January 2011

Notices

Regulatory Notices

Information Notice

FINRA®

Financial Industry Regulatory Authority

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

Regulatory Notice 11-01

BD and IA Renewals for 2011

2011 Final Renewal Statements for Broker-Dealers, Investment Adviser Firms, Agents and Investment Adviser Representatives, and Branches

Payment Deadline: February 4, 2011

Executive Summary

FINRA is issuing this *Notice* to help firms review, reconcile and respond to their Final Renewal Statements and reports that are currently available in Web CRD/IARD for the annual registration renewal process. The payment deadline is February 4, 2011.

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

Background & Discussion

Final Renewal Statements

On January 3, 2011, Final Renewal Statements and reports became available for viewing and printing in Web CRD. These statements reflect the final status of broker-dealer, registered representative, investment adviser firm and investment adviser representative registrations and/or notice filings as of December 31, 2010. Any adjustments in fees owed because of registration terminations, approvals, firm IA registrations or notice filings subsequent to the Preliminary Renewal Statement are included in this final reconciled statement.

If the amount assessed on the Final Renewal Statement is greater than the amount assessed on the Preliminary Renewal Statement, the additional renewal fees are due by February 4, 2011. If the amount assessed on the Final Renewal Statement is less than the amount assessed on the Preliminary Renewal Statement, FINRA has issued a credit to the firm's Web CRD/IARD Daily Account.

January 2011

Notice Type
- Renewals

Suggested Routing
- Compliance
- Finance
- Legal
- Operations
- Registered Representatives
- Registration
- Senior Management

Key Topics
- Web CRD®
- IARD™
- Registration
- Renewals

Referenced Rules & Notices
- NTM 02-48

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

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

FINRA must receive full payment of the Final Renewal Statement fees by February 4, 2011.

Renewal Payment

A Final Renewal Statement that reflects a zero balance requires no further action by the firm. If you believe your firm overpaid and is due a renewal refund, please check your firm's Daily Account to verify FINRA transferred the overpayment. As a service to firms, FINRA transferred all renewal overpayments to each firms' Daily Accounts on January 3, 2011. To request a refund check, have an appropriate signatory send a request on firm letterhead and mail to:

FINRA Finance Department
9509 Key West Avenue
Rockville, MD 20850

If the Final Renewal Statement reflects an amount due, FINRA must receive payment no later than February 4, 2011. Firms have four payment options:

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

Automatic Daily Account-to-Renewal Account Transfer

To facilitate payment of renewal fees, FINRA will automatically transfer funds from a firm's Daily Account to its Renewal Account on February 4, 2011, the Final Renewal Statement payment deadline. FINRA will transfer funds only if a firm has sufficient funds available in its Daily Account on February 4 to cover the full amount owed.

Please Note: If your firm does not want funds automatically transferred, ensure that FINRA receives your payment by February 4. Separately, if your firm wishes to transfer funds between affiliated firms, submit a **Web CRD/IARD Account Transfer Form** available on the FINRA website prior to the renewal deadline.

Web CRD/IARD E-Pay

The Web CRD/IARD E-Pay application is accessible from the Final Renewal Statement and the **FINRA** or **IARD** websites. E-Pay allows a firm to make an electronic payment from a designated bank account to its Web CRD/IARD Renewal Account. Please note that in order for funds to be posted to a firm's Renewal Account by February 4, 2011, firms must submit payment electronically, no later than 8 p.m. Eastern Time (ET) on February 2, 2011.

Check

The check should be drawn on the firm's account and you should plan for U.S. mail delivery and payment processing time. To ensure prompt processing of your renewal payment check:

- include a print-out of the first page of your Final Renewal Statement with payment (do not include any other forms or fee submissions);
- write your firm's CRD number and "Renewal" on the check memo line; and
- mail payment to:

U.S. Mail

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

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

Overnight or Express Delivery

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

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

Wire Payment

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

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

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

- inform the bank to credit the funds to the FINRA bank account;
- provide the firm's CRD number and "Renewal" as reference only; and
- record the confirmation number of the wire transfer provided by the bank.

Renewal Reports

Renewal reports include all individual registrations renewed for 2011; however, they do not include registrations that were "pending approval" or "deficient" at year-end. Firms should examine their reports carefully to ensure that all registration approvals are correct. FINRA also suggests that firms include these reports in firms' permanent records.

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

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

Discrepancies

If a firm finds any discrepancies between its records and those maintained on Web CRD/IARD, the firm must report the discrepancy to FINRA at the same address used for refund requests. Firms must report all discrepancies by February 4, 2011. Copies of appropriate documentation from the firm's Web CRD/IARD queues, such as a Web CRD-generated notice of termination, notification of deficient condition, or notice of approval, should be readily available upon request by FINRA.

The 2011 Renewal Program Bulletin contains detailed instructions to help firms complete the renewal process. This publication is available at *www.finra.org/renewals*.

Regulatory Notice 11-02

Know Your Customer and Suitability

SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations

Effective Date: October 7, 2011

Executive Summary

The SEC approved FINRA's proposal to adopt rules governing know-your-customer and suitability obligations[1] for the consolidated FINRA rulebook.[2] The new rules are based in part on and replace provisions in the NASD and NYSE rules.

The text of the new rules is set forth in Attachment A. The rules take effect on October 7, 2011.

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

Discussion

The know-your-customer and suitability obligations are critical to ensuring investor protection and promoting fair dealing with customers and ethical sales practices. As part of the process of developing the consolidated FINRA rulebook, FINRA proposed and the SEC approved FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability). The new rules retain the core features of these important obligations and at the same time strengthen, streamline and clarify them.[3] The new rules are discussed separately below.

January 2011

Notice Type

- Consolidated FINRA Rulebook
- Rule Approval

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topics

- Know Your Customer
- Suitability

Referenced Rules & Notices

- FINRA Rule 2090
- FINRA Rule 2111
- Information Notice 3/12/08
- NASD IM-2210-6
- NASD IM-2310-2
- NASD Rule 2310
- NASD Rule 3110
- NTM 01-23
- NYSE Rule 405
- SEA Rule 17a-3

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Know Your Customer

In general, new FINRA Rule 2090 (Know Your Customer) is modeled after former NYSE Rule 405(1) and requires firms to use "reasonable diligence,"[4] in regard to the opening and maintenance[5] of every account, to know the "essential facts" concerning every customer.[6] The rule explains that "essential facts" are "those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."[7] The know-your-customer obligation arises at the beginning of the customer-broker relationship and does not depend on whether the broker has made a recommendation. Unlike former NYSE Rule 405, the new rule does not specifically address orders, supervision or account opening—areas that are explicitly covered by other rules.

