock price or better, which price is based upon the prices at which the security is trading at the time the firm receives the order. See Rules 6220, 6320A, 6320B and 6420.
4. See paragraphs (F) and (G) of Rules 6282(a)(4), 6380A(a)(5), 6380B(a)(5) and 6622(a)(5).
5. FINRA notes that this requirement applies only when reporting OTC transactions in NMS securities to the ADF or a TRF and is not applicable to reporting to the ORF.
6. As FINRA noted in [NASD Member Alert: Guidance Relating to “Execution Time” for Purposes of Compliance with NASD Trade Reporting Rules](#) (June 13, 2007), in surveilling for compliance with SEC Rule 611(b)(6) in this context, firms should compare routed ISOs with the protected quotations that were displayed at the time of routing.
7. SEC staff has further indicated that it does not believe it would be possible for manual routing of an ISO to comply with the requirement in Rule 611(b)(6). See SEC Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS (April 4, 2008 update), FAQ 3.03: Executing and Reporting Block Trades Pursuant to ISO Exception.
8. See, *e.g.*, Rules 6282(c)(5), 6380A(c)(5), 6380B(c)(5) and 6622(c)(5).
9. See Rule 7440(a)(2). Rule 7450 generally requires all applicable order information required to be recorded under Rule 7440 to be reported to OATS. Although Rule 7440(a)(2) requires order event times to be recorded to the second, FINRA published guidance in 2011 in connection with the expansion of OATS to all NMS stocks stating that firms that capture time in milliseconds should report time to OATS in milliseconds. See [Regulatory Notice 11-03](#) (January 2011); see also OATS Reporting Technical Specifications, Cover Memo, at iv (May 3, 2011 ed.). The amendments codify this guidance into Rule 7440(a)(2).
10. See Rules 6282.04, 6380A.04, 6380B.04, 6622.04, 7130.01, 7230A.01, 7230B.01, 7330.01 and 7440(a)(2).
11. OATS uses four fields, including the execution time stamp, to link an OATS Execution Report or OATS Combined Order/Execution Report to the corresponding trade report.
12. See Rules 7130(g), 7230A(i), 7230B(h) and 7330(h).
13. See, *e.g.*, Rules 6282(g)(2), 6380A(g)(2), 6380B(f)(2), and 6622(f)(2) and (f)(3).
14. See subparagraph (3) in Rules 6282(g), 6380A(g) and 6380B(f) and subparagraph (4) in Rule 6622(f).

15. The FINRA facilities retain historic trade data and the amount of data retained varies among the facilities.
16. Pursuant to Section 31 of the Exchange Act, FINRA and the national securities exchanges are required to pay transaction fees and assessments to the SEC that are designed to recover the costs related to the government's supervision and regulation of the securities markets and securities professionals. FINRA obtains its Section 31 fees and assessments from its membership in accordance with Section 3.
17. See Rules 7140(b), 7240A(b), 7240B(b) and 7340(b).
18. See Rules 6282(a)(2), 6380A(a)(2), 6380B(a)(2) and 6622(a)(2). Similarly, under Rule 6622(a)(3), any Securities Act Rule 144A transaction in a restricted equity security that is executed on a non-business day must be reported by the time the ORF closes the next business day.
19. A step-out allows a member firm to allocate all or part of a client's position from a previously executed trade to the client's account at another firm. In other words, a step-out functions as a client's position transfer, rather than a trade; there is no exchange of shares and funds and no change in beneficial ownership. The step-out function was designed and implemented as a service to facilitate the clearing process for firms involved in these types of transfers. See [Trade Reporting FAQ 301.1](#).
20. See Rules 7130(g), 7230A(i), 7230B(h) and 7330(h). Thus, for example, a firm cannot use one TRF to step out of an OTC trade that was originally reported to another TRF.
21. For purposes of reporting step-outs/step-ins to the FINRA facilities, the firm stepping out of (or transferring) the position is the "executing party" with the trade reporting obligation and the firm stepping into (or receiving) the position is the contra party.
22. Alternatively, one firm may submit a locked-in trade on behalf of the other firm, if the firms have the requisite agreements in place (*i.e.*, AGU or QSR). In that instance, the trade acceptance and comparison functionality would not be used.
23. See Rules 7140(a)(2), 7240A(a)(2) and 7340(a)(2).
24. FINRA notes that where trades are not locked-in pursuant to agreement, contra parties are required to accept or decline a trade within 20 minutes after execution, and FINRA generally expects contra parties to complete the process of accepting or declining a trade, including any subsequent updates, within that time frame. See Rules 7130(b), 7230A(b) and 7330(b).
25. See Rules 7140(a)(2), 7240A(a)(2) and 7340(a)(2).
26. See Rules 7140(a)(3), 7240A(a)(3) and 7340(a)(3).
27. See the March 21, 2014, OATS Report, "[Firms Capturing Time in Milliseconds Required to Report to OATS in Milliseconds Beginning April 7, 2014.](#)"

Each firm is required to report its side to effectuate a step-out; however, if the two firms have the proper agreements in place (*i.e.*, an Automatic Give-Up (AGU) or Qualified Special Representative (QSR) agreement), the step-out can be effectuated with only one submission. The amendments do not affect the process for effectuating a step-out with a single submission via AGU or QSR.

