

Securities Briefing Series



Towards a Consolidated Rulebook: FINRA's Proposals Achieve Harmonization, but Raise Questions

The Financial Industry Regulatory Authority ("FINRA") published on May 14, 2008, four regulatory notices proposing rules for its "Consolidated Rulebook." The proposals address the following areas:

- (1) Supervision and supervisory controls;¹
- (2) Financial responsibility;²
- (3) Books and records requirements;³ and
- (4) Investor education and protection.⁴

FINRA's existing rulebook is called the "Transitional Rulebook" and consists of the NASD rules, which are applicable to all FINRA members, and certain rules incorporated from the New York Stock Exchange ("NYSE") Rulebook, which are applicable to FINRA members that also are NYSE members. The recent proposals would eliminate corresponding rules in the Transitional Rulebook, and the Consolidated Rulebook eventually will replace the Transitional Rulebook in its entirety.⁵

The comment period for each of the proposals ends on June 13, 2008. Separate comment periods will follow FINRA's filing of the rule proposals—in their current or amended form—for approval by the Securities and Exchange Commission ("SEC").

We discuss below the more significant substantive aspects of the various rule proposals, and their implications for FINRA members.⁶

I. Supervision and Supervisory Controls: Regulatory Notice 08-24

FINRA has proposed new FINRA Rules 3110 and 3120 on supervision and supervisory controls, respectively, and FINRA Rule 3150 regarding holding customer mail.⁷ The proposal would make certain

¹ FINRA Regulatory Notice 08-24 (May 2008) ("Notice 08-24"). The four regulatory notices discussed herein are available at <http://www.finra.org/RulesRegulation/NoticestoMembers/2008Notices/index.htm>.

² FINRA Regulatory Notice 08-23 (May 2008) ("Notice 08-23").

³ FINRA Regulatory Notice 08-25 (May 2008) ("Notice 08-25").

⁴ FINRA Regulatory Notice 08-26 (May 2008) ("Notice 08-26").

⁵ See FINRA Information Notice (Mar. 12, 2008) (describing the rulebook consolidation process).

⁶ We do not address *all* aspects of the proposals here. In particular, we do not discuss all of the numerous organizational and technical changes that the proposed rule changes would make. The notices include the full text of the various proposed rules as compared to the existing rules.

substantive changes to the requirements of NASD Rules 3010, 3012, 3040, and 3110(i), and would incorporate certain aspects of the NYSE rules, in addition to making various organizational and clarifying changes.

A. Supervision: Proposed FINRA Rule 3110

Proposed FINRA Rule 3110 sets forth requirements relating to a member's supervisory system, written procedures, and internal inspections. In addition, Notice 08-24 proposes Supplementary Material to accompany proposed FINRA Rule 3110. The proposed Supplementary Material would include some rule text from existing NASD Rule 3010, as well as additional guidance relating to firms' obligations under proposed Rule 3110. While some aspects of the supervision requirements are more flexible than they are under existing NASD rules, other aspects may create broader obligations. Highlights of the proposed changes are discussed below.

1. Supervisory System for All Activities of the Broker-Dealer

Proposed FINRA Rule 3110(a) would require that a member designate an appropriately registered principal(s) with authority to supervise each type of business in which the member engages. This requirement is broader than existing NASD Rule 3010(a), which requires such designation only with respect to activities for which registration as a broker-dealer is required. It is, however, consistent with existing NASD Rule 3010(b)(1), which requires written supervisory procedures for each type of business in which the member engages.⁸ Moreover, the NYSE has long required its members to supervise and control each business activity of the member and has brought enforcement actions against members for failing to supervise non-securities activities.⁹

2. Written Procedures

a) Review of Transactions Relating to Member's Investment Banking and Securities Business

In addition to the general requirement to have written supervisory procedures for each business activity, the proposed rule would specify that members must have written supervisory procedures that require a registered principal to review all transactions relating to the member's investment banking or securities business. While the language of the proposed rule seems very similar to existing NASD Rule 3010(d)(1), which requires the "review and endorsement by a registered principal in writing, on an internal record, of all transactions," FINRA observes that the new rule clarifies that the review must include "all transactions relating to the investment banking and securities business of the member firm." It is not clear whether the clarification contemplates a broader or narrower subset of transactions and, if so, what transactions are encompassed by the change, or whether it is meant to have the same scope as the existing rule. The proposed rule also would require written evidence of such review.

The proposed Supplementary Material includes a provision stating that members may use a "risk-based system" to conduct this review.¹⁰ This language suggests that firms may use risk-based filters to identify and rank those transactions that merit supervisory review.

⁷ The proposal also would create FINRA Rules 3170 regarding tape recording of registered persons and 1260 regarding a member's duty to investigate applicants for registration. These new standalone rules would replace subsections of existing rules (respectively, NASD Rules 3010(b)(2) and 3010(e)). The notice does not include the text of proposed Rule 3170, which FINRA says would include only minor clarifying changes from Rule 3010(b)(2). Proposed Rule 1260 would not involve substantive changes to existing requirements.

⁸ Proposed FINRA Rule 3110(b)(1) would retain this requirement.

