

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-63999; File No. SR-FINRA-2010-061)

March 1, 2011

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Adopting, as Modified by Amendment No. 1, Rules Governing Guarantees, Carrying Agreements, Security Counts and Supervision of General Ledger Accounts in the Consolidated FINRA Rulebook

I. Introduction

On November 12, 2010, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt rules governing guarantees, carrying agreements, security counts and supervision of general ledger accounts in the consolidated FINRA Rulebook. The proposed rule change was published for comment in the Federal Register on November 24, 2010.³ The Commission received one comment letter on the proposed rule change.⁴ On February 24, 2011, FINRA responded to the comments and filed Amendment No. 1 to the proposed rule change.⁵ The Commission is publishing this notice and order to solicit comments

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Exchange Act Release No. 63375 (November 24, 2010), 75 FR 74759 (December 1, 2010) (Notice of Filing of Proposed Rule Change; File No. SR-FINRA-2010-061) (“Notice”).

⁴ See Letter from D. Grant Vingoe, Arnold & Porter LLP (“Arnold & Porter”), to Elizabeth M. Murphy, Secretary, SEC, dated December 22, 2010 (available at <http://www.sec.gov/comments/sr-finra-2010-061/finra2010061.shtml>).

⁵ See Amendment No. 1 dated February 24, 2011 (“Amendment No. 1”) and FINRA’s response to comments, dated February 24, 2011 (“Response to Comments”), which are available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA, and on the Commission’s website at <http://www.sec.gov/rules/sro.shtml>.

on Amendment No. 1 and to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

II. Description of Proposed Rule Change, as Modified by Amendment No. 1

A. Background

1. Purpose

As part of the process of developing a new consolidated rulebook (“Consolidated FINRA Rulebook”),⁶ FINRA is proposing to adopt new, consolidated rules governing guarantees, carrying agreements, security counts and supervision of general ledger accounts. FINRA proposes to adopt FINRA Rules 4150 (Guarantees by, or Flow Through Benefits for, Members), 4311 (Carrying Agreements), 4522 (Periodic Security Counts, Verifications and Comparisons) and 4523 (Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts) in the Consolidated FINRA Rulebook and to delete NASD Rule 3230, NYSE Rules 322, 382, 440.10 and 440.20 and NYSE Rule Interpretations 382/01 through 382/05, 409(a)/01 and 440.20/01.⁷

The proposed rules would, in combination with other consolidated financial responsibility rules approved by the SEC,⁸ enhance FINRA’s authority to execute effectively its

⁶ The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) 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”). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see Information Notice, March 12, 2008 (Rulebook Consolidation Process).

⁷ For convenience, the Incorporated NYSE Rules are referred to as the “NYSE Rules.”

⁸ See Exchange Act Release No. 60933 (November 4, 2009), 74 FR 58334 (November 12, 2009) (Order Granting Accelerated Approval to Proposed Rule Change; File No. SR-FINRA-2008-067). See also Regulatory Notice 09-71 (December 2009) (SEC Approves

financial and operational surveillance and examination programs. Consistent with the approach that FINRA discussed in SR-FINRA-2008-067 and Regulatory Notice 09-71, many of the requirements set forth in the proposed rules are substantially the same as requirements found in current rules and, where appropriate, are tiered to apply only to carrying or clearing firms, or to firms that engage in certain specified activities.⁹ Certain of the proposed rule provisions are new for FINRA members that are not Dual Members (“non-NYSE members”). Certain other provisions are new for both Dual Members and non-NYSE members alike.

In Amendment No. 1, FINRA proposes new Supplementary Material .04 to Rule 4311. This Supplementary Material is technical in nature. It is intended to remind members that, for purposes of paragraphs (c)(1)(F) and (c)(2) of Rule 4311, the receipt and delivery of customers’ funds and securities and the safeguarding of such funds and securities must comply with the requirements of the SEC’s financial responsibility rules, in particular Exchange Act Rule 15c3-3 and applicable SEC guidance. Amendment No. 1 would redesignate the original Supplementary Material .04 as .05.

2. Proposed Amendments

FINRA proposes the following amendments to its rules.

- (A) Proposed FINRA Rule 4150 (Guarantees by, or Flow Through Benefits for, Members)

Consolidated FINRA Rules Governing Financial Responsibility) and Regulatory Notice 09-03 (January 2009) (Financial Responsibility and Related Operational Rules).

⁹ For purposes of the new consolidated financial responsibility rules and the proposed rules, FINRA has specified in the rule text where appropriate that all requirements that apply to a member that clears or carries customer accounts also apply to any member that, operating pursuant to the exemptive provisions of Exchange Act Rule 15c3-3(k)(2)(i), either clears customer transactions pursuant to such exemptive provisions or holds customer funds in a bank account established thereunder. For further discussion, see 74 FR 58334. See also proposed FINRA Rule 4523.02 in this rule filing.