## Corporate Financing Rule

### SEC Approves Amendments to FINRA Rule 5110 to Permit Termination Fees and Rights of First Refusal; Provide an Exemption From the Filing Requirements for Certain Collective Investment Vehicles; and Clarify the Electronic Filing Requirement

Effective Date: May 15, 2014

#### Executive Summary

The SEC approved amendments to FINRA Rule 5110 (Corporate Financing Rule — Underwriting Terms and Arrangements) to expand the circumstances in which termination fees and rights of first refusal are permissible; exempt from the filing requirements certain collective investment vehicles that are not registered as investment companies; and make clarifying, non-substantive changes regarding documents filed through FINRA's electronic filing system.<sup>1</sup> The amendments become effective May 15, 2014.

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

Questions concerning this *Notice* should be directed to:

- ▶ Paul Mathews, Vice President, Corporate Financing, at (240) 386-4623 or [Paul.Mathews@finra.org](mailto:Paul.Mathews@finra.org);
- ▶ James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8270 or [Jim.Wrona@finra.org](mailto:Jim.Wrona@finra.org);
- ▶ Kathryn M. Moore, Associate General Counsel, OGC, at (202) 728-8200 or [Kathryn.Moore@finra.org](mailto:Kathryn.Moore@finra.org).

#### May 2014

##### Notice Type

- ▶ Rule Amendment

##### Suggested Routing

- ▶ Compliance
- ▶ Corporate Finance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management
- ▶ Syndicate
- ▶ Underwriting

##### Key Topics

- ▶ Electronic Filing
- ▶ Exchange-Traded Funds
- ▶ Investment Banking
- ▶ Rights of First Refusal
- ▶ Termination Fees
- ▶ Underwriting

##### Referenced Rules & Notices

- ▶ FINRA Rule 2310
- ▶ FINRA Rule 5110
- ▶ FINRA Rule 5121

## Background & Discussion

FINRA Rule 5110, among other things, regulates underwriting compensation, requires the filing of specified information in connection with public offerings in which firms will participate, and prohibits unfair arrangements in connection with public offerings of securities. FINRA amended Rule 5110's provisions regarding unfair arrangements to (1) expand the circumstances under which firms and issuers may negotiate termination fees and rights of first refusal (ROFR), with specified conditions; (2) exempt from the filing requirements certain collective investment vehicles that are not registered as investment companies; and (3) clarify the electronic filing requirement.

### Termination Fees and Rights of First Refusal

FINRA Rule 5110(f) (Unreasonable Terms and Arrangements) sets forth terms and arrangements that, when proposed in connection with a public offering of securities, are considered unfair and unreasonable. FINRA amended its requirements regarding termination fees and ROFR to provide firms with a greater degree of flexibility in negotiating the terms of their agreements for terminated offerings, while also providing protection for issuers if a firm fails materially to perform the underwriting services contemplated in the written agreement. FINRA amended Rule 5110(f)(2)(D) (Prohibited Arrangements) to permit, in the event the public offering is not completed, termination fees or a ROFR in a written agreement between the issuer and the participating member, provided that:

1. the agreement specifies that the issuer has a right of "termination for cause," which shall include the participating member's material failure to provide the underwriting services contemplated in the written agreement;<sup>2</sup>
2. the issuer's exercise of its right of "termination for cause" eliminates any obligations with respect to the payment of any termination fee or provision of any ROFR;<sup>3</sup>
3. the amount of any specified termination fee must be reasonable in relation to the underwriting services contemplated in the agreement, and any fees arising from underwriting services provided under a ROFR must be customary for those types of services; and
4. the issuer shall not be responsible for paying the termination fee unless an offering or other type of transaction (as set forth in the agreement) is consummated within two years of the date the engagement is terminated by the issuer.

Rule 5110 would continue to provide that the duration of any ROFR may not be for more than three years from the date of commencement of sales of the public offering (in the case of a successful offering). In the case of a terminated offering, FINRA amended Rule 5110(f)(2)(E) to provide that the duration of an ROFR may not be for more than three years from the date the issuer terminates the engagement. In both cases, the agreement may not provide for more than one opportunity to waive or terminate the ROFR in consideration of any payment or fee.<sup>4</sup>

### **Filing Requirements for Certain Exchange-Traded Funds**

Rule 5110(b)(8) (Exempt Offerings) generally provides an exemption for investment companies from the filing requirements of the rule.<sup>5</sup> Due to this exemption, exchange-traded funds (ETF) that are structured as investment companies generally are exempt. However, this exemption does not include certain other ETF that are not investment companies. FINRA believes it is appropriate to add an exemption for these products even if they do not fall under the definition of an investment company. Accordingly, FINRA amended Rule 5110(b)(7) to exempt from the filing requirements of Rule 5110 offerings of securities issued by a pooled investment vehicle, whether formed as a trust, partnership, corporation, limited liability company or other collective investment vehicle, that is not registered as an investment company under the Investment Company Act and has a class of equity securities listed for trading on a national securities exchange, provided that such equity securities may be created or redeemed on any business day at their net asset value per share.