⁹ See Citigroup Global Markets, Inc., Hearing Board Decision 06-141 (Sept. 13, 2006) (in which the NYSE charged Citigroup with failure to reasonably supervise its precious metals desk).

¹⁰ Proposed FINRA Rule 3110(b)(2) & Supp. Mat. .06.

b) Supervision of Outside Securities Activities

One of the most significant changes proposed in Notice 08-24 is the proposal to delete NASD Rule 3040, "Private Securities Transactions of an Associated Person," and replace it with an alternative supervisory regime. Sometimes referred to as the ban on "selling away," NASD Rule 3040 addresses how firms should supervise associated persons who participate in "private securities transactions," a term of art that has been interpreted in the past to include certain investment advisory activities conducted by registered representatives away from their firms.¹¹ Specifically, under NASD Rule 3040, once a firm approves a private securities transaction that involves "selling compensation" received by an associated person, the firm must record the transaction on its books and records and supervise the associated person's participation in the transaction.¹² According to Notice 08-24, FINRA intends to replace the existing transaction-specific approval process with new "streamlined" provisions.¹³

Under proposed FINRA Rule 3110(b)(3), a firm would determine whether to allow its associated persons to conduct any "investment banking or securities business" away from it. If the firm decides to approve any such activity, then the activity must be supervised by the firm as if it were conducted on behalf of the firm. Interestingly, Notice 08-24 does not address the exact scope of the new approval and supervision requirement. The term "investment banking or securities business" is used in the context of registration requirements—e.g., NASD Rule 1031(a)—and is currently defined in Article 1 of the By-Laws to mean the "business, carried on by a broker, dealer, or municipal securities dealer (other than a bank or department or division of a bank), or government securities broker or dealer, of underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer, or of purchasing and selling securities upon the order and for the account of others."

At first blush, the plain reading of the new proposed rule seemingly suggests that firms would no longer be required to supervise outside investment advisory activities of registered representatives, regardless of whether the registered representative participates in the execution of a securities transaction for his or her advisory clients. It is not clear, however, whether this is the intended regulatory outcome. Given the potential breadth of the term "securities business," the existing guidance regarding whether an associated person participates in the execution of a securities transaction for advisory clients (e.g., by placing orders) likely would remain relevant in the future. It is evident that this particular aspect of the proposal is in need of further clarification, and firms should consider providing their comments to FINRA.

With regard to registered representatives who may also act as bank employees (referred to as "dual employees" in proposed FINRA Rule 3110(b)(3)), their bank-related securities activities would not be required to be supervised by the firm, provided that certain conditions are met to ensure that the bank or a supervised bank affiliate has adequate policies and procedures to guard against fraud committed by dual employees.¹⁴ These conditions require, among other things, that the bank or a supervised bank affiliate have a "comprehensive view of the dual employee's securities activities." Presumably, FINRA is concerned about the potential risk of dual employees taking advantage of any regulatory gap created by

¹¹ See NASD Notices to Members 94-44 (May 1994) and 96-33 (May 1996) (stating that if a registered representative acting as an investment adviser "participates in the execution of a securities transaction such that his or her actions go beyond a mere recommendation," the activity must be treated as a private securities transaction subject to NASD Rule 3040).

¹² The term "selling compensation" is broadly defined to include "any compensation paid directly or indirectly from whatever source" in connection with any purchase or sale of a security. NASD Rule 3040(e)(2).

¹³ The requirement to approve each private securities transaction is subject to certain exceptions in the case of advisory services that are provided by associated persons for an asset-based or a performance-based fee.

¹⁴ See Proposed FINRA Rule 3110 Supp. Mat. .07 (addressing a member's re-evaluation of the adequacy of the supervisory system of a bank or supervised bank affiliate that supervises dual employees, when the member received notice of a dual employee's violations of applicable policies and procedures).

having two supervisory regimes for their securities activities. It is not clear, however, what specific steps should be taken to close any such gap.¹⁵

While Notice 08-24 raises some interesting questions about what it means to have effective supervision of dual employees, proposed FINRA Rule 3110(b)(3) provides some measure of regulatory relief to banks that are interested in using the dual employee model in order to comply with the so-called "broker push-out" requirements under the Gramm-Leach-Bliley Act ("GLBA"). For most banks, these requirements, as implemented by Regulation R under GLBA, take effect in January 2009.¹⁶ Historically, banks were concerned about the potential reach of NASD Rule 3040, which they argued should not apply to bank-related securities activities of dual employees,¹⁷ and it appears that this provision was intended to address those concerns.

