

Discretionary Accounts and Transactions

FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Discretionary Accounts and Transactions

Comment Period Expires: December 28, 2009

Executive Summary

As part of the process of developing a new consolidated rulebook (the Consolidated FINRA Rulebook),¹ FINRA is requesting comment on a proposed consolidated FINRA rule governing discretionary accounts and transactions.

The text of the proposed rule is set forth in Attachment A.

Questions regarding this *Notice* should be directed to Afshin Atabaki, Assistant General Counsel, Office of General Counsel, at (202) 728-8902.

Action Requested

FINRA encourages all interested parties to comment on the proposed rule. Comments must be received by December 28, 2009.

Members and other interested parties can submit their comments using the following methods:

- Emailing comments to pubcom@finra.org; or
- Mailing comments in hard copy to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

November 2009

Notice Type

- Request for Comment
- Consolidated FINRA Rulebook

Suggested Routing

- Compliance
- Legal
- Operations
- Senior Management
- Systems
- Trading

Key Topic(s)

- Authorization
- Discretionary Power
- Documentation
- Record Retention
- Supervision
- Time or Price Discretion

Referenced Rules & Notices

- Advisers Act Rule 202(a)(11)-1
- Information Notice 3/12/08
- NASD Rule 2510
- NASD Rule 3110
- NTM 03-73
- NTM 83-70
- NYSE Rule 408
- NYSE Rule Interpretation 408
- Regulatory Notice 08-25
- SEA Rule 17a-3
- SEA Rule 17a-4

To help FINRA process and review comments more efficiently, persons should only use one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this Notice will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.²

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.³

Background

The FINRA rulebook contains several provisions regarding discretionary accounts and transactions,⁴ including NASD Rule 2510 and Incorporated NYSE Rule 408 (and its Interpretation).⁵

NASD Rule 2510

NASD Rule 2510 addresses the obligations of members that have discretionary power over a customer's account.

Rule 2510(a) (Excessive Transactions) prohibits members and their agents or employees that have discretionary power over a customer's account from effecting any excessive transactions in view of the financial resources and character of such discretionary account. Rule 2510(b) (Authorization and Acceptance of Account) provides that a member or registered representative may not exercise any discretionary power in such account unless the customer has given prior written authorization to a stated individual, and the account has been accepted in writing by the member or a designated partner, officer or manager of the member. Rule 2510(c) (Approval and Review of Transactions) requires that a member or a designated partner, officer or manager of the member approve promptly in writing each discretionary order entered and review all discretionary accounts at frequent intervals to detect and prevent excessive transactions.

NASD Rule 2510(d) (Exceptions) provides certain exceptions from the requirements of paragraphs (a) through (c) of the rule. NASD Rule 2510(d)(1) provides an exception for investment discretion granted by a customer as to the price at which or the time to execute an order given by a customer for the purchase or sale of a definite amount of a specified security. However, the authority to exercise such discretion will be in effect only until the end of the business day on which the customer granted such discretion, unless the customer provides a specific written contrary indication signed and dated, or it is a valid good-'til-canceled instruction issued on a "not-held" basis for an institutional account as defined in NASD Rule 3110(c)(4).⁶ Rule 2510(d)(1) also requires that any exercise of time or price discretion be reflected on the order ticket.

NASD Rule 2510(d)(2) provides an exception for bulk exchanges at net asset value of money market mutual funds using negative response letters sent to customers, subject to specified conditions. FINRA staff has issued guidance regarding the use of the negative response process under Rule 2510(d)(2) in certain circumstances.⁷

NYSE Rule 408 and Rule Interpretation 408

NYSE Rule 408(a) prohibits members and their employees from exercising discretionary power in a customer's account without first obtaining: (1) the customer's written authorization (substantially similar to NASD Rule 2510(b)); (2) the signature of the person(s) authorized to exercise discretion in the account (similar to NASD Rule 3110(c)(3)(A)); and (3) the date such discretionary authority was granted (similar to NASD Rule 3110(c)(3)(B)). The requirements of NYSE Rule 408(a) also apply to those circumstances where a member or an employee accepts orders for a customer account from a third person (*i.e.*, an agent of the customer).

NYSE Rule 408(b) requires that: (1) employees notify a supervisor and obtain his or her prior approval before exercising discretionary power in a customer's account (substantially similar to NASD Rule 2510(b)); (2) the supervisor frequently review the account (substantially similar to NASD Rule 2510(c)); and (3) members maintain a written statement of the supervisory procedures governing such accounts (substantially similar to the general requirements of NASD Rule 3010(b)(1)). The rule further requires that an order entered on a discretionary basis by an employee be identified as discretionary on the order ticket (similar to SEA Rule 17a-3(a)(6)(i)).⁸

NYSE Rule 408(c) prohibits employees that have discretionary power over a customer's account from effecting any excessive transactions in view of the financial resources of such customer (substantially similar to NASD Rule 2510(a)).