### **Electronic Filing**

Rule 5110(b) (Filing Requirements) generally provides that no firm or person associated with a firm shall participate in any manner in a public offering of securities subject to FINRA Rules 2310, 5110 or 5121 unless the specified documents and information relating to the offering have been filed with and reviewed by FINRA. FINRA amended Rule 5110(b) (5) to make clarifying, non-substantive changes regarding documents filed through FINRA's electronic filing system.<sup>6</sup>

## Endnotes

1. See Securities Exchange Act Release No. 72114 (May 7, 2014), 79 FR 27355 (May 13, 2014) (Order Approving SR-FINRA-2014-004).
2. The specific meaning of “termination for cause” would be dictated by the agreement. For purposes of the rule, a “termination for cause” would include a firm’s material failure to perform the underwriting services contemplated in the written agreement.
3. Firms would continue to be permitted to receive reimbursement of out-of-pocket, bona fide, accountable expenses actually incurred by the participating firm in connection with a terminated offering as provided in amended Rule 5110(f)(2)(D)(i).
4. Rule 5110(f)(2)(G) is redesignated as Rule 5110(f)(2)(F), which prohibits any payment or fee to waive or terminate a ROFR regarding future public offerings, private placements or other financings that exceed specified values or that are not paid in cash.
5. Rule 5110(b)(8)(C) exempts from the rule’s filing requirements securities of “open-end” investment companies as defined in Section 5(a)(1) of the Investment Company Act of 1940 (“Investment Company Act”) and securities of any “closed-end” investment company as defined in Section 5(a)(2) of the Investment Company Act that (1) makes periodic repurchase offers pursuant to Rule 23c-3(b) under the Investment Company Act and (2) offers its shares on a continuous basis pursuant to Rule 415(a)(1)(xi) of SEC Regulation C.
6. The effective date of the electronic filing requirements under Rule 5110 was July 12, 2002. See [Notice to Members 02-26](#).

## Attachment A

New language is underlined; deletions are in brackets.

\* \* \* \* \*

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

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

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

(a) No Change.

**(b) Filing Requirements**

(1) through (4) No Change.

**(5) Documents to be Filed**

(A) The following documents relating to all proposed public offerings of securities that are required to be filed under paragraph (b)(4) above shall be filed [with] through FINRA's electronic filing system for review:

(i) [Three copies of the] The registration statement, offering circular, offering memorandum, notification of filing, notice of intention, application for conversion and/or any other document used to offer securities to the public;

(ii) [Three copies of any] Any proposed underwriting agreement, agreement among underwriters, selected dealers agreement, agency agreement, purchase agreement, letter of intent, consulting agreement, partnership agreement, underwriter's warrant agreement, escrow agreement, and any other document that describes the underwriting or other arrangements in connection with or related to the distribution, and the terms and conditions relating thereto; and any other information or documents that may be material to or part of the said arrangements, terms and conditions and that may have a bearing on FINRA's review;

(iii) [Three copies of each] Each pre- and post-effective amendment to the registration statement or other offering document, [one] with a copy marked to show changes; and [three (3) copies of] any other amended document previously filed pursuant to subparagraphs (i) and (ii) above, [one] with a copy marked to show changes; and

(iv) [Three copies of the] The final registration statement declared effective by the SEC or equivalent final offering document and a list of the members of the underwriting syndicate, if not indicated therein, and one copy of the executed form of the final underwriting documents and any other document submitted to FINRA for review.

(B) [All documents] Documents that are filed with the SEC through the SEC's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") System that are referenced in FINRA's electronic filing system shall be treated as filed with FINRA.

(6) No Change.

#### **(7) Offerings Exempt from Filing**

Notwithstanding the provisions of subparagraph (1) above, documents and information related to the following public offerings need not be filed with FINRA for review, unless subject to the provisions of Rule 5121(a)(2). However, it shall be deemed a violation of this Rule or Rule 2310, for a member to participate in any way in such public offerings if the underwriting or other arrangements in connection with the offering are not in compliance with this Rule or Rule 2310, as applicable:

(A) through (E) No Change.

(F) exchange offers of securities where:

(i) No Change.

(ii) the company issuing securities qualifies to register securities with the SEC on registration statement Forms S-3, F-3, or F-10, pursuant to the standards for those Forms as set forth in subparagraphs (C)(i) and (ii) of this paragraph; [and]

(G) offerings of securities by a church or other charitable institution that is exempt from SEC registration pursuant to Section 3(a)(4) of the Securities Act[.]; and

(H) offerings of securities issued by a pooled investment vehicle, whether formed as a trust, partnership, corporation, limited liability company or other collective investment vehicle, that is not registered as an investment company under the Investment Company Act and has a class of equity securities listed for trading on a national securities exchange; provided that such equity securities may be created or redeemed on any business day at their net asset value per share.

(8) through (9) No Change.

**(c) Underwriting Compensation and Arrangements**

(1) No Change.

**(2) Amount of Underwriting Compensation**

(A) No Change.

(B) For purposes of determining the amount of underwriting compensation, all items of value received or to be received from any source by the underwriter and related persons which are deemed to be in connection with or related to the distribution of the public offering as determined pursuant to subparagraph[s] (3) [and (4)] below shall be included.

(C) through (E) No Change.

(3) No Change.

(d) through (e) No Change.

**(f) Unreasonable Terms and Arrangements**

(1) No Change.

**(2) Prohibited Arrangements**

Without limiting the foregoing, the following terms and arrangements, when proposed in connection with a public offering of securities, shall be unfair and unreasonable.

(A) through (C) No Change.

