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Panel Topics:

- Outside Business Activities
- Background Checks
- Customer Complaints
- Handling Forms U-4 and U-5; Other Reporting Requirements
- Receipt of Gifts and Entertainment

<u>Outside Business Activities</u>

- **FINRA / NASD Rule 3030**:

  "No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. Activities subject to the requirements of Rule 3040 shall be exempted from this requirement."

- **NASD Notice to Members 01-79**:

  Associated Persons' Reporting Responsibilities

  Associated persons are required, either under Rule 3040 or Rule 3030, to report ***any*** kind of business activity engaged in away from their firms.

- **<u>In the Matter of Department of Enforcement v. Andrew P. Schnieder</u>, National Adjudicatory Council, Complaint No. C10030088 (Dec. 7, 2005)**

  Conduct Rule 3030 prohibits any person associated with a member firm from being "employed by, or accept[ing] compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member." The rule was "intended to improve the supervision of registered personnel by providing information to member firms concerning outside business activities of their representatives." NASD Notice to Members 88-86 (introducing the substance of what is now Conduct Rule 3030 in Article III, Section 43 of the NASD Rules of Fair Practice). Member firms are to receive "prompt notification of all outside business activities of their associated persons so that the member's objections, if any, to such activities [can] be raised at a meaningful time and so that appropriate supervision [can] be exercised." Id. (emphasis added); see also NASD Notice to Members 01-79 (emphasizing that under Conduct Rule 3030 associated persons are required "to report any kind of business activity engaged in away from their firm"); Dist. Bus. Conduct Comm. v. Cruz, Complaint No. C8A930048, 1997 NASD Discip. LEXIS 62, at *96 (NBCC Oct. 31, 1997) (explaining that **<u>Rule 3030's reach extends to all outside business activity, not just securities-related activity</u>**).

  (emphasis added).

- **<u>In the Matter of District Business Conduct Committee For District No. 5 v. Respondent</u>, National Adjudicatory Council, Complaint No. C05960074 (Sept. 18, 1998)**

  - Case where associated person was not involved in selling a product that can be confused with a security related to her business with the member firm.

  - She's involved with a company that sells subscriptions to magazines. Nothing to do with the securities business whatsoever.

  - None of that mattered to the National Adjudicatory Council -- They still found that the activity related to this company, without the disclosure, was outside business activity that had to be disclosed.

  - Completely unrelated business still falls within the purview of 3030.

- **NASD Sanction Guidelines**

  (Next page)

Background Checks

- **Hiring and retaining qualified, honest employees is critical to a firm's success**

  - According to the 2004 ADP Hiring Index, nearly 50% of all job applicants submitted inaccurate or incorrect information to their potential employers.

- **Guidance from the FDIC on "Developing an Effective Pre-Employment Background Screening Process" (from: Financial Institution Letter, FIL-46-2006 (June 1, 2005)).**

  - Pre-employment background screening process can be an effective risk-management tool.

  - Used effectively, the pre-employment background screening process may reduce turnover: (1) by verifying that the potential employee has the requisite skills, certification, license, or degree for the position; (2) deter theft and embezzlement; and (3) prevent litigation over hiring practices

  - A common practice is to require written applications rather than resumes from applicants.

    - ◊ Standardized applications provide legal protection that a resume cannot. For example, resumes may contain information that cannot be used in the hiring process, such as personal information or membership that is irrelevant to the hiring decision.

    - ◊ Written applications should state that untruthfulness or material omissions are grounds for termination and that by signing the form, the applicant attests to the accuracy of the information provided. Without a signature on an application, a candidate cannot be later terminated on the basis of falsification. This is especially relevant for those candidates who fail to disclose criminal convictions. While a conviction is not necessary a valid reason for automatically rejecting a candidate, the omission or lying about a conviction may become the basis for disqualification.

    - ◊ Applications also allow information about the applicant to be collected in a standardized format that can be compared to other applicants and more readily identifies inconsistencies.

  - When selecting a third-party service provided for background screening of potential employees, due diligence should be used, just as with selecting any other service provided.

  - Pre-employment screening is not an invasion of privacy, but a verification of information provided by the applicant. Nevertheless, the pre-screening process

must comply with the various federal and state laws protecting the rights of potential employees.

- **From Business.gov**:

  - Employees do have a right to privacy in certain areas:

    - **Credit Reports** – Under the Fair Credit Reporting Act (FCRA), employers must get an employee's written consent before seeking an employee's credit report. If you decide not to hire or promote someone base on information in the credit report, you must provide a copy of the report and let the applicant know of his or her right to challenge the report under the FCRA. Some states have more stringent rules limiting the use of credit reports.

    - **Criminal Records** – The extent to which a private employer may consider and applicants criminal history varies from state to state.

      - ◊ The FBI offers assistance to businesses in the areas of employee background investigation. Employers are advised to contact the agency or the appropriate state identification bureau (or state police) for the correct procedures to follow for obtaining an FBI fingerprint background check for employment or licensing purposes.

    - **Lie Detector Tests** – The Employee Polygraph Protection Act prohibits most private employers from using lie detector tests, either for pre-employment screening or during the course of employment. The law includes a list of exceptions (applicable to armored car services, guard services, pharmaceuticals). Even though there is no federal law specifically prohibiting you from using a written honesty test on job applicants, these tests frequently violate federal and state laws that protect against discrimination and violations of privacy

    - **Medical Records –** Under the Americans with Disabilities Act, employers may inquire only about an applicant's ability to perform specific job duties and cannot request an employee's medical records. As long as the employee can do the job, with or without reasonable accommodation, an employer may not make an employment decision based on an employee's disability. Some states also have laws protecting the confidentiality of medical records.

    - **Bankruptcies –** Bankruptcies are a matter of public record and may appears on an individual's credit report. The federal Bankruptcy Act prohibits employers from discriminating against applicants because they have filed for bankruptcy.

    - **Military Service –** Military service records may be released only under limited circumstances, and consent is generally required. The military may, however, disclose name, rank, salary, duty assignments, awards, and duty status without the member's consent.

- **School Records –** Under the Family Education Rights and Privacy Act and similar state laws, educational records are confidential and will not be released by the school without a student's consent.

- **Workers' Compensation Records –** Workers' compensation appeals are part of the public record and may be used in a hiring decision if an employer can show the applicant's injury might interfere with his or her ability to perform required duties.

- **Other Topics**:

  - Interesting Articles Regarding MySpace, Facebook, and online social networking sites:

Employers Use MySpace for Hiring and, Now, Defending Discrimination Claims
Posted by Molly DiBianca On November 30, 2008
(http://www.delawareemploymentlawblog.com/hiring_firing/hiring/background_checks/)

Employers have used MySpace to screen potential job candidates. Employers have fired employees for something posted on the employee's Facebook and MySpace pages. Even the incoming White House administration is requiring applicants to disclose any potentially embarrassing content on social networking sites. So we've seen the role Facebook and MySpace have played in hiring and firing decisions. But there is a new use for employers--using Facebook and MySpace in litigation. Specifically, litigation against former or current employees.

Dan Schwartz at the CT Employment Law Blog pointed out this new use as described in an article at Law.com entitled "Are Social Networking Sites Discoverable?" The article concludes that the information found on a plaintiff's MySpace or Facebook page is likely discoverable during litigation. From the article:

Although these sites provide users with a sense of intimacy and community, they also create a potentially permanent record of personal information that becomes a virtual information bonanza about a litigant's private life and state of mind. The converse thus becomes the moral for litigation counsel -- this new generational fount of potentially discoverable information should be high on the list of priorities when evaluating a new matter.

Dan raises a great point--what if the employee's website contains comments that would disprove his claim? For example, if an employee is claiming national-origin harassment and his co-workers said that there was an environment of friendly, though inappropriate (but not unwelcome), banter between the young males in the department. The employee claims that he never engaged in this banter but, instead, he was subject to frequent comments so severe that it made his workplace a hostile environment. So there's the employee's word and the word of his co-workers. Not much to go on as far as a defense goes.

But what if the employee's MySpace page was peppered with inappropriate comments of his own? And what if the comments were exactly the ones identified by the co-workers?

It's not difficult to imagine this potentially case-changing scenario. It looks like MySpace and Facebook are here to stay as a tool for employers to learn potentially crucial information about employees--old and new.

From: **New Study Shows Increase in Online Applicant Screening**
Posted by Molly DiBianca On September 18, 2008 In: Background Checks , Hiring
(http://www.delawareemploymentlawblog.com/hiring_firing/hiring/background_checks/)

1 in 5 employers use social networking sites to screen prospective employees. That's according to a new study by Careerbuilder. 34% reported that they rejected candidates based on what they discovered during their online search. We've written quite a bit about this practice, including what to look for if you do elect to incorporate online background checks into your hiring repertoire.

Here's what other employers have been looking for and, specifically, what will prompt them to reject a candidate:

41% - content posted about alcohol or drug use
40% - “inappropriate of provocative” pictures
29% - candidate appeared to have poor communications skills
28% - candidate bad-mouthed their previous company or fellow employee
27% - candidate lied about qualifications
22% - discriminatory comments related to race, gender, religion, etc.
22% - candidate’s screen name was unprofessional
21% - candidate was linked to criminal behavior
19% - candidate shared confidential information from previous employers

. . . .
Just as with criminal backgrounds, employers should not make a per se decision without first giving the candidate an opportunity to explain the results of the report and any circumstances surrounding the arrest and/or conviction. The same interactive discussion should occur if an employer finds something on the candidate's social-networking site that gives them concerns.

One thing that opponents of this practice seem to overlook is that employers have an affirmative duty, legally, and for business reasons, to make the best hiring decisions possible, using all of the information reasonably available to them. The only real threat of suit here is if the employer does not take the few minutes required to do an internet search on a candidate who, after being hired, commits an act of workplace violence. If the employee's MySpace page was filled with images of violence and words of rage, you can bet your last nickel that the employer will face a negligent hiring lawsuit for hiring the employee without taking the free and quick step of running that internet search.

Handling Forms U-4 and U-5; Other Reporting Requirements [1]

I. WHAT IS NEW IN THE REPORTING FORMS AND CUSTOMER COMPLAINT AREAS

A. FINRA PROPOSED RULE 4530 (Comment Period Expired January 16, 2009)

FINRA proposes replacing NASD Rule 3070 and NYSE Rule 351 with a single rule, proposed FINRA Rule 4530 (Reporting Requirements), in the Consolidated FINRA Rulebook. Proposed FINRA Rule 4530 is based in large part on NASD Rule 3070, taking into account requirements under NYSE Rule 351. The proposed rule also includes a "Supplementary Material" section that contains certain clarifications and definitions as well as codifications of existing staff guidance. The most significant proposed changes affect the following areas: External Findings; Internal Conclusions; Reporting Obligation; Reporting Deadline; Domestic and Foreign Actions; Civil Litigation, Arbitration, Other Claims for Damages; Statutory Disqualifications; Internal Disciplinary Actions Against Associated Persons; Elimination of the Exemption for Dual Members Subject to Another SRO's Rule; Filing of Related Documents With FINRA; Addition of Supplementary Material.