As stated in the Notice, Proposed Rule 4150(a) is based in large part on NYSE Rule 322.¹⁰ Proposed Rule 4150(a) requires that prior written notice be given to FINRA whenever a member guarantees, endorses or assumes, directly or indirectly, the obligations¹¹ or liabilities of another person (including an entity).¹² Paragraph (b) of the rule requires that prior written approval must be obtained from FINRA whenever any member receives flow-through capital benefits in accordance with Appendix C of Exchange Act Rule 15c3-1.¹³

(B) Proposed FINRA Rule 4311 (Carrying Agreements)

Proposed FINRA Rule 4311 is based on NASD Rule 3230 and NYSE Rule 382.¹⁴ The proposed rule governs the requirements applicable to members when entering into agreements for the carrying of any customer accounts in which securities transactions can be effected. Historically, the purpose of the NASD and NYSE rules upon which the proposed rule is based has been to ensure that certain functions and responsibilities are clearly allocated to either the introducing or carrying firm, consistent with the requirements of the self-regulatory organization and SEC's financial responsibility and other rules and regulations, as applicable.¹⁵

¹⁰ NASD Rules do not have a provision that corresponds to NYSE Rule 322. Accordingly, the requirements of proposed FINRA Rule 4150 would be new to non-NYSE members.

¹¹ FINRA noted that the term "obligations" includes financial obligations, as well as other obligations that may have a financial impact on a member, such as performance obligations.

¹² NASD Rule 0120(n) defines "person" to include any natural person, partnership, corporation, association, or other legal entity. Similarly, NYSE Rule 2(d) states that "person" means a natural person, corporation, limited liability company, partnership, association, joint stock company, trust, fund or any organized group of persons whether incorporated or not. All references to "persons" in this filing include entities.

¹³ FINRA notes the proposed rule is designed to align with the requirements of Appendix C.

¹⁴ Proposed FINRA Rule 4311 also is based on NYSE Rule Interpretations 382/01 through /05 and 409(a)/01.

¹⁵ See, e.g., Notice to Members 94-7 (February 1994) (SEC Approves New NASD Rule Relating to the Obligations and Responsibilities of Introducing and Clearing Firms) and

As discussed in the Notice, Proposed FINRA Rule 4311(a)(1) prohibits a member, unless otherwise permitted by FINRA, from entering into an agreement for the carrying on an omnibus or fully disclosed basis, of any customer account in which securities transactions can be effected, unless the agreement is with a carrying firm that is a FINRA member.

Proposed FINRA Rule 4311(b)(1) requires that the carrying firm must submit to FINRA for prior approval any agreement for the carrying of accounts, whether on an omnibus or fully disclosed basis, before such agreement may become effective.¹⁶ The proposed rule also provides that the carrying firm must submit to FINRA for prior approval any material changes to an approved carrying agreement before the changes may become effective. The proposed rule codifies the practice under NASD Rule 3230 of permitting use of pre-approved standardized forms of agreement, with the exception of agreements with parties that are not U.S.-registered broker-dealers. The proposed rule requires a carrying firm to submit to FINRA for approval each carrying agreement with a non-U.S.-registered broker-dealer.

FINRA Rule 4311(b)(3) codifies the current practice under NYSE Rule 382 of requiring that as early as possible, but not later than 10 business days, prior to the carrying of any accounts of a new introducing firm (including the accounts of any piggyback or intermediary introducing firm(s)), the carrying firm must submit to FINRA a notice identifying each such introducing firm by name and CRD number and include such additional information as FINRA may require.¹⁷

NYSE Information Memo 82-18 (March 1982) (Carrying Agreements – Amendments to Rules 382 and 405).

¹⁶ Proposed FINRA Rule 4311(b)(1) is consistent with the requirements of NASD Rule 3230(e) and NYSE Rule 382(a).

¹⁷ This is a new requirement for non-NYSE carrying members, and permits FINRA to obtain additional information that enables it to evaluate the impact of the new carrying arrangement on the financial and operational condition of the member.

FINRA Rule 4311(b)(4) expressly requires each carrying firm to conduct appropriate due diligence with respect to any new introducing firm relationship. The rule provides that such due diligence must assess the financial, operational, credit and reputational risk that such arrangement will have upon the carrying firm. The rule also provides that FINRA, in its review of any arrangement, may in its discretion require specific items to be addressed by the carrying firm as part of the firm's due diligence requirement under the rule. The rule further provides that the carrying firm must maintain a record, in accord with the time frames prescribed by Exchange Act Rule 17a-4(b), of the due diligence conducted for each new introducing firm.