Suitability

New FINRA Rule 2111 generally is modeled after former NASD Rule 2310 (Suitability) and requires that a firm or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile."[8] The rule further explains that a "customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."[9]

The new rule continues to use a broker's "recommendation" as the triggering event for application of the rule and continues to apply a flexible "facts and circumstances" approach to determining what communications constitute such a recommendation. The new rule also applies to recommended investment strategies, clarifies the types of information that brokers must attempt to obtain and analyze, and discusses the three main suitability obligations. Finally, the new rule modifies the institutional-investor exemption in a number of important ways.

Recommendations

The determination of the existence of a recommendation has always been based on the facts and circumstances of the particular case.[10] That remains true under the new rule. FINRA reiterates, however, that several guiding principles are relevant to determining whether a particular communication could be viewed as a recommendation for purposes of the suitability rule.

For instance, a communication's content, context and presentation are important aspects of the inquiry. The determination of whether a "recommendation" has been made, moreover, is an objective rather than subjective inquiry.[11] An important factor in this regard is whether—given its content, context and manner of presentation—a particular communication from a firm or associated person to a customer reasonably would be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or investment strategy. In addition, the more individually tailored the communication is to a particular customer or customers about a specific security or investment strategy, the more likely the communication will be viewed as a recommendation. Furthermore, a series of actions that may not constitute recommendations when viewed individually may amount to a recommendation when considered in the aggregate. It also makes no difference whether the communication was initiated by a person or a computer software program. These guiding principles, together with numerous litigated decisions and the facts and circumstances of any particular case, inform the determination of whether the communication is a recommendation for purposes of FINRA's suitability rule.

Strategies

The new rule explicitly applies to recommended investment strategies involving a security or securities.[12] The rule emphasizes that the term "strategy" should be interpreted broadly.[13] The rule is triggered when a firm or associated person recommends a security or strategy regardless of whether the recommendation results in a transaction. Among other things, the term "strategy" would capture a broker's *explicit* recommendation to hold a security or securities.[14] The rule recognizes that customers may rely on firms' and associated persons' investment expertise and knowledge, and it is thus appropriate to hold firms and associated persons responsible for the recommendations that they make to customers, regardless of whether those recommendations result in transactions or generate transaction-based compensation.

FINRA, however, exempted from the new rule's coverage certain categories of educational material—which the strategy language otherwise would cover—as long as such material does not include (standing alone or in combination with other communications) a recommendation of a particular security or securities.[15] FINRA believes that it is important to encourage firms and associated persons to freely provide educational material and services to customers.

Customer's Investment Profile

The new rule includes an expanded list of explicit types of information that firms and associated persons must attempt to gather and analyze as part of a suitability analysis. The new rule essentially adds age, investment experience, time horizon, liquidity needs and risk tolerance[16] to the existing list (other holdings, financial situation and needs, tax status and investment objectives).[17] Recognizing that not every factor regarding a "customer's investment profile" will be relevant to every recommendation, the rule provides flexibility concerning the type of information that firms must seek to obtain and analyze.[18] However, because the listed factors generally are relevant (and often crucial) to a suitability analysis, the rule requires firms and associated persons to document with specificity their reasonable basis for believing that a factor is not relevant in order to be relieved of the obligation to seek to obtain information about that factor.[19]

Main Suitability Obligations

The new suitability rule lists in one place the three main suitability obligations: reasonable-basis, customer-specific and quantitative suitability.[20]

- Reasonable-basis suitability requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the firm's or associated person's familiarity with the security or investment strategy. A firm's or associated person's reasonable diligence must provide the firm or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy.
- Customer-specific suitability requires that a broker have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile. As noted above, the new rule requires a broker to attempt to obtain and analyze a broad array of customer-specific factors.
- Quantitative suitability requires a broker who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile. Factors such as turnover rate, cost-equity ratio and use of in-and-out trading in a customer's account may provide a basis for finding that the activity at issue was excessive.

The new rule makes clear that a broker must have a firm understanding of both the product and the customer.[21] It also makes clear that the lack of such an understanding itself violates the suitability rule.[22]

Institutional-Investor Exemption

FINRA Rule 2111(b) provides an exemption to customer-specific suitability for recommendations to institutional customers under certain circumstances. The new exemption harmonizes the definition of institutional customer in the suitability rule with the more common definition of "institutional account" in NASD Rule 3110(c)(4).[23] Beyond the definitional requirements, the exemption's main focus is whether the broker has a reasonable basis to believe the customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies,[24] and whether the institutional customer affirmatively acknowledges that it is exercising independent judgment.[25]

In regard to an institutional investor, a firm that satisfies the conditions of the exemption fulfils its customer-specific obligation,[26] but not its reasonable-basis and quantitative obligations under the suitability rule. FINRA believes that, even when institutional customers are involved, it is crucial that brokers understand the securities they recommend and that those securities are appropriate for at least some investors. FINRA also believes that it is important that a firm not recommend an unsuitable number of transactions in those circumstances where it has control over the account. FINRA emphasizes, however, that quantitative suitability generally would apply only with regard to that portion of an institutional customer's portfolio that the firm controls and only with regard to the firm's recommended transactions.[27]

Endnotes

1 *See* Securities Exchange Act Release No. 63325 (November 17, 2010), 75 FR 71479 (November 23, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039).

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

3 To the extent that past *Notices to Members, Regulatory Notices*, case law, etc., do not conflict with new rule requirements or interpretations thereof, they remain potentially applicable, depending on the facts and circumstances of the particular case.

4 FINRA notes that it replaced the term "due diligence" used in former NYSE Rule 405(1) with the term "reasonable diligence" in new FINRA Rule 2090 for consistency with the language used in new FINRA Rule 2111. FINRA did not intend by such action to impair or adversely affect established case law and other interpretations discussing the diligence that is required to comply with know-your-customer or suitability obligations.

5 A broker-dealer must know its customers not only at account opening but also throughout the life of its relationship with customers in order to, among other things, effectively service and supervise the customers' accounts. Since a broker-dealer's relationship with its customers is dynamic, FINRA does not believe that it can prescribe a period within which broker-dealers must attempt to update this information. As with a customer's investment profile under the suitability rule, a firm should verify the "essential facts" about a customer under the know-your-customer rule at intervals reasonably calculated to prevent and detect any mishandling of a customer's account that might result from the customer's change in circumstances. The reasonableness of a broker-dealer's efforts in this regard will depend on the facts and circumstances of the particular case. Firms should note, however, that SEA Rule 17a-3 requires broker-dealers to, among other things, attempt to update certain account information every 36 months regarding accounts for which the broker-dealers were required to make suitability determinations.