(See FINRA Notice to Members 08-71 for more information)

B. BROKERCHECK

BrokerCheck website:

http://www.finra.org/InvestorInformation/InvestorProtection/p005882

- Effective March 19, 2007, BrokerCheck updated and expanded for the first time since 1998
- 24 hours/7days a week access - With disclosure reports about individual representatives available on-line within seconds
- Improved search capabilities
- Disclosure requirements concerning historic complaints (redesign of CRD legacy system)
- Question 7F on the Form U5 - Now available through BrokerCheck

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[1] The Panelists wish to thank Mr. Robert A. Buhlman of Bingham McCutchen LLP. These materials closely follow Mr. Buhlman's materials prepared for another conference. Utilizing Mr. Buhlman's framework, these materials provide relevant updates regarding FINRA and SEC activity over the past twelve months.

C. FINRA'S PROPOSED CHANGES TO FROMS U4 AND U5 (Comment Period Ended May 27, 2008)

- Proposed changes would require firms to report, as customer complaints, allegations of sales practice violations made in arbitration claims and civil lawsuits against registered persons who are not named as parties in those proceedings.

- The proposals also include revisions to Forms U4 and U5 designed to ease, clarify or facilitate reporting requirements and other technical and/or conforming changes.

D. WEB CRD/LARD

Web CRD Small Firm Resources Website:

http://www.finra.org/RegulatorySystems/CRD/CRDSmallFirmResource/index.htm

- Currently, CRD uses Release 2008.2 (released June 23, 2008).

E. RULE HARMONIZATION - FINANCIAL INDUSTRY REGULATORY AUTHORITY (FINRA)

- FINRA Regulatory Notice 08-25: Proposed Consolidated FINRA Rules Governing Books and Records Requirements; Comment Period Expired: June 13, 2008

  - Based in large part on the current rules, the proposed rules would rewrite the FINRA books and records provisions with three goals in view: (1) to streamline the books and records rules tomake themas clear as possible; (2) to group books and records requirements along similar subject matter lines to make finding them a more intuitive process and to provide firms with a better understanding of the regulatory scheme; and (3) to eliminate those books and records requirements contained in the current NASD (FINRA) and NYSE Rules that have become obsolete or otherwise duplicative.

F. *ROSENBERG V. METLIFE, INC.*

- New York Court of Appeals Decision on March 29, 2007

- The Court of Appeals in *Rosenberg* concluded statements on a Form U5 are protected by an absolute privilege under New York law

- On April 22, 2008, the New York Supreme Court for New York County held *Rosenberg* "unequivocally rules out monetary damages, of any kind, for a claimed defamation in a required U-5 filing." *Barclays Capital Inc. v. Shen*, 857 N.Y.S.2d 873, 879.

II. REVISITING CRITICAL ISSUES IN CUSTOMER COMPLAINT REPORTING

A. KEY DEFINITIONS AND APPLICATION OF TERMS

- Definition of *"Sales Practice Violation"* and how it is applied
- Application of "Consumer-initiated"
- Definition of *"Investment-related"*
- Definition of *"Involved"*
  - In written customer complaints
  - Requirement to be named a party in an arbitration or civil litigation

B. REPORTING CUSTOMER COMPLAINTS - NYSE RULE 351(A) AND NASD (FINRA)/FINRA RULE 3070(A)

- FINRA Regulatory Notice 08-17: Reporting of Customer Complaints Relating to Auction Rate Securities; Effective Date: April 1, 2008
  - FINRA has added three new product categories for use by member firms in reporting customer complaints relating to auction rate securities.
  - NASD Rule 3070(c) and incorporated NYSE Rule 351(d) require all members and member organizations to report, on a quarterly basis, statistical information regarding customer complaints.
  - This information is required to be filed by the fifteenth calendar day of the month following the end of the quarter.
  - Member firms are required to submit quarterly statistical reports under NASD Rule 3070(c) and incorporated NYSE Rule 351(d) using the new product categories beginning with second quarter reports that are due to FINRA by July 15, 2008.
  - FINRA member firms may voluntarily use the three new product categories when reporting customer complaints for the first quarter of 2008.

- From FINRA Regulatory Notice 08-20: Proposed Revisions to Question 14I on Form U4 and Question 7E on Form U5 to Raise the Dollar Threshold from $10,000 to $15,000.
  - Currently, Questions 14I(1)(c) and 14I(2) on Form U4 and Questions 7E(1)(c) and 7E(2) on Form U5 require customer complaints to be reported only when they have been settled for $10,000 or more.
  - Recognizing that the monetary threshold for settlements of customer complaints was set some time ago and has never been adjusted for inflation, members of the Working Group are considering raising the existing settlement amount to $15,000 to more accurately reflect the business criteria (including the cost of litigation) firms consider when deciding to settle claims.

B. REPORTING SETTLEMENTS

- Timing of arbitration and litigation settlements - who must report and when
- Reporting settlements of other customer complaints
- Reporting settlements - NYSE Rule 351(a) and NASD Rule 3070(a)
- Expungement issues

C. QUARTERLY REPORTING OF CUSTOMER COMPLAINTS

III. TRACE, OATS, ACT AND BLUE SHEETS

The Trade Reporting and Compliance Engine is the FINRA developed vehicle that facilitates the mandatory reporting of over the counter secondary market transactions in eligible fixed income securities. All broker/dealers who are FINRA member firms have an obligation to report transactions in corporate bonds to TRACE under an SEC approved set of rules.

A. RECENT RULE CHANGES AND NOTICES

- February 22, 2008, FINRA Trade Reporting Notice: FINRA has modified the TRACE System to accept equity CUSIPs, and reminds member firms that they must report transactions to TRACE in securities that are "TRACE-eligible securities," such as unlisted convertible debt, unlisted equity-linked notes and similar debt securities.
  - FINRA reminds firms that only unlisted convertible debt and unlisted equity linked notes are treated as debt for purposes of trade reporting; convertible debt and equity-linked notes that are listed on a national securities exchange must be reported to the appropriate equity trade reporting facility.
- July 28, 2008, FINRA Trade Reporting Notice: FINRA changed the effective date for reporting ELNs from August 4, 2008 to November 3, 2008.
- FINRA Regulatory Notice 08-42: Guidance on Transactions in TRACE-Eligible Securities Under SEC Rule 144
  - FINRA reminds firms that, unless exempt under NASD Rule 6230(e), once a security is eligible under NASD Rule 6210 as a TRACE-eligible security, all secondary market transactions in the security are "reportable TRACE transactions," as defined in NASD Rule 6210(c). This includes securities that are eligible because they were initially issued pursuant to Section 4(2) of the Securities Act of 1933 and subsequently purchased or sold pursuant to SEC Rule 144A.
- FINRA Regulatory Notice 08-43: SEC Approves Expanding Disseminated Real-Time TRACE Data; Effective Date: November 3, 2008
  - On November 3, 2008, FINRA will begin to publicly disseminate additional data elements for corporate bond transactions that are reported to TRACE. The additional data elements indicate whether a transaction is an interdealer transaction or a transaction with a customer and, if a customer transaction, whether the broker-dealer is on the buy or the sell side.

B. RECENT ENFORCEMENT ACTIONS

- TRACE Actions
- OATS Actions

C. DISCUSSION RE: ACT AND BLUE SHEETS

IV. COMPLIANCE DEPARTMENT ROLE

A. HELPFUL REPORTING FORMS FOR USE INTERNALLY

B. CLERICAL TASKS COMPARED TO TOUGH JUDGMENT CALLS - DISCUSSION

REPORTING ISSUES STATUTORY DISQUALIFICATION, TRACE, OATS, ACT AND BLUE SHEETS

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This outline is for informational purposes only. It is not intended to be legal advice or an analysis of a particular legal matter. Readers should not act without seeking professional legal counsel. Transmission and receipt of this publication does not create an attorney-client relationship.

I. THE FORMS

A. Forms U-4 and U-5

The Forms U-4 and U-5 are the two most familiar regulatory filings for registered representatives. The Form U-4 is the Uniform Application for Securities Industry Registration or Transfer and the Form U-5 is the Uniform Termination Notice for Securities Industry Registration.

B. Form U-4: Uniform Application for Securities Industry Registration or Transfer

1. Who Must File:

   a. Any "Applicant" seeking to transfer to a new broker-dealer, seeking to take an examination to become a registered representative or earn another license or seeking to add another registration in another state or another SRO;

      and

      the broker-dealer through which the representative will be registered.

   b. Both the "Applicant" and an "Appropriate Signatory" of he broker-dealer must sign the Form U-4.

   c. The Firm must give an arbitration disclosure when asking an associated person to sign a Form U-4. See NASD Rule 3080.

   d. A member may employ a third party to file the forms electronically on its behalf. NASD Rule 1140(e).

2. Where:

   a. Filing is done electronically to the Central Registration Depository ("CRD") located in Maryland.

   b. As part of the firm's recordkeeping requirements, it shall maintain the signed forms and make them available upon request. See NASD Rule 1140(c)(1).

3. When:

   a. When transferring to a new firm as a registered representative.

   b. When scheduling to take a securities examination.

c. When adding registrations in states or SROs.

d. When amendments are necessary, not later than 30 days after the member learns of the facts or circumstances. (Amendments involving a statutory disqualification must be filed not later than 10 days after the statutory disqualification occurs.) NASD (FINRA) By-Laws Article V Sec. 2(c).

4. Discussion

The NASD (FINRA) requires persons to apply for registration with the NASD (FINRA). NASD (FINRA) By-Laws, Article V, Sec. 2. The NASD (FINRA) sets rules and regulations setting the appropriate standards for applicants for membership. NASD (FINRA) By-Laws, Article Ill, Sec. 2(a). NASD (FINRA) members cannot permit persons associated with them to engage in the investment banking or securities business unless the member determines that the person has satisfied the NASD (FINRA)'s registration requirements and is not subject to a disqualification under Article Ill, Section 4 (statutory disqualification). NASD (FINRA) By-Laws, Article V, Sec. 1. See NASD Rule 1031.

Before a registration can become effective, registered representatives must pass a Qualification Examination for Representatives. NASD Rule 1031(a).

The Form U-4 is the Application for Registration with the NASD (FINRA), other SROs, states and U.S. territories. All forms required to be filed by NASD (FINRA) Article V, Section 2, i.e., the Form U-4, shall be filed through an electronic process or such other process as the Association may prescribe to the CRD. NASD Rule 1140(a). CRD has required electronic filing through Web CRD since August 1999.

Amendments must be no later than 30 days after the member or individual learns of the facts or circumstances warranting it. In February 2004, the SEC announced amendments to Section 4 of Schedule A to the NASD (FINRA) By-Laws establishing a late fee of $10 per day, up to a maximum of $300, to be assessed by NASD (FINRA) against members that fail timely to report a new disclosure event or an amendment. The amendments became operative on March 8, 2004 and there was a six-month transition period. Those late fees are now fully effective.

