

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58626; File No. SR-FINRA-2008-046)

September 23, 2008

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change, and Amendment No. 1 Thereto, to Amend the By-Laws of FINRA Regulation to Realign the Representation of Industry Members on the National Adjudicatory Council to Follow More Closely the Categories of Industry Representation on the FINRA Board

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 8, 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. On September 17, 2008, FINRA filed Amendment No. 1 to the proposed rule change. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

FINRA is proposing to amend the By-Laws of FINRA’s regulatory subsidiary (“FINRA Regulation”) to realign the representation of industry members on the National Adjudicatory Council (“NAC”) to follow more closely the industry representation on the FINRA Board of Governors (“FINRA Board”), to eliminate the Regional Nominating Committees, to transfer such committees’ responsibilities for NAC industry appointments to the FINRA Nominating Committee (“Nominating Committee”), and to change the name of “NASD Regulation” and “NASD” to “FINRA Regulation ” and “FINRA” respectively. The text of the proposed rule

¹ 15 U.S.C. 78s(b)(1).

change is available at FINRA, on its Web site (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 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

Background on FINRA and Its Regulatory Subsidiary

On July 30, 2007, NASD and the New York Stock Exchange consolidated their member firm regulation operations into a combined organization, FINRA. As part of the consolidation, the SEC approved amendments to the NASD By-Laws to implement governance and related changes.³ The approved changes included a FINRA Board governance structure that balanced public and industry representation and designated seven governor seats to represent member firms of various sizes based on the criteria of firm size.

FINRA Regulation (formerly known as NASD Regulation) is a subsidiary of FINRA that operates according to the Plan of Allocation and Delegation of Functions by NASD to

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 56145 (July 26, 2007), 72 FR 42169 (August 1, 2007), as amended by Securities Exchange Act Release No. 56145A (May 30, 2008), 73 FR 32377 (June 6, 2008) (File No. SR-NASD-2007-023).

Subsidiaries, as amended, which NASD adopted first in 1996 when it formed NASD Regulation. FINRA Regulation's By-Laws were not amended at the time of the consolidation, other than in a few sections where those By-Laws conflicted with the new FINRA By-Laws.

The proposed rule change would modify the FINRA Regulation By-Laws to: restructure the industry representation on the NAC to parallel the firm-size criteria for industry representation on the FINRA Board; modify the nomination process for certain industry member seats on the NAC by using the Nominating Committee and discontinuing the Regional Nominating Committees; and adopt conforming changes to reflect the corporate name change and similar matters.⁴

The National Adjudicatory Council

The NAC is appointed pursuant to the FINRA Regulation By-Laws to review all disciplinary decisions issued by Hearing Panels and presides over disciplinary matters that have been appealed to or called for review by the NAC. The NAC also reviews statutory disqualification matters and considers appeals of membership proceedings and exemption requests.⁵

Under current FINRA Regulation By-Law provisions, the NAC must consist of no fewer than 12 and no more than 14 members.⁶ The number of non-industry members, including at

⁴ The proposed rule change would revise, delete, and/or renumber various provisions of the FINRA Regulation By-Laws. Renumbered sections are referred to herein as "proposed FINRA Regulation By-Laws." All other sections (that is, sections for which new numbering did not result from the proposed revisions) are referred to as "current FINRA Regulation By-Laws."

⁵ See current FINRA Regulation By-Laws, Article V, Section 5.1 (Appointment and Authority).

⁶ The 2008 NAC consists of 14 members, and the NAC has had no fewer than 14 members consistently for many years. To reflect past practices, the proposed rule change would eliminate the 12 to 14 member range currently indicated in the FINRA Regulation By-

least three public members, must equal or exceed the number of industry members.⁷ Since 1999, each of five geographic regions, which had been established by the NASD Board of Governors, has been represented on the NAC. Non-industry members of the NAC and two “at-large” industry members currently are nominated to serve on the NAC by the Nominating Committee and then appointed by the FINRA Regulation Board.⁸ The five industry members of the NAC who are drawn from the five geographic regions are first selected through Regional Nominating Committees (through either an uncontested or a contested nomination process), then nominated by the Nominating Committee, and finally appointed by the FINRA Regulation Board.

Discussion of Changes to the NAC Election Process

The proposed rule change would amend Article I (Definitions), Article V (National Adjudicatory Council), and Article VI (National Adjudicatory Council Regional Nominations for Industry Members) of the FINRA Regulation By-Laws to replace the current regionally based approach for appointing industry representatives to the NAC with a process that is based on firm size and is similar to the FINRA Board’s approach.⁹ The NAC’s regionally based

Laws and state instead that the NAC shall consist of 14 members, divided equally between industry and non-industry. The proposal would eliminate the concept of non-industry members exceeding industry members and state simply that non-industry NAC members will equal industry NAC members. Given that the population of the NAC will be 14, its balanced nature can be achieved with an equal industry/non-industry composition.