Similar to NASD Rule 2510(d)(1), NYSE Rule 408(d) excludes from the requirements of NYSE Rules 408(a) through (c) the exercise of certain time or price discretion, including a valid good-'til-canceled instruction issued on a "not-held" basis for an institutional account. However, the definition of "institutional account" for purposes of the exclusion under NYSE Rule 408(d) differs from the definition of "institutional account" for purposes of the exclusion under NASD Rule 2510(d)(1).⁹

NYSE Rule 408.10 requires that all discretionary orders in listed index warrants be approved and initialed on the day entered by a Senior Registered Options Principal or Registered Options Principal.¹⁰

NYSE Rule Interpretation 408/01 (Automatic Money Market Fund Redemptions) addresses the obligation of members that offer their customers automatic money market fund redemption programs whereby debit balances created by the purchase of securities in a customer's account are automatically satisfied by the redemption of shares of a money market fund in the account.¹¹ Such programs are subject to specific conditions, including the requirement to notify customers in writing regarding the programs.

Proposal

FINRA proposes to transfer NASD Rule 2510 into the Consolidated FINRA Rulebook as FINRA Rule 3260 with certain changes that take into account requirements under NYSE Rule 408. The most significant proposed changes are described generally below. However, FINRA urges member firms to carefully review the entire attached proposed rule text to understand the full extent of the proposed changes. Unless otherwise noted below, the provisions in NASD Rule 2510 will transfer, subject only to non-substantive changes, as part of proposed FINRA Rule 3260.

A. Transactions by Members and Their Associated Persons (Proposed FINRA Rule 3260(a))

To provide additional clarity, proposed FINRA Rule 3260(a) groups together the requirements (such as trade-by-trade approval and frequent review of accounts) applicable to members and their associated persons that have discretionary power over a customer's account. The proposed rule clarifies that the requirements apply to all associated persons of a member, not just agents, employees and registered representatives. Consistent with the proposed changes to the consolidated FINRA rules governing books and records,¹² the proposed rule requires that a customer's written authorization be provided to a named, natural person or persons and that the discretionary account be accepted in writing by a designated partner, officer or manager of a member denoting that the account has been accepted in accordance with the member's policies and procedures for acceptance of discretionary accounts. Further, consistent with NYSE Rule 408(b), the proposed rule clarifies that the designated partner, officer or manager responsible for denoting acceptance of discretionary accounts, approving discretionary orders and reviewing such accounts has to be someone other than the person vested with discretionary power.

In addition, consistent with NASD Rule 3110(c)(3)(B) and NYSE Rule 408(a),¹³ the proposed rule requires that members and associated persons obtain the customer's "dated" prior written authorization to identify the date that the discretionary authority was granted.¹⁴

B. Transactions by Agents of Customers (Proposed FINRA Rule 3260(b))

Proposed FINRA Rule 3260(b) requires that, before accepting orders for a customer's account from any person other than the customer, members and associated persons obtain the customer's dated prior written authorization granting discretionary power to such person. This provision establishes a baseline requirement, regardless of the type of account.

This change is based in part on the existing requirements of NYSE Rule 408(a) regarding accepting orders for a customer account from a third person and SEA Rule 17a-3(a)(17)(ii) (which requires that, for each discretionary account with a natural person, members maintain a record containing the dated signature of the customer granting authorization).

FINRA is soliciting comments specifically on the ability of members to obtain the required written authorizations from customers in an institutional account (*e.g.*, sub-account customers in a master account—sub-account arrangement).

C. Specific Discretionary Activities by Members and Their Associated Persons in a Customer's Account; Extent Permissible (Proposed FINRA Rule 3260(c))

Proposed FINRA Rule 3260(c) provides that notwithstanding the requirements of proposed FINRA Rule 3260(a) members may, subject to certain conditions, exercise time or price discretion, effect bulk exchanges at net asset value of money market mutual funds using negative response letters (consistent with the conditions set forth in current NASD Rule 2510(d)(2)), effect redemptions of money market mutual funds for payment of securities purchases and effect transactions to satisfy an indebtedness to the member.