C. Form U-5: Uniform Termination Notice for Securities Industry Registration

1 Who Must File:

a. The broker-dealer files the Form U-5. It must be signed by an "Appropriate Signatory."

b. Individuals may submit Part II of the Internal Review DRP or changes to current residential address. In these cases, the individual must sign.

2. Where:

a. Electronically with the CRD.

b. The firm must maintain the signed forms as part of its recordkeeping requirements and make them available upon request. See NASD Rule 1140(d).

3. When:

a. When terminating the association of a person who is registered with a firm (full termination).

b. When amendments are necessary, not later than 30 days after the member learns of the facts or circumstances.

c. Partial terminations are filed when terminating a registration with a particular SRO or jurisdiction.

The obligation to file an amendment on a Form U-5 does not lapse after a certain period of time. (There has been confusion over whether the obligation to amend would lapse more than two years after an individual's registration lapses.) NASD (FINRA) has clarified that the obligation to amend the Form U-5 under Article V Section 3 does not lapse. See Form U-4 and U-5, Interpretive Questions, Form U-5 Question 7E, Q-1, posted August 5, 2005.

4. Discussion

The NASD (FINRA) also requires the broker-dealer to give notice of the "termination of the association with a member of a person who is registered with it." NASD (FINRA) By-Laws, Article V, Sec. 3(a). Notice must be given not later than 30 days after the termination.

The NASD (FINRA) retains jurisdiction over the person whose registration is terminated for two years after the effective date of the termination of registration. NASD (FINRA) By-Laws, Article V, Sec. 4(a).

The Forms U-4 and U-5 must always be kept current "by supplementary amendments via electronic process." NASD (FINRA) By-Laws, Article V, Sec. 2(c) and 3(b). Such amendments must be filed not later than 30 days after learning of the facts or circumstances giving rise to the amendment (or not later than 10 days after learning of a statutory disqualification).

D. FORM RE-3

The Form RE-3 is a NYSE Form filed to comply with the reporting requirements of NYSE Rule 351.

1. Who Must File:

   a. NYSE "Member Organizations."

2. About Whom:

   a. NYSE "Member Organizations."

   b. Registered or Non-Registered.

   c. Employees associated with the NYSE "Member Organization."

3. Where:

   a. NYSE – Also now done electronically through the EFP system.

4. When:

   a. Within 30 days of a reportable event.

E. NASD RULE 3070

NASD Rule 3070 is similar to, but not identical to, NYSE Rule 351, setting forth similar reporting requirements.

1. Who Must File:

   a. NASD (FINRA) Members – except any member subject to substantially similar reporting requirements of another SRO (i.e. NYSE Rule 351) is exempt from subparagraphs 3070(a)-(c). NASD Rule 3070(e).

2. About Whom:

   a. The NASD (FINRA) Member.

   or

   b. A person associated with The NASD (FINRA) Member.

3. Where:

   a. NASD (FINRA) — Electronically.

4. When:

   a. No later than 10 business days [Rule 3070(b)].

F. NASD RULE 3070(F)

NASD Rule 3070(f), effective May 21, 2003, requires that copies of certain documents listed in the Rule — basically documents regarding criminal matters and civil litigation or arbitration complaints (except those already filed with the FINRA Dispute Resolution) — be filed with the NASD (FINRA). NASD (FINRA) Members who are also NYSE member organizations are not exempt from this provision.

II. CUSTOMER COMPLAINTS

A. FORMS U-4 AND U-5

Written customer complaints are currently reportable on the Form U-4 in Question 141(3). They are reportable on the Form U-5 in Question 7E3.

1. The Questions:

    a. Form U-4:

    Q. 141(3): "Within the past twenty-four (24) months, have you been the subject of an investment-related, consumer-initiated, written complaint, not otherwise reported . . . which:

    i. alleged that you were involved in one or more sales practice violations and contained a claim for compensatory damages of $5,000 or more (if no damage amount is alleged, the complaint must be reported unless the firm has made a good faith determination that the damages from the alleged conduct would be less than $5,000), or,

    ii. alleged that you were involved in forgery, theft, misappropriation or conversion of funds or securities?"

    b. Form U-5:

    Asks the same question "in connection with events that occurred while the individual was employed by or associated with your firm," which would be reportable on the Form U-4.

    c. Key Terms:

    (1) *involved* in a (2) *sales practice violation* and (3) compensatory damages of $5,000 or more.

2. Checklist:

____ a. Is a sales practice violation alleged?

"Sales practice violation" is a defined term in the Forms. It means "any conduct directed at or involving a customer" which would constitute a violation of any rules for which a person could be disciplined by any SRO; a violation of the `34 Act, or a violation of any state statute prohibiting fraudulent practices in connection with the offer, sale or purchase of a security or in connection with rendering investment advice. The DRP page for this Question provides a space to describe the allegations and to give a brief summary of events related to the allegations. (One of the changes in the Forms adopted in August 1999 and now in use is that each Question now has a separate DRP Page which can be filed electronically.)

Securities: SROs have jurisdiction over securities, but do not have jurisdiction over non-securities such as fixed annuities. Accordingly, allegations in a written customer complaint about exclusively non-securities which are not within any SRO's jurisdiction are not allegations of "sales practice violations." However, allegations of theft or forgery regarding non-securities may be reportable.

____ b. Are there alleged compensatory damages of $5,000 or more?

If a damage amount is alleged in the complaint letter, then the amount alleged controls, but only the amount of compensatory damages (exclude amounts claimed for punitive damages).

If no damage amount is claimed in the complaint letter, the complaint is reportable unless the firm makes a "good faith" determination that the damages from the alleged conduct would be less than $5,000.

Note: it is the firm, not the registered person, that is required to make the damages calculation.

Note: in performing the damages calculations, no method of calculating damages is specified. Moreover, the issue is the amount of damages, not the cost of the securities at issue. On an unauthorized trading claim, for example, the damages are generally viewed as the difference between the amount that the customer paid for the security and the amount that he sold it for (or could have sold it for if he sold when he became aware of the unauthorized trade), not the total price of the security.

____ c. Is the complaint in writing?

Only written complaints are reportable. Oral complaints themselves are not. However, one of the historical amendments to the Forms U-4 and U-5 requires that a settlement of a complaint – including an oral complaint – for an amount of $10,000 or more must be reported, if the other reporting criteria are met. See infra Question 141(2) and Question 7E(2).

Draft complaints are in writing.

____ d. Is the registered person the "subject of" the written complaint?

This term is undefined. Clearly, more than one person can be the "subject of the complaint. However, the mere mention of a person's name does not mean that s/he is the "subject." The definition of "involved" in, below, may support a determination that a particular person is not the "subject."

____ e. Does the written complaint allege that the registered person was "involved" in the alleged sales practice violation (including for failure to supervise the alleged malefactor)?

"Involved" is defined in the Forms as doing an act or aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act.

Note: It is not relevant whether the person was actually "involved" in the violation; the question is whether s/he is alleged to have been "involved."

This presents one of the most debated issues in the reporting context. The customer's allegations control and the firms do not take into account extraneous facts – even if those facts show that allegations are untrue or impossible.

Note: A complaint letter that simply lists everyone who the customer encountered in his unhappy experience at the firm does not necessarily allege that each of the people listed was "involved" in the alleged sales practice violation. As to each registered person named, the complaint should be analyzed as to whether it alleges "involvement" in a sales practice violation. For example, a branch manager who is mentioned only with reference to his failure to return telephone calls after the fact (but not alleged as a failure to supervise) is not alleged to be "involved" in a sales practice violation.

____ f. Is the complaint "investment-related"?

"Investment-related" is defined as pertaining to securities, commodities, banking, insurance, or real estate (including being associated with a broker-dealer, investment advisor, bank, etc.).

Note: "Investment related" is broader than "sales practice violation" in scope and application.

____ g. Is the complaint "consumer-initiated"? This term is undefined in the Forms.

However, the NASD (FINRA) has issued interpretive guidance describing the term as follows: "The term includes a current, former, or prospective customer or a person who can act for such person by law or contract, including an executor, conservator, or a person holding a power of attorney. An example of a person who is not a `consumer' is a customer's relative who does not hold a power of attorney." Form U-4 and U-5 Interpretive Questions ("Interpretive Questions") p. 3.

In essence, only a written complaint by a customer, whether current, former or prospective, or the customer's legal representative need be reported.
Also, NASD (FINRA) has clarified that complaints sent by the customer first to a regulator or SRO, which then forwards it to the firm, are "consumer-initiated." Interpretative Questions, p. 8.

Finally, written responses obtained in response to a communication from the firm (i.e. some kind of outreach) are also "consumer-initiated" for reporting purposes, even if the firm makes the first contact and the customer is responding. Interpretative Questions, p. 8.

____ h. Does the complaint allege that the registered person was "involved in forgery, theft, misappropriation or conversion"? Q. 14I(3)(b).

If so, the $5,000 limit is inapplicable.

Such claims involving non-securities are reportable.

____ i. Is the complaint "otherwise reported"?

If the complaint has "evolved" into an arbitration or litigation, and the individual is named as a respondent or defendant and the other reporting criteria are met, Q. 141(3) (the customer complaint question) should be answered "no" and Q. 141(1) (the arbitration/litigation question) should be answered "yes." However, this is an amendment, not an initial filing. Accordingly, an amended, not an initial, DRP should be filed.

Note that if the subsequent arbitration concerns a different subject matter, the earlier customer complaint remains reportable.

B. WITHDRAWALS OF CUSTOMER COMPLAINTS

One issue that comes up with regularity is how to report a customer complaint which meets the reporting criteria, but is voluntarily withdrawn by the customer. For example, a customer may send a reportable complaint letter one day and withdraw it the very next day with a second letter.

The Guidance takes the view that the initial complaint must be reported and it can be reported as "withdrawn" on the Customer Complaint DRP in item 9. Interpretive Questions, p.8.

C. Passage Of Twenty Four Months

Question 141(3) specifically asks whether the registered representative has been the subject of the written complaint "within the past twenty four (24) months."

After twenty four (24) months have passed from the date the report of the complaint is received by the CRD, if nothing else occurs, the individual may amend the Form to change the affirmative response to Question 141(3) to a negative response and to report the complaint as "Closed/No Action" on the DRP page filed with the amended Form.

The firm and the individual both should track the date when the filing of an amendment would be appropriate. A written complaint will remain on the CRD for twenty-four months from the date it is received by the CRD, not the date it is received by the firm.

1. Form U-5:

   The same definitions and criteria apply to the reporting of customer complaints on the Form U-5, Question 7E(3), as on the Form U-4.

   The U-5 reporting of customer complaints is limited to:

   a. "events that occurred while the individual was employed by or associated with your firm"

      and

   b. events that have not previously been reported on a Form U-4 by the firm filing the Form U-5.

2. Form RE-3:

   NYSE Member Organizations must file an RE-3 if the Member Organization or a registered or non-registered employee associated with such member organization:

   a. Is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery. See NYSE Rule 351(a)(2).

3. NASD Rule 3070(a)(2):

   Sets forth the same customer complaint reporting obligation for NASD (FINRA) members who are not subject to NYSE reporting obligations.