6 FINRA Rule 2090.

7 FINRA Rule 2090.01.

8 FINRA Rule 2111(a). Former NASD Rule 2310 contained interpretative material (IMs) discussing a variety of types of misconduct. Although FINRA eliminated those IMs, most of the types of misconduct that the IMs discussed were either explicitly covered by other rules or incorporated in some form into the new suitability rule. The exception was unauthorized trading, which had been discussed in IM-2310-2. However, it is well-settled that unauthorized trading violates just and equitable principles of trade under FINRA Rule 2010 (previously NASD Rule 2110). *See, e.g., Robert L. Gardner*, 52 S.E.C. 343, 344 n.1 (1995), *aff'd*, 89 F.3d 845 (9th Cir. 1996) (table format); *Keith L. DeSanto*, 52 S.E.C. 316, 317 n.1 (1995), *aff'd*, 101 F.3d 108 (2d Cir. 1996) (table format); Jonathan G. Ornstein, 51 S.E.C. 135, 137 (1992); *Dep't of Enforcement v. Griffith*, No. C01040025, 2006 NASD Discip. LEXIS 30, at *11-12 (NAC December 29, 2006);

Endnotes continued

Dep't of Enforcement v. Puma, No. C10000122, 2003 NASD Discip. LEXIS 22, at *12 n.6 (NAC August 11, 2003). The new suitability rule does not alter that conclusion. Unauthorized trading continues to be serious misconduct that violates FINRA Rule 2010.

9 FINRA Rule 2111(a).

10 *See Michael Frederick Siegel*, Securities Exchange Act Release No. 58737, 2008 SEC LEXIS 2459, at *21 (October 6, 2008) (explaining that whether a communication "constitutes a recommendation is a 'facts and circumstances inquiry to be conducted on a case-by-case basis'"), *aff'd in relevant part*, 592 F.3d 147 (D.C. Cir. 2010), *cert. denied*, 2010 U.S. LEXIS 4340 (May 24, 2010). FINRA has stated that "defining the term 'recommendation' is unnecessary and would raise many complex issues in the absence of specific facts of a particular case." Securities Exchange Act Release No. 37588, 1996 SEC LEXIS 2285, at *29 (August 20, 1996), 61 FR 44100, 44107 (August 27, 1996) (Notice of Filing and Order Granting Accelerated Approval of NASD's Interpretation of Its Suitability Rule).

11 FINRA has repeatedly explained that a broker cannot avoid suitability obligations through a disclaimer where—given its content, context and presentation—the particular communication reasonably would be viewed as a recommendation. *See Notice to Members 01-23* (April 2001). FINRA Rule 2111.02, moreover, explicitly states that a firm or associated person "cannot disclaim any responsibilities under the suitability rule." In the same vein, it is well-settled that a "broker's recommendations must be consistent with his customer's best interests" and are "not suitable merely because the customer acquiesces in [them]." *Dane S. Faber*, Securities Exchange Act Release No. 49216, 2004 SEC LEXIS 277, at *23-24 (February 10, 2004); *see also Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *12 (NAC August 9, 2004) ("[A] broker's recommendations must serve his client's best interests and the test for whether a broker's recommendations are suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs").

12 *See* FINRA Rules 2111(a) and 2111.03.

13 *Id.*

14 *Id.* The new rule does not, however, broaden the scope of *implicit* recommendations. In limited circumstances, FINRA and the SEC have recognized that implicit recommendations can trigger suitability obligations. For example, FINRA and the SEC have held that associated persons who effect transactions on a customer's behalf without informing the customer have implicitly recommended those transactions, thereby triggering application of the suitability rule. *See, e.g., Rafael Pinchas*, 54 S.E.C. 331, 341 n.22 (1999) ("Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of the NASD rules."); *Paul C. Kettler*, 51 S.E.C. 30, 32 n.11 (1992) (stating that transactions a broker effects for a discretionary account are recommended). Although such holdings continue to act as precedent regarding those issues, FINRA notes that nothing in the new rule is intended to change the longstanding application of the suitability rule on a recommendation-by-recommendation basis. The new rule would not apply, for instance, to *implicit* recommendations to hold securities that are transferred into an account.

Endnotes continued

15 *See* FINRA Rule 2111.03.

16 During the rulemaking process, some commenters argued that factors such as a customer's investment experience, time horizon and risk tolerance are ones to be considered when reviewing a customer's portfolio as a whole, not the individual trades. According to those commenters, requiring consideration of such factors on a trade-by-trade basis would prevent customers from creating a diverse portfolio made up of securities with different levels of liquidity, risk and time horizons. FINRA reiterates that a recommendation-by-recommendation analysis and consideration of a customer's investment portfolio are not mutually exclusive concepts. Although suitability is a recommendation-by-recommendation analysis, FINRA Rule 2111 explicitly permits the suitability analysis to be performed within the context of the customer's other investments. In fact, the rule requires (as did the previous suitability rule) firms and associated persons to make reasonable efforts to gather and analyze information about a customer's other investments as part of the suitability review. Moreover, the new rule explicitly covers recommended investment strategies.

17 *See* FINRA Rule 2111(a).

18 *See* FINRA Rule 2111.04.

19 *Id.*

20 *See* FINRA Rule 2111.05.

21 *See* FINRA Rule 2111(a); FINRA Rule 2111.04; FINRA Rule 2111.05(a).

22 *See* FINRA Rules 2111.04 and 2111.05(a).

23 *See* FINRA Rule 2111(b). FINRA is proposing to adopt NASD Rule 3110(c)(4) as FINRA Rule 4512(c), without material change. *See* Securities Exchange Act Release No. 63181 (October 26, 2010), 75 FR 67155 (November 1, 2010) (Notice of Filing Proposed Rule Change; File No. SR-FINRA-2010-052).

24 *See* FINRA Rule 2111(b). FINRA reiterates that, in some cases, the broker may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a broker's customer-specific obligations under the suitability rule would not be diminished by the fact that the broker was dealing with an institutional customer. However, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent decision.

25 FINRA Rule 2111(b).

26 FINRA emphasizes that the institutional-customer exemption applies only if all of the conditions in Rule 2111(b) are satisfied. It is not sufficient, for example, that an institutional customer affirmatively indicates that it is exercising independent judgment in evaluating recommendations. The institutional customer also must meet the definitional criteria and the broker must have a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies.