Curiously, this provision does not include a similar exemption for persons who are dually employed by U.S. and foreign broker-dealers. Hopefully, this is an oversight, given that the policy rationale for allowing an exemption for bank employees should apply equally (if not more strongly) to employees of broker-dealers—especially if they are affiliates. If FINRA is prepared to recognize that bank regulators provide effective regulation with respect to supervision of private securities transactions, it would seem logical also to recognize certain foreign regulators (e.g., the U.K.'s Financial Services Authority). Firms may wish to comment to FINRA on this aspect of the proposed rule.

c) Review of Correspondence and Internal Communications

Notice 08-24 describes Proposed FINRA Rule 3110(b)(4) as generally incorporating the substance of, but "streamlining," NASD Rule 3010(d). Notably, the proposed rule requires the review and retention of internal communications relating to the member's investment banking or securities business, rather than only incoming and outgoing correspondence with the public relating to this subject matter. This scope is consistent with the guidance on review and supervision of electronic communications provided last year in FINRA Regulatory Notice 07-59.¹⁸

Some language from the existing NASD rule would be moved to the proposed Supplementary Material, which also would provide guidance with regard to several other aspects of the rule.¹⁹ Other language in the proposed Supplementary Material would codify guidance in Notice 07-59. For example, proposed Supplementary Material .09 would state that a member may employ risk-based principles to determine the extent to which additional policies and procedures may be appropriate for the review of correspondence and internal communications that do *not* relate to the member's investment banking or securities business.²⁰ Like existing NASD Rule 3010(d)(2), this proposed Supplementary Material also requires additional measures, if the member's procedures do not require that *all* correspondence be reviewed before use or distribution.²¹ Proposed Supplementary Material .10 addresses the written evidence members must retain of their reviews. Specifically, this Supplementary Material would require

¹⁵ For example, does FINRA expect broker-dealers to enter into a formal information-sharing arrangement with banks or supervised bank affiliates in order to ensure the effectiveness of the bank or supervised bank affiliate's anti-fraud policies and procedures? What happens in the event that customers serviced by any dual employee object to such information sharing?

¹⁶ See Exchange Act Release No. 56,501 (Sept. 24, 2007), 72 Fed. Reg. 56,514, at 56,546 (Oct. 3, 2007) (adopting Regulation R).

¹⁷ See Letter from Sarah A. Miller, ABA Securities Association, to Nancy C. Morris, SEC (Mar. 26, 2007) (commenting on proposed Regulation R and referencing ABASA's 2001 request for guidance from the NASD regarding the application of NASD Rule 3040 to dual employees).

¹⁸ FINRA Regulatory Notice 07-59 (Dec. 2007) ("Notice 07-59").

¹⁹ See Proposed FINRA Rule 3110 Supp. Mat. .09-.12.

²⁰ Notice 07-59 permits members, with respect to subject matter for which FINRA rules and federal securities laws do not mandate review, to use risk-based principles to determine the extent to which the review of incoming, outgoing, and internal electronic communications is necessary. Notice 07-59 provides further guidance regarding considerations relevant to such risk-based determinations.

²¹ Specifically, the member's procedures must provide for education and training of associated persons regarding firm procedures for correspondence, documentation of this education and training, and surveillance and follow-up to ensure compliance.

that a review be evidenced electronically or on paper, and that it clearly identifies the reviewer, the communication, and actions the member took as a result of any significant regulatory issues identified in the review. Like Notice 07-59, it also cautions that “[m]erely opening a communication is not sufficient review.” Incorporating language from Notice 07-59, proposed Supplementary Material .11 would permit a principal to delegate to unregistered persons the review of correspondence and internal communications, provided that steps are taken to ensure proper execution of the delegated functions and to evidence the principal’s overall supervisory control.

d) Review of Customer Complaints

Proposed FINRA Rule 3110(b)(5) would require procedures to “capture, acknowledge, and respond to all written (including electronic) customer complaints.” This provision is modeled on NYSE Rule 401A, except that unlike the NYSE rule, it would not cover oral customer complaints.

e) Documentation and Supervision of Supervisory Personnel

Proposed FINRA Rule 3110(b)(6), which would replace NASD Rule 3010(b)(3), retains the existing requirements for the maintenance of records regarding designated supervisory personnel. In addition, the proposed rule would address the supervision of supervisory personnel, currently addressed by NASD Rule 3012(a)(2). Under the existing rule, members must adhere to specific requirements with respect to the review and supervision of producing managers’ customer account activity. The proposed rule would eliminate the specific requirements relating to who may supervise a producing manager, as well as the requirement to institute heightened supervision for any producing manager whose revenues meet a certain threshold.²²

In place of NASD Rule 3012(a)(2)’s specific requirements, proposed FINRA Rule 3110(b)(6) would include two prohibitions, along with a requirement for procedures to prevent conflicts of interest from compromising supervision. First, the proposed rule would prohibit supervisors from supervising their own activities. Second, the proposed rule would require procedures that prohibit supervisors from reporting to, or having their compensation or continued employment determined by, someone they supervise. A very limited exception to these prohibitions would be allowed where compliance is impossible because of the member’s size or the supervisor’s position in the firm.²³ Unlike the “limited size and resources” exception from the existing requirements, the proposed rule would not require a member to notify FINRA when it relies upon the exception, but the member would have to document the basis for the exception and have adequate policies and procedures.²⁴

Finally, the proposed rule would require procedures to prevent supervision from being compromised due to potential conflicts of interest with respect to the associated person being supervised, including the associated person’s position, the revenue he or she generates for the firm, or compensation the supervisor may derive from the associated person being supervised. This provision appears to be a catch-all admonition to firms to identify and address potential conflicts of interest relating to supervision. It is unclear, however, what sort of procedures the proposed rule contemplates. For instance, would this requirement be satisfied by systems that check for and raise “red flags” for further investigation? Or, would it require some sort of layered or redundant supervision, whereby additional review would be required with respect to, e.g., certain high-ranking or high-producing individuals? Firms may wish to comment to FINRA on this aspect of the proposed rule.

