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VIA FEDERAL EXPRESS

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Re: Regulatory Notice 09-12 - ARS Reporting

Dear Messrs. Ketchum and Menchel:

<u>Executive Summary</u>

The Securities Industry and Financial Markets Association ("SIFMA"),[1] on behalf of certain member firms, requests that the Financial Industry Regulatory Authority ("FINRA") reconsider and withdraw the new reporting requirements set forth in Regulatory Notice 09-12.[2] Specifically, RN 09-12 introduces two new reporting requirements. First, it requires that global

[1] SIFMA brings together the shared interests of more than 600 securities firms, banks and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. More information about SIFMA is available at http://www.sifma.org.

[2] Regulatory Notice 09-12 (February 2009) *Auction Rate Securities - Reporting Requirements for Settlements of Customer Disputes Involving Auction Rate Securities* ("RN 09-12").

settlements entered into between regulatory agencies and member firms regarding auction rate securities ("ARS") must be reported as individual settlements on Forms U-4 and U-5 or pursuant to New York Stock Exchange Rule 351 ("Rule 351") and National Association of Securities Dealers Rule 3070 ("Rule 3070"), provided that the customer who participated in the global settlement had previously made a reportable complaint against a registered representative or a claim for damages against an individual or a member firm. Second, RN 09-12 requires that in connection with ARS "settlements," regulatory filings must report the par amount paid for the ARS as the "settlement" amount, and may not reflect the value of the ARS, *even though* the firms received the ARS back as part of the transaction.

What is really at stake is this: RN 09-12 seeks to emblazon a permanent mark on the Central Registration Depository ("CRD") records of individual representatives who sold ARS and whose customers complained. This is so because CRD does not archive customer settlements. Thus, any reported ARS "settlements" would remain on the individual representative's record forever. RN 09-12 in effect would require firms to alter and distort the accurate disclosures they have already made (described infra), which would be archived after two years, and replace such factually accurate disclosure with a fiction – the fiction that the customer "settled" with the individual representative for the par amount that the firm paid the customer for the ARS. This fiction does not serve the interest of disclosure or investor protection, but is merely a device to convert a two-year disclosure into a permanent mar on a representative's record. If implemented retroactively, RN-09-12 would require member firms to make many thousands of new, inaccurate filings on Forms U4, U5 and RE-3, and to amend equal numbers of existing filing that already represent the most accurate and complete state of disclosure.

This submission presents three reasons why the new requirements of RN 09-12 should not be implemented. First, the global, regulatory ARS settlements were factually, procedurally and legally *not* settlements of individual customer complaints or claims for damages, so they should not be reported as such. Second, as issued, the new requirements are unenforceable as a matter of law because they constitute promulgation of a rule change in contravention of Exchange Act requirements and they violate the due process rights of thousands of registered representatives. Finally, the requirements would result in inaccurate, incomplete and misleading disclosures, thereby undermining the factual integrity of the Central Registration Depository ("CRD") to the detriment of the investing public, regulators, registered representatives and prospective employers.

I. THE ARS SETTLEMENTS WERE GLOBAL SETTLEMENTS BETWEEN MEMBER FIRMS AND REGULATORS, NOT SETTLEMENTS OF INDIVIDUAL CUSTOMER COMPLAINTS.

A. The ARS Global Settlements

Beginning in August 2008, a number of FINRA member firms reached agreements in principle with various regulators settling claims regarding the firms' roles in the ARS market. As part of the agreements, the firms agreed to institute plans to purchase eligible ARS from certain customers. The settlements were the subject of public announcements by regulators and widespread press coverage:

Dates Settlements In Principle Were Announced	Members	Regulators Who Announced Settlements
August 7, 2008	Citigroup Global Markets Inc. ("CGMI")	United States Securities and Exchange Commission's ("SEC") Division of Enforcement; State of New York; North American Securities Administrators Association ("NASAA").
August 8, 2008	UBS Securities LLC and UBS Financial Services, Inc. ("UBS")	SEC; State of New York; NASAA
August 14, 2008	JP Morgan Chase & Co.	State of New York; NASAA
August 14, 2008	Morgan Stanley & Co.	State of New York; NASAA
August 15, 2008	Wachovia Securities, LLC and Wachovia Capital Markets, LLC ("Wachovia")	SEC; State of Missouri; State of New York; NASAA
August 21, 2008	Goldman, Sachs & Co.	State of New York; NASAA
August 21, 2008	Merrill Lynch, Pierce, Fenner & Smith Inc.	SEC; Commonwealth of Massachusetts; State of New York; NASAA
August 21, 2008	Deutsche Bank Securities Inc. and Deutsche Bank AG	State of New York; NASAA
September 16, 2008	Credit Suisse Securities (USA) LLC	State of New York; NASAA
October 8, 2008	Banc of America Securities LLC and Banc of America Investment Services, Inc.	SEC; State of New York; NASAA
October 8, 2008	RBC Capital Markets Corp.	SEC; State of New York; NASAA

