

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-78094; File No. SR-FINRA-2016-014)

June 17, 2016

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change Relating to Composition, Terms of Members and Election Procedures for the National Adjudicatory Council

I. Introduction

On April 28, 2016, 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 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend the By-Laws of FINRA’s regulatory subsidiary, FINRA Regulation, Inc. (“FINRA Regulation”), to expand the size of the National Adjudicatory Council (“NAC”) to 15 members, with the number of non-industry members exceeding the number of industry members; lengthen the terms of office of future NAC members to four years; and update the process used for sending and counting ballots in the event of a contested nomination and election to fill certain NAC industry member seats. The proposed rule change was published for comment in the Federal Register on May 13, 2016.<sup>3</sup> The Commission received four comment

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

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

<sup>3</sup> See Securities Exchange Act Release No. 77786 (May 9, 2016), 81 FR 29929 (May 13, 2016) (“Notice”).

letters on the proposal.<sup>4</sup> Thereafter, FINRA submitted a letter in response to the comment letters.<sup>5</sup> This order grants approval of the proposed rule change.

## II. Description of the Proposal<sup>6</sup>

The FINRA Regulation By-Laws establish the composition of the NAC,<sup>7</sup> the terms of its members, and the process by which members are selected. The NAC is currently composed of fourteen members.<sup>8</sup> The number of Non-Industry Members, which must include at least three Public Members, equals the number of Industry Members.<sup>9</sup> The seven Industry Members

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<sup>4</sup> See Letters from Steven B. Caruso, Esq., Maddox Hargett Caruso, P.C., dated May 9, 2016 (“Caruso Letter”); David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, dated May 19, 2016 (“FSI Letter”); Hugh Berkson, Public Investors Arbitration Bar Association, dated June 2, 2016 (“PIABA Letter”); and Christopher E. Berman, Barry University, dated June 2, 2016 (“Berman Letter”).

<sup>5</sup> See Letter from Gary Dernelle, Associate General Counsel, FINRA, dated June 13, 2016 (“FINRA Letter”).

<sup>6</sup> A full description of the proposal can be found in the Notice. See Notice, *supra* note 3.

<sup>7</sup> The NAC acts on behalf of FINRA in several capacities and its powers are authorized by the By-Laws of FINRA Regulation and FINRA’s Code of Procedure. The NAC presides over disciplinary matters appealed to or called for review by the NAC. The NAC also acts, when requested, in statutory disqualification and membership proceedings; considers the appeals of members seeking exemptive relief; and retains the authority to review decisions proposed in other proceedings as set forth in the Code of Procedure. For most matters that the NAC considers, it prepares a proposed written decision, which becomes final FINRA action if the Board does not call the matter for review. See Notice, *supra* note 3.

<sup>8</sup> See FINRA Regulation By-Laws, Article V (National Adjudicatory Council), Section 5.2(a) (Number of Members and Qualifications).

<sup>9</sup> *Id.* A “Non-Industry Member” of the NAC includes any Public Member, an officer or employee of an issuer of securities listed on a market for which FINRA provides regulation, an officer or employee of an issuer of unlisted securities that are traded in the over-the-counter market, or any individual who would not otherwise fall within the definition of an Industry Member. See FINRA Regulation By-Laws, Article I (Definitions), paragraph (ee). A “Public Member” generally is a Non-Industry Member who has no material business relationship with a broker or dealer or a self-regulatory organization registered under the Act. See FINRA Regulation By-Laws, Article I (Definitions), paragraph (hh). An “Industry Member” generally includes a person who is or served in the prior year as an officer, director, employee or controlling person of a

include two Small Firm NAC Members, one Mid-Size Firm NAC Member, two Large Firm NAC Members and two at-large Industry Members.<sup>10</sup>