⁷ See current FINRA Regulation By-Laws, Article V, Section 5.2 (Number of Members and Qualifications).

⁸ Consistent with Article V of the FINRA Regulation By-Laws, the current 14-member NAC includes seven industry and seven non-industry members. Five of the industry NAC members represent the five geographic regions. The remaining two industry seats are "at-large" seats, which NASD historically used and FINRA currently uses to add balance to the types of firms being represented on the NAC.

⁹ The FINRA Board consists of eleven Public Governors (who are appointed), ten Industry Governors (seven of whom are elected by industry members), the current Chief Executive Officer ("CEO") of NYSE Regulation, and the current CEO of FINRA. The

election process is a legacy NASD practice that no longer parallels the governance structure of the FINRA Board. The proposed rule change would replace the five regionally based industry members of the NAC with two small firm, one mid-size firm, and two large firm industry representatives. The make-up of the NAC under the proposed rule change would follow more closely the current make-up of the FINRA Board.

The restructured NAC would therefore consist of 14 members, including seven industry members, two of whom are “at large” and five of whom are designated specifically as representatives of large firms, mid-size firms, and small firms, and seven non-industry members, three of whom are public.¹⁰ The tenure of NAC members is generally three years and the terms of the NAC members are staggered. The proposal would not disrupt the process of approximately one-third of the NAC members completing their service in a particular year and being replaced with newly appointed NAC members. The proposal would result in a Small Firm and a Large Firm NAC Member joining the NAC near the beginning of 2009; a Mid-Sized Firm NAC Member joining in 2010; and a Small Firm and Large Firm NAC Member joining in 2011. The proposed selection process would allow for the service of NAC members with knowledge,

ten Industry Governors include: (a) three elected Governors who are registered with member firms that employ 500 or more registered persons (Large Firm Governors); (b) one elected Governor who is registered with a member firm that employs at least 151 and no more than 499 registered persons (Mid-Size Firm Governor); (c) three elected Governors who are registered with member firms that employ at least one and no more than 150 registered persons (Small Firm Governors); (d) one appointed Governor who is associated with a floor member of the New York Stock Exchange; (e) one appointed Governor who is associated with an independent contractor financial planning member firm or an insurance company affiliate; and (f) one appointed Governor who is associated with an affiliate of an investment company. See FINRA By-Laws, Article VII (Board of Governors).

¹⁰ A public member of the NAC has no material business relationship with a broker or dealer or a self-regulatory organization registered under the Act.

impartiality, and judicial temperament, while maintaining the same level of indirect representation of FINRA's membership.

In conjunction with eliminating the regionally based criteria for identifying industry NAC members, the proposed rule change also would simplify the NAC appointment process for industry representatives and follow more closely the procedures for electing industry members of the FINRA Board. The process proposed would eliminate the five Regional Nominating Committees and have the Nominating Committee perform their functions instead. Rather than relying on Regional Nominating Committees to first identify possible industry candidates before submission of the candidates to the Nominating Committee and the FINRA Regulation Board, the Nominating Committee would identify and solicit candidates for all NAC seats, including the five industry-member positions that are based on firm size.¹¹ The Nominating Committee would be free to consult with or receive recommendations for industry NAC members from other FINRA committees, such as the District Nominating Committees, before communicating its nominations to the FINRA Board.

The proposed rule change would continue the current process of allowing individuals who seek to serve on the NAC but were not nominated, known as additional candidates, to gather petitions in support of their candidacy and potentially compete in a contested election. Additional candidates would petition to be considered as Small, Mid-Size, or Large Firm NAC Members based on the size of the firm with which they are registered.

Under the proposal, additional candidates would be able to qualify for a contested election by gathering petitions from three percent of the firms in their size category, which is lower than the ten percent requirement additional candidates currently need to gather when they

¹¹ See proposed FINRA Regulation By-Laws, Article V, Section 5.3 (Appointments).

seek to qualify for a regional NAC seat.¹² In the event of a contested election, FINRA members would have an opportunity to vote for a NAC candidate based on firm size.¹³ Specifically, small, mid-size, or large firms would vote for NAC candidates only if the contested election was for a NAC seat designated for a firm of corresponding size.