D. 2008 Notices and Updates

1. FINRA Regulatory Notice 08-20:

FINRA proposed revisions to Question 14I on FormU4 and Question 7E on FormU5 to Require the Reporting of Allegations of Sales Practice Violations Made Against Registered Persons in a Civil Lawsuit or Arbitration in Which the Registered Person Is Not a Named Party

As proposed by the Working Group, Questions 14I(2) and (3) on FormU4 would read as follows:

14I(2): Have you ever been the subject of an investment-related, consumer-initiated complaint, arbitration claim or civil litigation, not otherwise reported under question 14I(1) above, which alleged that you were involved in one or more sales practice violations, and that was settled for an amount of $10,000 or more, or resulted in an arbitration award or civil judgment against the named respondent(s), regardless of amount?

14I(3): Within the past twenty-four (24)months, have you been the subject of an investment-related, consumer-initiated, written complaint, arbitration claim or civil litigation, not otherwise reported under question 14I(1) or (2) above, which:

(a) alleged that you were involved in one or more sales practice violations and contained a claim for compensatory damages of $5,000 or more (if no damage amount is alleged, the complaint, arbitration claim or civil litigation must be reported unless the firm has made a good faith determination that the damages from the alleged conduct would be less than $5,000), or

(b) alleged that you were involved in forgery, theft, misappropriation or conversion of funds or securities?

As proposed by the Working Group, Questions 7E(2) and (3) on FormU5 would read as follows:

7E(2): In connection with events that occurred while the individual was employed by or associated with your firm, was the individual the subject of an investment related, consumer-initiated complaint, arbitration claim or civil litigation, not otherwise reported under question 7(E)(1) above, which alleged that the individual was involved in one or more sales practice violations, and that was settled for an amount of $10,000 or more, or resulted in an arbitration award or civil judgment against the named respondent(s), regardless of amount?

7E(3): In connection with events that occurred while the individual was employed by or associated with your firm, was the individual the subject of an investment-related, consumer-initiated, written

complaint, arbitration claim or civil litigation, not otherwise reported under questions 7(E)(1) or 7(E)(2) above, which:

(a) would be reportable under question 14I(3)(a) on FormU4, if the individual were still employed by your firm, but which has not previously been reported on the individual's FormU4 by your firm; or

(b) would be reportable under question 14I(3)(b) on FormU4, if the individual were still employed by your firm, but which has not previously been reported on the individual's FormU4 by your firm.

2. Other Revisions Proposed by FINRA::

Proposed Revisions to Question 14I on Form U4 and Question 7E on Form U5 to Raise the Dollar Threshold from $10,000 to $15,000

Currently, Questions 14I(1)(c) and 14I(2) on FormU4 and Questions 7E(1)(c) and 7E(2) on FormU5 require customer complaints to be reported only when they have been settled for $10,000 or more. Recognizing that the monetary threshold for settlements of customer complaints was set some time ago and has never been adjusted for inflation, members of the Working Group are considering raising the existing settlement amount to $15,000 to more accurately reflect the business criteria (including the cost of litigation) firms consider when deciding to settle claims.

Proposed Revisions to the Initial Form U5 to Allow Firms to Amend the "Reason for Termination" and the "Date of Termination"

The proposed change would require firms to provide a reason for the amendment. To monitor such amendments, including those reporting terminations for cause, FINRA staff is proposing to notify other regulators and the broker-dealer currently employing the person (if the person is with another firm) when a reason for termination or date of termination has been amended.

Technical, Conforming and Other Changes to Forms U4 and U5

These changes are generally intended to clarify the information elicited by regulators and to facilitate reporting by firms and regulators.

3. FINRA Information Notice - February 21, 2008: FINRA Secures Relief for Member Firms for Certain Record Retention Requirements; Effective Date: February 19, 2008

Effective February 19, 2008, FINRA member firms can rely on Web CRD to satisfy their record retention requirements with respect to certain Forms U4, U5 and BR filed in Web CRD. Member firms are no longer required to maintain hard copies and/or electronic images of these forms, provided they adhere to the terms of the no-action relief granted by the staff of the SEC.

III. ARBITRATIONS AND LITIGATIONS

A. FORMS U-4 AND U-5

1. The Questions

Form U-4, Question 141(1)(a), (b) and (c), asks:

"Have you ever been named as a respondent/defendant in an investment-related, consumer-initiated arbitration or civil litigation which alleged that you were involved in one or more sales practice violations and which:

(a) is still pending, or,

(b) resulted in an arbitration award or civil judgment against you, regardless of amount, or,

(c) was settled for an amount of $10,000 or more?"

The U-5, Question 7E(1), employs the same criteria as the U-4, except that it is applicable only to "events that occurred while the individual was employed by or associated with your firm."

2. Reporting of Statements of Claim and Complaints
Key Factors: The registered person must be named as a party as a respondent or defendant and allegedly "involved" in one or more "sales practice violations."

Also, there is *no minimum reportable amount*.

3. Checklist:

____ a. Was the registered person named?

If the registered person is not named as a respondent or defendant, the arbitration/litigation is not reportable as to him/her.

If the registered person is named, the arbitration/litigation may be reportable as to him/her regardless of the amount at issue (so long as the other reporting criteria are met), including that the individual is allegedly involved in a sales practice violation.

Otherwise, many of the same terms appear in Question 141(1) (arbitration and civil litigations) as in Question 141(3) (written customer complaints). These include the following:

____ b. Is the arbitration/civil litigation "investment-related?"

See definition above.

____ c. Is the complaint "consumer-initiated"?

See discussion above.

Note that civil litigations brought by regulators are reportable under a separate Question – Question 14H(2).

____ d. Does the arbitration/civil litigation allege one or more "sales practice violations"?

See definitions above.

____ e. Does the arbitration/civil litigation allege that the registered person was involved in the alleged sales practice violations?

See definitions above.

Note that a registered person who is sued solely as a "control person" or under some other theory of respondeat superior does not meet the criterion of "involved." The individual must be allegedly "involved" in a "sales practice violation," including allegedly failing to supervise another.

Note that complaints that list in the caption a string of individuals about whom nothing is said in the body of the complaint, other than to identify them by title, would not require a filing as to those individuals, based on the "involved" requirement. This is a useful point when complaints name the officers and directors of the firm. If, however, the body of the complaint/statement of claim accuses the officer/director of "failure to supervise," reporting may be required.

Note, again, that the issue is the allegations, not the actualities. That is, it is the allegations in the Statement of Claim or the Complaint which may trigger reporting.

If the dispute was previously reported as a customer complaint, the registered person is to "amend" his U-4 by changing the answer to Q. 141(3) to "no" when he reports a "yes" to Q. 141(1). An amended, not an initial, DRP should be filed.

4. Reporting of Awards and Decisions

All adverse awards or judgments against an individual of any amount are reportable. (Forum fees alone are not considered an adverse award.)

If the registered person prevails at hearing, the registered person may file an amended Form U-4 changing the answer to Q. 141(1) from "yes" to "no." This is permissible because the individual would no longer be named in a pending matter.

For the same reason, if the arbitration is dismissed by the arbitration panel before a hearing, the registered person may file an amended Form U-4 changing the answer to Q. 141(1) from "yes" to "no." The disposition is then reported on the Arbitration/Civil Litigation DRP page.

5. Reporting of Withdrawn Claims And Settlements of Arbitrations or Litigations

If the complaint is withdrawn as to a particular respondent prior to any settlement or award, the registered person may file an amendment changing his answer to Q. 14(1)(1) to "no." Again, this is because the individual would no longer be named in a *pending* matter.

Any subsequent settlement involving other parties would not need to be reported by the individual dismissed "prior to" the settlement.

However, if an individual is dismissed as part of a settlement of $10,000 or more, then the individual must report the settlement, under Question 141(1)(c). See Interpretive Questions, p.5.

This is an issue which generates some debate and disagreements: was the individual dismissed prior to or as part of the settlement? It seems the timing is critical. However, another factor may be whether the claimant had agreed to accept consideration in excess of $10,000 at the time he agreed to dismiss the individual.

a. If the complaint is settled as to some respondents but not others, the respondents who do not settle must continue to report the arbitration as pending.

b. If the settlement is otherwise reportable as to a registered person, because the claim was withdrawn "as part of" a settlement, his/her failure to contribute to the settlement does not alter the filing requirement. The amount of any contribution (or the absence of a contribution) by the registered person is reportable on the DRP.

c. In calculating whether the settlement is $10,000 or above, the amount of the registered person's contribution is irrelevant. The question is whether the "complaint" was settled for $10,000 or more.

6. Form RE-3:

NYSE Member Organizations must file an RE-3 if the member organization or a registered or non-registered employee associated with such member organization:

> is a defendant or respondent in any securities or commodities-related civil litigation or arbitration which has been disposed of by judgment, award or settlement for an amount exceeding $15,000. However, when a member organization is the defendant or respondent, then the reporting to the Exchange shall be required only when such judgment, award or settlement is for an amount exceeding $25,000. NYSE Rule 351(a)(7).

NASD Rule 3070(a)(7) sets forth a similar reporting obligation for NASD (FINRA) members who are not also NYSE members.

IV. SETTLEMENTS OF CUSTOMER COMPLAINTS

A. FORMS U-4 AND U-5

Settlements of customer complaints may also be reportable.

1. Question 141(2) of the Form U-4 asks as follows:

> Have you ever been the subject of an investment-related, consumer-initiated complaint, not otherwise reported under question 141(1) above, which alleged that you were involved in one or more sales practice violations, and which complaint was settled for an amount of $10000 or more.

The U-5, Question 7E(2), employs the same criteria as the U-4, except that it is applicable only to "events that occurred while the individual was employed by or associated with your firm."

2. Settlements of customer complaints:

A settlement of $10,000 or over is always reportable on the Forms U-4 and U-5 if the complaint was reportable. In addition,

a. It is critical to note that the settlements of oral complaints for $10,000 or more are reportable, if the other reporting criteria are met.

b. Attorneys' fees are not included in the settlement amount for reporting purposes. See Interpretive Questions, p. 6.

c. Settlements above the reportable limit are reportable and remain on the CRD forever; the 24 month "deletion" provision applies only to complaints that are not settled or settled below the reportable limit.

FINRA Regulatory Notice 08-20 (April 2008): Proposed Revisions to Question 14I on Form U4 and Question 7E on Form U5 to Raise the Dollar Threshold from $10,000 to $15,000

> Currently, Questions 14I(1)(c) and 14I(2) on FormU4 and Questions 7E(1)(c) and 7E(2) on FormU5 require customer complaints to be reported only when they have been settled for $10,000 or more. Recognizing that the monetary threshold for settlements of customer complaints was set some time ago and has never been adjusted for inflation, members of the Working Group are considering raising the existing settlement amount to $15,000 to more accurately reflect the business criteria (including the cost of litigation) firms consider when deciding to settle claims.