The FINRA Board appoints the NAC and its members.<sup>11</sup> The FINRA Board appoints Non-Industry Members and at-large Industry Members from candidates recommended by the Nominating Committee. The FINRA Board also appoints Small Firm, Mid-Size Firm and Large Firm NAC Members, either from candidates recommended by the Nominating Committee, or in the event of a contested election for a Small Firm, Mid-Size Firm or Large Firm NAC Member vacancy, the candidate who is elected by FINRA members based on their vote for a candidate.<sup>12</sup> The Small Firm, Mid-Size Firm or Large Firm NAC Member candidate receiving the largest number of votes from firms of corresponding size is declared the nominee, and the Nominating Committee sends a written certification of the results to the FINRA Board and nominates such candidate for appointment to the NAC.<sup>13</sup>

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broker-dealer; is an officer, director or employee of an entity that owns a material equity interest in a broker-dealer; owns personally a material equity interest in a broker-dealer; provides professional services to broker-dealers, or to a director, officer, or employee of a broker-dealer in their professional capacity, where the revenues from such services meet material thresholds; or is or served in the prior year as a consultant, employee or provider of professional services to a self-regulatory organization registered under the Act. See FINRA Regulation By-Laws, Article I (Definitions), paragraph (x).

<sup>10</sup> See FINRA Regulation By-Laws, Article V (National Adjudicatory Council), Section 5.2(a) (Number of Members and Qualifications).

<sup>11</sup> See FINRA Regulation By-Laws, Article V (National Adjudicatory Council), Section 5.3 (Appointments).

<sup>12</sup> Id.

<sup>13</sup> See FINRA Regulation By-Laws, Article VI (Selection of Small Firm, Mid-Size Firm and Large Firm Industry Members of the National Adjudicatory Council), Section 6.13 (Certification of Nomination). The FINRA Board is required to appoint to the NAC the candidate who receives the most votes in any contested election for a Small Firm, Mid-Size Firm or Large Firm NAC Member seat. See FINRA Regulation By-Laws Article V (National Adjudicatory Council), Section 5.5 (Rejection of Nominating Committee Nominee).

The proposed rule change amends the FINRA Regulation By-Laws in three ways. First, it amends Section 5.2 of the FINRA Regulation By-Laws to expand the size of the NAC from fourteen members to fifteen members and require that the NAC have more Non-Industry Members, including at least three Public Members, than Industry Members. Accordingly, FINRA would add one Non-Industry Member seat to the current 14-member committee.

Second, the proposed rule change lengthens the term of office of future NAC members by one year, from three to four years.<sup>14</sup> In addition, the NAC would be divided into four classes, rather than the current three, that are as equal in number as feasible.<sup>15</sup>

Finally, the proposed rule change streamlines the NAC election process and aligns it with the process currently used for elections involving the FINRA District Committees. The proposed rule change amends Section 6.7 of the FINRA Regulation By-Laws by deleting the term “envelope” and adding language to permit ballots to be delivered by additional means.<sup>16</sup> The

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<sup>14</sup> See Proposed FINRA Regulation By-Laws, Article V (National Adjudicatory Council), Section 5.6(a) and (c) (Term of Office). FINRA stated that the proposed rule change would not alter or extend the term of any NAC member serving currently; the rule change would apply prospectively.

<sup>15</sup> See Proposed FINRA Regulation By-Laws, Article V (National Adjudicatory Council), Section 5.6(b) (Term of Office). The proposed rule change also amends Section 5.6(a) of the FINRA Regulation By-Laws to provide a three-year transitional period during which the FINRA Board may appoint new NAC members to terms of office less than four years to achieve the staggering necessary to divide the NAC into four classes. FINRA anticipates that, beginning in January 2017, and ending in December 2019, new NAC members would be appointed to terms of either three years or four years to achieve the result of a NAC that is divided into four classes, with each NAC member serving a term of four years. The proposed rule change also makes a conforming amendment to Section 5.6(b) of the FINRA Regulation By-Laws to delete obsolete text related to a prior rule change that replaced region-based Industry NAC members with Industry members that represent FINRA member firms of various sizes. See Securities Exchange Act Release No. 58909 (November 6, 2008), 73 FR 68467 (November 18, 2008) (Order Approving File No. SR-FINRA-2008-046).