The regulators explained the regulatory settlements by describing allegations of the *firms'* conduct. The SEC's press releases typically contained the following paragraph:

> The ARS market collapsed in mid-February 2008, leaving over [tens of thousands of customers] holding these illiquid securities

> indefinitely. The conduct underlying the proposed charges stems from [member firms'] marketing of auction rate securities as cash alternatives. However, the liquidity of these securities was premised on [member firms'] providing support bids for auctions [they] managed when there was not enough customer demand, but this was not adequately disclosed to customers. When [member firms] stopped supporting auctions in February 2008, it led to widespread auction failure, for [tens of thousands of customers].

See Press Releases Announcing Regulatory Settlements with Firms, Appendix, Exhibit A.[3]

After the announcements of the settlements in principle, the regulators and the firms continued to negotiate specific terms, leading to formal, civil Consents to Judgment ("Consents") by member firms in which the member firms neither admitted nor denied the allegations.[4] *See* Consents, Appendix, Exhibit B. Pursuant to the agreements with regulators, the member firms typically agreed to the following pertinent terms, among others:

- Within a number of months of the agreement, member firms agreed to repurchase at par from eligible retail customers, including natural persons, charities and small businesses, ARS purchased by those customers within a defined time period;
- Member firms agreed to make whole any losses sustained by customers who purchased eligible ARS before specific dates, and sold such securities after that date at a loss;
- Member firms agreed not to liquidate their own inventories of a particular ARS before liquidating their customers' holdings;

[3] We are submitting with this Letter an Appendix containing the referenced Exhibits.

[4] *See, e.g., Securities Exchange Commission v. Citigroup Global Markets Inc.*, United States District Court for the Southern District of New York, C.A. No. 1:08-cv-10753-DAB, CGMI's Consent dated December 22, 2008; *Securities and Exchange Commission v. UBS Securities LLC and UBS Financial Services Inc.*, United States District Court for the Southern District of New York, C.A. No. 1:08-cv-10754-DAB, UBS's Consent dated October 31, 2008; In *the Matter of: Wachovia Securities, LLC and Wachovia Capital Markets, LLC*, Office of the Secretary of State, State of Missouri, Case No. AP-08-28, Wachovia's Consent dated December 8, 2008; *In the Matter of Wachovia Securities, LLC and Wachovia Capital Markets, LLC*, Attorney General of the State of New York Investor Protection Bureau, Assurance No. 08-179, Wachovia's Assurance of Discontinuance dated February 4, 2009; and *Securities and Exchange Commission v. Wachovia Securities, LLC*, United States District Court for the Northern District of Illinois, Eastern Division, CA No. 1:09-cv-00743, Wachovia's Consent dated January 27, 2009. Appendix, Exhibits B1-B5. Other formal Consents are still being negotiated.

- To the extent that a customer incurred consequential damages beyond the loss of liquidity (restored per the above), the member firms agreed to participate in a special arbitration process that the customer could elect, at which the member firms would not contest liability, but could challenge damages;

- This arbitration process was voluntary on the part of the customer and if a customer elected not to take advantage of it, the customer could pursue all other arbitration or legal or equitable remedies available through any other administrative or judicial process available to the customer.

Id.

Individual customers were not parties to the regulatory actions in which the Consents entered. They were not parties to these regulatory settlements. They did not agree to any terms whatsoever. They did not provide any releases. Indeed, they expressly were given the right to pursue individual claims.

Importantly, registered representatives were also not parties to the regulatory actions in which the Consents entered. They were not parties to these regulatory settlements. They were not the subjects of any regulatory findings. They did not agree to any terms whatsoever. They did not receive the benefit of any releases. They did not agree to make any payments. They remained exposed to potential arbitrations and other potential claims by individual investors.

