

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58932; File No. SR-FINRA-2008-032)

November 12, 2008

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval to a Proposed Rule Change, as Modified by Amendment No. 1, to Adopt FINRA Rules 2350 through 2359 (Regarding Trading in Index Warrants, Currency Index Warrants, and Currency Warrants), FINRA Rule 2360 (Options), and FINRA Rule 2370 (Security Futures) in the Consolidated FINRA Rulebook

I. Introduction

On July 29, 2008, the Financial Industry Regulatory Authority, Inc (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)), filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt NASD Rules 2840 through 2853 regarding Trading in Index Warrants, Currency Index Warrants, and Currency Warrants, 2860 (Options), and 2865 (Security Futures) as FINRA Rules 2350 through 2359, 2360, and 2370, respectively, in the consolidated FINRA rulebook (“Consolidated FINRA Rulebook”), and to delete the corresponding provisions in Incorporated NYSE Rules 414 (Index and Currency Warrants), 424 (Report of Options), and the 700 Series (Option Rules). The proposed rule change was published for comment in the Federal Register on August 15, 2008.³

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 58333 (August 8, 2008), 73 FR 47991 (“Notice”).

The Commission received one comment letter on the proposed rule change.⁴ FINRA filed Amendment No. 1 to the proposed rule change on October 8, 2008.⁵

II. Description

FINRA proposes to adopt, with minor changes described below: (1) NASD Rules 2840 through 2853 (regarding Trading in Index Warrants, Currency Index Warrants, and Currency Warrants) as FINRA Rules 2350 through 2359; (2) NASD Rule 2860 (Options) as FINRA Rule 2360; and (3) NASD Rule 2865 (Security Futures) as FINRA Rule 2370.

Warrants, options, and security futures rules were adopted by FINRA to address the specific risks that pertain to these derivative securities, and to implement provisions of the federal securities laws and Commission rules.⁶ These rules include, among other things, provisions requiring specific disclosure documents, additional diligence in approving the opening of accounts, and specific requirements for confirmations, account statements, suitability, recordkeeping, and reporting. The rules also contain provisions imposing limits on the size of an options or warrant position and on the number of options contracts or warrants that can be exercised during a fixed period.

Warrant Rules

FINRA proposes to adopt NASD rules on index warrants, currency index warrants, and currency warrants, NASD Rules 2840 through 2853, as FINRA Rules 2350 through 2359, in

⁴ See letter to Florence E. Harmon, Acting Secretary, Commission, from Melissa MacGregor, Vice President and Assistant General Counsel, Securities Industry and Financial Markets Association (“SIFMA”) dated September 4, 2008 (“SIFMA Letter”).

⁵ In Amendment No. 1, FINRA responded to issues raised in the SIFMA Letter. In that regard, FINRA proposed to amend FINRA Rule 2360(b)(18) to allow a Limited Principal-General Securities Sales Supervisor to accept the discretionary options account.

⁶ For example, Rule 9b-1(d) under the Act requires a broker-dealer to furnish a customer with a copy of the options disclosure document before accepting an options order from a customer. 17 CFR 240.9b-1(d).

substantially the form they exist today. The proposed rule change would reorganize certain requirements, grouping them along similar subject matter lines, by combining the statement of general applicability and definitions into a single rule (FINRA Rule 2351), and creating a single rule addressing position and exercise limits and liquidations (FINRA Rule 2359).

Options Rule

FINRA proposes to adopt NASD Rule 2860 as FINRA Rule 2360 with minor modifications to: (1) delete obsolete definitions; (2) change all references to “Registered Options and Security Futures Principal” to “Registered Options Principal;” (3) permit a Limited Principal-General Securities Sales Supervisor to approve the opening of an options account; (4) modify the confirmation disclosure requirements consistent with recent changes to the equity confirmation disclosure requirements; (5) incorporate NASD Interpretative Materials 2860-1 and 2860-2 into the rule text or as Supplementary Material; and (6) codify as Supplementary Material the provisions in NASD Notice to Members 07-03 (“Notice 07-03”) regarding control relationships.⁷

Security Futures Rule

FINRA proposes to adopt NASD Rule 2865 as FINRA Rule 2370 with minor changes to preserve the general parallel treatment of options and security futures. In particular, FINRA proposes to update the provisions regarding discretionary accounts to conform to recent rule amendments made to the options rule.⁸ Under the proposed rule change, each firm must designate specific principals qualified to supervise security futures activities to review

⁷ See Notice, supra note 3, for a discussion of these proposed revisions.

⁸ See Securities Exchange Act Release No. 57775 (May 5, 2008), 73 FR 26453 (May 9, 2008) (SR-FINRA-2007-035) (“Release No. 34-57775”).

discretionary accounts.⁹ A principal other than the principal who accepted the account would review the acceptance of each discretionary account to determine that the principal accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the strategies or transactions proposed and must maintain a record of the basis for such determination.