Endnotes continued

27 It is axiomatic that the suitability rule applies only to recommended transactions. *See, e.g., Dep't of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *46 (July 30, 2009) (explaining that transactions that were not recommended could not be used to inflate the cost-to-equity ratio and the turnover rate). Case law also has long established that quantitative suitability "occurs when a registered representative has control over trading in an account and the level of activity in that account is inconsistent with the customer's objectives and financial situation." *Harry Gliksman*, 54 S.E.C. 471, 475 (1999), *aff'd*, 24 F. App'x 702 (9th Cir. 2001); *see also Pinchas*, 54 S.E.C. at 337 (same). In general, the control element "is satisfied if the broker has either discretionary authority or de facto control over the account. De facto control is established when the client routinely follows the broker's advice 'because the customer is unable to evaluate the broker's recommendations and to exercise independent judgment.'" *Medeck*, 2009 FINRA Discip. LEXIS 7, at *34 (citations omitted).

In *Pryor, McClendon, Counts & Co.*, Securities Exchange Act Release No. 45402, 2002 SEC LEXIS 284 (February 6, 2002), the SEC analyzed allegations of churning by focusing on that portion of the city of Atlanta's portfolio that the broker-dealer respondent controlled and those transactions that the respondent recommended. *Id.* at *4, *15-16, *20-23. The SEC also held that, for purposes of churning, the respondent controlled the portion of Atlanta's portfolio at issue because the respondent engaged in a scheme to defraud Atlanta with the city's investment officer, who had authority to trade Atlanta's securities portfolio. *Id.* at *20-21 & n.10 (citing *Smith v. Petrou*, 705 F. Supp. 183, 187 (S.D.N.Y. 1989)).

Attachment A

Below is the text of the new FINRA rules.

* * * * *

2000. DUTIES AND CONFLICTS

* * * * *

2090. Know Your Customer

Every member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.

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

.01 Essential Facts. For purposes of this Rule, facts "essential" to "knowing the customer" are those required to (a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules.

* * * * *

2100. TRANSACTIONS WITH CUSTOMERS

2110. Recommendations

2111. Suitability

(a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.

(b) A member or associated person fulfills the customer-specific suitability obligation for an institutional account, as defined in NASD Rule 3110(c)(4), if (1) the member or associated person has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently, both in general and with regard to particular transactions and investment strategies involving a security or securities and (2) the institutional customer affirmatively indicates that it is exercising independent judgment in evaluating the member's or associated person's recommendations. Where an institutional customer has delegated decisionmaking authority to an agent, such as an investment adviser or a bank trust department, these factors shall be applied to the agent.

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

.01 General Principles. Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA's rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

.02 Disclaimers. A member or associated person cannot disclaim any responsibilities under the suitability rule.

.03 Recommended Strategies. The phrase "investment strategy involving a security or securities" used in this Rule is to be interpreted broadly and would include, among other things, an explicit recommendation to hold a security or securities. However, the following communications are excluded from the coverage of Rule 2111 as long as they do not include (standing alone or in combination with other communications) a recommendation of a particular security or securities:

(a) General financial and investment information, including (i) basic investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment, (ii) historic differences in the return of asset classes (e.g., equities, bonds, or cash) based on standard market indices, (iii) effects of inflation, (iv) estimates of future retirement income needs, and (v) assessment of a customer's investment profile;

(b) Descriptive information about an employer-sponsored retirement or benefit plan, participation in the plan, the benefits of plan participation, and the investment options available under the plan;

(c) Asset allocation models that are (i) based on generally accepted investment theory, (ii) accompanied by disclosures of all material facts and assumptions that may affect a reasonable investor's assessment of the asset allocation model or any report generated by such model, and (iii) in compliance with NASD IM-2210-6 (Requirements for the Use of Investment Analysis Tools) if the asset allocation model is an "investment analysis tool" covered by NASD IM-2210-6; and

(d) Interactive investment materials that incorporate the above.

.04 Customer's Investment Profile. A member or associated person shall make a recommendation covered by this Rule only if, among other things, the member or associated person has sufficient information about the customer to have a reasonable basis to believe that the recommendation is suitable for that customer. The factors delineated in Rule 2111(a) regarding a customer's investment profile generally are relevant to a determination regarding whether a recommendation is suitable for a particular customer, although the level of importance of each factor may vary depending on the facts and circumstances of the particular case. A member or associated person shall use reasonable diligence to obtain and analyze all of the factors delineated in Rule 2111(a) unless the member or associated person has a reasonable basis to believe, documented with specificity, that one or more of the factors are not relevant components of a customer's investment profile in light of the facts and circumstances of the particular case.

.05 Components of Suitability Obligations. Rule 2111 is composed of three main obligations: reasonable-basis suitability, customer-specific suitability, and quantitative suitability.

(a) The reasonable-basis obligation requires a member or associated person to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member's or associated person's familiarity with the security or investment strategy. A member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.

(b) The customer-specific obligation requires that a member or associated person have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile, as delineated in Rule 2111(a).

(c) Quantitative suitability requires a member or associated person who has actual or de facto control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive and unsuitable for the customer when taken together in light of the customer's investment profile, as delineated in Rule 2111(a). No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

.06 Customer's Financial Ability. Rule 2111 prohibits a member or associated person from recommending a transaction or investment strategy involving a security or securities or the continuing purchase of a security or securities or use of an investment strategy involving a security or securities unless the member or associated person has a reasonable basis to believe that the customer has the financial ability to meet such a commitment.

.07 Institutional Investor Exemption. Rule 2111(b) provides an exemption to customer-specific suitability regarding institutional investors if the conditions delineated in that paragraph are satisfied. With respect to having to indicate affirmatively that it is exercising independent judgment in evaluating the member's or associated person's recommendations, an institutional customer may indicate that it is exercising independent judgment on a trade-by-trade basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions for its account.

* * * * *

Regulatory Notice 11-03

Order Audit Trail System (OATS)

FINRA Expands the Order Audit Trail System to All NMS Stocks

Effective Date: July 11, 2011

Executive Summary

The OATS order recording and reporting obligations in FINRA Rules 7410 through 7470 (OATS Rules) currently apply to orders for equity securities listed on the NASDAQ Stock Market and OTC equity securities. Effective July 11, 2011, FINRA will begin expanding, in three phases, the order recording and reporting obligations in the OATS Rules to include orders in all NMS stocks, in addition to OTC equity securities.[1]

FINRA is also announcing that it has published an updated edition of the *OATS Reporting Technical Specifications* that details the reporting changes that will become effective starting July 11, 2011. The January 11, 2011, version of the *OATS Reporting Technical Specifications* is available on FINRA's website at *www.finra.org/oats*.