► Duration of Limited Time or Price Discretion

In light of inquiries from members regarding the duration of an oral authorization for time or price discretion, FINRA proposes to clarify that notwithstanding the requirements of proposed FINRA Rule 3260(a) members may exercise: (1) time or price discretion given by a customer *during* a normal trading session, provided that such discretion is only valid during that session; or (2) time or price discretion given by a customer *after the close* of a normal trading session, provided that such discretion is only valid during the next normal trading session. Such limited time or price discretion may be given orally by a customer. The proposed change has no impact on the duration of good-'til-canceled orders for institutional accounts (as set forth in current NASD Rule 2510(d)(1)).

► Redemptions of Money Market Funds for Payment of Securities Purchases and Transactions to Satisfy Indebtedness to the Member

As discussed above, transactions involving automatic money market fund redemption programs are subject to specific conditions, including the requirement that customers be given written notice specifically informing them of such programs. Additionally, FINRA believes that members and their customers should be provided the flexibility to enter into written agreements that allow certain transactions by members to satisfy an indebtedness to them (such as to satisfy margin requirements).

Therefore, the proposed rule clarifies that notwithstanding the requirements of proposed FINRA Rule 3260(a) a member may effect redemptions of money market funds for payment of securities purchases or effect transactions to satisfy an indebtedness to the member (*e.g.*, margin requirements), provided that such redemptions or transactions are permitted by a prior signed, written agreement between the member and customer that prominently discloses the terms of such arrangements. However, the proposed rule provides that any provisions in such agreement allowing the use of negative response letters remain subject to applicable FINRA rules and federal securities laws governing the use of such letters.

D. Addition of Supplementary Material (Proposed FINRA Rules 3260.01 and .02)

FINRA proposes adding supplementary material to:

- Clarify that the requirements of paragraphs (a) and (c) of proposed FINRA Rule 3260 relating to transactions by member firms and their associated persons apply only to the extent member firms may maintain broker-dealer discretionary accounts or otherwise exercise broker-dealer discretion in an account as permitted under the federal securities laws. This proposed change is designed to make these requirements self-limiting, as there are currently SEC rulemaking proposals pending that address the ability of broker-dealers to maintain discretionary accounts or otherwise exercise broker-dealer discretion in an account;¹⁵ and
- Require that customers' prior written authorizations, records denoting acceptance of accounts and written agreements between member firms and customers be preserved for at least six years after the date that such records are updated and that the last update to such records, or the original records if there are no updates, be preserved for at least six years after the date the account is closed. The proposed six-year retention period is consistent with the record retention period for similar customer account records under the proposed consolidated FINRA rules governing books and records and under the Exchange Act.¹⁶ Further, the proposed rule requires that member firms preserve records relating to the approval of discretionary orders for the period of time and accessibility specified in SEA Rule 17a-4(b), which is for at least three years. The proposed three-year retention period is consistent with the record retention period for order tickets under the Exchange Act.

FINRA proposes to delete NYSE Rule 408 and Rule Interpretation 408 as these provisions are substantially similar to proposed FINRA Rule 3260, otherwise incorporated as described above, rendered obsolete by the approach reflected in proposed FINRA Rule 3260, or addressed by other rules as described above.

Endnotes

- 1 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 member firms, 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 member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 3/12/08* (Rulebook Consolidation Process).
- 2 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *Notice to Members (NTM) 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (Exchange Act or SEA) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 4 This proposal excludes product-specific discretionary account requirements such as set forth in FINRA Rules 2354 (Discretionary Accounts), 2360(b)(18) (Discretionary Accounts) and 2370(b)(18) (Discretionary Accounts), which have been adopted as part of FINRA's set of consolidated rules addressing index warrants, options and security futures, respectively. See Exchange Act Release No. 58932 (November 12, 2008), 73 FR 69696 (November 19, 2008) (Order Granting Accelerated Approval; File No. SR-FINRA-2008-032). This proposal also excludes certain recordkeeping requirements relating to discretionary accounts (current NASD Rule 3110(c)(3) (Customer Account Information)) that are being addressed as part of the proposed changes to the consolidated FINRA rules governing books and records. See *Regulatory Notice 08-25* (May 2008) (Proposed Consolidated FINRA Rules Governing Books and Records Requirements).

Additionally, this proposal excludes NASD IM-2310-2(b)(4)(A)(ii) (Discretionary Accounts) (relating to fair dealing with customers), NASD Rules 2720(l) (Discretionary Accounts) (relating to transactions in securities issued by a member or an affiliate of a member or by a company with which a member has a conflict of interest) and 2810(b)(2)(C) (Suitability) (relating to direct participation programs) and FINRA Rule 5110(f)(2)(K)(ii) (Prohibited Arrangements) (relating to underwriting terms and arrangements). Some of these other provisions relating to discretionary accounts and transactions are more restrictive, but generally consistent with NASD Rule 2510.