To mirror recent changes to the options rule, the proposed rule change would eliminate the requirement that discretionary orders be approved on the day of entry by a principal qualified to supervise security futures activities if a firm uses computerized surveillance tools. Discretionary orders for firms using computerized surveillance tools instead may be reviewed in accordance with the member firm's written supervisory procedures. Firms that do not use computerized surveillance tools must, as they do today, establish and implement procedures requiring principals qualified to supervise security futures activities who have been designated to review discretionary accounts to approve and initial each discretionary order on the day entered.¹⁰

Finally, FINRA proposes to limit the duration of the time and price discretionary authority to the end of the business day on which the customer granted such discretion, absent specific written contrary indication signed and dated by the customer. This limitation would not apply to discretion exercised in an institutional account, as defined in NASD Rule 3110(c)(4), pursuant to Good-Till-Canceled instructions issued on a "not held" basis. The proposed rule

⁹ As provided in NASD Rule 1022(f)(5), any Registered Options Principal that supervises security futures products must complete a firm-element continuing education program that addresses security futures and a principal's responsibilities for supervising such products.

¹⁰ See Release No. 34-57775, supra note 8, relating to recent changes to FINRA's options rule.

change would require that any exercise of time and price discretion be reflected on the order ticket. These changes mirror the limitations to discretionary authority provided in NASD Rule 2510(d) and the options rule.

Deleted Rules

FINRA proposes to delete the following Incorporated NYSE Rules as the substance of such rules is addressed in the proposed FINRA rules:¹¹ Incorporated NYSE Rules 414 (Index and Currency Warrants); 424 (Reports of Options); 700 (Applicability, Definitions and References); 704 (Position Limits); 705 (Exercise Limits); 707 (Liquidation of Positions); 709 (Other Restrictions on Exchange Option Transactions and Exercises); 720 (Registration of Options Principals); 721 (Opening of Accounts); 722 (Supervision of Accounts); 723 (Suitability); 724 (Discretionary Accounts); 725 (Confirmations); 726 (Delivery of Options Disclosure Document and Prospectus); 727 (Transactions with Issuers); 728 (Restricted Stock); 730 (Statement of Accounts); 732 (Customer Complaints); 780 (Exercise of Option Contracts); 781 (Allocation of Exercise Assignment Notices); and 791 (Communications to Customers).

FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval.

III. Discussion and Commission's Findings

After careful review of the proposed rule change, and the comment letter and FINRA's response, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.¹²

¹¹ FINRA advises that, in several instances, the Incorporated NYSE Rules are no longer applicable by their own terms as the NYSE no longer trades options.

¹² In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,¹³ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and in general to protect investors and the public interest.

The Commission notes that the warrant rules (NASD Rules 2840 through 2853) and the security futures rule (NASD Rule 2865) are being incorporated into the Consolidated FINRA Rulebook in substantially the same form that exists today, with only minor changes to improve the organization of the rules and to ensure parallel treatment of options and security futures. NASD Rule 2860 also will be incorporated into the Consolidated FINRA Rulebook in substantially the same form that exists today, except for modifications to: (1) delete obsolete definitions; (2) change all references to “Registered Options and Security Futures Principal” to “Registered Options Principal;” (3) permit a Limited Principal-General Securities Sales Supervisor to approve the opening of an options account; (4) allow a Limited Principal-General Securities Sales Supervisor (Series 9/10) in addition to a Registered Options Principal (Series 4) to accept the discretionary options account; (5) modify the confirmation disclosure requirements consistent with recent changes to the equity confirmation disclosure requirements;¹⁴ (6) incorporate NASD Interpretative Materials 2860-1 and 2860-2 into the rule text or as Supplementary Material; and (7) codify as Supplementary Material the provisions in NASD Notice to Members 07-03 (“Notice 07-03”) regarding control relationships. Lastly, Incorporated NYSE Rules 414, 424, 700, 705, 707, 709, 720-728, 730, 732, 780-781, 791 are being deleted because the substance of these rules is addressed in the proposed FINRA Rules.

¹³ 15 U.S.C. 78o-3(b)(6).

¹⁴ See Securities Exchange Act Release No. 58814 (October 20, 2008), 73 FR 63527 (October 24, 2008) (SR-Amex-2008-53).