Questions concerning this *Notice* should be directed to:

- Legal Section, Market Regulation, at (240) 386-5126; or
- Office of General Counsel, at (202) 728-8071.

For technical questions regarding OATS reporting, please contact the OATS Help Desk at (800) 321-6273.

January 2011

Notice Type

- Rule Amendment

Suggested Routing

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

Key Topics

- OATS

Referenced Rules & Notices

- NASD IM-1013-1
- NASD IM-1013-2
- Rule 7400 Series
- SEC Regulation NMS

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Background & Discussion

The OATS Rules currently impose obligations on FINRA member firms to record in electronic form and report to FINRA on a daily basis certain information about orders originated, received, transmitted, modified, canceled or executed by firms relating to OTC equity securities and equity securities listed and traded on The Nasdaq Stock Market, Inc. (NASDAQ).[2] Beginning July 11, 2011, FINRA will begin phasing in the expansion of the OATS Rules to include orders for all NMS stocks, as that term is defined in Rule 600(b)(47) of Regulation NMS.[3] This change effectively extends the OATS recording and reporting requirements to NMS stocks listed on markets other than NASDAQ (*e.g.*, NYSE, NYSE Amex and NYSE Arca).[4] The expansion of the OATS Rules to all NMS stocks will be accomplished in three phases based on the symbol of the security.[5] The phases will be implemented on July 11, 2011, July 18, 2011, and July 25, 2011. FINRA will announce at a later date the details of which security symbols will be subject to OATS reporting during each phase.

FINRA is also publishing a new edition of the *OATS Reporting Technical Specifications (OATS Technical Specifications)* that details the reporting obligations of firms subject to the OATS Rules in light of these amendments. Firms can find the January 11, 2011, version of the *OATS Technical Specifications* on FINRA's website at *www.finra.org/oats*.

To accommodate the increased volume of OATS data anticipated by the expansion, effective July 11, 2011, the reporting deadline to submit OATS data will be extended to 8:00 a.m. (from 5:00 a.m.) Eastern Time. Also effective July 11, FINRA will make the following changes, among others, to the OATS reporting system:

- create standard values for Receiving and Originating Department ID fields;
- add a new Order Origination Code;
- eliminate the Received By Desk ID;
- align the OATS Account Type Code with the NYSE Account Type Indicators;
- create a new Exchange Participant ID field on all Route Reports identifying routes to a national securities exchange;
- generally require each reporting MPID to use unique Routed Order IDs and Branch/Sequence Numbers each day; and
- reduce the allowable clock drift from three seconds to one second, and require timestamps to be reported to OATS in milliseconds if the firm captures the time in milliseconds.

These changes, as well as other changes to the OATS system and requirements, are described in detail in the January 11, 2011, version of the *OATS Technical Specifications*. Firms should carefully review the *OATS Technical Specifications* for more details on these changes.

Endnotes

1 *See* Securities Exchange Act Release No. 63311 (November 12, 2010), 75 FR 70757 (November 18, 2010).

2 FINRA Rule 7410 defines an "OTC equity security" for purposes of the OATS Rules as an equity security that is not an NMS stock, except that the term does not include restricted equity securities and direct participation programs, as those terms are defined in FINRA Rule 6420.

3 Rule 600(b)(47) of Regulation NMS defines "NMS stock" as "any NMS security other than an option." 17 CFR 242.600(b)(47). An "NMS security" is defined as "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." 17 CFR 242.600(b)(46).

4 In connection with the expansion of the OATS requirements, FINRA created an exclusion from the definition of "Reporting Member" in FINRA Rule 7410 to exclude certain orders received by firms that generally conduct their trading activities on the floor of an exchange. Under the exemption, a member firm will not be considered a "Reporting Member" with respect to an order if: (i) the firm was approved as a FINRA member pursuant to NASD IM-1013-1 or NASD IM-1013-2; (ii) the firm operates consistent with NASD IM-1013-1 or NASD IM-1013-2, including limiting its business operations to "permitted floor activities," as that term is defined in NASD IM-1013-1 and NASD IM-1013-2; and (iii) the order was received by the firm through systems operated and regulated by the NYSE or NYSE Amex.

5 Firms should report information to OATS using the symbol assigned by the listing exchange.

Regulatory Notice 11-04

Private Placements of Securities

FINRA Requests Comment on Proposed Amendments to FINRA Rule 5122 to Address Member Firm Participation in Private Placements

Comment Period Expires: March 14, 2011

Executive Summary

FINRA requests comment on a proposal to amend FINRA Rule 5122, which requires, subject to certain exemptions, disclosure in the offering document of the intended use of offering proceeds, expenses, and the amount of selling compensation to be paid to the broker-dealer and its associated persons, in any private placement in which a participating broker-dealer (or its control entity) is the issuer.[1] The rule also requires that at least 85 percent of the offering proceeds must be used for the business purposes identified in the offering document. Lastly, the rule requires each offering document to be submitted to FINRA to allow the staff to conduct *ex post* reviews to assess compliance with the rule and to identify problematic terms and conditions.

The amendments proposed in this *Notice* expand Rule 5122 to reach all private placements in which a member firm participates—not just those in which the member firm (or its control entity) is the issuer—while retaining nearly all of the existing exemptions, including those for offerings sold solely to certain institutions, qualified purchasers and other sophisticated investors. However, to reflect the broader scope of the proposed rule and its prior experience with Rule 5122, FINRA proposes to eliminate the exemption for offerings in which a member acts primarily in a wholesaling capacity.

The text of the proposed rules is available as Attachment A to this *Notice*.

Questions regarding this *Notice* should be directed to:

- Joseph E. Price, Senior Vice President, Corporate Financing/Advertising Regulation, at (240) 386-4623; or
- Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel, at (202) 728-8104.

January 2011

Notice Type

- Request for Comment

Suggested Routing

- Compliance
- Corporate Financing
- Executive Representative
- Legal
- Operations
- Senior Management

Key Topics

- Affiliates
- Institutional Accounts
- Member Private Offerings
- Offering Proceeds
- Private Placements
- Private Placement Memoranda
- Regulation D

Referenced Rules & Notices

- FINRA Rule 2010
- FINRA Rule 2020
- FINRA Rule 2111
- FINRA Rule 5122
- FINRA Rule 5110
- NASD Rule 2210
- NASD Rule 3010
- NTMs 03-71, 05-18 and 05-48
- Regulation D
- Regulatory Notices 09-05 and 09-27
- SEA Section 10(b)
- SEA Rule 10b-5
- Securities Act Section 17

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Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by March 14, 2011.