3. Internal Inspections

Proposed FINRA Rule 3110(c) would replace NASD Rule 3010(c), on which it is largely based. The most significant change proposed is the elimination of the requirement to conduct heightened office inspections

²² See NASD Rule 3012(a)(2)(A)(i), (a)(2)(C).

²³ Proposed Supplementary Material .13 states that such exceptions generally will occur only where the member is a sole proprietor in a single-person firm, or where a registered person is the (or one of several of the) most senior executive officer(s) or similar position(s) of the member.

²⁴ See NASD Rule 3012(a)(2)(A)(iii).

when the branch office manager and the person conducting the inspection report to the same person. Instead, the rule would require procedures that are reasonably designed to achieve two objectives aimed at avoiding conflicts of interest or preventing them from having an adverse impact on internal inspections.

The first objective would be to ensure that the person conducting an internal inspection is not an associated person assigned to the location, and is not supervised by and does not report to such a person. The proposed rule would include an exception if the member's size or business model makes compliance with this requirement impossible, subject to certain conditions.²⁵

The second objective would be to prevent the inspection from being compromised by conflicts of interest such as economic, commercial, or financial interests.

The substance of the requirement to conduct periodic internal inspections would remain the same. The requirements relating to written reports of such inspections also would remain largely the same, with a few changes. For example, details regarding certain of the areas to be covered by inspection reports—namely, transmittal of funds between customers and registered representatives and between customers and third parties, changes of customer account information, and validation of such changes—would be relocated to proposed FINRA Rule 3110(c) from NASD Rule 3012.²⁶

4. Branch Office and OSJ Definitions and Standards for Review of Offices

The definitions of branch office and office of supervisory jurisdiction (“OSJ”) would remain the same in proposed FINRA Rule 3110(d). The standards for review of offices, currently located in NASD IM-3010-1, would be adopted with little textual change as proposed Supplementary Material .14. Proposed Supplementary Material .03 and .04, respectively, would address one-person OSJs and the supervision of multiple OSJs by a single principal.

5. Annual Compliance Meeting for Registered Personnel

Proposed Supplementary Material .05 to FINRA Rule 3110 would address the means by which a member satisfies the requirement in Proposed FINRA Rule 3110(a)(7) (currently in NASD Rule 3010(a)(7)) that all registered personnel attend an annual compliance meeting. The proposed language generally would codify past FINRA guidance. However, it specifically allows the requirement to be met by means such as an on-demand webcast, provided safeguards ensure that the registered person in fact attends the entire meeting and is able to ask questions of the presenter and receive answers in a timely manner. Past guidance, in contrast, referred to a requirement that attendees be able to hear presenters “live.”²⁷

6. Insider Trading Review Procedures

Proposed Supplementary Material .08 to FINRA Rule 3110 would add a specific requirement for procedures to review securities transactions for the accounts of the member or its associated persons and their family members, in order to identify potential instances of insider trading. The proposed Supplementary Material also would require the member to conduct promptly an internal investigation to determine whether the transaction in fact violated applicable laws and rules and, in many cases, to report the status of such investigations to FINRA, as discussed below. These provisions are drawn from NYSE Rule 342.21, which applies to NYSE-listed securities and related financial instruments, and NYSE Rule 351(e). The proposed Supplementary Material is broader than NYSE Rule 342.21 because it requires firms to review trading in all securities transactions, not just NYSE-listed securities, but narrower than

²⁵ Proposed Supplementary Material .16 states that this exception generally applies only where the member has only one office or the member uses a business model in which small or single-person offices report directly to an office of supervisory jurisdiction (“OSJ”) manager who is also considered the offices’ branch office manager.

²⁶ Compare Proposed FINRA Rule 3110(c)(2) with NASD Rule 3012(a)(2)(B).

²⁷ See NASD Notice to Members 99-45 (June 1999).

NYSE Rule 351(e) because it imposes filing requirements only for members that provide investment banking services.²⁸

The reports, which would have to be signed by a senior officer of the member, are slightly different from the current NYSE Rule 351(e) reports, impose more onerous timeframes, and would have to be filed with FINRA as follows:

- a) Within 10 business days of initiating an internal investigation under the rule, a written report disclosing the member's identity; the date the investigation commenced the security, trades, accounts, employees, or employee's family members under review; and including a copy of the policies and procedures required by this provision.
- b) Each quarter, by the 15th day of the month following the quarter, a written report on the progress of open internal investigations filed with FINRA.
- c) Within five days of completing an internal investigation filed with FINRA, a written report stating the results of the investigation, any internal disciplinary action taken, and any referral of the matter to FINRA or another authority.

As with current NYSE Rules 342.21 and 351(e), the Supplementary Material does not define "internal investigation," and members will likely continue to struggle to implement this provision. FINRA-only members may want to review NYSE Information Memo 06-06 to understand some of the issues involved. Firms may wish to comment to FINRA on this aspect of the proposed rule.