SIFMA submitted a comment letter that generally supported the proposal, but requested one change and one clarification in the area of options discretionary accounts. The proposed rule, as is the case today in NASD Rule 2860(b)(18), requires that a Registered Options Principal, other than the Registered Options Principal who accepted the account, review the acceptance of each discretionary account to determine that the Registered Options Principal accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risk of the strategies or transactions proposed.¹⁵ SIFMA believes that discretionary options accounts “are subject to sufficient supervisory scrutiny and the additional requirement of a second approval is unnecessary to protect investors” in light of the frequent supervisory review of the activity in the account by a Registered Options Principal who is not exercising the discretionary authority.¹⁶ In the event that FINRA believes that a second approval is necessary, SIFMA “strongly urges” that FINRA permit the acceptance of the discretionary account, as well as the review of the acceptance of the discretionary account, to be performed by either a Registered Options Principal (Series 4) or a Limited Principal-General Securities Sales Supervisor (Series 9/10).¹⁷ Lastly, SIFMA requested clarification in FINRA Rule 2360(b)(18) that the frequent supervisory review by a Registered Options Principal who is not exercising the discretionary authority may be performed by a Limited Principal-General Securities Sales Supervisor (Series 9/10) in addition to a Registered Options Principal (Series 4).¹⁸

¹⁵ See proposed FINRA Rule 2360(b)(18)(A)(ii).

¹⁶ See SIFMA Letter at 2, supra note 4.

¹⁷ Id.

¹⁸ Id.

In response to the SIFMA Letter, FINRA filed Amendment No. 1 to the proposed rule change.¹⁹ In Amendment No. 1, FINRA noted that SIFMA commented on provisions that were the subject of recent amendments as part of FINRA’s overall revisions to options supervision. According to FINRA, the proposed rule change simply moves into the FINRA consolidated rulebook the current NASD provisions, which are generally consistent across the options exchanges.²⁰ FINRA disagreed with SIFMA’s assertion that review of the acceptance of a discretionary options account is “unnecessary to protect investors.” FINRA stated that it continues to believe that heightened supervision in the form of requiring a review of the acceptance of a discretionary options account is both appropriate and necessary.²¹ FINRA noted however, that consistent with the rules of the CBOE,²² it proposes to amend FINRA Rule 2360(b)(18) to permit greater flexibility and allow a Limited Principal-General Securities Sales Supervisor (Series 9/10) in addition to a Registered Options Principal (Series 4) to accept the discretionary options account.²³ FINRA believed, consistent with the CBOE provision, that the review of the acceptance of a discretionary options account must be performed by a Registered Options Principal (Series 4). Similarly, FINRA believed that the “frequent appropriate

¹⁹ See Amendment No. 1, supra note 5.

²⁰ As examples of discretionary options accounts rules on other exchanges, FINRA pointed to Chicago Board Options Exchange (“CBOE”) Rule 9.10, American Stock Exchange Rule 924, NASDAQ OMX PHLX Rule 1027, and Boston Options Exchange Chapter XI Section 12. FINRA also noted that the International Securities Exchange has filed a proposed rule change (SR-ISE-2008-21) with the Commission to make conforming changes to its Rule 611 (Discretionary Accounts).

²¹ See Amendment No. 1, supra note 5, at 4.

²² Interpretations and Policies .02 to CBOE Rule 9.2 specifies that the review of the acceptance of a discretionary account must be performed by a Series 4 qualified individual. See Securities Exchange Act Release No. 56971 (December 14, 2007), 72 FR 72804 (December 21, 2007) (SR-CBOE-2007-106).

²³ See Amendment No. 1, supra note 5, at 4.

supervisory review by a Registered Options Principal who is not exercising the discretionary authority” should be performed by a Registered Options Principal (Series 4).²⁴

The Commission believes that the proposed rule change to incorporate rules relating to warrants, options, and security futures into the Consolidated FINRA Rulebook and to delete corresponding NYSE Incorporated Rules is appropriate. In addition the Commission believes that the revision to the proposed rule text and the clarification contained in Amendment No. 1 appropriately address the issues raised in the SIFMA Letter.

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,²⁵ for approving the proposed rule change, as modified, prior to the thirtieth day after the date of publication of notice in the Federal Register. FINRA’s proposed changes, with the exception of the proposed revisions contained in Amendment No. 1, were published for comment by the Commission. The Commission believes that the proposed changes to FINRA Rule 2360 that are part of Amendment No. 1 are consistent with Interpretations and Policies .02 to CBOE Rule 9.2, which was published for comment and approved by the Commission.²⁶ Accordingly, the Commission finds that there is good cause, consistent with Section 6(b)(5) of the Act,²⁷ to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as modified by Amendment No. 1, is

²⁴ Id.

²⁵ 15 U.S.C. 78s(b)(2).

²⁶ See Securities Exchange Act Release Nos. 56492 (September 21, 2007), 72 FR 54952 (September 27, 2007) (SR-CBOE-2007-106); and 56971 (December 14, 2007), 72 FR 72804 (December 21, 2007) (SR-CBOE-2007-106).

²⁷ 15 U.S.C. 78s(b)(5).

consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2008-032 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2008-032. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that

you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2008-032 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁸ that the proposed rule change (SR-FINRA-2008-032), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁹

Florence E. Harmon
Acting Secretary

²⁸ 15 U.S.C. 78s(b)(2).

²⁹ 17 CFR 200.30-3(a)(12).