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

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

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

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

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments on its site one week after the end of the comment period.[2]

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

Background and Discussion

FINRA Rule 5122 was developed in response to abuses in the sale of private placements issued by broker-dealers and their control entities.[4] Rule 5122 generally requires, subject to certain exemptions, that a member firm or associated person engaging in a private placement of unregistered securities issued by the firm (or a control entity of the firm):

- disclose to investors in a private placement memorandum, term sheet or other offering document the intended use of offering proceeds, the offering expenses and the amount of compensation that will be paid to the broker-dealer and its associated persons;
- submit, via email, the offering document to the FINRA Corporate Financing Department at or prior to the time it is provided to any prospective investor; and
- comply with the requirement that at least 85 percent of the offering proceeds raised may not be used to pay for offering costs, discounts, commissions or any other cash or non-cash sales incentives, and must be used for the business purposes disclosed in the offering document.[5]

FINRA staff conducts *ex post* reviews of offering documents to assess compliance with the rule and to identify problematic terms and conditions. Occasionally, when warranted, FINRA will contact a member firm and request additional information regarding the use of proceeds or other clarifying information. The rule does not require that completion of an offering be delayed until FINRA staff has issued a "no-objections" letter, as FINRA Rule 5110 requires with respect to public offerings.

Rule 5122 defines "control" as beneficial interest of more than 50 percent of the outstanding voting securities of a corporation or the right to more than 50 percent of the distributable profits or losses of a non-corporate entity. The rule also provides various exemptions, including offerings of private placements:

- to institutional accounts, qualified purchasers, qualified institutional buyers, investment companies and banks;
- to employees of the issuer (or its control entity) and securities issued in certain conversions, stock splits and restructuring transactions;
- of exempted securities, certain notes with short-term maturities, variable contracts, modified guaranteed annuity contracts and life insurance policies, commodity pools, options and other derivatives not based principally on the member's (or its control entity's) securities, unregistered investment grade rated debt and preferred securities; and
- in which the member acts primarily in a wholesaling capacity, as evidenced by an agreement to sell less than 20 percent of the offered securities in retail transactions.

Rule 5122 plays an important part in the effort to protect investors in the narrow segment of the private placement market it was designed to address. It does not, however, address private placements in which the issuer is neither a broker-dealer nor its control entity.[6] The vast majority of private placements remain outside the scope of the rule. As an illustration, FINRA has received approximately 300 filings pursuant to Rule 5122 during the first year that the rule has been in effect, whereas several thousand Form Ds are filed annually with the SEC in connection with private placements.[7]

To provide investors with additional protection from fraud and abuse, FINRA proposes to amend Rule 5122 to govern all private placements in which a member participates, subject to certain exemptions.

Proposed Rule Changes

As described below, FINRA proposes to expand the rule to reach any private placement in which a member participates, subject to all but one of the exemptions that exist in the rule today.

Participation in a Private Placement

The proposed amendments incorporate the definition of "participation" from Rule 5110 (Corporate Financing Rule), which corresponds to the types of services typically provided by a broker-dealer in a private placement.[8] Because designation as a "control entity" would no longer be relevant to the scope of the rule, the proposed amendments delete that term.

Disclosure Requirements

Given the expanded scope of the amended rule, FINRA proposes that member firms participating in a private placement of securities issued by an affiliate alert investors to potential conflicts of interest. Specifically, the proposed amendments require that the offering document disclose if a participating member is an affiliate of the issuer and the nature of the affiliation.[9] In several recent SEC and FINRA enforcement cases concerning private placements, a participating broker-dealer was affiliated with the issuer, and this affiliation facilitated the broker-dealer's misuse or conversion of offering proceeds.[10]

To ensure that the disclosure requirements reach the amount and type of *any* compensation that will be paid directly or indirectly to a participating member firm for its associated persons in connection with a private placement subject to the rule, the proposed amendments replace the term "selling compensation" with the term "compensation."[11]

Filing With FINRA

Under the proposed amendments, as under the current rule, an offering document for any private placement subject to the rule would have to be filed with FINRA at or prior to the first time it is provided to any prospective investor. As under the current rule, the filing requirement would not impose any delay in the offering. The offering may proceed while FINRA staff reviews the offering document. Of course, if FINRA staff determines that an offering document presents an apparent investor protection issue, the responsible member should expect FINRA staff to contact the broker-dealer concerning the matter, whether or not the offering has already commenced.

Use of Offering Proceeds

Under the proposed amendments, as under the current rule, at least 85 percent of the offering proceeds of a private placement subject to the rule may not be used to pay for offering costs and compensation, and must be used for business purposes disclosed in the offering document. Neither the current rule nor the proposed amendments place any limitation on the amount that may be paid for offering costs and compensation. They merely restrict the *percentage of offering proceeds* that may be used for those purposes. This provision has had the salutary effect of ensuring that the offering document discloses the business purposes of the offering, that investors' money is dedicated to those business purposes, and that no more than 15 percent of the money raised is used to pay for offering costs and compensation. For that reason, we propose to preserve this provision in the expanded rule.

In addition, to conform to proposed changes in the section on disclosures discussed above,[12] the proposed amendments replace the phrase "any other cash or non-cash sales incentives" with the phrase "any other compensation to participating broker-dealers or associated persons."

Elimination of Wholesaling Exemption

The proposed amendments eliminate the existing exemption under Rule 5122(c) for offerings in which a member acts primarily in a wholesaling capacity. The basis for this exemption was that distribution of the private placement by independent retail broker-dealers would obviate the need for the rule, which focused on private placements in which the selling member or its control entity was the issuer. However, recent enforcement cases have involved private placements in which a broker-dealer affiliated with an issuer acted primarily as the wholesaler, thus demonstrating the need for more investor protection.[13] Moreover, given that the proposed amendments expand the rule to reach all private placements, the reliance upon the efforts of an "independent" broker-dealer is no longer relevant.

Request for Comment

FINRA specifically requests comment on certain aspects of the proposed amendments. Are any other modifications to the requirements concerning use of proceeds, disclosure and filing, other than those proposed, necessary or appropriate to afford protection to investors, in light of the proposed expansion of the rule? Are there any additional investor protections that the rule should provide? Do the exemptions in the proposed rule continue to ensure that the types of private placements that generally have not presented investor protection concerns will be excluded from the rule?