Proposed FINRA Rule 4311(c) requires that each carrying agreement in which accounts are to be carried on a fully disclosed basis must specify the responsibilities of each party to the agreement.¹⁸ The proposed rule also requires each carrying agreement in which accounts are to be carried on a fully disclosed basis to expressly allocate to the carrying firm the responsibility for preparing and transmitting statements of account to customers.

FINRA Proposed Rule 4311(d) requires that each customer whose account is introduced on a fully disclosed basis must be notified in writing upon the opening of the account of the existence of the carrying agreement and the responsibilities allocated to each respective party.¹⁹

Proposed FINRA Rule 4311(e) requires that each carrying agreement must expressly state that to the extent that a particular responsibility is allocated to one party, the other party or parties will supply to the responsible organization all appropriate data in their possession pertinent to the proper performance and supervision of that responsibility.²⁰

¹⁸ Proposed FINRA Rule 4311(c) is based in part on NASD Rule 3230(a) and NYSE Rule 382(b).

¹⁹ Proposed FINRA Rule 4311(d) is based in part on NASD Rule 3230(g), NYSE Rule 382(c), and NYSE Rule Interpretation 382/03.

²⁰ This is a new requirement for non-NYSE members.

Proposed FINRA Rule 4311(f) provides that a carrying agreement may authorize an introducing firm to issue negotiable instruments directly to its customers on the carrying firm's behalf, using instruments for which the carrying firm is the maker or drawer, provided that the parties comply with Exchange Act Rule 15c3-3 and further that the introducing firm represents to the carrying firm in writing that the introducing firm maintains, and will enforce, supervisory policies and procedures with respect to such negotiable instruments that are satisfactory to the carrying firm.²¹

Proposed FINRA Rules 4311(g) and 4311(h) generally address obligations of parties to provide referenced information, such as any written customer complaints and exception reports, to each other and/or to FINRA and are based upon existing NASD and NYSE rule provisions.

Proposed FINRA Rule 4311(i) provides that all carrying agreements must require each introducing firm to maintain its proprietary and customer accounts, and the proprietary and customer accounts of any introducing firm for which it is acting as an intermediary in obtaining clearing services from the carrying firm, in such a manner as to enable the carrying firm and FINRA to specifically identify the proprietary and customer accounts belonging to each introducing firm.²²

(C) Proposed FINRA Rule 4522 (Periodic Security Counts, Verifications and Comparisons)

Proposed FINRA Rule 4522(a) requires each member firm that is subject to the requirements of Exchange Act Rule 17a-13 to make the counts, examinations, verifications,

²¹ Proposed FINRA Rule 4311(f) is based in part on NASD Rule 3230(d) and NYSE Rule 382(f).

²² Proposed FINRA Rule 4311(i) is based largely on NASD Rule 3230(h) and does not have a corresponding provision in NYSE Rule 382.

comparisons, and entries set forth in that rule.²³ Proposed FINRA Rule 4522(b) requires each carrying or clearing member subject to Exchange Act Rule 17a-13 to make more frequent counts, examinations, verifications, comparisons, and entries where prudent business practice would so require.²⁴

(D) Proposed FINRA Rule 4523 (Assignment of Responsibility for General Ledger Accounts and Identification of Suspense Accounts)

Proposed FINRA Rule 4523 is intended to help assure the accuracy of each member's books and records.²⁵ Proposed FINRA Rule 4523(a) requires that each member must designate an associated person to be responsible for each general ledger bookkeeping account and account of similar function used by the member. The associated person must control and oversee entries into each such account and determine that the account is current and accurate as necessary to comply with all applicable FINRA rules and federal securities laws governing books and records and financial responsibility requirements.

Proposed FINRA Rule 4523(b) requires that each carrying or clearing member must maintain a record of the name of each individual assigned primary and supervisory responsibility for each account as required by paragraph (a) of the rule.

Proposed FINRA Rule 4523(c) provides that each member must record, in an account that must be clearly identifiable as a suspense account, money charges or credits and receipts or deliveries of securities whose ultimate disposition is pending determination.

²³ Proposed FINRA Rule 4522(a) is based in part on NYSE Rule 440.10.

²⁴ Id.

²⁵ Proposed FINRA Rule 4523 is based on NYSE Rule 440.20. NASD Rules do not have a provision that corresponds to NYSE Rule 440.20; therefore, the requirements of proposed FINRA Rule 4523 are new to non-NYSE members.

(E) Implementation Date

FINRA will announce the implementation date of these proposed rule changes in a Regulatory Notice to be published no later than 90 days following Commission approval. The implementation date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval.

