

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-59075; File No. SR-FINRA-2008-055)

December 10, 2008

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Proposed Rule Change to Adopt FINRA Rule 2114 (Recommendations to Customers in OTC Equity Securities) in the Consolidated FINRA Rulebook

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-5 thereunder,<sup>2</sup> notice is hereby given that on November 4, 2008, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt NASD Rule 2315 (Recommendations to Customers in OTC Equity Securities) as FINRA Rule 2114 in the Consolidated FINRA Rulebook, subject to certain amendments.

The text of the proposed rule change is available at FINRA, on its Web site ([www.finra.org](http://www.finra.org)), and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

As part of the process of developing the new consolidated rulebook ("Consolidated FINRA Rulebook"),<sup>3</sup> FINRA is proposing to adopt in the Consolidated FINRA Rulebook NASD Rule 2315 (Recommendations to Customers in OTC Equity Securities) with certain modifications.

a. The Current Rule

NASD Rule 2315 is intended to address potential fraud and abuse in transactions involving securities not listed on an exchange and certain other higher risk securities. The rule mandates that a member conduct a due diligence review of an issuer's current financial and business information before recommending a covered security. The rule supplements existing FINRA rules and the federal securities law, including suitability obligations and the requirement that any recommendation to a customer have a reasonable basis. The rule requirements go beyond the basic suitability obligations to ensure that a registered representative has, at a minimum, confirmed the existence of and

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<sup>3</sup> The current FINRA rulebook includes, in addition to FINRA Rules, (1) NASD Rules and (2) rules incorporated from NYSE ("Incorporated NYSE Rules") (together, the NASD Rules and Incorporated NYSE Rules are referred to as the "Transitional Rulebook"). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE ("Dual Members"). For more information about the rulebook consolidation process, see FINRA Information Notice, March 12, 2008 (Rulebook Consolidation Process).

reviewed essential information that reveals the financial condition and business prospects of these riskier issuers.

Specifically, the rule requires a member to review “current financial statements” and “current material business information” before it recommends the purchase or short sale of those securities that are published or quoted in a “quotation medium” and are either (1) not listed on Nasdaq or a national securities exchange or (2) are listed on a regional securities exchange and do not qualify for dissemination of transaction reports via the Consolidated Tape. Such securities may be more susceptible to fraud and abuse because they often are thinly capitalized or lack the profitability, liquidity or available business and financial information that listing standards require. The rule does not apply to recommendations to sell long positions and also exempts certain other transactions, including those with an “institutional account” under NASD Rule 3110(c)(4), a “qualified institutional buyer” under Rule 144A of the Securities Act of 1933 (“Securities Act”), or a “qualified purchaser” under Section 2(a)(51) of the Investment Company Act of 1940.<sup>4</sup>

The rule defines “current financial statements” to include balance sheets, statements of profit and loss and publicly available financial statements and reports. The definition makes certain distinctions between foreign private issuers and all other issuers. FINRA has interpreted the term “current material business information” to mean information that is available or relates to events that have occurred in the 12 months prior

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<sup>4</sup> Among the other exemptions, the Rule’s requirements also do not apply to transactions that meet the requirements of Rule 504 of Regulation D of the Securities Act; those involving a security of an issuer with at least \$50 million in total assets and \$10 million in shareholder’s equity; and those involving a security with worldwide average daily trading volume value of at least \$100,000 during each of the six months preceding the recommendation.

to the recommendation. The proposed definition of “current material business information,” discussed below, would supersede this prior interpretation.<sup>5</sup>

The required review must be conducted by a Series 24 principal or someone supervised by a Series 24 principal. Members are required to keep a written record of the information reviewed, the date of the review and the name of the person who conducted the review. The proposed rule change would add a requirement that, in the event the person designated to perform the review is not registered as a Series 24 principal, the member must document the name of the Series 24 principal who supervised the designated person. FINRA believes this change will help document the Series 24 principal with supervising responsibility in association with review.<sup>6</sup>

b. Proposed Changes to the Current Rule

The proposed rule change would expand the scope of the rule to cover a recommendation to buy any “OTC Equity Security,” irrespective of whether the security is published on a quotation medium. The term “OTC Equity Security” would have the same meaning as in NASD Rule 6610 (which will be renumbered as FINRA Rule 6420 in the Consolidated FINRA Rulebook<sup>7</sup>) and encompasses any non-exchange-listed security and certain exchange-listed securities that do not otherwise qualify for real-time trade dissemination. FINRA believes that those OTC Equity Securities not published on

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<sup>5</sup> Telephone conference among Philip Shaikun, Associate Vice President and Associate General Counsel, FINRA, and Haimera Workie, Branch Chief, Securities and Exchange Commission, and Darren Vieira, Attorney Advisor, Commission, on December 3, 2008.

<sup>6</sup> Telephone conference among Philip Shaikun, FINRA, and Haimera Workie, Branch Chief and Darren Vieira, Attorney Advisor, on December 3, 2008.

<sup>7</sup> See Securities Exchange Act Release No. 58643 (September 25, 2008), 73 FR 57174 (October 1, 2008) (Order Approving SR-FINRA-2008-021; SR-FINRA-2008-022; SR-FINRA-2008-026; SR-FINRA-2008-028 and SR-FINRA-2008-029).

a quotation medium pose the same, if not greater, risk of fraud and manipulation that the rule seeks to redress.

The proposed rule change also would add an express definition of “current material business information” to include “information that is ascertainable through the reasonable exercise of professional diligence and that a reasonable person would take into account in reaching an investment decision.”

Finally, the proposed rule change would eliminate the exemption from the rule for a security with a worldwide average daily trading volume value of at least \$100,000 during each of the six calendar months preceding the recommendation, as well as a related exemption for a convertible security where the underlying security satisfies the trading volume exemption requirements. FINRA believes that the advent of the Internet and the increased number of trading venues has rendered that threshold unreliable to screen out less risky securities.

FINRA will announce the implementation date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>8</sup> 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 the trade, and in general, to protect investors and the public interest. FINRA believes that the proposed rule change will help protect investors against fraud in the trading of unlisted and certain other riskier securities and will clarify

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<sup>8</sup> 15 U.S.C. 78o-3(b)(6).

and streamline NASD Rule 2315 for adoption as a FINRA Rule in the new Consolidated FINRA Rulebook. NASD Rule 2315 has previously have been found to meet the statutory requirements, and FINRA believes that rule has since proven effective in achieving the statutory mandates.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is 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](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2008-055 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-2008-055. 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 a.m. and 3 p.m. Copies of such 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-2008-055 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>9</sup>

Florence E. Harmon  
Acting Secretary

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<sup>9</sup> 17 CFR 200.30-3(a)(12).