B. Supervisory Control System: Proposed FINRA Rule 3120

Proposed FINRA Rule 3120 would replace NASD Rule 3012, parts of which would be moved to proposed FINRA Rule 3110. The basic requirements for the supervisory control system would remain the same. However, the annual report to management required under the rule would be required to include certain additional information, if the member has reported gross revenue of at least \$150 million on its FOCUS reports in the prior calendar year. These requirements, modeled on but not identical to those in NYSE Rule 342.30, include:

1. A tabulation of the reports to FINRA regarding customer complaints and internal investigations in the preceding year; and
2. Discussion of the member's compliance efforts in the preceding year, including procedures and educational programs, with respect to trading and marketing activities; investment banking activities; antifraud and sales practices; finance and operations; supervision; anti-money laundering; and risk management.

C. Holding Customer Mail: Proposed FINRA Rule 3150

The proposal also would create FINRA Rule 3150 regarding holding customer mail, which would replace NASD Rule 3110(i). In contrast to the existing time limits on holding a customer's mail, the new rule would permit a member to hold mail for a period specified on the customer's written instructions. Several new burdens would accompany this greater flexibility, however.

1. First, if the customer's instructions request that mail be held for a time period that is an extended time, the member must verify at regular intervals that the instructions still apply. The proposed rule does not define "extended time" or

²⁸ "Investment banking services" would be defined in this context to "include, without limitation, acting as an underwriter, participating in a selling group in an offering for the issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital or equity lines of credit or serving as placement agent for the issuer or otherwise acting in furtherance of a private offering of the issuer." Proposed FINRA Rule 3110, Supp. Mat. .08(c).

“regular intervals.” Nor does the proposal address what actions on the member’s part would be deemed sufficient verification.

2. Second, the member “must be able to communicate with the customer in a timely manner to provide important account information, as necessary” while mail is being held. The proposed rule does not address how, as a practical matter, members may comply with this requirement. It is unclear, for example, whether members would be able to rely upon an email address, cell phone number, or voice mail at a home number already in the member’s customer file, absent customer instructions to the contrary, or whether a customer would need to specify a means of contact in the written instructions requesting the mail hold.
3. Third, the new rule would require the member to “take actions reasonably designed to ensure” that customer mail it is holding is not tampered with, held without the customer’s consent, or used improperly by an associated member. It is unclear whether the actions to ensure that mail is not held without customer consent require anything beyond the requirement that the customer’s written instructions be obtained and regularly verified.

D. Proposals to Eliminate Other NASD and NYSE Rules

FINRA observed that in addition to revising the supervisory rules as described above, it is proposing to eliminate a number of existing NASD and NYSE Rules. Notable deletions include:

1. NYSE Rule 342.13, which requires that a supervisor of an office, a group of offices, or a sales department or activity have three years of experience as a registered representative or equivalent experience.
2. NYSE Rule 343, which imposes restrictions on sharing office space with any other broker-dealer, investment advisor, or other person with a securities or commodities business with the public.

II. Financial Responsibility: Regulatory Notice 08-23

FINRA has proposed rules that, as a general matter, would adopt the substance of existing NASD and/or NYSE rules regarding financial responsibility. The proposed rules include a number of requirements drawn from existing NYSE rules that lack corresponding provisions in the NASD rules.²⁹ However, many of these requirements would apply only to FINRA members that clear or carry customer accounts or that operate pursuant to the exemptive provisions of Rule 15c3-3(k)(2)(i) under the Securities Exchange Act of 1934 (“Exchange Act”) (“(k)(2)(i) members”).³⁰ Thus, FINRA-only members that are clearing, carrying, or (k)(2)(i) members would become subject to new requirements, whereas NYSE members that are not clearing, carrying, or (k)(2)(i) members would be relieved of these obligations. Several of the proposed

²⁹ Several of the proposed provisions have similar requirements in the existing NASD rules, except that the NYSE rule and proposed FINRA rule, unlike the corresponding NASD rule, are self-operative (*i.e.*, they require members to comply even without any direction from FINRA). These are noted below.

³⁰ Rule 15c3-3(k)(2)(i) exempts from the reserve and custody requirements any broker-dealer:

Who carries no margin accounts, promptly transmits all customer funds and delivers all securities received in connection with his activities as a broker or dealer, does not otherwise hold funds or securities for, or owe money or securities to, customers and effectuates all financial transactions between the broker or dealer and his customers through one or more bank accounts, each to be designated as "Special Account for the Exclusive Benefit of Customers of (name of the broker or dealer)."

FINRA states that, for purposes of these proposed rules, the category of (k)(2)(i) members does not include firms that have elected the exemption but do not operate pursuant to it. Notice 08-23, endnote 5.

rules would include qualifications (e.g., a *de minimis* exception) not present in the rules on which they are based.

In addition to the proposed financial responsibility rules, FINRA proposes to adopt FINRA Rules 9557 and 9559, which would be based on NASD Rules 9557 and 9559 governing notice and hearing procedures for firms experiencing financial and operational difficulties. Under these proposed rules, a Rule 9557 notice would be effective immediately, but the appeals process would be more expedited than under the existing rules.