The proposed rule change would ensure that the winner of a contested election serves on the NAC. While all NAC members would continue to be recommended initially by the Nominating Committee and appointed by the FINRA Board,¹⁴ the candidate who receives the most votes in any contested election for a Small, Mid-Size, or Large Firm NAC Member seat would be required under the FINRA Regulation By-Laws to be appointed to the NAC.¹⁵ The current By-Law section that discusses the procedure in the event that the Regional Nominating Committee's nominee is rejected by the National Nominating Committee would accordingly be deleted. The proposal would not change the NAC selection process if no additional candidates reach the threshold to qualify for a contested election. As in the past when there are no additional candidates, the industry NAC members selected by the Nominating Committee would not have a contested election and would be recommended for appointment to the NAC.¹⁶

¹² Compare current FINRA Regulation By-Laws, Article VI, Section 6.15 (Requirement for Petition Supporting Additional Candidate) with proposed FINRA Regulation By-Laws, Article VI, Section 6.2 (Designation of Additional Candidates).

¹³ See proposed FINRA Regulation By-Laws, Article VI, Section 6.3 (List of FINRA Members Eligible to Vote) and Article VI, Section 6.7 (Ballots).

¹⁴ The seven non-industry members and two at-large industry members would continue to follow the nomination and Board appointment process currently employed for non-industry and at-large industry NAC members.

¹⁵ See proposed FINRA Regulation By-Laws, Article V, Section 5.3 (Appointments) and 5.5 (Rejection of Nominating Committee Nominee).

¹⁶ The proposed FINRA Regulation By-Laws retain the possibility that the Nominating Committee could propose two or more candidates for a single open small, mid-size, or large firm NAC seat. See proposed FINRA Regulation By-Laws, Article VI, Section 6.5

To verify that a NAC nominee or candidate would satisfy the definition of an Industry, Small Firm, Mid-Sized Firm, Large Firm, Non-Industry, or Public Member of the NAC, the proposed rule change would authorize the FINRA Secretary to collect information from candidates as is reasonably necessary to serve as the basis for such a determination.¹⁷

The proposed rule change would modify slightly the provision that restricts NAC members and certain committees from communicating in an official capacity in support of a candidate in a contested election. The current rules, which permit individuals who are Directors or NAC or other committee members to communicate their views regarding a candidate in an individual capacity, would remain the same. The modification would specify the narrow circumstances under which the Nominating Committee may support its candidate by sending a maximum of two mailings in support of its nominee.¹⁸ The proposal would clarify that this limited support is available during contested NAC elections by referring to support allowed “under these By-Laws,” which includes the support allowed under Article IV, Section 4.16.¹⁹

The proposed rule change would designate the Secretary of FINRA, instead of the FINRA Regulation Secretary, as the person who would send notice to FINRA members

(Notice of Contested Nomination). In such a case, there would be a contested election. The proposed rule change would clarify that only when the Nominating Committee nominates two or more candidates for the same open seat would the Nominating Committee trigger a contested election.

¹⁷ See proposed FINRA Regulation By-Laws, Article V, Section 5.4 (Nomination Process).

¹⁸ See proposed FINRA Regulation By-Laws, Article IV, Section 4.16(b) (Communication of Views Regarding Contested Election or Nomination). Section 4.16(b) would also mirror the language of the FINRA By-Law provision that allows, in contested elections, the appropriate FINRA committee to communicate a responsive message in reply to an additional candidate's communication. See FINRA By-Laws, Article VII, Section 11(b) (Communication of Views).

¹⁹ See proposed FINRA Regulation By-Laws, Article VI, Section 6.6 (Administrative Support).

announcing a contested NAC election; assist in preparing ballots; prepare a list of FINRA members eligible to vote; arrange for the location for counting of ballots by an independent agent; resolve ballots that were set aside, if necessary; extend a time period regarding elections for good cause; and similar duties.²⁰ The proposal designates the FINRA Secretary because this office fulfills the same role when FINRA holds elections for the Board of Governors.

As a result of the NAC's restructuring, FINRA would continue to promote fair representation of its members because seven of the NAC seats will be drawn from members of the industry and the industry candidates for five of those seats will be announced to the membership and are subject to a potential election by member firms of a similar size.

In addition, the rule change would indicate in proposed Article V, Section 5.10 (Filling of Vacancies) that the NAC may continue to function while FINRA fills a vacancy on the NAC. The proposal also would incorporate the concept into Section 5.10 from proposed Section 5.9 (Disqualification), which specifies that a vacancy on the NAC lasting six months or less will not cause a violation of the compositional requirements of current Article V, Section 5.2 (Number of Members and Qualifications).