3. Form RE-3:

NYSE Member Organizations must file an RE-3 if the Member Organization or a registered or non-registered employee associated with such Member Organization:

> is the subject of any claim for damages by a customer, broker or dealer which is settled for an amount exceeding $15,000. However, when the claim for damages is against a member organization, then the reporting to the Exchange shall be required only when such claim is settled for an amount exceeding $25,000. NYSE Rule 351(a)(8).

NASD Rule 3070(a)(8) sets forth a similar reporting obligation for NASD (FINRA) members who are not also NYSE members.

Note that these questions use the phrase "any claim for damages." This phrase has broader application than the Forms U-4 and U-5 because it includes "any claim for damages," not just claims for "sales practice violations."

V. TERMINATIONS

A. Reporting of Terminations on Form U-4

The Form U-4 requires the reporting of resignations or terminations in certain circumstances.

1. Question 14J asks:

"Have you ever voluntarily *resigned*, been discharged or permitted to *resign* after allegations were made that accused you of:

(1) violating investment-related statutes, regulations, rules or industry standards of conduct?

(2) fraud or the wrongful taking of property?

(3) failure to supervise in connection with *investment-related* statutes, regulations, rules or industry standards of conduct?"

2. A response may be required in the case of voluntary resignations.

3. Under the current Form, the registered person is required to respond to this question if s/he resigned after allegations were made that accused him/her of the listed offenses.

   This latter point raises the questions: (i) "how long after"; and (ii) what if the resignation or discharge had nothing to do with the accusation. While the literal language of the Question seems to call for an affirmative response even if the termination was long after and entirely unrelated to the accusations, the definitions moderate that draconian interpretation. The definition of "resign" and "resigned" states: "Include any termination in which the allegations are a proximate cause of the separation ..."

The Forms do not define what constitutes a violation of "industry standards of conduct" for purposes of Question 14J.

B. Reporting of Terminations on Form U-5

The Form U-5 is required to report the terminations of registration and must be filed by the member firm.

Question 3 requires a report of the reason for termination:

1. Voluntary

2. Deceased

3. Permitted to Resign

4. Discharged

5. Other

The latter three reasons require further "explanation" of the reasons.

Note: This Question should be approached with *extreme caution*.

C. Registration Comment Request Form

A firm wishing to explain unusual circumstances or irregularities in an individual's registration history that: (1) relate to the date or reason for termination on the Form U-5 and (2) cannot be addressed otherwise through a form filing, may submit a Registration Comment Request Form asking that NASD (FINRA) enter a comment on the firm's behalf. NASD (FINRA) will review the request and, if appropriate, will enter the

Registration Comment onto web CRD. If NASD (FINRA) determines that the request goes beyond the scope and intent of the Registration Comment function, NASD (FINRA) will reject the request and will notify the firm.

Registration Comments are not disclosed through NASD (FINRA)'s BrokerCheck Program. They are viewable by CRD users.

D. Reporting of "Internal Reviews"

Form U-5, Question 7B, requires disclosure if the registered person currently is, or at termination was, under "internal review" for certain matters.

The question states:

> Q. 7B: "Currently is, or at termination was, the individual under internal review for fraud or wrongful taking of property, or violating investment-related statutes, regulations, rules or industry standards of conduct?"

The terms "internal review," "fraud" and "industry standards of conduct" are undefined in the Form U-5. However, the "Specific Instructions for Completing the Form U-5" states as follows:

> "Generally, this item is used to report matters of a compliance nature, BUT NOT matters of a competitive nature. Responses should not include situations relating to disputes between the firm and the individual over ownership or possession of information or records pertaining to business conducted by the individual."

E. Reporting of Terminations After Allegations

Form U-5, Question 7F, similar to Form U-4, Question 14J, asks whether the individual resigned after allegations were made that accused the individual of:

1. violating investment-related statutes, regulations, rules or industry standards of conduct;

2. fraud or wrongful taking of property; or

3. failure to supervise.

The key questions here are (1) when are "allegations made" and (2) were the allegations the proximate cause of the separation.

There is no written guidance on what constitutes "allegations made" against an individual. The terms do have some common sense meaning. The question is whether allegations made by the firm against an individual are enough to trigger a report. Because there is no express exclusion in the Question, it would seem that allegations by the firm that accused an individual of the listed conduct can trigger a report. The "proximate cause" requirement is express because it is included in the definition of

resigned. Thus, the allegations of the listed conduct must be a proximate cause of the separation to trigger a report under Question 7F.
The notice to members (July 2003 NTM 03-42) talked about the new Question 7F as mirroring Question 14J on the Form U-4, with both questions "relating to terminations for cause." However, on its face, the question covers voluntary resignations in which the allegations are a proximate cause of the resignation.

F. DISCIPLINARY TERMINATIONS

Under Rule 351(a)(10), disciplinary terminations of unregistered employees should be reported on a Form RE-3.

VI. FIRM'S INTERNAL FINDINGS

A. Reporting of "Violations" (Form RE-3)

1. Question 1 on the Form RE-3 asks for a report when a NYSE Member Organization or a registered or non-registered employee associated with such Member Organization:

> Has violated any provision of any securities law or regulation, or any agreement with or rule or standard of conduct of any governmental agency, self-regulatory organization, or business or professional organization, or engaged in conduct which is inconsistent with just and equitable principles of trade or detrimental to the interests or welfare of the Exchange.

2. NASD Rule 3070(a)(1) is similar, except it provides:

> And the member knows or should have known that any of the aforementioned events have occurred.

   It also reads *found* to have violated.

3. On March 16, 2006, the NYSE issued an Information Memo (Number 06-11) giving guidance on reporting under NYSE Rule 351(a)(1).

   a. Obligation attaches once Firm has concluded that violative conduct has taken place.

   b. For individuals, Rule 351(a)(1) must be read in conjunction with the reporting requirements of Rule 351(a)(10), regarding disciplinary actions. If the Firm imposes disciplinary action less severe than that which is reportable under Rule 351(a)(10), the Firm need not make a filing under Rule 351(a)(1).

   c. If the Firm does not impose discipline, a filing need only be made for recidivist or on-going violative conduct.

d. For the Firm, a filing is required under Rule 351(a)(1) for:

i. systemic failures involving numerous customers, multiple errors or significant dollar amounts; or

ii. conduct that has widespread or potential widespread impact to the firm, its customers or the industry.

B. Internal Disciplinary Action By The Firm (Form RE-3)

1. NYSE Member Organizations must file an RE-3 if the member organization or a registered or non-registered employee associated with such member organization:

   is the subject of any disciplinary action taken by the member or member organization against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of $2,500, or any other significant limitation on activities.

2. NASD Rule 3070(a)(10) is similar, but the last phrase reads "or otherwise disciplined in any manner which would have significant limitation on the individual's activities on a temporary or permanent basis."

   a. includes terminations involving non-registered employees as long as they are "disciplinary."

   b. includes "limitations on activity," presumably including taking away responsibilities such as supervisory responsibilities.

VII. CRIMINAL ISSUES

A. Form U-4 and U-5

1. Questions 14A and 14B of the Form U-4 ask:

   a. (1) Have you ever

      (a) been convicted of or pled guilty or nolo contendere ("no contest") in a domestic, foreign, or military court to any *felony*?

      (b) been *charged* with any *felony*?

   (2) Based upon activities that occurred while you exercised control over it, has an organization ever

(a) been convicted of or pled guilty or nolo contendere ("no contest") in a domestic or foreign court to any felony?

(b) been charged with any felony?

b. (1) Have you ever

(a) been convicted of or pled guilty or nolo contendere ("no contest") in a domestic, foreign or military court to a *misdemeanor involving investments or an investment-related business* or any fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses?

(b) been charged with a *misdemeanor* specified in 14B(1)(a)?

(2) Based upon activities that occurred while you exercised control over it, has an organization ever

(a) been convicted of or pled guilty or nolo contendere ("no contest") in a domestic or foreign court to a misdemeanor specified in 14B(1)(a)?

(b) been *charged* with a misdemeanor specified in 14B(1)(a)?

2. Question 7C on the Form U-5 asks:

While employed by or associated with your firm, or in connection with events that occurred while the individual was employed by or associated with your firm, was the individual:

a. convicted of or did the individual plead guilty or nolo contendere ("no contest") in a domestic, or foreign or military court to any *felony*?

b. *charged* with any *felony*?

c. convicted of or did the individual plead guilty or nolo contendere ("no contest") in a domestic, foreign or military court to a *misdemeanor involving investments or an investment-related business*, or any fraud, false statements or omissions, wrongful taking of property, bribery, perjury, forgery, counterfeiting, extortion, or a conspiracy to commit any of these offenses?

d. *charged* with a *misdemeanor* specified in 7(C)(3)?

3. Felonies

a. An individual must report felony

i. convictions

ii. guilty pleas

iii. nolo contendere pleas

iv. charges

b. *Felonies* are generally defined by statute. The Forms provide a definition for jurisdictions which do not differentiate as follows:

> an offense punishable by a sentence of at lest one year imprisonment and/or a fine of at least $1,000. The term also includes a general court martial.

c. *Charged* means being accused of a crime in a formal complaint, information or indictment (or equivalent formal charge).

d. *Misdemeanors* are reportable if they involve one of the listed offenses, investment, financial or truth related offenses.

e. The Form U-4 requires an affirmative response if the individual has ever been the subject of a reportable event.

f. The Form U-5 requires a report if the event occurs while employed by or associated with the Firm or in connection with events that occurred then.

g. However, Firms must only answer "yes" if they have actual notice of an action that is required to be reported. That is

> communication by the responsible agency/authority regarding the initiation of a criminal or regulatory action directly to a representative of the Firm who is aware of the Form U-5 reporting requirement or should be because they have responsibility for it.

h. Interpretive Questions, p. 8.

4. Form RE-3

NYSE Member Firms must report if a registered or non-registered employee is arrested, arraigned, indicted or convicted of, or pleads guilty to, or pleads no contest to, a list of offenses related to the securities, finances and truth. See NYSE Rule 351(a)(5).

5. NASD Rule 3070(a)(5)

Is similar.

VIII. SRO AND REGULATORY INVESTIGATIONS AND PROCEEDINGS

A. FORMS U-4 AND U-5

1. Question 14G of the Form U-4 states:

   "Have you been notified, in writing, that you are now the subject of any

   (1) regulatory complaint or *proceeding* that could result in a "yes" answer to any part of 14C, D or E?

   (2) *investigation* that could result in a "yes" answer to any part of 14A, B, C, D or E?"

2. Question 7A of the Form U-5 asks:

   "Currently is, or at termination was, the individual the subject of an investigation or proceeding by a domestic or foreign governmental body or *self-regulatory organization* with jurisdiction over *investment-related business*?"

3. Key Terms:

   These questions require an affirmative response if the registered person is the subject of an "investigation," "regulatory complaint" or "proceeding" — "investigation" and "proceeding" are defined in the Form U-4.