E. Capital Compliance: Proposed FINRA Rule 4110

1. Authority to Increase Capital Requirements

Under proposed FINRA Rule 4110(a), FINRA would have the authority to prescribe greater net capital requirements for certain member firms, or require any such member to restore or increase its net capital or net worth, when deemed necessary for the protection of investors or in the public interest. Unlike NYSE Rule 325(d), on which it is based, the proposed rule would apply only to carrying, clearing, and (k)(2)(i) member firms. FINRA would exercise its authority under the rule by issuing the member a notice pursuant to proposed FINRA Rule 9557 (a "Rule 9557 notice").³¹ Like the recipient of an NASD Rule 9557, but in contrast to members' rights in connection with NYSE Rule 325(d), a recipient of a FINRA Rule 9557 would be entitled to request an expedited hearing on the matter.

2. Suspension of Business Operations

Proposed FINRA Rule 4110(b)(1), like NASD Rule 3130(e), would require a member firm to suspend operations during any period in which it is not in compliance with Exchange Act Rule 15c3-1, unless otherwise permitted by FINRA. New language would expressly permit a member to effect liquidating transactions upon customer direction, as well as proprietary transactions that are reasonably expected to increase the member's net capital or reduce its risk.

3. Withdrawal of Equity Capital

Proposed FINRA Rule 4110(c)(1) would prohibit a member from withdrawing equity capital for a period of one year after contribution, unless otherwise permitted by FINRA in writing. Proposed FINRA Rule 4110(c)(2) would prohibit certain members, absent FINRA's written approval, from withdrawing capital, paying a dividend or effecting a similar distribution that would reduce the member's equity, where such actions, aggregated on a net basis, in any rolling 35-calendar-day period, would exceed 10 percent of the member's excess net capital. Unlike NYSE Rule 312(h), on which it is based in part, the proposed rule would apply only to carrying, clearing, and (k)(2)(i) member firms. The 10 percent limit would create a *de minimis* exception not present in NYSE Rule 312(h).

4. Sale-and-Leasebacks, Factoring, Financing, Loans, and Similar Arrangements

a) General Rule

Proposed FINRA Rule 4110(d)(1)(A) is based on NYSE Rule 328(a), except that it would apply only to carrying, clearing, and (k)(2)(i) member firms and would include a *de minimis* exception. The proposed provision would prohibit a carrying, clearing, or (k)(2)(i) member from consummating a sale-and-leaseback arrangement with respect to any of its assets, or a sale, factoring, or financing arrangement with respect to any unsecured accounts receivable, if the arrangement would increase the member's tentative net capital by 10 percent or more, absent FINRA's prior written authorization.

³¹ The proposed rule would assign this authority to FINRA's executive vice president charged with oversight for financial responsibility (or his or her delegate).

b) Sale or Factoring of Customer Debit Balances

Proposed FINRA Rule 4110(d)(1)(B), which also is based on NYSE Rule 328(a), would prohibit any carrying member from consummating any arrangement concerning the sale or factoring of customer debit balances, regardless of amount, absent FINRA's prior written authorization.

c) Loan Agreements

Proposed FINRA Rule 4110(d)(2) is based on NYSE Rule 328(b), but it would apply only to carrying, clearing, and (k)(2)(i) member firms and would include a *de minimis* exception. This provision would require FINRA's prior approval of any loan agreement, if the proceeds exceed 10 percent of the member's tentative net capital and if the loan is intended to reduce the deduction in computing net capital for fixed assets and other assets that cannot readily be converted into cash under Exchange Act Rule 15c3-1(c)(2)(iv).

d) Aggregate Threshold

In contrast to NYSE Rule 328, proposed FINRA Rule 4110 would include a subsection (d)(3) that requires members subject to 4110(d)(1)(A), (d)(1)(B), and (d)(2) to aggregate all arrangements under those paragraphs and, if this aggregate would exceed 20 percent of the member's tentative net capital, refrain from consummating any such arrangement absent FINRA's prior written authorization. This requirement tempers the *de minimis* exceptions in 4110(d)(1)(A) and (d)(2).

e) "Ready Market" Determinations

Proposed FINRA Rule 4110(d)(4) is the same in substance as NYSE Rule 328(c) and would apply to all members. This proposed provision would require FINRA's approval before securities may be deemed to have a "ready market," where such determination must be made in connection with an agreement involving the acceptance of securities as collateral for a bank loan under Exchange Act Rule 15c3-1(c)(11)(ii).

5. Subordinated Loans, Notes Collateralized by Securities, and Capital Borrowings

Proposed FINRA Rule 4110(e) is based in part on NYSE Rule 420. Subsection (e)(1) would require that all subordinated loans or notes collateralized by securities satisfy standards set by FINRA, in addition to the requirements of Appendix D of Exchange Act Rule 15c3-1. This provision lacks the more specific requirements of NYSE Rule 420(a) and (b). Similar to NYSE Rule 420(c), proposed FINRA Rule 4110(e)(2) requires FINRA's approval in order for proceeds of any secured or unsecured borrowing by a general partner of a member that is a partnership (or from certain LLC participants of a member that is an LLC) to be contributed to the member to qualify as capital in the member's net capital calculation. The proposal would require the member to submit a signed copy of the loan agreement. As under NYSE Rule 420, the loan agreement would have to have a duration of at least 12 months and provide that the lender has no recourse to the member's assets.