The proposed rule change would amend the FINRA Regulation By-Law provisions regarding resignation, removal, appointment, and disqualification of NAC members and the NAC's authority to act on FINRA's behalf by designating the FINRA Board as the body authorized to oversee the NAC.²¹ The FINRA Board has long had explicit authority under Articles XII and XIII of its By-Laws to establish procedures for disciplinary proceedings and to

²⁰ See proposed FINRA Regulation By-Laws, Article VI, Sections 6.5, 6.7, 6.8, 6.10, 6.11, 6.13, and 6.14.

²¹ See current FINRA Regulation By-Laws, Article V, Sections 5.1 (Appointment and Authority), and proposed Sections 5.7-5.9.

impose sanctions in certain circumstances, and has consistently relied on the NAC to render judgment on disciplinary matters, including imposing sanctions. The proposal would reinforce these roles by simplifying the FINRA Board's relationship with the NAC and establishing directly with the FINRA Board the authority to remove all NAC members (for refusal, failure, neglect, or inability to discharge duties), accept their resignations, appoint them, and declare them disqualified. Moreover, the FINRA Board's direct authority over resignation, removal, appointment, and disqualification would logically extend the FINRA Board's existing authority to review the substance of the NAC's appellate decisions, which exists through the FINRA Board's discretionary power to call a case for review by the FINRA Board.²² FINRA believes that the proposed rule change will benefit the appellate portion of the disciplinary process by extending the FINRA Board's oversight of the NAC's members.

The proposed rule change would amend current Article V, Section 5.2 of the FINRA Regulation By-Laws (Number of Members and Qualifications) to eliminate the reference that the Chair of the NAC shall automatically serve as a Director of the FINRA Regulation Board for a one-year term. As a result of the NASD and NYSE consolidation, the NAC Chair's automatic service on the FINRA Board of Governors was previously eliminated in 2007. Accordingly, the NAC Chair no longer automatically has the prerequisite requirement to be appointed to the FINRA Regulation Board.²³

²² See Rule 9351.

²³ Additional changes to the FINRA Regulation By-Laws regarding the FINRA Regulation Board and capital stock will be proposed by FINRA in a related proposed rule change that FINRA anticipates filing in the near future.

Conforming Changes Relating to the New FINRA name

The proposed rule change would make certain non-substantive changes to several articles of the FINRA Regulation By-Laws as follows:

- “the NASD” or “NASD” is replaced with “FINRA” or “the Corporation;”
- “NASD Regulation” is changed to “FINRA Regulation;”
- “the Rules of the Association” is replaced with “the Rules of the Corporation;” and
- “National Nominating Committee” is replaced with “Nominating Committee.”

The proposed rule change would modify the term “Industry Member” in the definitional section of FINRA Regulation’s By-Laws, Article I, by limiting the look-back test that characterizes NAC or committee members as industry if they have served as an officer, director, or employee of a broker or dealer, among other reasons, within the past twelve months. The current provision uses a three year look-back test. This proposed change would make the definition of “Industry Member” for NAC and other committee members consistent with the “Industry Governor” and “Industry committee member” definitions in the FINRA By-Laws.²⁴

The proposal would also add the term “independent director” to the portion of the definition of “Industry Member” that excludes outside directors of a broker or dealer. Independent director is synonymous with outside director, but would be added to the exclusionary clause to harmonize the FINRA Regulation By-Laws with the FINRA By-Laws’ use of the term “independent director” when defining an Industry Governor. In addition, the definition of “Public Director” and “Public Member,” which refers to NAC or committee members, would be modified to clarify that, for example, a Public Director’s service on FINRA

²⁴ See FINRA By-Laws, Article I(t).

Regulation's Board or a Public Member's service on the NAC does not disqualify that person from satisfying the definition of Public Director or Public Member.²⁵

The proposed rule change would reflect that FINRA Regulation's Delaware registered agent is Corporate Creations Network Inc.

The effective date of the proposed rule change will be the date of 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,²⁶ 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; and Section 15A(b)(4) of the Act,²⁷ which requires that FINRA rules are designed to assure a fair representation of FINRA's members in the administration of its affairs. The composition of the FINRA Board has previously been found to meet the statutory requirement, and FINRA believes that the proposed rule change will align the representation of industry members on the NAC to follow more closely the industry representation on the FINRA Board.

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 nor received.

²⁵ See proposed FINRA Regulation By-Laws, Article I(hh) and (ii).

²⁶ 15 U.S.C. 78o-3(b)(6).

²⁷ 15 U.S.C. 78o-3(b)(4).

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 reason for so finding or (ii) as to which FINRA 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. Please include File Number SR-FINRA-2008-046 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-2008-046. 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-2008-046 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.²⁸

Florence E. Harmon
Acting Secretary

²⁸ 17 CFR 200.30-3(a)(12).