

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59605; File No. SR-FINRA-2008-055)

March 19, 2009

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 Rule 2114 (Recommendations to Customers in OTC Equity Securities) in the Consolidated FINRA Rulebook

I. Introduction

On November 4, 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 (“SEC” or “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 FINRA Rule 2114 (Recommendations to Customers in OTC Equity Securities) in the consolidated FINRA Rulebook. The proposed rule change was published for comment in the Federal Register on December 10, 2008.³ The Commission received three comments in response to the proposed rule change.⁴ On February 13, 2009, FINRA filed Amendment No. 1 to amend the proposed rule change and respond to the comment

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 59075 (December 10, 2008), 73 FR 76429 (December 16, 2008) (SR-FINRA-2008-055) (“Rulemaking Notice”).

⁴ See Ronald C. Long, Director of Regulatory Affairs, Wachovia Securities LLC, dated December 9, 2008 (“Wachovia Letter”); Dale E. Brown, CAE, President and CEO, Financial Services Institute, dated January 6, 2009 (“FSI Letter”); and Amal Aly, Esq., Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated January 6, 2009 (“SIFMA Letter”).

letters.⁵ This order provides notice of the proposed rule change, as modified by Amendment No. 1, and approves the proposed rule change as amended on an accelerated basis.

II. Description of the Proposed Rule Change

FINRA proposed 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 including those contained in Amendment No. 1 discussed further below.

1. 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 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

⁵ Amendment No. 1 permits a General Securities Sales Supervisor (*i.e.*, a Series 8 or Series 9/10 qualified supervisor) to perform certain reviews the proposed rule would otherwise have required a Series 24 principal to perform or supervise.

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 1940.⁶

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 to the recommendation. The proposed definition of “current material business information,” discussed below, would supersede this prior interpretation.⁷

⁶ 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.

⁷ 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.

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.

2. 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 has been renumbered as FINRA Rule 6420 in the Consolidated FINRA Rulebook⁸) 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 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 a 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.”

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

⁸ 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).

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.

Finally, as modified by Amendment No. 1, the proposed rule requires that the due diligence review must be conducted by a person registered as a General Securities Principal (Series 24) or General Securities Sales Supervisor (Series 8 or 9/10), or someone supervised by a General Securities Principal or General Securities Sales Supervisor.⁹ 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 General Securities Principal or General Securities Sales Supervisor, the member must document the name of the General Securities Principal or General Securities Sales Supervisor who supervised the designated person. FINRA believes this change will help document the person with supervising responsibility in association with review.¹⁰

III. Comment Letters

The Commission received three comments on the proposal,¹¹ as well as FINRA's response to comments,¹² all of which are discussed below. Two commenters, a full service

⁹ Series references relate to the relevant FINRA qualifying examination series. The Series 8 examination was replaced by the Series 9 and 10 examinations effective August 16, 1999. A list of qualifying series examinations is available at FINRA's website, www.finra.org.

¹⁰ Telephone conference among Philip Shaikun, Associate Vice President and Associate General Counsel, FINRA, and Haimera Workie, Branch Chief and Darren Vieira, Attorney Advisor, on December 3, 2008.

¹¹ Ronald C. Long, Director of Regulatory Affairs, Wachovia Securities LLC, dated December 9, 2008 ("Wachovia Letter"); Dale E. Brown, CAE, President and CEO, Financial Services Institute, dated January 6, 2009 ("FSI Letter"); and Amal Aly,

brokerage firm and a trade association of securities firms, banks and asset managers, offered qualified support for the proposed rule change.¹³ One commenter, a trade association for the independent broker-dealer community, opposed the proposed rule change.¹⁴

1. Review by a Series 24 Principal

Proposed Rule 2114 would require a member to conduct a due diligence review of an issuer's current financial and business information before recommending a covered security. The proposed rule provides that the due diligence review must be performed by a Series 24 registered principal, or by a designee of the Series 24 registered principal, in which case the member must keep a record of the Series 24 principal who supervised the review. Two commenters suggested that a person with a Series 9/10 registration should be permitted to perform the reviews instead of Series 24 principals under the rule.¹⁵ One of those commenters also suggested that a person with a Series 8 registration also should be permitted to perform these reviews.¹⁶ In response to these comments, FINRA amended the proposed rule to provide that either a General Securities Principal (*i.e.*, a Series 24 principal) or a General Securities Sales Supervisor (*i.e.*, a Series 8 or 9/10 supervisor) may perform the due diligence review.¹⁷

2. Expanded Scope of the Rule to Any Non-Exempt OTC Equity Security

Esq., Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated January 6, 2009 ("SIFMA Letter").

¹² Letter from Philip Shaikun, Associate Vice President and Associate General Counsel, FINRA, dated February 13, 2009 ("FINRA Letter").

¹³ See SIMFA and Wachovia Letters.

¹⁴ See FSI Letter.

¹⁵ Wachovia and SIFMA Letters.

¹⁶ SIFMA Letter.

¹⁷ Amendment No. 1 to SR-FINRA-2008-055.