Based on FINRA's experience with the current rule, it does not appear that the filing requirement has been unnecessarily burdensome to firms. As discussed above, the filing requirement does not require any delay in the offering while FINRA staff reviews the filing. Nevertheless, are there any improvements in the filing process that could ensure that firms are not subject to unnecessary burdens? Are there any approaches that could further improve the efficiency of the filing process?

We also request comment on the existing requirement that at least 85 percent of the offering proceeds of a private placement subject to the rule may not be used to pay for offering costs and compensation and must be used for the business purposes disclosed in the offering document. Neither the current rule nor the proposed amendments place any limitation on the amount that may be paid for offering costs and compensation. They merely restrict the *percentage of offering proceeds* that may be used for those purposes. Nevertheless, we request comment on whether this requirement imposes an unnecessary burden on smaller private placements. If so, please provide specific examples of these burdens.

Endnotes

1 The term "private placement" refers to a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act of 1933.

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

3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing.

4 *See e.g., SEC v. Provident Royalties, LLC.*, SEC Complaint No. 3-09-cv-1238-L (filed July 1, 2009), Litigation Release No. 21118 (July 7, 2009) and related FINRA case *Dep't of Enforcement v. Provident Asset Management, LLC, AWC* No. 2009017497201 (March 17, 2010) (private placements sold to thousands of investors using offering documents that contained material omissions regarding the use of offering proceeds). *In re David V. Siegel*, Rel. 34-62803 (August 31, 2010) and *In re Axiom Capital Management*, Exchange Act Release No.61563 (February 22, 2010) (SEC found Siegel and Axiom failed to supervise unsuitable sales of private placements made by registered representatives to customers who were elderly, retired with limited income and risk averse); *In re Mark Tuminello*, Exchange Act Release No. 59739 (April 9, 2009) (SEC found that Tuminello failed to disclose material information and concealed facts that made models incorporated into the private placement offering documents misleading); *In re Ross Owen Haugen*, Exchange Act Release No.59458 (February 26, 2009) (SEC found that Haugen sold $15 million in private placement securities and made false representations that contradicted statements in the private placement memorandum); *In re Jeffrey L. Gibson*, (SEC Opinion) Exchange Act Release No. 57266 (February 4, 2008) (SEC found that Gibson raised $875,000 in connection with the offer and sale of a private placement and then misappropriated $450,000 to purchase commercial real property); *In re Maria T. Giesige*, (SEC Opinion) Exchange Act Release No. 60000 (May 29, 2009) (SEC found that Giesige raised $1.49 million in a private placement that resembled a Ponzi scheme and failed to perform due diligence on the issuer prior to recommending that clients invest in the offering). *See also, Dep't of Enforcement v. Pinnacle Partners Financial Corporation*, Complaint No. 2010021324501 (Press Rel. December 3, 2010); *SEC v. Medical Capital Holdings, Inc.*, Litigation Release No. 21141 (July 20, 2009).

5 Rule 5122 became effective on June 17, 2009.

6 FINRA has issued guidance concerning a broker-dealer's responsibilities with respect to private placements. In April 2010, FINRA published *Regulatory Notice 10-22*, which reminds broker-dealers of their regulatory obligations under FINRA's suitability rule and the anti-fraud requirements of the federal securities laws to conduct a reasonable investigation of the issuer and securities they recommend in private placements.

Endnotes continued

7 *See* Report of U.S. Securities and Exchange Commission, Office of Inspector General, Office of Audits (March 31, 2009), which noted that in 2008 there were over 20,000 Form D filings that represented total estimated offerings of $609 billion. FINRA staff's review of a sample of filings made in 2010 indicates that approximately 15 percent disclosed broker-dealer participation in a particular offering.

8 Rule 5110(a)(5) defines "participation" as the following:

Participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to SEC Rule 13e-3.

9 An "affiliate" would be defined as a company that controls, is controlled by or is under common control with a broker-dealer.

10 *See e.g., Provident, supra* note 4, in which the controlling broker-dealer told investors that 86 percent of the offering proceeds would be allocated to oil and gas investments when in fact more than 50 percent of the proceeds were used to pay the dividends and expenses of earlier offerings.

11 The term "selling" was improperly viewed by some as narrowing the disclosure requirements beyond those which were intended by the rule.

12 *See supra* note 11.

13 *See e.g., Provident, supra* note 4; *SEC v. Sunwest Management Inc.*, Case No. CV-06056-TC, Litigation Release No. 20920 (March 2, 2009); and *State of Idaho v. Douglas Swenson, DBSI, Inc., et al.*, Complaint No. cv0C0900859 (January 14, 2009). The SEC alleged that Sunwest and its affiliated broker-dealer that acted as the wholesaler in a private placement that raised over $300 million from more than 1,300 investors made false promises of high annual returns while concealing that proceeds from new investors were commingled to pay other investors. The State of Idaho alleged that DBSI Securities, a wholesaler affiliated with the issuer, raised over $1 billion while defrauding investors, commingling funds and omitting material information. In each of these cases, independent broker-dealers sold the issuers' securities to retail investors.

ATTACHMENT A

The following is the text of the proposed amendments to Rule 5122. New text is underlined; deletions are in brackets.

5122. Private Placements of Securities [Issued by Members]

(a) Definitions

[(1) Member Private Offering]

[A "member private offering" means a private placement of unregistered securities issued by a member or a control entity.]

[(2) Control Entity]

[A "control entity" means any entity that controls or is under common control with a member, or that is controlled by a member or its associated persons.]

[(3) Control]

[The term "control" means beneficial interest, as defined in Rule 5130(i)(1), of more than 50 percent of the outstanding voting securities of a corporation, or the right to more than 50 percent of the distributable profits or losses of a partnership or other non-corporate legal entity. Control will be determined immediately after the closing of an offering, and in the case of an offering with multiple intended closings, immediately following each closing.]

(1) Affiliate

The term "affiliate" means a company that controls, is controlled by or is under common control with a broker-dealer.

(2) Control

For purposes of this Rule, the term "control" has the meaning specified in Rule 5121.

(3) Participation

For purposes of this Rule, the term "participation" has the meaning specified in Rule 5110(a)(5).

(4) Private Placement

The term "private placement" means a non-public offering of securities conducted in reliance on an available exemption from registration under the Securities Act.