<sup>16</sup> The proposed rule change would also make a conforming amendment to Section 6.9 of the FINRA Regulation By-Laws concerning ballots that are returned as undelivered.

proposed rule change aligns the ballot preparation process in NAC elections with that used in FINRA District Committee elections and allows FINRA members to vote using online and telephonic methods in addition to paper ballots.<sup>17</sup>

The proposed rule change also amends Section 6.10 of the FINRA Regulation By-Laws to simplify the tabulation of ballots by the Independent Agent, by eliminating the provision in Section 6.10 of the FINRA Regulation By-Laws that permits NAC candidates and their representatives to observe the Independent Agent's accounting of ballots in contested NAC elections. The proposed rule change would align the ballot counting process used in NAC elections with the process used in FINRA District Committee elections, which does not provide candidates the ability to be present while the Independent Agent opens and counts the ballots.<sup>18</sup> The proposed rule change will thus expedite the accounting process and permit the Secretary of FINRA to notify the candidates more quickly of NAC election results.

### III. Summary of Comment Letters and FINRA's Response

One commenter supported the proposed rule change and believed that expanding the size of the NAC and requiring that the number of Non-Industry Members exceed the number of

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<sup>17</sup> See FINRA Regulation By-Laws, Article VIII (District Committees), Section 8.11 (Ballots).

<sup>18</sup> See FINRA Regulation By-Laws, Article VIII (District Committees), Section 8.14 (General Procedures for Qualification and Accounting of Ballots). According to FINRA, the opportunity to observe the Independent Agent's qualification and accounting of ballots was rarely used by NAC candidates and provided candidates no additional grounds for recourse. Candidates and their representatives are not allowed to see the vote of any FINRA member and the final determination of the qualification of a ballot rests with the Secretary of the Corporation. See FINRA Regulation By-Laws, Article VI (Selection of Small Firm, Mid-Size Firm and Large Firm Industry Members of the National Adjudicatory Council), Section 6.10 (General Procedures for Qualification and Accounting of Ballots). FINRA noted that the Secretary of the Corporation must still certify election results. See FINRA Regulation By-Laws, Article VI (Selection of Small Firm, Mid-Size Firm and Large Firm Industry Members of the National Adjudicatory Council), Section 6.13 (Certification of Nomination).

Industry Members would “clearly advance the public interest and protect investors. . . .”<sup>19</sup> Two commenters generally supported the proposed rule change, but believed that FINRA should increase the number of Public Members on the NAC instead of adding an additional Non-Industry Member to the NAC.<sup>20</sup> Finally, one commenter expressed concerns about modifying the composition of the NAC and lengthening the term of office of future NAC members.<sup>21</sup>

A. Composition of the NAC

Two commenters suggested that FINRA increase the number of Public Members on the NAC.<sup>22</sup> Specifically, one commenter expressed concern that while altering the NAC’s composition to include a majority of Non-Industry Members would “enhance its reputation for impartiality and reduce the possibility of deadlock[,]” persons with significant industry connections may qualify as Non-Industry Members.<sup>23</sup> Similarly, another commenter believed that issuers and employees of issuers who would be categorized as Non-Industry Members “may be more closely aligned with Industry Members under certain circumstances.”<sup>24</sup> One commenter, however, raised concerns about modifying the composition of the NAC.<sup>25</sup> This commenter believed that the current composition of the NAC achieves a more balanced perspective and that increasing the number of Non-Industry Members on the NAC could diminish expertise on the NAC.

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<sup>19</sup> See Caruso Letter (recommending that the proposed rule change be approved on an expedited basis).

<sup>20</sup> See Berman Letter and PIABA Letter.

<sup>21</sup> See FSI Letter.

<sup>22</sup> See Berman Letter and PIABA Letter.

<sup>23</sup> See Berman Letter.

<sup>24</sup> See PIABA Letter.

<sup>25</sup> See FSI Letter.