III. Summary of Comment Letter and FINRA's Response

The proposed rule change was published for comment in the Federal Register on November 24, 2010, and the comment period closed on December 22, 2010. The Commission received one comment letter in response to the proposing release, the Arnold & Porter letter.²⁶ Arnold & Porter expressed concerns about the scope of proposed FINRA Rule 4311. Specifically, the commenter suggested that proposed FINRA Rule 4311 was not clear as to whether a FINRA member firm that operates pursuant to the exemptive provision of Exchange Act Rule 15c3-3(k)(2)(i) is engaged in carrying activity and, thereby, subject to the rule. In FINRA's response, it noted that FINRA had specified in the rule text where appropriate those requirements of the proposed rule which are intended to apply to firms that operate pursuant to the exemptive provisions of Exchange Act Rule 15c3-3(k)(2)(i).²⁷

The Arnold & Porter letter also raised concerns as to whether proposed FINRA Rule 4311 impacts the status of DVP/RVP clearance and settlement arrangements across international borders that may be structured as omnibus accounts where U.S.-registered broker-dealers seek to

²⁶ See supra note 4.

²⁷ See also Notice, note 6, at FR 74760 (stating, “[f]or purposes of the new consolidated financial responsibility rules and the proposed rules, FINRA has specified in the rule text where appropriate that all requirements that apply to a member that clears or carries customer accounts also apply to any member that, operating pursuant to the exemptive provisions of SEA Rule 15c3-3(k)(2)(i), either clears customer transactions pursuant to such exemptive provisions or holds customer funds in a bank account established thereunder.”).

designate these accounts at a foreign affiliate as approved foreign control locations under Exchange Act Rule 15c3-3. As FINRA stated in its response, the proposed rule applies to arrangements to carry customer accounts and is “not meant to address the substantive requirements of SEA Rule 15c3-3(c) as it applies to good control locations nor to apply to cross-border clearance and settlement arrangements that are structured on a basis that is permissible under and consistent with SEC rules.”²⁸

Finally, FINRA noted that the propriety of structuring cross-border clearance and settlement arrangements in the manner described by the commenter, and the propriety of a U.S.-registered broker-dealer’s reliance on Exchange Act Rule 15c3-3(k)(2)(i) for various business activities, were outside the scope of the proposed rule change.²⁹

IV. Discussion and Commission Findings

The Commission has carefully considered the proposed rule change, as modified by Amendment No. 1, the comment letter received, and FINRA’s response, and finds that the proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder that are applicable to a national securities association.³⁰ In particular, the Commission finds that the proposal is consistent with Section 15A(b)(6) of the Exchange Act,³¹ which requires, among other things, that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable

²⁸ See Response to Comments.

²⁹ Id.

³⁰ In approving this proposed rule change, the Commission notes that it has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³¹ 15 U.S.C. 78o-3(b)(6).

principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, protect investors and the public interest.

The Commission believes that FINRA adequately addressed the concerns raised by the commenter in its response. Further, the rule language in Amendment No. 1 reminds FINRA members that, for purposes of paragraphs (c)(1)(F) and (c)(2) of Rule 4311, the receipt and delivery of customers' funds and securities and the safeguarding of such funds and securities must comply with the requirements of the SEC's financial responsibility rules, in particular Exchange Act Rule 15c3-3 and applicable SEC guidance. The Commission believes the proposed rule change, as modified by Amendment No. 1, will further the purposes of the Exchange Act by, among other things, clarifying and streamlining the requirements surrounding carrying agreements, as well as the rules governing guarantees, security counts, and supervision of general ledger accounts.

V. Accelerated Approval

The Commission finds goods cause, pursuant to Section 19(b)(2) of the Exchange Act,³² for approving the proposed rule change, as modified by Amendment No. 1 thereto, prior to the 30th day after publication of Amendment No. 1 in the Federal Register. The changes proposed in Amendment No. 1 add clarity to Rule 4311 and do not raise novel regulatory concerns. In particular, Amendment No. 1 further reminds FINRA members that, for purposes of paragraphs (c)(1)(F) and (c)(2) of Rule 4311, receipt and delivery of customers' funds and securities and the safeguarding of such funds and securities must comply with the requirements of the SEC's financial responsibility rules, in particular Exchange Act Rule 15c3-3 and applicable SEC guidance.

³² 15 U.S.C. 78s(b)(2).

Accordingly, the Commission finds that good cause exists to approve the proposal, as modified by Amendment No. 1, on an accelerated basis.

VI. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 1 to the proposed rule change is consistent with the Exchange 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-2010-061 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-2010-061. 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 website (<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 website viewing and printing 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-2010-061 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,³³ that the proposed rule change (SR-FINRA-2010-061), 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.³⁴

Cathy H. Ahn
Deputy Secretary

³³ 15 U.S.C. 78(b)(2).

³⁴ 17 CFR 200.30-3(a)(12).