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Endnotes continued

- 5 For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.
- 6 *See infra* note 9.
- 7 *See* Staff Interpretive Memo, dated May 15, 2008 (allowing use of the negative response process to designate an alternative money market sweep fund when the existing sweep fund closes with inadequate notice to permit a member to provide the 30-day prior notice required under Rule 2510(d)(2)(D)); Letter from Patricia Albrecht, Assistant General Counsel, NASD, to George T. Simon, Foley & Lardner, LLP, dated January 26, 2005 (allowing use of the negative response process to complete the transfer of customer funds from one money market mutual fund to another notwithstanding that proceeds were held as free credit balances for an intervening period between redemption and reinvestment). This proposal does not alter the existing guidance.
- 8 *See also* NYSE Rule Interpretation 408/02 (Identification of Discretionary Orders) (which addresses the marking of order tickets with a specific series of numbers or symbols for purposes of identifying orders entered on a discretionary basis).
- 9 NYSE Rule 408.11 defines the term “institutional account” to mean the account of: (1) a bank; (2) a savings association; (3) an insurance company; (4) a registered investment company; (5) a state or a political subdivision; (6) a pension or profit sharing plan, subject to ERISA, with more than \$25 million in total assets under management, or of a federal agency or political subdivision; (7) any person that has a net worth of at least \$45 million and financial assets of at least \$40 million; or (8) an SEC registered investment adviser.
- NASD Rule 3110(c)(4) defines the term “institutional account” to mean the account of: (1) a bank; (2) a savings and loan association; (3) an insurance company; (4) a registered investment company; (5) an SEC registered investment adviser or a state registered investment adviser; or (6) a person with total assets of at least \$50 million.
- 10 The Incorporated NYSE Rules relating to Senior Registered Options Principals were deleted as part of a prior rule change. *See* Exchange Act Release No. 58932 (November 12, 2008), 73 FR 69696 (November 19, 2008) (Order Granting Accelerated Approval; File No. SR-FINRA-2008-032). The FINRA consolidated rules relating to index warrants require that a Registered Options Principal frequently review such discretionary accounts and that any member that does not utilize computerized surveillance tools for the frequent and appropriate review of discretionary activity establish and implement procedures to require specific Registered Options Principals who have been designated to review discretionary accounts to approve and initial each discretionary order on the day entered. *See* FINRA Rules 2354 and 2360(b)(18)(A).

Endnotes continued

- 11 FINRA issued similar guidance in 1983. *See NTM 83-70* (December 1983) (Automatic Money Market Fund Redemptions).
- 12 *See Regulatory Notice 08-25* (May 2008).
- 13 FINRA is proposing to delete the requirement of Rule 3110(c)(3)(B) to record the date that the discretionary authority was granted as part of the proposed changes to the consolidated FINRA rules governing books and records. *See Regulatory Notice 08-25* (May 2008). FINRA believes that it is more appropriate to reposition this requirement into proposed FINRA Rule 3260.
- 14 *See also* SEA Rule 17a-3(a)(17)(ii) (which requires that, for each discretionary account with a natural person, members maintain a record containing the dated signature of the customer granting authorization).
- 15 In 2005, the SEC adopted Rule 202(a)(11)-1 under the Advisers Act, a principal purpose of which was to deem broker-dealers offering “fee-based brokerage accounts” not subject to the Advisers Act. Rule 202(a)(11)-1 also included several interpretive positions regarding Advisers Act Section 202(a)(11)(C), including a provision that any account over which a broker-dealer exercises investment discretion (other than on a temporary or limited basis) is subject to the Advisers Act. In March 2007, Rule 202(a)(11)-1 was vacated. *See Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007). In September 2007, the SEC re-proposed its interpretive positions for comment, including the provision regarding the application of the Advisers Act to discretionary accounts. *See* Investment Advisers Act Release No. 2652 (September 24, 2007), 72 FR 55126 (September 28, 2007) (Interpretive Rule Under the Advisers Act Affecting Broker-Dealers).
- 16 *See Regulatory Notice 08-25* (May 2008). However, FINRA notes that currently members are required to preserve account records evidencing the granting of discretionary authority with respect to accounts of non-natural persons for only three years. *Compare* SEA Rule 17a-4(b)(6), *with* SEA Rule 17a-3(a)(17)(ii), *and* SEA Rule 17a-4(e)(5) (which requires a six-year retention period with respect to similar records for a discretionary account with a natural person).