FINRA’s proposed rule is based on existing NASD Rule 2315. This rule requires a member to review “current financial statements” and “current material business information” before it recommends the purchase or short sale of 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.¹⁸ 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 proposed rule would also eliminate the exemption in NASD Rule 2315(e)(1)(E) for a security with a worldwide average daily trading volume value of at least \$100,000 during each month of the six full calendar months immediately before the date of the recommendation, and a related exemption for a convertible security where the underlying security meets the requirements of NASD Rule 2315(e)(1)(E). Two commenters opposed eliminating this exemption.¹⁹ One commenter indicated that the elimination of the exemption would require a due diligence review to be conducted for large, well-capitalized companies whose securities, in the commenter’s opinion, likely do not pose the type of risk that is intended to be addressed by the proposed rule.²⁰ The commenter also suggested, as an alternative or in addition to the exemption for securities with a worldwide average daily trading volume value of over \$100,000, that FINRA adopt an exemption based on the

¹⁸ NASD Rule 2315 had not been amended to reflect Nasdaq’s registration as a national securities exchange.

¹⁹ SIFMA and FSI Letters.

²⁰ SIFMA Letter.

underlying company's market capitalization.²¹ FINRA responded that it proposed to eliminate average daily trading volume and convertible security exemptions out of concern that the advent of the Internet and the increased number of trading venues has rendered the trading volume threshold unreliable to screen out less risky securities.²² FINRA noted that bringing certain larger companies within the purview of the rule does not dissipate this investor protection concern, and FINRA additionally noted that certain larger companies may qualify for another exemption to the rule applying to the securities of issuers that have at least \$50 million of total assets and \$10 million in shareholders equity.²³

One commenter opposed any expansion of the scope of the proposed rule beyond the scope of the NASD rule.²⁴ In this commenter's view, the expansion of the scope of the proposed rule would: (1) "result in reduced investor access to these securities by increasing the barriers to entry in the marketplace"; (2) delay the processing of purchases of non-exempt OTC Equity Securities; (3) reduce competition as firms leave the market of providing OTC Equity Security execution; (4) subject firms that remain in the market to higher compliance burdens; and (5) cause "overwhelming" recordkeeping and compliance burdens. FINRA disagreed that the proposed amendment would cause such deleterious effects.²⁵ FINRA stated that it believes investors will be better protected by the proposed rule amendment because recommendations of OTC Equity Securities that trade in the unlisted market, absent

²¹ Id.

²² FINRA Letter.

²³ Id.

²⁴ FSI Letter.

²⁵ FINRA Letter.

the due diligence required by the rule, pose substantial risk to investors.²⁶ FINRA also noted that the proposal would apply only to recommendations (as does the current rule), and not to unsolicited transactions, and therefore would not deny investors access to the OTC Equity Securities market. FINRA also disagreed that the proposal will result in processing delays for purchases of OTC Equity Securities, noting that the required due diligence should be completed before the recommendation is made.²⁷

3. Miscellaneous Comments

One commenter suggested that FINRA provide an exemption from the proposed rule for firms that (1) generate less than 5% of their commission revenue from OTC Equity Securities transactions, and (2) do not make a market in such securities.²⁸ The commenter asserted that such an exemption would allow FINRA to meet its investor protection goals without causing “unintended consequences” such as increasing compliance burdens or reducing competition.²⁹ FINRA stated that it believes that such an exemption would undermine the purpose of the rule by allowing a significant volume of OTC Equity Securities to escape the rule’s review requirements.³⁰

IV. Discussion and Commission Findings

After careful review of the proposed rule change, the comments, and FINRA’s response to the comments, the Commission finds that the proposed rule change is consistent with the requirements of the Act, and the rules and regulations thereunder that are applicable

²⁶ Id.

²⁷ Id.

²⁸ FSI Letter.

²⁹ Id.

³⁰ FINRA Letter.

to a national securities association.³¹ In particular, the Commission believes the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,³² 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 believes that the proposed rule change will help protect investors against fraud in the trading of unlisted and certain other securities and will clarify and streamline NASD Rule 2315 for adoption as a FINRA Rule in the new Consolidated FINRA Rulebook. The Commission has found NASD Rule 2315, upon which the proposed rule is based, to be consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.³³

The Commission also finds good cause for approving Amendment No. 1 to the proposed rule change prior to the thirtieth day after the date of publication of notice in the Federal Register. Amendment No. 1 clarifies the operation of the proposed rule in response to a comment. The changes in Amendment No. 1 do not significantly alter the proposed rule which was subject to a full notice and comment period. The Commission finds that it is in the public interest to approve the proposed rule change, as modified by Amendment No. 1, as soon as possible to expedite its implementation. Accordingly, the Commission finds that

³¹ 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).

³² 15 U.S.C. 78o-3(b)(6).

³³ See Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Microcap Initiative—Recommendation Rule, Securities Exchange Act Release No. 46376 (August 19, 2002), 67 FR 54832 (August 26, 2002) (SR-NASD-99-04).

there is good cause, consistent with and in furtherance of the objectives of Sections 6(b)(5)³⁴ and 19(b)³⁵ of the Act, to approve Amendment No. 1 on an accelerated basis.

V. 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 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-2008-055 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, 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

³⁴ 15 U.S.C. 78f(b)(5).

³⁵ 15 U.S.C. 78s(b).

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].

VI. Conclusions

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁶ that the proposed rule change (SR-FINRA-2008-055), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁷

Florence E. Harmon
Deputy Secretary

³⁶ 15 U.S.C. 78s(b)(2).

³⁷ 17 CFR 200.30-3(a)(12).