   In brief, these definitions remove the concern that this question was intended to solicit information about informal or routine inquiries, examinations or requests for information. An affirmative response is not required unless and until the registered person is formally advised that s/he is the subject of a formal investigation directed at him/her.

   a. A "proceeding" is defined as a (1) "formal administrative or civil action" initiated by a governmental agency or SRO (2) a felony (which is also a defined term) criminal indictment or information or (3) a misdemeanor (which is also a defined term) criminal information, but does not include an arrest or similar charge in the absence of a formal criminal indictment or information.

   b. An "investigation" is defined depending on the agency or SRO initiating it:

      i. .With respect to the SEC, an "investigation" is after the "Wells" notice has been given.

      ii. With respect to the NASD (FINRA), an "investigation" is after the "Wells" notice has been given or after the registered person

has been advised by the staff "that it intends to recommend formal disciplinary action."

iii. With respect to other SROs, an "investigation" is a "formal investigation."

iv. The NYSE has stated in an Information Memo (Number 05-93) that NYSE investigations are also only reportable after a "Wells" notice or communication of an intention to recommend disciplinary action.

v. With respect to the states or state agencies, an "investigation" is an action or procedure "designated as" an "investigation" by the jurisdiction.

vi. "Investigations" also include grand jury investigations..

Where these definitions still leave room for ambiguity, the following are useful guidelines:

c. The definition of "investigation" states expressly that it does not mean to include "subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, `blue sheet' requests or other trading questionnaires, or examinations."

d. For an SRO or jurisdiction that does not define its activities in terms of "formal investigations," it may be useful to consider whether the inquiry has reached a stage equivalent to an SEC "Wells" notice.

e. In order for an "investigation" or "proceeding" to trigger a reporting obligation, the individual must be informed of it in writing on the Form U-4. The Form U-5 does not use the word in writing, but the requirement can be read into the terms investigation and proceeding.

B. FORM RE-3

The Form RE-3 requires a report if a "Member Organization" or a registered or non-registered employee associated with such "Member Organization":

> is named a defendant or respondent in any proceeding brought by a regulatory or self-regulatory body alleging the violation of any provision of the Securities Exchange Act of 1934, or of any other Federal or state securities, insurance, or commodities statute, or of any rule or regulation thereunder, or of any agreement with, or of any provision of the constitution, rules or similar governing instruments of, any securities, insurance or commodities regulatory or self-regulatory organization; NYSE Rule 351(a)(3).

NASD Rule 3070(a)(3) sets forth a similar reporting obligation for NASD (FINRA) Members which are not also NYSE Members.

IX. DISCIPLINARY ACTIONS AND FINDINGS (REGULATORY)

A. FINDINGS, ORDERS AND DISCIPLINARY ACTIONS BY FEDERAL AND STATE REGULATORS AND SROS

1. Form U-4

a. Questions 14C, D and E:

These questions require an affirmative answer, in connection with SEC or CFTC, federal or state regulatory, securities commission, state or federal bank examiner, insurance commission or SRO findings, and orders and final orders, if the registered person has:

i. been "found" to have made a false statement, or omission.

ii. been "found" to have been "involved" in a violation of SEC/CFTC laws/regulations, other investment-related regulations/statutes or SRO rule violations (other than "minor rule violations").

iii. been "found" to have been the "cause" of an investment-related business having its authorization to do business denied, suspended, revoked or restricted.

iv. had an "order" entered against him/her by a regulator in connection with investment related activity.

v. had a civil money penalty or cease and desist order entered by the SEC or CFTC.

vi. had his/her license denied, suspended or revoked or prevented, by order, from association or had his/her activities restricted by a regulator.

vii. been disciplined by expulsion, suspension or restriction of activities by an SRO.

viii. had a "final order" entered by a state securities commission, state or federal banking, savings and loan or credit union agency or state insurance commission that (1) bars the individual from association or engaging in business or (2) is a "final order" based on violations of law or regulations that prohibit fraudulent, manipulative or deceptive conduct.

b. Key Terms:

i. "Orders" are written directives issued pursuant to statutory authority and procedures. Orders do not include special

stipulations, undertakings, payment agreements or activity limitations unless included in a written order.

ii. "Findings" are adverse final actions. Findings include consent decrees in which the respondent did not admit or deny the findings. Findings do not include informal resolutions. Findings do not include agreements, deficiency letters, examination reports, memoranda of understanding, letters of caution or admonishments.

iii. "Final Orders" are written directives or declaratory statements issued by a Question 14D(2) agency, pursuant to applicable statutory authority and procedures, that constitutes a final action by that agency.

Questions 14D(2)(a) and (b) were the two most recently added Disclosure Questions on the Form U-4, effective in July 2003. They require the reporting of certain events that may subject an individual to a statutory disqualification under the expanded definition of the term enacted at the time.

2. Form U-5

a. Question 7D asks:

While employed by or associated with your *firm*, or in connection with events that occurred while the individual was employed by or associated with your firm, was the individual *involved* in any *disciplinary action* by a domestic or foreign governmental body or self regulatory organization (other than those designated as a *"minor rule violation"* under a plan approved by the U.S. Securities and Exchange Commission) with jurisdiction over *the investment-related businesses*?

3. Form RE-3

The Form RE-3 requires a report if the Member Organization or a registered or non-registered employee associated with the Member Organization:

> is denied registration or is expelled, enjoined, directed to cease and desist, suspended or otherwise disciplined by any securities, insurance or commodities industry regulatory or self-regulatory organization or is denied membership or continued membership in any such self-regulatory organization; or is barred from becoming associated with any member or member organization of any such self-regulatory organization. NYSE Rule 351(a)(4).

NASD Rule 3070(a)(4) sets forth a similar reporting obligation for NASD (FINRA) Members who are not also NYSE Member Organization.

Note that the phrase "otherwise disciplined" adds a potentially broad dimension to this reporting question.

X. CIVIL JUDICIAL

Court Injunctions, Court Findings of Involvement In Violations of Investment-Related Statutes or Regulations and Settlement Agreements with States or Foreign Financial Regulatory Authorities of such actions. These are reportable under Question 14H(1). Generally, this is viewed as covering civil judicial actions brought by regulators, not by private clients. Civil actions by private clients are covered by 141. Question 14H(2) asks if the individual is named in an investment-related civil action that could result in a yes to Question 14H(1).

XI. FINANCIAL DISCLOSURES

1. Compromises with Creditors, Bankruptcy Petitions and Involuntary Bankruptcy Petition (for the Individual, Organization or Broker-Dealer) — These are reportable under Question 14K.

2. Denied, paid out or revoked bonds — These are reportable under Question 14L.

3. Unsatisfied judgments or liens — These are reportable under Question 14M.

XII. STATUTORY DISQUALIFICATION

A. Overview

Under the Exchange Act certain persons are disqualified from working in the securities industry. Members of the NASD (FINRA) and the national securities exchanges are prohibited from associating with persons (registered or unregistered) who are statutorily disqualified. The exchanges and the NASD (FINRA) may, however, at the request of a member apply to the SEC for permission for the member to associate with an individual who is statutorily disqualified. The SEC may, similarly, be asked to enter an order that it will not bring proceedings based on the association of a disqualified person with a broker-dealer.

B. Definition of Statutory Disqualification

1. Exchange Act Definition

   Section 3(a)(39) of the Exchange Act describes the seven statutory disqualifications:

   a. Bars, expulsions, or suspensions

      This includes anyone who:

i. "has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with" a member of any self-regulatory organization or foreign equivalent;

ii. been barred or suspended from being associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer by the SEC of a foreign equivalent for a period not exceeding 12 months; or

iii. ad an order denying, suspending, or revoking the person's registration or right to participate in any contract market by the CFTC or foreign equivalent.

See Section 3(a)(39)(A) & (B).

b. Conduct responsible for a bar or suspension

Anyone who "by his conduct while associated with a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or [commodities dealer] has been found to be a cause *of any effective suspension, expulsion, or order" that includes a suspension, expulsion or bar* and was issued by any domestic authority or foreign equivalent is disqualified.

See Section 3(a)(39)(C) & (D).

c. Being associated with persons in the first two categories

Anyone who "has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person described by subparagraph (A), (B), (C), or (D) of this paragraph — i.e., those subject to the bars and suspensions described above is also a statutorily disqualified person.

See Section 3(a)(39)(E).

d. Violating, aiding or abetting violations, or failing to adequately supervise others who violated the securities laws

i. This includes anyone who:

- "has committed or omitted any act, or is subject to an order or finding" that he "willfully violated" any of the federal or foreign securities act;

- "willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision" of any federal or foreign securities act; or

- "failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation."

See Section 3(a)(39)(F); 15(b)(4)(D), (E) & (G) (ii), (iii)

ii. Any similar action taken against an individual by a state insurance regulator or state or federal banking regulator or state securities commission will also create a disqualification if the order

"(i) bars such person from association with an entity regulated by [them] or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or"

"(ii) constitutes a final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct."

See Section 3(a)(39)(F); 15(b)(4)(H).

e. Criminal convictions

i. Anyone who has "[been convicted of] any ... felony within ten years of the date of the filing of an application for membership or participation in, or to become associated with a member of, such self-regulatory organization" is disqualified or, who within the past ten years, has been convicted *of any felony or misdemeanor* or foreign equivalent involving:

- the purchase or sale of any security;
- the taking of a false oath;
- the making of a false report;
- bribery;
- perjury;
- burglary;
- the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities;

- violation of section 152 [concealment of assets from a custodian or trustee in a bankruptcy proceeding], 1341 [mail fraud], 1342 [mail fraud], or 1343 [wire fraud] or chapter 25 [counterfeiting and forgery] or 47 [fraud and perjury] of title 18, United States Code.

ii. Also disqualified is anyone who, during the last ten years, has been convicted of a felony, misdemeanor or foreign equivalent that

arises out of the conduct of the business of a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, investment adviser, bank, insurance company, fiduciary, transfer agent, foreign person performing a function substantially equivalent to any of the above or entity or person required to be registered under the Commodity Exchange Act."

See Section 3(a)(39)(F); 15(b)(4)(B).

f. Injunction from investment related activities

i. Anyone who "is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as":

- an investment adviser;
- underwriter;
- broker;
- dealer;
- municipal securities dealer;
- government securities broker;
- government securities dealer;
- transfer agent;
- foreign person performing a function substantially equivalent to any of the above; or
- entity or person required to be registered with the Commodity Exchange Act or any substantially equivalent foreign statute or regulation is disqualified.

ii. Also disqualified is anyone enjoined from being

- "an affiliated person or employee of any investment company, bank, insurance company," similar foreign entity or "person required to be registered under the Commodity Exchange Act or similar foreign act" or from

- "engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security."

See Section 3(a)(39)(F); 15(b)(4)(C).

g. Making false statements or filing false reports with an SRO or foreign equivalent

Anyone who "has willfully made or caused to be made in any application for membership or participation in, or to become associated with a member of, a self-regulatory organization, report required to be filed with a self-regulatory organization, or proceeding before a self-regulatory organization, [or any similar foreign organization] any statement which was at the time, and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, report, or proceeding any material fact which is required to be stated therein" is disqualified.

See Section 3(a)(39)(F); 15(b)(4)(G)(i).