F. Regulatory Notification and Business Curtailment: Proposed FINRA Rule 4120

1. Regulatory Notification

Proposed FINRA Rule 4120(a) is based on NYSE Rule 325(b) but would apply only to carrying, clearing, and (k)(2)(i) members. It would require such members to notify FINRA promptly if net capital falls below certain specified percentages.

2. Restrictions on Business Expansion

Proposed FINRA Rule 4120(b) is based on NASD Rule 3130(c) and NYSE Rule 326(a) but would apply only to carrying, clearing, and (k)(2)(i) members. This proposed rule would prohibit such a member from expanding its business during any period when specified conditions have been present for a specified time period. Unlike the existing NASD rule, this prohibition would be self-operative. A separate sub-

section, however, as under the NASD rule would permit FINRA to restrict *any member's* business expansion by issuing a Rule 9557 notice.

3. Reduction of Business

Proposed FINRA Rule 4120(c) is based on NASD Rule 3130(d) and NYSE Rule 326(b) but would apply only to carrying, clearing, and (k)(2)(i) members. This proposed rule would require such a member to reduce its business to satisfy FINRA's capital standards when specified conditions have been present for a specified time period. Unlike the existing NASD rule, this requirement would be self-operative. A separate sub-section, however, as under the NASD rule would permit FINRA to restrict *any member's* business expansion by issuing a Rule 9557 notice.

G. Notifications, Questionnaires, and Reports: Proposed FINRA Rule 4521

Proposed FINRA Rule 4521 would govern FINRA's authority to request certain information from members to assist it in its surveillance and examination functions. The rule is based in part on NASD IM-3130 and Rule 3150, as well as NYSE Rules 325(b)(2), 416 and 421(2).

Proposed FINRA Rule 4521(a) would require a carrying, clearing, or (k)(2)(i) member to provide financial and operational information about the member or any of its correspondents, as FINRA deems essential for the protection of investors and the public interest. Existing NASD Rule 3150 requires most carrying and clearing members to provide this information, but FINRA observes that this would be a new requirement for some firms that are not NYSE members. Late fees would apply when a member does not file requested data in a timely manner.

Two other requirements in the proposed rule are drawn from NYSE rules and would be new for certain FINRA-only members. Proposed FINRA Rule 4521(e) would require a carrying, clearing, or (k)(2)(i) member to provide FINRA with written notification within 48 hours if its tentative net capital has declined at least 20 percent compared to its most recent FOCUS report or its most recent such notification to FINRA, whichever is later. Proposed FINRA Rule 4521(f) would require members carrying margin accounts for customers to submit, on a settlement-date basis, (1) the total of all debit balances in securities margin accounts, and (2) the total of all free credit balances in cash or margin accounts.

H. Other Proposed Financial Responsibility Rules

Proposed FINRA Rule 4130 would state requirements for members subject to the Treasury Department's liquid capital requirements. The proposed rule would be substantially similar to NASD Rule 3131.

FINRA also proposes to adopt FINRA Rule 4140 to authorize FINRA to request that a member provide an audit or examination report if FINRA has concerns about the accuracy or integrity of the member's financial statements, books and records, or prior audited financial statements. This provision is intended to incorporate authority that FINRA currently has under NASD Rule 3130 and IM-3130 and NYSE Rule 418. Late fees would apply when a member does not file a requested report in a timely manner.

I. Notice and Hearing Procedures: Proposed FINRA Rules 9557 and 9559

FINRA proposes to adopt FINRA Rules 9557 and 9559. Based on NASD Rules 9557 and 9559, these rules would lay out the notice and hearing procedures for firms experiencing financial and operational difficulties. Under these proposed rules, a Rule 9557 notice would be effective immediately, rather than seven days after service as in the current rule. A timely request for a hearing generally would stay the notice's effectiveness for 10 business days after service or until a written order is issued, whichever occurs first. Under existing NASD Rule 9557, a member receiving a notice must file a request for a hearing before the effective date. The proposed rule would require the member to submit a hearing request within two business days of service.

Proposed Rule 9559 would add a new requirement that panelists for a Rule 9557 proceeding be current or former members of the FINRA Financial Responsibility Committee. The hearing would have to be held

within five business days after the member requests a hearing, in contrast to 14 days under the existing NASD rule. Proposed FINRA Rule 9559(o)(4) would require that a written order of the Hearing Panel's determinations be issued within two business days following the close of a Rule 9557 hearing, with a written decision to follow within seven days. In contrast, existing NASD Rule 9559(o)(2) requires an initial decision within 21 days following a Rule 9557 hearing.