(D) [The payment of any] Any compensation by an issuer to a member or person associated with a member in connection with an offering of securities that is not completed according to the terms of agreement between the issuer and underwriter, except: [those negotiated and paid in connection with a transaction that occurs in lieu of the proposed offering as a result of the efforts of the underwriter and related persons and provided, however, that]

(i) the reimbursement of out-of-pocket accountable, bona fide expenses actually incurred by the member or person associated with a member [shall not be presumed to be unfair or unreasonable under normal circumstances.]; and

(ii) a termination fee or a right of first refusal, as set forth in a written agreement between the issuer and the participating member, provided that:

a. the agreement specifies that the issuer has a right of “termination for cause,” which shall include the participating member’s material failure to provide the underwriting services contemplated in the written agreement;

b. an issuer’s exercise of its right of “termination for cause” eliminates any obligations with respect to the payment of any termination fee or provision of any right of first refusal;

c. the amount of any termination fee must be reasonable in relation to the underwriting services contemplated in the agreement and any fees arising from underwriting services provided under a right of first refusal must be customary for those types of services; and

d. the issuer shall not be responsible for paying the termination fee unless an offering or other type of transaction (as set forth in the agreement) is consummated within two years of the date the engagement is terminated by the issuer.

[(E) Any “tail fee” arrangement granted to the underwriter and related persons that has a duration of more than two years from the date the member’s services are terminated, in the event that the offering is not completed in accordance with the agreement between the issuer and the underwriter and the issuer subsequently consummates a similar transaction, except that a member may demonstrate on the basis of information satisfactory to FINRA that an arrangement of more than two years is not unfair or unreasonable under the circumstances.]

[(F)](E) Any right of first refusal provided to the underwriter or related persons to underwrite or participate in future public offerings, private placements or other financings that:

(i) has a duration of more than three years from the date of [effectiveness or] commencement of sales of the public offering or the termination date of the engagement between the issuer and underwriter; or

(ii) has more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee.

(G) through (I) redesignated as (F) through (H).

~~[(J)](I)~~ When proposed in connection with the distribution of a public offering of securities on a “firm commitment” basis, any over[ ] allotment option providing for the over[ ] allotment of more than 15% of the amount of securities being offered, computed excluding any securities offered pursuant to the over[ ] allotment option.

(K) through (M) redesignated as (J) through (L).

**(g) Lock-Up Restriction on Securities**

(1) No Change.

**(2) Exceptions to Lock-Up Restriction**

Notwithstanding paragraph (g)(1) above, the following shall not be prohibited:

(A) the transfer of any security:

(i) through (ii) No Change.

(iii) if the aggregate amount of securities of the issuer held by the underwriter [or] and related persons do not exceed 1% of the securities being offered;

(iv) through (viii) No Change.

(B) No Change.

**(h) Non-Cash Compensation**

(1) No Change.

**(2) Restrictions on Non-Cash Compensation**

In connection with the sale and distribution of a public offering of securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) through (B) No Change.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by paragraph ([d]h)(2)(D);

(ii) through (iii) No Change.

(iv) the payment or reimbursement by the issuer or affiliate of the issuer is not conditioned by the issuer or an affiliate of the issuer on the achievement of a sales target or any other non-cash compensation arrangement permitted by paragraph ([d]h)(2)(D).

(D) No Change.

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in paragraph ([d]h)(2)(D).

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by paragraphs ([d]h)(2)(C) through (E). The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with paragraphs ([d]h)(2)(C) through (E).

(i) No Change.

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1 No Change.

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## Trade Reporting

### FINRA Issues an Interpretation to Clarify the Classification and Trade Reporting of Certain “Hybrid” Securities to FINRA

Effective Date: June 16, 2014

#### Executive Summary

FINRA is publishing this *Notice* to provide additional information on how trades in certain securities that have both debt- and equity-like features (hybrid securities) must be reported to FINRA. Specifically, the SEC approved an interpretation regarding the appropriate trade reporting facility to which firms should report transactions in the following three types of hybrid securities: (1) unlisted depositary shares having a liquidation preference of \$1,000 or more; (2) unlisted non-convertible, preferred securities having a liquidation preference of \$1,000 or more; and (3) unlisted capital trust securities (also referred to as trust preferred securities) (together, “covered hybrid securities”).<sup>1</sup>

In accordance with this interpretation, on June 16, 2014, firms will be required to report transactions in covered hybrid securities to the Trade Reporting and Compliance Engine (TRACE). However, firms may request the set-up of a new hybrid security for trade reporting purposes in accordance with this interpretation prior to that date. A list of covered hybrid securities that will be moved from the OTC Reporting Facility (ORF) to TRACE on June 16, 2014, is attached as Appendix A.

Questions regarding this *Notice* should be directed to:

- ▶ Ola Persson, Vice President, Transparency Services, at (212) 858-4796 or by [email](#); or
- ▶ Racquel Russell, Associate General Counsel, Office of General Counsel, at (202) 728-8363 or by [email](#).