In its response, FINRA noted that the current and proposed FINRA Regulation By-Laws do not limit the ability of the Board to appoint more than three Public Members to the NAC.<sup>26</sup> However, FINRA believed that explicitly increasing the number of Non-Industry Members that must also be Public Members would unnecessarily restrict FINRA’s flexibility to appoint to the NAC a diversity of Non-Industry Members and Public Members that serve best, based on the pool of potential candidates, to strengthen the quality of the NAC and its deliberations and decisions. Further, with respect to concerns regarding Non-Industry Members aligning with Industry Members because of their connections to the securities industry, FINRA made clear that the term Non-Industry Member explicitly excludes any individual that would otherwise fall within the definition of an Industry Member<sup>27</sup> and that the proposed rule change is similar to the current FINRA By-Laws that require the number of public governors that serve on the Board to exceed the number of industry governors.<sup>28</sup>

In response to the commenter’s concern that increasing the number of Non-Industry Members may diminish the NAC’s balanced perspective and expertise, FINRA noted that the proposed rule change still maintains FINRA’s custom of “substantial industry participation in the NAC’s adjudication of disciplinary and other matters.” Further, FINRA represented that it is committed to appointing Non-Industry Members that are both highly qualified and provide unique perspectives in NAC deliberations, including expertise in a variety of subjects and issues important to the matters the NAC considers, such as the federal securities laws, just and

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<sup>26</sup> See FINRA Letter.

<sup>27</sup> See FINRA Letter (citing to FINRA Regulation By-Laws, Article I (Definitions), paragraph (ee) (defining Non-Industry Member)).

<sup>28</sup> According to FINRA, while the terms Non-Industry Member and Public Governor are not identical, they are comparable. See FINRA Letter.

equitable principals of trade, best professional practices, and corporate governance and compliance.

B. Terms of Office for NAC Members

One commenter explicitly supported extending the terms of NAC members from three to four years.<sup>29</sup> This commenter believed that the annual turnover of NAC members compromised the NAC's effectiveness and that unseasoned members lacked the same institutional knowledge as members that have spent a more significant amount of time on the NAC.<sup>30</sup> However, another commenter raised concerns about extending terms on the NAC.<sup>31</sup> This commenter, while recognizing the benefit of extending member terms to four years, believed that the current three-year term allows for a rolling board with a variety of views. Accordingly, this commenter suggested that FINRA amend its proposal to re-evaluate the proposed four-year term at a future date.

In its response, FINRA noted that the proposed rule change would maintain the current NAC member term limit, which generally prohibits NAC members from serving consecutive terms, and staggered terms. According to FINRA, this should allow a "regular infusion of fresh ideas and knowledge and generally serve the goal of invigorating NAC deliberations" with the composition of the NAC changing each year, while allowing NAC members to be fully productive for a longer term. Further, with respect to the commenter's suggestion to re-evaluate the four-year term at a future date, FINRA noted that the NAC's decisions are generally subject to discretionary review by the FINRA Board of Governors. As a result, the FINRA Board of Governors is "well placed to conduct an ongoing evaluation of the NAC's effectiveness and the

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<sup>29</sup> See Berman Letter.

<sup>30</sup> See Berman Letter.

<sup>31</sup> See FSI Letter.

quality of its decision making” and therefore, amending the proposed rule change to establish a date for reevaluating the effectiveness of the longer member terms is unnecessary.

#### C. NAC Selection Process

One commenter believed that the revised selection process for contested elections would make the process more efficient and allow for electronic balloting.<sup>32</sup>

#### IV. Discussion and Commission Findings

After carefully considering the proposal, the comments submitted, 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 that are applicable to a national securities association.<sup>33</sup> Specifically, the Commission finds that the proposed rule change is consistent with Sections 15A(b)(4), 15A(b)(6) and 15A(b)(8) of the Act,<sup>34</sup> which require, among other things, that FINRA rules assure a fair representation of its members in the administration of its affairs; are 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 provide a fair procedure for disciplining of members and persons associated with members.