(b) Requirements

No member or associated person may [offer or sell any security] participate in a [Member Private Offering] private placement unless the following conditions have been met:

(1) Disclosure Requirements

(A) If an offering has a private placement memorandum or term sheet, then such memorandum or term sheet must be provided to each prospective investor and must contain the following disclosures [addressing]:

(i) the intended use of the offering proceeds; [and]

(ii) the offering expenses and the amount and type of [selling] compensation that will be paid to [the member] participating broker-dealers [and its] or associated persons; and

(iii) if applicable, that the issuer and any participating broker-dealer are affiliates and the nature of the affiliation.

(B) If an offering does not have a private placement memorandum or term sheet, then the member must prepare an offering document that contains the disclosures required in subparagraph (b)(1)(A) [(i) and (ii)] and provide such document to each prospective investor.

(2) Filing Requirements

[A member must file t] The private placement memorandum, term sheet or such other offering document must be filed with the Corporate Financing Department at or prior to the first time the document is provided to any prospective investor. Any amendment[(s)] or exhibit[(s)] to the private placement memorandum, term sheet or other offering document also must be filed with the Department within ten days of being provided to any investor or prospective investor.

(3) Use of Offering Proceeds

For each [Member Private Offering] private placement, at least 85% of the offering proceeds raised [must] may not be used [for business purposes, which shall not include] to pay for offering costs, discounts, commissions, [or any other cash or non-cash sales incentives] and any other compensation to participating broker-dealers or associated persons, and must be used for the business purposes required to be disclosed by paragraph (b)(1)(A)(i). [The use of the offering proceeds also must be consistent with the disclosures required in paragraph (b)(1)]

(4) Correction of Errors

If, in connection with [the offer and sale of] any private placement [security in a Member Private Offering], a member or associated person discovers after the fact that one or more of the conditions [listed above] of this Rule have not been met, the member or associated person must promptly conform the offering to comply with this Rule.

(c) Exemptions

The following [Member Private Offerings] private placements are exempt from the requirements of this Rule:

(1) offerings sold solely to:

(A) institutional accounts, as defined in NASD Rule 3110(c)(4);

(B) qualified purchasers, as defined in Section 2(a)(51)(A) of the Investment Company Act;

(C) qualified institutional buyers, as defined in Securities Act Rule 144A;

(D) investment companies, as defined in Section 3 of the Investment Company Act;

(E) an entity composed exclusively of qualified institutional buyers, as defined in Securities Act Rule 144A; and

(F) banks, as defined in Section 3(a)(2) of the Securities Act.

(2) offerings of exempted securities, as defined in Section 3(a)(12) of the Exchange Act;

(3) offerings made pursuant to Securities Act Rule 144A or SEC Regulation S;

[(4) offerings in which a member acts primarily in a wholesaling capacity (i.e., it intends, as evidenced by a selling agreement, to sell through its affiliate broker-dealers, less than 20% of the securities in the offering);]

[(5)](4) offerings of exempt securities with short term maturities under Section 3(a)(3) of the Securities Act;

[(6)](5) offerings of subordinated loans under SEA Rule 15c3-1, Appendix D (see NASD Notice to Members 02-32 (June 2002));

[(7)](6) offerings of "variable contracts", as defined in Rule 2320(b);

[(8)](7) offerings of modified guaranteed annuity contracts and modified guaranteed life insurance policies, as referenced in Rule 5110(b)(8)(E);

[(9)](8) offerings of unregistered investment grade rated debt and preferred securities;

[(10)](9) offerings to employees and affiliates of the issuer or its control entities;

[(11)](10) offerings of securities issued in conversions, stock splits and restructuring transactions that are executed by an already existing investor without the need for additional consideration or investments on the part of the investor;

[(12)](11) offerings of securities of a commodity pool operated by a commodity pool operator, as defined under Section 1a(5) of the Commodity Exchange Act;

[(13)](12) offerings of equity and credit derivatives, including OTC options; provided that the derivative is not based principally on the member or any if its control entities; and

[(14)](13) offerings filed with the Department under Rules 2310, 5110 or Rule 5121.

(d) Confidential Treatment

FINRA shall accord confidential treatment to all documents and information filed pursuant to this Rule and shall utilize such documents and information solely for the purpose of review to determine compliance with the provisions of applicable FINRA rules or for other regulatory purposes deemed appropriate by FINRA.

(e) Application for Exemption

Pursuant to the Rule 9600 Series, FINRA may exempt a member or associated person from the provisions of this Rule for good cause shown.

Information Notice

New Rate for Fees Paid Under Section 31 of the Exchange Act

Effective Date: January 21, 2011

Executive Summary

Effective January 21, 2011, the Section 31 fee rate applicable to specified securities transactions on the exchanges and in the over-the-counter markets will increase from its current rate of $16.90 per million dollars in transactions to a new rate of $19.20 per million dollars in transactions.

Finance-related questions should be directed to: Sheila Gregory, Accounting Manager, Finance, at (240) 386-5388.

Legal and interpretive questions should be directed to: Brant Brown, Associate General Counsel, Office of General Counsel, at (202) 728-6927.

Discussion

On December 22, 2010, the Securities and Exchange Commission (SEC) announced in Fee Rate Advisory #5 for Fiscal Year (FY) 2011 that President Obama signed a continuing resolution (H.R. 3082) that will fund federal agencies, including the SEC , for approximately two months. The continuing resolution stipulates that it shall be deemed the SEC's "regular appropriation" for FY 2011, and therefore will trigger changes in the rate of fees collected by the SEC. Effective January 21, 2011, the Section 31 fee rate applicable to specified securities transactions on the exchanges and in the over-the-counter markets will increase from its current rate of $16.90 per million dollars in transactions to a new rate of $19.20 per million dollars in transactions. Until that date, the current rate of $16.90 per million dollars will remain in effect.

January 6, 2011

Suggested Routing

- Compliance
- Legal
- Trading

Key Topic

- Section 31 Fees

Referenced Rules & Notices

- Section 3 of Schedule A to the By-Laws
- Section 31 of the Securities Exchange Act of 1934

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The SEC is required to adjust the filing and securities transaction fee rates on an annual basis, after consultation with the Congressional Budget Office and the Office of Management and Budget. More information is in the SEC's April 29, 2010, order regarding the fee rates for FY 2011.

The SEC will issue further notices as appropriate, and the notices will be posted on the SEC's website at *www.sec.gov*.

FINRA obtains its Section 31 fees from its membership, in accordance with Section 3 of Schedule A to the By-Laws. Section 3 specifies that the amount assessed on members will be determined periodically in accordance with Section 31 of the Exchange Act.