#### May 2014

##### Notice Type

- ▶ Guidance

##### Suggested Routing

- ▶ Compliance
- ▶ Fixed Income
- ▶ Legal
- ▶ Operations
- ▶ Systems
- ▶ Trading
- ▶ Training

##### Key Topics

- ▶ Capital Trust Security
- ▶ Depositary Shares
- ▶ Hybrid Security
- ▶ Over-the-Counter Reporting Facility
- ▶ Preferred Shares
- ▶ TRACE
- ▶ Transaction Reporting
- ▶ Trust Preferred Security

##### Referenced Rules & Notices

- ▶ FINRA Rule 6420
- ▶ FINRA Rule 6622
- ▶ FINRA Rule 6700 Series
- ▶ FINRA Rule 6710
- ▶ Regulation NMS
- ▶ Regulation NMS Rule 600(b)(47)
- ▶ Regulatory Notice 08-72
- ▶ SEA Rule 144(a)(3)
- ▶ SEA Rule 144A
- ▶ SEA Section 31
- ▶ Section 3 of Schedule A to the FINRA By-Laws

## Background and Discussion

FINRA trade reporting rules generally require that firms report over-the-counter (OTC) transactions in debt securities that are “TRACE-Eligible Securities”<sup>2</sup> and equity securities to FINRA. FINRA Rule 6622 requires that firms report OTC transactions in “OTC Equity Securities”<sup>3</sup> to ORF and the FINRA Rule 6700 series requires firms to report transactions in TRACE-Eligible Securities to TRACE.

In consultation with the industry, FINRA has determined that the term “TRACE-Eligible Security” includes the following covered hybrid securities (and thus these securities should be reported to TRACE):<sup>4</sup>

1. unlisted capital trust and trust preferred securities;<sup>5</sup>
2. unlisted depositary shares having a liquidation preference of \$1,000 or more (or a cash redemption price of \$1,000 or more) that is a fractional interest in a non-convertible,<sup>6</sup> preferred security (“hybrid \$1,000 depositary share”); and
3. unlisted non-convertible, preferred securities having a liquidation preference of \$1,000 or more (or a cash redemption price of \$1,000 or more) (“hybrid \$1,000 preferred security”), such as a hybrid \$1,000 preferred security that is offered directly to an investor or a preferred security underlying multiple hybrid \$1,000 depositary shares.

Any such security deemed a “TRACE-Eligible Security” would be excluded from the defined term “OTC Equity Security.”<sup>7</sup>

All other preferred securities and depositary shares representing fractional interests in these securities, except the covered hybrid securities identified above, will continue to be included in the defined term “OTC Equity Security,” and firms must report transactions in such securities to ORF.<sup>8</sup> For example, a non-convertible preferred security having a par value or liquidation preference of \$25 that is not listed on an equity facility of a national securities exchange would be an “OTC Equity Security” under the interpretation and would be required to be reported to ORF.

Thus, beginning on June 16, 2014, any firm reporting a trade in a hybrid security must report the transaction to the appropriate facility in compliance with this interpretation. However, prior to June 16, 2014, any firm requesting the set-up of a new hybrid security for trade reporting purposes may, but is not required to, do so in accordance with this interpretation.

A list of covered hybrid securities that will be moved from ORF to TRACE on June 16, 2014, is attached as Appendix A.

## Endnotes

1. See Securities Exchange Act Release No. 71927 (April 10, 2014), 79 FR 21494 (April 16, 2014) (Order Approving Proposed Rule Change, as Modified by Amendment No. 1 of File No. SR-FINRA-2013-039).
2. FINRA Rule 6710(a) defines “TRACE-Eligible Security” as a debt security that is United States (“U.S.”) dollar-denominated and issued by a U.S. or foreign private issuer, and, if a “restricted security” as defined in Securities Act Rule 144(a)(3), sold pursuant to Securities Act Rule 144A; or is a debt security that is U.S. dollar-denominated and issued or guaranteed by an Agency as defined in paragraph (k) or a Government-Sponsored Enterprise as defined in paragraph (n). However, the term “TRACE-Eligible Security” does not include a debt security that is: issued by a foreign sovereign, a U.S. Treasury Security as defined in paragraph (p), or a money market instrument as defined in paragraph (o).
3. FINRA Rule 6420(f) defines “OTC Equity Security” to include “any equity security that is not an ‘NMS stock’ as that term is defined in Rule 600(b)(47) of SEC Regulation NMS; provided, however, that the term ‘OTC Equity Security’ shall not include any Restricted Equity Security.” FINRA Rule 6420(k) defines “Restricted Equity Security” to mean “any equity security that meets the definition of ‘restricted security’ as contained in Securities Act Rule 144(a)(3).”
4. This interpretation applies solely to a hybrid security that is not listed on an equity facility of a national securities exchange. See e.g., [FINRA Trade Reporting Notice—2/22/08](#), (FINRA applied TRACE reporting requirements, distinguishing between listed and unlisted securities, and required firms to report transactions in unlisted convertible debt and unlisted equity-linked notes to TRACE, and OTC transactions in convertible debt and equity-linked notes listed on an equity facility of a national securities exchange to an appropriate FINRA equity trade reporting facility for NMS Stocks (the Alternative Display Facility (ADF) or a trade reporting facility (TRF)). For purposes of this interpretation, the term “listed on an equity facility of a national securities exchange” means a security that qualifies as an NMS stock (as defined in Rule 600(b)(47) of Regulation NMS under the Act) as distinguished from a security that is listed on a bond facility of a national securities exchange. See 17 CFR 242.600(b)(47).
5. The term “TRACE-Eligible Security” includes capital trust securities and trust preferred securities (other than a capital trust security or a trust preferred security that is listed on an equity facility of a national securities exchange) and transactions in such securities must be reported to TRACE (and not to ORF) in compliance with the applicable reporting requirements. This interpretation would apply even if the capital trust security (or a trust preferred security) was previously listed on an equity facility of a national securities exchange and reported to a FINRA equity facility, but has since been delisted. Once delisted, the security must be reported to TRACE. Similarly, any other hybrid security that does not meet the definition of “covered hybrid security” solely because it is listed on a national securities exchange would be required to be reported to TRACE once delisted.