Attachment A

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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Text of Proposed New FINRA Rule

(Marked to Show Changes from NASD Rule 2510; NASD Rule 2510 and NYSE Rule 408 (and Its Interpretation) to Be Deleted in Their Entirety from the Transitional Rulebook)

* * * * *

[2510]3260. Discretionary Accounts and Transactions

(a) [Excessive] Transactions by Members and Their Associated Persons

No member or associated person of the member shall exercise any discretionary power in a customer's account unless such customer has given a dated prior written authorization to exercise discretionary power to a named, natural person or persons and the account has been accepted in writing by a partner, an officer or a manager, other than the person vested with discretionary power, designated by the member denoting that the account has been accepted in accordance with the member's policies and procedures for acceptance of discretionary accounts. No such member or associated person shall effect with or for [any] such [customer's] account [in respect to which such member or his agent or employee is vested with any discretionary power] any transactions of purchase or sale [which] that are excessive in size or frequency in view of the financial resources and character of such account. A partner, an officer or a manager, other than the person vested with discretionary power, designated by the member shall approve promptly in writing each discretionary order entered in such discretionary accounts and shall review such discretionary accounts at frequent intervals in order to detect and prevent transactions that are excessive in size or frequency in view of the financial resources and character of the account.

(b) [Authorization and Acceptance of Account] Transactions by Agents of Customers

No member or [registered representative] associated person of the member shall [exercise any discretionary power in a customer's account] accept orders for a customer's account from a person other than the customer unless such customer has given a dated prior written authorization to exercise discretionary power to such person

[a stated individual or individuals and the account has been accepted by the member, as evidenced in writing by the member or the partner, officer or manager, duly designated by the member, in accordance with Rule 3010].

[(c) Approval and Review of Transactions]

[The member or the person duly designated shall approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account.]

[(d)c) [Exceptions] Specific Discretionary Activities; Extent Permissible]

[This Rule](1) Notwithstanding the requirements of paragraph (a) of this Rule, [shall not apply to:] members may:

(1)(A)(i) Exercise discretion as to [the price at which or] the time or price [when] of execution of an order [given by a customer] for the purchase or sale of a definite dollar amount or quantity of a specified security [shall be executed] given by a customer:

a. during a normal trading session, provided that such time or price discretion shall be in effect only until the end of that normal trading session [, except that the authority to exercise time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent a specific, written contrary indication signed and dated by the customer.]; or

b. after a normal trading session, provided that such time or price discretion shall be in effect only during the next normal trading session; or

(ii) Exercise discretion as [This limitation shall not apply] to time [and] or price [discretion exercised in] for an institutional account, as defined in NASD Rule 3110(c)(4), pursuant to valid [G]ood-[T]il-[C]ancelled instructions issued on a “not-held” basis.

Any exercise of time [and] or price discretion must be reflected on the order ticket[;].

(2)(B) Effect bulk exchanges at net asset value of money market mutual funds (“funds”) utilizing negative response letters, provided:

(A)(i) The bulk exchange is limited to situations involving mergers and acquisitions of funds, changes of clearing members and exchanges of funds used in sweep accounts;

[(B)](ii) The negative response letter contains a tabular comparison of the nature and amount of the fees charged by each fund;

[(C)](iii) The negative response letter contains a comparative description of the investment objectives of each fund and a prospectus of the fund to be purchased; and

[(D)](iv) The negative response feature will not be activated until at least 30 days after the date on which the letter was mailed.

(C) Effect redemptions of funds for payment of securities purchases or effect transactions to satisfy an indebtedness to the member (e.g., margin requirements), provided that such redemptions or transactions are permitted by a prior signed, written agreement between the member and customer that prominently discloses the terms of any such arrangement. Any provision in such agreement allowing for the use of negative response letters shall be applicable only to the extent permitted by FINRA rules and the federal securities laws.

••• Supplementary Material: — — — — —

.01 Compliance With Federal Securities Laws Governing Discretionary Accounts and Transactions. The requirements of paragraphs (a) and (c) of this Rule shall apply only to the extent members may maintain broker-dealer discretionary accounts or otherwise exercise broker-dealer discretion in an account as permitted under the federal securities laws.

.02 Record Retention. For purposes of this Rule, members shall preserve customers' prior written authorizations, records denoting acceptance of accounts and written agreements between members and customers that subsequently are updated for at least six years after the date that they are updated. Members shall preserve the last update to such records, or the original records if there are no updates, for at least six years after the date the account is closed. For purposes of paragraph (a) of this Rule, members shall preserve records relating to the approval of discretionary orders for the period of time and accessibility specified in SEA Rule 17a-4(b).

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