The Commission believes that FINRA’s proposal to add one Non-Industry Member to the NAC should enhance the independence of the NAC and continue to ensure that a diversity of expertise, experiences and views are represented on the NAC. With respect to commenters’ suggestion that FINRA should increase the number of Public Members on the NAC,<sup>35</sup> the Commission notes that under the proposed rule change FINRA still may appoint more than three

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<sup>32</sup> See Berman Letter.

<sup>33</sup> In approving this proposed rule change, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>34</sup> 15 U.S.C. 78o-3(b)(4), (b)(6) and (b)(8).

<sup>35</sup> See Berman Letter and PIABA Letter.

Public Members to the NAC,<sup>36</sup> but retains flexibility to appoint an additional Non-Industry Member or Public Member. According to FINRA, requiring that the Non-Industry Member be a Public Member would restrict its ability to appoint members that serve best, “based on the pool of potential candidates, to strengthen the quality of the NAC as an adjudicatory body and its deliberations and decisions.”<sup>37</sup> Further, with respect to concerns that the current composition of the NAC provides a more balanced perspective and expertise,<sup>38</sup> FINRA has represented that it will continue to appoint Non-Industry Members that are both highly qualified and provide unique perspectives and expertise in NAC deliberations.<sup>39</sup> Moreover, while Non-Industry Members would exceed the number of Industry Members, seven of the fifteen NAC members would continue to be Industry Members, including two Small Firm NAC Members, one Mid-Size Firm NAC Member, two Large Firm NAC Members, and two at-large Industry Members.<sup>40</sup> Accordingly, the Commission believes that the proposed rule change continues to allow for substantial industry participation, while enhancing the overall independence of the NAC.

The Commission also believes it is appropriate for FINRA to increase the term of NAC members from three to four years. While one commenter raised concerns about extending

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<sup>36</sup> See current and proposed FINRA Regulation By-Laws, Article V (National Adjudicatory Council), Section 5.2(a) (Number of Members and Qualifications) (stating that the National Adjudicatory Council shall consist of at least three Public Members).

<sup>37</sup> See FINRA Letter.

<sup>38</sup> See FSI Letter.

<sup>39</sup> See FINRA Letter. In the past, Non-Industry Members have included professors of law, finance, and business; current and former public pension and retirement system advisers; and leaders of independent, non-profit organizations that provide educational and outreach programs to issuers and investors. Id.

<sup>40</sup> See current and proposed FINRA Regulation By-Laws, Article V (National Adjudicatory Council), Section 5.2(a) (Number of Members and Qualifications).

member terms,<sup>41</sup> the Commission believes that the proposed rule change will allow NAC members to spend more time serving and being fully productive after gaining experience on the NAC. At the same time, the Commission believes the current term limits, staggered terms, and composition of the NAC should continue to provide the NAC with varied perspectives and views.

The Commission also believes that the proposed changes to the NAC selection process to modernize and streamline the process and to align it with the process used in FINRA District Committee elections are appropriate.<sup>42</sup> The proposed rule change would allow ballots to be delivered and voted by means other than the mail and further simplify the tabulation process by eliminating the provision that allowed NAC candidates and their representatives to observe the Independent Agent's accounting of ballots in a contested election. FINRA stated that candidates rarely opted to observe the Independent Agent and observing the Independent Agent did not provide candidates additional grounds for recourse. NAC candidates and their representatives were not allowed to see the vote of any FINRA member and the final determination of the qualification of a ballot rested with the Secretary of FINRA.

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<sup>41</sup> See FSI Letter.

<sup>42</sup> See FINRA Regulation By-Laws, Article VIII (District Committees), Sections 8.11 (Ballots), 8.13 (Ballots Returned as Undelivered), and 8.14 (General Procedures for Qualification and Accounting of Ballots).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>43</sup> that the proposed rule change (FINRA-2016-014) be, and it hereby is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>44</sup>

Robert W. Errett  
Deputy Secretary

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<sup>43</sup> 15 U.S.C. 78s(b)(2).

<sup>44</sup> 17 CFR 200.30-3(a)(12).