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6. Non-convertible means not convertible into or exchangeable for property or shares of any other series or class of the issuer's capital stock.
7. This interpretation also applies to unlisted American Depositary Receipts (ADRs) on hybrid securities in the same manner in which it applies to the underlying hybrid security. Thus, an unlisted ADR on a covered hybrid security would be excluded from the definition of "OTC Equity Security" under the interpretation and would be required to be reported to TRACE. Whereas, an unlisted ADR on a depository share having a par value or liquidation preference of \$25 would be an "OTC Equity Security" under the interpretation and would be required to be reported to ORF.
8. Pursuant to Section 31 of the Act, FINRA and the national securities exchanges are required to pay transaction fees and assessments to the SEC that are designed to recover the costs related to the government's supervision and regulation of the securities markets and securities professionals. See 15 U.S.C. 78ee. FINRA obtains its Section 31 fees and assessments from its membership, in accordance with Section 3 of Schedule A to the FINRA By-Laws. The transactions that are assessable under Section 3 of Schedule A to the FINRA By-Laws are reported to FINRA through one of FINRA's equity trade reporting facilities: the ORF, the ADF, or a TRF. As expressly stated in the Act, sales of bonds, debentures, or other evidence of indebtedness (debt securities) are excluded from Section 31 of the Act. See 15 U.S.C. 78ee(b). Because of this exclusion under Section 31 of the Act, transactions reported to TRACE are not subject to the regulatory transaction fee under Section 3 of Schedule A to the FINRA By-Laws. To determine whether a non-exchange listed security is an equity security or a debt security for purposes of assessing the regulatory transaction fee, FINRA relies on the facility to which the transaction is reported. If the transaction is reported to the ORF, the transaction is treated as one involving an equity security and is subject to the regulatory transaction fee. If the transaction is reported to TRACE, the transaction is treated as one involving a debt security and thus is not subject to the regulatory transaction fee. See [\*Regulatory Notice 08-72\*](#).

## Appendix A

CUSIP/CINS	Symbol	Issuer	Issue Description
U0201H106	ALFI	ALLY FINANCIAL	7% Perp Pfd Shs Series G - Reg S
02005N605	GMSPZ	ALLY FINANCIAL, INC.	PERP PFD SER G 7%
060505DT8	BACYL	BANK OF AMERICA	Depository Shares Representing 1/25th Fixed to Floating (Non Cumulative Preferred Series M)
060505ED2	BCXQL	BANK OF AMERICA	Depository Share representing 1/25th Preferred Series U
064058AB6	BKNML	BANK OF NEW YORK	Depository Shares representing 1/100th Preferred Stock Series D
06738C828	BCBAY	BARCLAYS BK ADR	ADR Series 1 Repstg Preferred Shares Series 1 (United Kingdom)
05530RAB4	BBVZF	BBVA INTERNATIONAL	Guaranteed Preferred Securities (Spain)
U1362QAA7	CPDJP	CA PFD FDG TR	Noncum Tr Pfd Secs Without Fxd Mty 2003
151327202	CRFDZ	CENTAUR FDG CORP	PREF SHS SER B 9.08% 144A
151895406	CNTQP	CENTERPOINT PFD D	Flexible Preferred Series D
172967GR6	CYGXL	CITIGROUP INC.	Depository Shares representing 1/25th Preferred Series D
19075Q607	CBKAP	COBANK ACB/PFD SER E	Perp Preferred CL E Fixed to FLTG
239649205	DMRRP	DAYTON & MICH RR CO	Preferred Stock
30767E307	FCBTP	FARM CREDIT BANK	Perp Non Cumulative Sub Ser 1 Pfd 10% CI B
316773CM0	FTBXL	FIFTH THIRD BANCORP	Depository Share representing 1/25th Preferred Series H
31984K209	FCCTP	FIRST COMNTY CORP A	Preferred Series A
31984K308	FCCTO	FIRST COMNTY CORP B	Preferred Series B
344437504	FONRP	FONAR CORP PFD	Preferred Stock
369622SP1	GEAPP	GENERAL ELECTRIC	Perpetual Preferred Stock Series B Fixed to Floating Rate
369622ST3	GEAPO	GENERAL ELECTRIC CAP	Perpetual Preferred Series C
43787N207	HMTAP	HOMETOWN BANKSHARES	Non cumulative Perpetual Preferred