2. NYSE Definition

The NYSE defines statutory disqualification the same way as the Exchange Act. NYSE Rule 346(f) prohibits a "member, member organization, allied member, approved person, employee or any person directly or indirectly controlling, controlled by or under common control with a member or member organization" from having "associated with him or it any person who is known, or in the exercise of reasonable care should be known, to be subject to any `statutory disqualification' defined in Section 3(a)(39) of the Securities Exchange Act of 1934."

3. NASD Definition

The NASD, in its By-Laws, has a slightly narrower definition of statutory disqualification. Absent from the NASD definition are the provision under the Exchange Act disqualifying individuals who have (1) been found to have violated any of the domestic securities acts; (2) been found to have aided or abetted a violation or failed to supervise others who violated these acts; and (3) are subject to a finding by a bank regulator or state securities or insurance regulator. See NASD By-Laws Article III, Section 4. Similar violations of

foreign laws are, however, disqualifications under the NASD By-Laws. See Id. at (g).

Like the NYSE Rules, Article Ill, Section 3(b) of the By-Laws prohibits persons subject to a disqualification from associating with a member and firm and prohibits the member firm from continuing its membership if such an association exists. Section 3(b) states that

> [n]o person shall become associated with a member, continue to be associated with a member, or transfer association to another member . . . if such person is or becomes subject to a disqualification under Section 4; and no broker, dealer, municipal securities broker or dealer, or government securities broker or dealer shall be admitted to membership, and no member shall be continued in membership, if any person associated with it is ineligible to be an associated person under this subsection.

C. Applications to Associate With Disqualified Persons

The NASD and NYSE require a member who proposes to associate with a disqualified person to make an application to the SRO. In addition, the Exchange Act requires that, before a member associates with a disqualified individual, the exchange or association must "file notice with the Commission not less than thirty days prior to admitting any person to membership or permitting any person to become associated with a member." See Section 6(c); 15A(g). The Act requires that the notice "be in such form and contain such information as the Commission, by rule, may prescribe."

1. SRO Procedures

Both the NYSE and the NASD require members seeking to associate with a disqualified person to file an application. The NASD By-Laws, Article Ill, Section 3(d) allows "[a]ny member that is ineligible for continuance in membership" to "file with the Board an application requesting relief from the ineligibility pursuant to the Rules of the Association." Once an application is filed,

> [t]he Board may, in its discretion, approve the continuance in membership, and may also approve the association or continuance of association of any person, if the Board determines that such approval is consistent with the public interest and the protection of investors. Any approval hereunder may be granted unconditionally or on such terms and conditions as the Board considers necessary or appropriate.

In considering an application the By-Laws expressly allow the Board to "conduct such inquiry or investigation into the relevant facts and circumstances as it, in its discretion, considers necessary" and to collect information about "the background and circumstances giving rise to the failure to qualify or disqualification," as well as "the proposed or present business of a member and the conditions of association of any current or prospective associated person."

Although the NYSE rules do not contain the same level of detail, the application and review process is essentially the same, and indeed before any notice is filed with the SEC each SRO will submit the proposed notice to other relevant SRO's for their review and approval.

Both the NYSE and the NASD require firms to pay for an application to associate with a statutorily disqualified person:

a. Fee for application to the NYSE: $1000

b. Fee for application to NYSE if a notice to the SEC is filed: $1500 (rather than $1000)

c. Fee for application to NASD: $1500

d. Fee for an NASD hearing on an application: $2500

New York Stock Exchange Price List 2006 at 12; NASD By-Laws, Appendix A, Section 12(a).

In addition, the NASD imposes an annual fee on firms that continue "to employ as an associated person any individual subject to disqualification from association with a member." Id. at Section 12(b). When the disqualification arises from violations of a securities law, and the person is subject to heightened supervision, the annual fee is $1500. For all others, where the disqualification does not arise for the violation of a securities law, the annual fee is $1000. Id. See also SEC Release No. 34-34897 "Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Fees for Member Firms Employing Statutorily Disqualified Individuals" (Oct. 26, 1994).

2. Notice to the SEC

a. If the SRO agrees to allow a member to associate with a disqualified person, the SRO may have to file a notice with the SEC pursuant to Exchange Act Rule 19h-1. The rule has four parts:

First, the rule describes circumstances in which an application must be flied with the commission.

Second, it describes circumstances in which a notice need not be filed.

Third, the rule describes the content of the notice.

Fourth, the rule describes the process for applying to the SEC for a determination that it will not institute proceedings based on the disqualification.

b. Notice Must Be Filed:

A notice under the rule must be filed with the SEC regarding association with a disqualified person if that person:

i. controls such member;

ii. is a general partner or officer (or person occupying a similar status or performing similar functions) of such member;

iii. is an employee who, on behalf of such member, is engaged in securities advertising, public relations, research, sales, trading, or training or supervision of other employees who engage or propose to engage in such activities;

iv. is an employee with access to funds, securities or books and records; or

v. is a broker-dealer or controls a broker-dealer that is not registered with the SEC.

c. Notice Need Not Be Filed:

A notice need not be files with the SEC regarding association with a disqualified person when:

i. the person has already been allowed to associate with an SRO and proposes to associate with an SRO on terms and conditions that are "the same in all material respects" to those previously in place;

ii. a person who has already been allowed to associate with a member, proposes to associate with a different member (1) on terms and conditions that are "the same in all material respects" to those previously in place, and (2) the SRO finds no "intervening conduct or other circumstance" that would make association "inconsistent with the public interest or the protection of investors";

iii. the disqualification is an injunction from investment related activities that was entered more than 10 years ago;

iv. the disqualification arose from a finding that the person violated a federal securities act and the sanctions are no longer in effect;

v. the SEC previously instituted administrative proceedings relating to the same conduct and the sanction did not "restrict or limit the future securities activities of such person in the capacity now proposed" or, if a restriction was imposed "for a specified time period, such time period has elapsed";

vi. the disqualification is an injunction that (1) expressly states the SEC will not institute administrative proceedings against individual or restrict the person's right to act in the proposed capacity, or (2) if a restriction was imposed "for a specified time period, such time period has elapsed"; or

vii. the SEC has previously assented to the association.

Although a notice does not need to be made, in some instances (second, fifth and sixth, above) the rule requires the SRO to send a letter informing the SEC of the SRO's determination to allow the association.

d. Content of the Application:

If the SRO determines to allow the association of the disqualified person with the member, the SRO must file with the SEC a preliminary notification followed by the "notice of admission or continuance." The notice must contain:

i. the name and address of the person and of the employer;

ii. the basis for the disqualification, including the copy of the relevant order or decision;

iii. the date of proposed admission (if not already admitted) that is at least 30 days after the filing of the notice;

iv. a certified record of any hearing held by the SRO and any exhibits or written submissions considered by the SRO; and

v. an identification of other SROs that have indicated their agreement with the terms of the proposed admission.

The heart of the submission is a description written by or on behalf of the person describing "the activities engaged in by the person since the disqualification arose, the prospective business or employment in which the person plans to engage and the manner and extent of supervision to be exercised over and by such person." The description must be accompanied by a statement from the proposed employer describing:

(i) the qualifications, experience and disciplinary records of the proposed supervisors of the person and their family relationship (if any) to that person;

(ii) the findings and results of all examinations conducted, during the two years preceding the filing of the notice, by self-regulatory organizations of the main office of the proposed employer and of the branch office(s) in which

the employment will occur or be subject to supervisory controls;

(iii) a copy of a completed Form U-4 with respect to the proposed association of such person and a certification by the self-regulatory organization that such person is fully qualified under all applicable requirements to engage in the proposed activities; and

(iv) the name and place of employment of any other associated person of the proposed employer who is subject to a statutory disqualification (other than a disqualification specified in paragraph (a)(3)(iii) of this section).

e. Application for Relief from Disqualification:

With the notice, relying on the same information, a disqualified person subject to an "applicable disqualification" can ask the SEC to issue an order that it will not:

i. institute proceedings pursuant to section 15(b)(1)(B), 15(b)(4), 15(b)(6), 15B(a)(2), 15B(c)(2), 19(h)(2) or 19(h)(3) of the Act if such person seeks to obtain or continue registration as a broker or dealer or municipal securities dealer or association with a broker or dealer or municipal securities dealer so registered, or membership or participation in a self-regulatory organization;

ii. "otherwise direct" an SRO to deny a disqualified person association as provided for in section 6(c)(2), 15A(g)(2) or 17A(b)(4)(A) of the Act;

iii. deem such person unqualified pursuant to Rule G-4 of the Municipal Securities Rulemaking Board.

The rule defines the term "applicable disqualification" as:

(i) Any effective order of the Commission pursuant to section 15(b)(4) or (6), 15B(c)(2) or (4) or 19(h)(2) or (3) of the Act –

(A) Revoking, suspending or placing limitations on the registration, activities, functions, or operations of a broker or dealer;

(B) Suspending, barring, or placing limitations on the association, activities, or functions of an associated person of a broker or dealer;

(C) Suspending or expelling any person from membership or participation in a self-regulatory organization; or

(D) Suspending or barring any person from being associated with a member of a national securities exchange or registered securities association;

(ii) Any conviction or injunction of a type described in section 15(b)(4)(B) or (C) of the Act; or

(iii) A failure under the provisions of Rule G-4 of the Municipal Securities Rulemaking Board under the Act, to meet qualifications standards, and such failure may be remedied by a finding or determination by the Commission pursuant to such rule(s) that the person affected nevertheless meets such standards.

If a disqualification is not an "applicable disqualification," the SEC does not deem it necessary to grant relief. In those instances, the violation, while otherwise meeting the definition of a disqualification, will not be considered to disqualify the person from association with a member.

XIII. TRACE, OATS, ACT AND BLUE SHEETS

TRACE Requirements

The Trade Reporting and Compliance Engine (TRACESM) system is the FINRA developed system that captures the reporting of all eligible secondary market, over-the-counter transactions in eligible corporate bonds, including investment grade and high yield debt, medium term notes, and convertible bonds. TRACE went effective on July 1, 2002.

On February 7, 2005, FINRA began full dissemination of transaction and price data on the entire universe of corporate bonds bringing greater transparency to the debt markets.

Sampling of Recent Significant TRACE Enforcement Actions

- Firm censured and fined $10,000.

  Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it incorrectly reported corporate bond transactions in the Trade Reporting and Compliance Engine (TRACE) reporting system as principal capacity trades when, in fact, they were agency capacity trades. The findings stated that the firm failed to report the yields for corporate bond transactions and failed to report both the customer-side and dealer-side trades of corporate bond transactions to TRACE. (FINRA Case #20070071181-01)

- Firm censured and fined $17,500.

  Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report to TRACE transactions in TRACE-eligible securities executed on a business day during TRACE system hours within 15minutes of the time of execution and reported to TRACE transactions in TRACE eligible securities it was not required to rep

- Firm censured, fined $10,000, and required to revise its written supervisory procedures regarding TRACE.

  Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report the correct contra-party's identifier in transactions in TRACE-eligible securities to TRACE, and failed to report transactions in TRACE-eligible securities within 30minutes of execution. The findings stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws, regulations and NASD rules concerning TRACE. (FINRA Case #20050013890-01)ort. (FINRA Case #20060055189-01)

- Firm censured, fined $10,000, and required to revise its written supervisory procedures regarding TRACE

  Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report transactions in TRACE-eligible securities within 30minutes of execution. (FINRA Case #20050020359-02).

- Firm censured and fined $25,000.

  Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report the correct execution time for transactions in TRACE-eligible securities to TRACE, failed to report the correct terms of transactions, and submitted incorrect reports to TRACE that were not canceled or corrected. The findings stated that the firm reported transactions in TRACE-eligible securities to TRACE that it was not required to report because the transactions were executed outside the United States by its foreign affiliate. The findings also stated that the firm failed to enforce its written supervisory procedures relating to TRACE reporting, which specified that the firm's "desk supervisor" (or designee)must review the daily trading records in part to ensure that corporate bond trades executed and cleared outside the United States by a foreign affiliate of the firm would not be reported in the United States by the firm. (FINRA Case #20050001668-02)

- Firm censured and fined $60,000.

Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report corporate bond trades to TRACE because it mistakenly assumed that its clearing agent was reporting the trades, and no one at the firm took any steps to ensure and verify that TRACE-eligible trades were being reported. The findings stated that the firm ailed to retain copies of all outgoing email communications, and failed to prepare accurate securities received and forwarded blotters. (FINRA Case #2007007339501)

- Firm censured and fined $75,000.

Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to execute a Trade Reporting and Compliance Engine (TRACE) participant application agreement and failed to report all of its TRACE-eligible self-cleared corporate securities transactions to TRACE. The findings stated that the firm failed to report all of its self-cleared municipal securities transactions to the Municipal Securities Rulemaking Board (MSRB). The findings also stated that the firm failed to maintain a reasonable supervisory system and written supervisory procedures related to TRACE and MSRB reporting requirements; failed to ensure its written supervisory procedures were updated, maintained and enforced; and failed to ensure that they were reasonably designed to achieve compliance with applicable federal securities laws, rules and regulations related to TRACE and MSRB reporting requirements. (FINRA Case #2007007176601)

- Firm censured, fined $185,000, ordered to pay $299, plus interest, in restitution to customers and required to revise its written supervisory procedures regarding short sale reporting, TRACE trade reporting, trade reporting of municipal securities, riskless principal trade reporting, and best execution.

Without admitting or denying the sanctions, the firm consented to the described sanctions and to the entry of findings that it executed numerous short sale transactions and failed to report them to the Automated Confirmation Transaction Service (ACT) with a short sale modifier due to a technology issue that inaccurately treated principal short sales as long sales. The findings stated that the firm submitted to OATS New Order Reports and related subsequent reports where the timestamp for the related subsequent report occurred prior to the receipt of the order so that the OATS system was unable to create an accurate time-sequenced record from the receipt of the order through its resolution. The findings also stated that the firm failed to report the correct contra-party's identifier for transactions in TRACE-eligible securities to TRACE and failed to timely report Reportable Order Events (ROES) to OATS. The findings also included that the firm failed, within 90 seconds after execution, to transmit last sale reports of transactions in Over-the-Counter (OTC) equity securities to the OTC Reporting Facility and failed to designate some of them as late. (FINRA Case #20041000011-01)

OATS Requirements

The Order Audit Trail System (OATS) is part of an integrated audit trail system, developed by NASD. It provides a source of timed, sequenced order events, which when combined with existing quotation and trading information, is used to create a record of orders, quotes, and transactions for regulatory purposes, including surveillance of the NASDaq Market. NASD Rules 6950 through 6957 require member firms to develop a means for electronically capturing and reporting to NASD order data on specified events in the life cycle of every order for NASDaq-listed equity securities. The types of order events that firms must report include receipt, modification, cancellation, routing, and execution. Orders for an NASD member firm's proprietary account originated by a trading desk in the normal course of market making activities are not subject to reporting requirements; however, all other proprietary orders must be reported to OATS.

In addition, NASD Rule 6953 requires all member firms that have an obligation to record order, transaction, or related data under NASD Rules to synchronize the business clocks that are used for recording the date and time of any market event. Computer system and mechanical clocks must be synchronized every business day before market open, at a minimum, in order to ensure that recorded order event timestamps are accurate.

Recent Significant OATS Developments

- FINRA Regulatory Notice 07-39: SEC Approves Amendments Regarding OATS Routing Method Code for Intermarket Sweep Orders; Effective Date: February 4, 2008

  Effective February 4, 2008, firms that transmit an intermarket sweep order (ISO), as defined in Regulation NMS, in an OATS-eligible security to another member firm, electronic communications network, non-member or exchange, must record and report the fact that the order was an ISO in their OATS reports.

- On October 10, 2006, the SEC approved expanding the OATS reporting requirements to include OTC equity securities. In response to concerns raised by members regarding programming resources required for the implementation of Reg. NMS, NASD has delayed the implementation date of this rule until February 4, 2008. NASD is also reviewing the scope of covered securities under the new rule.

- On July 18, 2007, the SEC approved a NASDaq rule to exempt certain proprietary trading firms from OATS transmission requirements. Only firms that do not have customers and are members of NASDaq but not NASD are eligible for this OATS reporting exemption.

- May 8, 2006, implementation of OATS Phase III. The Phase Ill amendments to the OATS Rules: (1) implement the OATS reporting requirements for manual orders; (2) provide that members are required to capture and report the time the order is received by the member from the customer for all orders; (3) expand the order transmittal requirements to include orders routed to a member's trading desk or trading department; (4) exclude certain members from the definition of "Reporting Member" for those orders that meet specified conditions and are recorded and reported to OATS by another member; and (5) permit NASD to grant exemptive relief from the OATS reporting requirements in certain circumstances to members that meet specified criteria.

Sampling of Recent OATS Actions

- Firm censured, fined $116,000, and required to revise its written supervisory procedures concerning compliance with NASD Rules 3110(b)(1), 3370, 6130(d)(6), order handling, best execution, other trading rules, soft dollar accounts and trading, and other rules.

  Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that included, among other things, that the firm submitted reportable order events (ROEs) to OATS after the 4:00 AM deadline. In addition, FINRA determined that the firm transmitted reports to OATS that contained inaccurate, incomplete or improperly formatted data. (FINRA Case #20041000004-01)

- Firm censured and fined $15,000.

  Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to submit required information to the Order Audit Trail System(OATS) on 77 business days. The findings stated that the firm failed to report all of its Reportable Order Events (ROEs) it was required to report on these days. (FINRA Case #20060066641-01)

- FINRA Fines Three Firms a Total of $1.6Million for OATS Reporting and Supervision Violations

  FINRA fined three large firms a total of $1.6million for multi-year violations relating to FINRA's Order Audit Trail System(OATS) rules and related supervisory failures.

  Under the OATS rules, firms must report information related to the handling and execution of customer orders, as well as for certain proprietary orders for Nasdaq and OTC Equity securities. This information allows FINRA to recreate the life cycle of an order and is critical to effective regulation.

  "Firms must be vigilant in monitoring the accuracy and completeness of the data they provide to regulators and each firm must ensure that it reports all required order information, no matter which desk receives or handles the order," said Tom Gira, Executive Vice President of FINRA's Market Regulation Department.

  FINRA further found that the three firms did not have adequate systems of supervision in place to monitor their OATS reporting compliance.

OTC Reporting Facility

In July 2004, NASD generally discontinued its use of the term "ACT" for its automatic confirmation transaction service and replaced it with the term "NASDaq Market Center" or "service."' In June 2006, the transaction reporting system formerly called ACT became the OTC Reporting Facility.

NASD members are required to use the OTC Reporting Facility to report transactions in PORTAL securities, OTC equity securities, direct participation program securities.

In addition to the NASD OTC Reporting Facility, there is NASD/NASDAQ Trade Reporting Facility ("TRF"), a new limited liability company operated by NASDAQ. The TRF is a facility of NASD and subject to NASD's regulatory license and oversight.

The TRF is an automated trade reporting and reconciliation service operated on the ACT technology platform. The TRF electronically facilitates the post-execution steps of price and volume reporting, comparison and clearing of trades for NASDAQ-listed securities as well as for transactions in NYSE-, Amex- and regional-listed securities that occur off the floor. The benefits of the TRF include:

- Facilitates 90-second trade reporting for all NASDAQ-, NYSE-, Amex- and regional-listed securities;

- Collects last sale information;

- Disseminates last sale information to the NASDAQ ticker and to the media through NASDAQ's Trade Data Dissemination Service (TDDS); and

- Provides online access to real-time trade reporting information through the Time and Sales feature.

2008 Updates and Notices – OTC Reporting Facility

FINRA Information Notice April 1, 2008: FINRA Implements Changes to OTC Reporting Facility and OTC Bulletin Board Invoice Processes; Effective Date: April 1, 2008

FINRA's process for generating and mailing certain invoices related to charges for usage of the ORF and the OTCBB changed on April 1, 2008.

Blue Sheets Requirements

Since 1988, the rules of the SEC (Rule 17a-25) and each SRO (e.g., NASD Rules 8211 and 8213.) have required broker-dealers to respond to requests for trade data through the Electronic Blue Sheet System (EBS). The information sought by the SEC and SROs is usually used to conduct investigations of possible securities trading violations, and it is

also used by the SEC to reconstruct overall market conditions, primarily following significant market volatility.

The EBS System relies upon a universal electronic format created by the SEC and SROs to replace the previously manual process of requesting and submitting trade data. The EBS System requirements are very technical in nature and can only be satisfied through use of software specifically designed to format.the data in the required fashion. The vast majority of broker-dealers rely upon third-party vendors to provide the software and, in some cases these third parties also prepare the submissions.

Significant Blue Sheets Developments

In 2005, the Intermarket Surveillance Group (or ISG), the market surveillance organization consisting of members of each of the SROs, published a regulatory notice (ISG Regulatory Memorandum, ISG 2005-01) : 1) advising all SRO members that the SEC and ISG had detected increased inaccuracies in EBS submissions, 2) reminding members of their obligation to submit accurate submissions, and 3) requiring all members to conduct a validation of their systems for compliance with EBS System requirements to ensure accurate submissions. Each member was required to submit an initial validation report to its primary SRO by March 31, 2006 and all problems had to be addressed by the end of 2006. The ISG members have made clear that it is expected that all broker-dealers have supervisory systems in place to check the accuracy of their EBS submissions.

Enforcement Actions

Concurrent with the ISG's efforts in 2005, the NYSE commenced an investigation and settlement negotiation with a group of its member firms for failure to submit accurate EBS submissions. In January 2006, the NYSE's efforts resulted in a settlement with a group of twenty member-firms for submitting inaccurate EBS filings that did not properly identify short sales as such. In almost all cases, the member firms were relying on third-party software to prepare their EBS submissions, and they did not have systems in place to check the accuracy of those submissions. The firms were divided into three categories of offender, with fines of either $150,000, $300,000 or $500,000.