III. Books and Records Requirements: Regulatory Notice 08-25

FINRA has proposed new rules that would replace, in large part, existing NASD Rule 3110 and NYSE Rule 440, which require member firms to make and preserve books and records. The proposed rules would explicitly connect FINRA's recordkeeping requirements with the recordkeeping provisions of the Exchange Act and clarify relationships with other relevant rules. The proposal would create five new FINRA rules:

1. Proposed Rule 4511 would replace the member's obligation to make and preserve books and records set out in existing NASD Rule 3110(a) without any substantive changes.³²
2. Proposed Rule 4512 would alter some of the customer account information requirements from existing NASD Rule 3110(c). The proposed rule would require retention of the name of the associated person responsible for the account, rather than the signature of the registered representative introducing it.³³ With respect to discretionary accounts, the proposed rule would clarify that a member must maintain a record with a dated signature for each *named, natural* person—rather than simply “each person” as in the existing NASD rule—authorized to exercise discretion in the account.³⁴ Finally, the proposed rule would emphasize that firms may maintain and exercise discretion in discretionary accounts only to the extent permitted under the federal securities laws.³⁵
3. Proposed Rule 4513 would merge existing NASD Rules 3110(d) and 3110(e). The proposed rule would clarify that an OSJ's obligation to make and preserve customer complaint records applies only to complaints relating to that OSJ and offices it supervises. Members would be permitted to maintain the records elsewhere and make them available promptly at the OSJ upon FINRA's request. The proposed rule would extend the preservation requirement *from three to four years*, consistent with FINRA's four-year routine examination cycle.
4. Proposed Rule 4514 would clarify existing NASD Rule 3110(g) by requiring that a customer's written authorization for a member firm to obtain or submit negotiable paper on the customer's accounts be kept for three years *following the date of the authorization's expiration*.
5. Proposed Rule 4515 also clarifies existing NASD Rule 3110(j) by emphasizing that the essential facts on which a principal relies when approving account name or designation changes must be documented in writing *prior to execution*.

³² Notice 08-25 explains that NYSE Rule 440 is duplicative and would be deleted, but that NYSE Rules 440.10, 440.20, and NYSE Interpretation Handbook Rule 440.20/01, which have no equivalent NASD Rules, would remain part of the Transitional Rulebook to be addressed during a future revision.

³³ FINRA has requested comment regarding whether the signature requirement should be retained. Notice 08-25.

³⁴ The signature requirement would not apply to investment discretion granted by a customer as to the price or the time of execution of an order for a definite dollar amount or quantity of a specified security.

³⁵ Notice 08-25 states that “this proposed change is designed to make the rule self-limiting, as there are currently SEC rulemaking proposals pending that may limit the legal ability of broker-dealers to maintain discretionary accounts.” In addition, proposed Rule 4512 reconciles its requirements with federal securities laws and other existing NASD rules, including: (1) setting out a six-year retention period for customer account records (including six years *after* the closing of an account for certain records) which is consistent with the Exchange Act, (2) advising firms that there may be additional recordkeeping requirements under the Exchange Act and existing NASD Rule 3090, (3) allowing firms to maintain information required by the prior NASD rules for accounts opened pursuant to those rules, (4) clarifying the definition of key terms such as “maintain” and “preserve,” and (5) deleting redundant and outdated guidance in NASD IM-3110.

Revision to some parts of existing NASD Rule 3110 is postponed, and FINRA proposes to move certain other provisions of the rule to other sections of the rulebook. Existing NASD Rule 3110(b), which mandates that firms list on the order ticket the name of each dealer contacted and the quotations they received for each transaction in a non-exchange-listed security, would remain unchanged until it is incorporated into the Three Quote Rule (existing NASD Rule 2320(g)) later in the rulebook consolidation process. Existing NASD Rules 3110(f) requiring pre-dispute arbitration agreement disclosure and 3110(h) setting forth Order Audit Trail System (“OATS”)³⁶ recordkeeping standards would move into other sections of the rulebook with non-substantive changes.

IV. Investor Education and Protection: Regulatory Notice 08-26

Proposed FINRA Rule 2267 would replace existing NASD Rule 2280, which requires member firms that carry customer accounts and hold customer funds or securities to provide each customer, at least once per year, with (1) the NASD Regulation Public Disclosure Program Hotline Number, (2) the NASD Regulation website address, and (3) a statement regarding the availability of an investor brochure that includes a description of the Public Disclosure Program. The proposed rule would broaden the scope of member firms subject to its requirements. The rule would apply to all member firms, with two exceptions. A member firm would be excepted from the rule if it (a) has no customers, or (b) is an introducing firm and the carrying member agrees in a carrying agreement to comply with the rule on the introducing firm’s behalf. As such, the proposed rule would apply to member firms that conduct a limited customer business, such as mutual fund distributors and firms that deal solely with direct participation programs. The new rule also would replace the NASD references with FINRA ones, namely, FINRA BrokerCheck and FINRA’s website address. Consistent with existing guidance, the rule would expressly permit electronic delivery of the required information.

FOR MORE INFORMATION ON THIS OR OTHER SECURITIES MATTERS, CONTACT:

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³⁶ NASD Rule 3110(i) regarding holding mail for a customer would become a separate rule, which FINRA has proposed in Notice 08-24. *See supra*.