CUSIP/CINS	Symbol	Issuer	Issue Description
48124BAC9	JPYYL	JP MORGAN	Depositary Shares Representing 1/10th Preferred Series Q
46625HHA1	JFTTL	JP MORGAN CHASE	Depositary Shares Representing 1/10th Preferred Series I
46625HJQ4	JPJQL	JP MORGAN CHASE	Depositary Shares Representing 1/10th Preferred Series S Fixed to Floating
46625HJW1	JPMQL	JP MORGAN CHASE	Depositary Shares Representing 1/10th interest fixed to floating preferred series U
48126HAA8	JPPML	JP MORGAN CHASE	Dep Shs Repstg 1/10th Pfd Ser R
49455T202	KMRFZ	KINDER MORGAN 144A	Cumulative Pfd Ser A 144A
539439AA7	LLYDZ	LLOYDS BANKING	ADR Repstg Pref Shs 144A (United Kingdom)
539439AC3	LLYBZ	LLOYDS BANKING	ADR Repstg Pref Ser A 144A (United Kingdom)
539439AE9	LLYKY	LLOYDS BANKING	Sponsored ADR Representing Preferred Shares Fixed to Floating Reg S (United Kingdom)
539439AF6	LLYKZ	LLOYDS BANKING	ADR Repstg Pref Shs Fxd Fltg 144A (United Kingdom)
G5533WAB3	LLYZF	LLOYDS BANKING	Preferred Shares American Depositary receipt Representing Preferred 100 Shares Reg (-S Fixed to Floating) (United Kingdom)
539439AB5	LYGZY	LLOYDS BANKING GRP	Ordinary Shares (ADR representing preference shares Reg S) (United Kingdom)
55261FAG9	MTBPP	M&T BANK	Perpetual Preferred Series E Fixed to Floating
724481866	PBOWO	PITNEY BOWES INC	Preferred Series F 144a
693475AK1	PNCXL	PNC FINANCIAL	Depositary Shares Representing 1/100th Perpetual Preferred Series O
693475AM7	PNCYL	PNC FINANCIAL	Depositary Shares Representing 1/100th Perpetual Preferred Series R Fixed to Floating

CUSIP/CINS	Symbol	Issuer	Issue Description
74316E202	PSNNP	PROFESSIONAL SVC PFD	Preferred Stock
780097AU5	RLSPY	ROYAL BANK SCOTLAND	Sponsored ADR Ser U Repstg Pref U Shs (United Kingdom)
780097AE1	RBSLY	ROYAL BK SCOTLAND SE	American Depositary Shares
84129X206	SCSGP	SOUTHCREST FINL GROU	Preferred
846425841	SBSAO	SPAN BROAD SER B PFD	Series B Preferred Stock
900151507	TYABF	TURKIYE IS BANKA REG	Spons Reg S GDR
949746PM7	WFCNO	WELLS FARGO	Perp Pfd Cl A Ser K Fixed/Fltg
982356206	WRGFP	WRIGHT G F STL & WIR	Preferred Stock
98389Q206	XCSTP	XCELARATOR STUDI PFD	Preferred Stock
989701BD8	ZIONP	ZIONS BANC	Perpetual Preferred Series I
989701BF3	ZIONO	ZIONS BANCORPORATION	Series J Fixed/Floating Rate Non-Cumulative Perpetual Preferred Stock

## Security Futures

### April 2014 Supplement to the Security Futures Risk Disclosure Statement

Implementation Date: June 23, 2014

#### Executive Summary

FINRA has released the [April 2014 Supplement](#) (Supplement) to the October 2002 [Security Futures Risk Disclosure Statement](#) (Statement).<sup>1</sup> The Supplement adds new disclosure to accommodate proposed changes by OneChicago, LLC, to list a product with a physical delivery settlement cycle shorter than three business days. The implementation date of the Supplement is June 23, 2014.

Questions concerning this *Notice* should be directed to Matthew E. Vitek, Assistant General Counsel, Office of General Counsel, at (202) 728-8156.

#### Background & Discussion

FINRA has released the Supplement to the Statement. The Statement contains general disclosures on the characteristics and risks of security futures. The Supplement accommodates proposed changes by OneChicago, LLC, to list a product with a physical delivery settlement cycle shorter than three business days. The Supplement discloses that settlement by physical delivery may be effected on a timeframe shorter than three business days based on the rules of the exchange and subject to the National Securities Clearing Corporation's Rules and Procedures. As with the [previous supplement](#) to the Statement, the Supplement should be read in conjunction with the Statement.

FINRA Rule 2370(b)(11) requires a firm to deliver the current Statement to each customer at or prior to the time such customer's account is approved for trading security futures. Thereafter, the rule requires the firm to distribute each new or revised Statement to each customer having an account approved for such trading or, in the alternative, not later than the time a confirmation of a transaction is delivered to each customer that enters into a security futures transaction. Firms may separately distribute new supplements to such customers; firms are not required to redistribute the entire Statement or the earlier supplement.

#### May 2014

##### Notice Type

- ▶ Guidance

##### Suggested Routing

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

##### Key Topics

- ▶ Security Futures
- ▶ Security Futures Risk Disclosure Statement

##### Referenced Rules & Notices

- ▶ FINRA Rule 2370
- ▶ NTM 98-3

FINRA reminds firms that they may electronically transmit documents that they are required to furnish to customers under FINRA rules, including the Supplement, provided firms adhere to the standards contained in the SEC's May 1996 and October 1995 releases on electronic delivery,<sup>2</sup> and as discussed in [Notice to Members 98-3](#). Firms also may transmit the proposed supplement to customers through the use of a hyperlink, provided that customers have consented to electronic delivery.

The implementation date of the Supplement is June 23, 2014.

## Endnotes

1. See Securities Exchange Act Release No. 71981 (April 21, 2014), 79 FR 23034 (April 25, 2014) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change; File No. SR-FINRA-2014-019).
2. See Securities Act Release No. 7288 (May 9, 1996), 61 FR 24644 (May 15, 1996) and Securities Act Release No. 7233 (October 6, 1995), 60 FR 53458 (October 13, 1995).

# Election Notice

## Upcoming FINRA Board of Governors Election

**Petitions for Candidacy Due: June 20, 2014**

### Executive Summary

The annual meeting of FINRA firms will take place on or about Wednesday, August 6, 2014, to elect one Small Firm Governor and one Large Firm Governor to the FINRA Board of Governors (FINRA Board).

A formal notice of the meeting, including the precise date, time and location, will be mailed to executive representatives on or about July 7, 2014.

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

**Note: FINRA distributed this *Notice* electronically to the executive representative of each FINRA firm and it is posted online at [www.finra.org/Notices/Election/050614](http://www.finra.org/Notices/Election/050614). Executive representatives should circulate this *Notice* to their firms' branch managers.**

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

- ▶ Marcia E. Asquith, Senior Vice President and Corporate Secretary, at (202) 728-8949; or
- ▶ Jennifer Piorko Mitchell, Deputy Corporate Secretary, at (202) 728-8415.

**May 6, 2014**

### Suggested Routing

- ▶ Executive Representatives
- ▶ Senior Management

## Composition of the Board

The FINRA Board consists of 24 members,<sup>1</sup> including:

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

Of the 24 Board members, Public Governors, the Floor Member Governor, the Independent Dealer/Insurance Affiliate Governor and the Investment Company Affiliate Governor (Appointed Governors) are appointed by the FINRA Board from candidates recommended by the Nominating Committee.

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

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

- ▶ a small firm is defined as a firm that employs at least one and no more than 150 registered persons;<sup>2</sup>
- ▶ a mid-size firm is defined as a firm that employs at least 151 and no more than 499 registered persons;<sup>3</sup> and
- ▶ a large firm is defined as a firm that employs 500 or more registered persons.<sup>4</sup>

## Terms and Term Limits

Governors are appointed or elected for three-year terms to replace those whose terms expire. Governors may not serve more than two consecutive terms. If a governor is elected or appointed to fill a vacancy for a term of less than one year, the governor may serve up to two consecutive terms following the expiration of the governor's initial term.

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

## FINRA Nominating Committee Nominees

Pursuant to Article VII, Section 9 of the FINRA By-Laws, the FINRA Nominating Committee has nominated Gregory Fleming, Morgan Stanley Smith Barney for the Large Firm Governor seat. A profile of the nominee is attached.

With respect to the Small Firm Governor seat, the Nominating Committee determined it would not nominate a candidate for election in 2014. Instead, any eligible candidates who obtain the requisite number of valid petitions will be included on the ballot.

## Petition Process for Additional Candidates

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

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

As of close of business on Monday, May 5, 2014, the number of FINRA small firms was 3,781 and the number of large firms was 174.

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

The petition must identify the seat for which the petitioner is seeking to be nominated. The petitioner must submit sufficient information to determine the person's status with respect to the category for which he or she is petitioning to be nominated. The petitioner must also provide information sufficient for the corporate secretary to determine that the petitions are duly executed by the executive representatives of the requisite number of applicable size firm members. In addition, to assist in the process of verifying petitions, FINRA requests that all petitions submitted be dated by their signatory. **Petitions must be submitted no later than Friday, June 20, 2014.**

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

## Voting Eligibility

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

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

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

## Endnotes

1. See Article Eighth, paragraph (b) of the Restated Certificate of Incorporation of FINRA; Article VII, Section 4 of the FINRA By-Laws.
2. See Article I (ww) of the FINRA By-Laws.
3. See Article I (cc) of the FINRA By-Laws.
4. See Article I (y) of the FINRA By-Laws.

### Profile of Large Firm Governor Nominee

**GREGORY J. FLEMING** is the president of Morgan Stanley Wealth Management and president of Morgan Stanley Investment Management. He also serves as a member of the Morgan Stanley Operating Committee.

Mr. Fleming joined Morgan Stanley in February 2010 as president of Morgan Stanley Investment Management and assumed the additional role leading Wealth Management in January 2011.

Prior to joining the firm, Mr. Fleming served as president and chief operating officer of Merrill Lynch from June 2007 to early 2009. Previously Mr. Fleming ran Merrill Lynch's Global Investment Banking business and joined Merrill Lynch as an investment banker in 1992. He also has been a principal at Booz Allen Hamilton. After leaving Merrill Lynch in January of 2009 after 17 years, Mr. Fleming was a senior research scholar and Distinguished Visiting Fellow of the Center for the Study of Corporate Law at Yale Law School.

Mr. Fleming is a governor of the Financial Industry Regulatory Authority (FINRA), a director of Colgate University, a member of the Board of Advisors for the Yale Law School Center for the Study of Corporate Law, the Council on Foreign Relations, the Economic Club of New York, a Director on Turn 2 Foundation Board and a trustee for the Rippowam-Cisqua School in Bedford, NY. He is a Phi Beta Kappa, summa cum laude graduate in economics from Colgate University and received his J.D. from Yale Law School.