B. Regulatory Reporting of the Global Settlements by Firms

For reporting purposes, the Consents and agreements between the firms and various regulators have the following critical elements:

- The parties to the Consents and agreements were the firms and various regulators;

- The Consents were entered in regulatory *proceedings* in which individual registered representatives and individual clients were not parties and in which no *findings* appeared with respect to registered representatives or individual clients; and

- The Consents and agreements set forth eligibility criteria for participating in the ARS liquidation program that *were not dependent on whether the investor had made a prior complaint or not.*

The reporting of regulatory *proceedings, findings* and *orders* involving member firms is governed by the Form BD, Items 11C (the SEC or the Commodity Futures Trading Commission), 11D (any other federal regulatory agency, any state regulatory agency or foreign financial regulatory authority), 11E (any self-regulatory organization ("SRO")) and 11G (regulatory proceedings).[5] For example, firms must report if they have been *found* to have been involved in a violation of SRO Rules (Item 11E(2)) or *found* to have been involved in a violation of investment-related regulations or statutes (11D(2)). If an agreement takes the form of a consent order in which the respondent has neither admitted nor denied the findings, as was the case with the ARS Consents, it still constitutes an adverse final action for reporting purposes under these rules. *See* Form BD Explanation of Terms (Definition of *Found*). In addition, regulatory proceedings and discipline such as the ARS Consents may be reportable by the firms under SRO rules. *See* New York Stock Exchange Rule 351(a) and NASD Rule 3070(a).

By contrast, there are no questions on the individual reporting Forms, Forms U4 and U5, that require *individuals* to report settlements between their firms and regulators or *proceedings, findings* and *orders* involving their firms but not them. In effect, RN 09-12 purports to give "guidance" (but actually amounts to new requirements) that converts events which are only reportable by member firms into something which assertedly must be reported by individuals.[6]

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[5] The terms *proceedings, findings* and *orders* are defined in the Explanation of Terms in the Form BD.

[6] Individuals have to report *proceedings, orders* and *findings* involving the individuals. However, as established above, the regulatory *proceedings* and *orders* involved in the ARS settlements did not involve any individual representatives.

C. Regulatory Reporting of the Global Settlements by Registered Representatives Who Received Customer Complaints

Shortly after the ARS market seized in February 2008, certain individual customers complained to the firms about the loss of liquidity in various types of communications with various asserted allegations. As a result, the usual reporting criteria were applied for purposes of reporting these customer complaints:

- Customer complaints were reported applying the standard requirements; namely, that in order to be reportable on a registered representative's Form U4 or U5, there had to be a:
    - Consumer-initiated, written complaint;
    - Alleging that the individual registered representative was *involved* in a *sales practice violation* and;
    - Containing a claim for compensatory damages of $5,000 or more.

See Form U4, Questions 14I1 and 14I3(a). Thus, applying the standard reporting criteria, firms and registered representatives filed Form U4 and U5 amendments to report these written customer complaints.

Some of these customer complaints were denied by the firms and then amendments were filed reporting that they were denied. Other previously reported complaints were still "pending" at the time of the global regulatory settlements described above. In most of those cases, when the firms offered to repurchase the ARS pursuant to the global settlements, amendments were filed reporting the individual complaint as "closed," *see* Form U4 Customer Complaint DRP Item 9, and explaining that the complaint was being closed because the firm was offering to liquidate the ARS pursuant to the terms of a global settlement, *see* Form U4 Customer Complaint

DRP Item 28.[7] These were factually accurate amendments that reflected what actually happened. The firms did not settle these as individual customer complaints. There were no negotiations, discussions or settlement agreements with the individual customers. The firms entered regulatory settlements and Consents and then performed the terms of those Consents. As a matter of law and fact, the obligations to buy back the ARS arose out of the firms' Consents, *not* any individual settlements. Those regulatory settlements are reportable by the firms on the Form BD per the existing definitions and questions, and not by individuals. As a result, firms did not report individual settlements on Form U4 Questions 14I(1)(c) or 14I(2) or Customer Complaint DRP Item 11.

By contrast, when firms did agree to settle an individual, reportable claim (*e.g.*, settlements reached before the global settlements or settlements involving ARS not covered by the global settlements) the firms applied the standard criteria to report such settlements. However, firms did not report the "par" amount as the settlement amount because the ARS repurchased had value. Now, even these filings are impacted by RN 09-12, because RN 09-12 has the new requirement that the settlement amount must be reported as par without regard to the bilateral exchange. Thus, in this respect as well, RN 09-12 would require hundreds, if not thousands, of refilings.

[7] The mechanics of the global regulatory settlements involved mailing offers to purchase the ARS to all customers covered by the ARS settlement. The offer was in no way related to or contingent upon a preexisting complaint. Indeed, offer letters were sent to eligible customers who never complained.

These reporting conventions were followed throughout the industry for months without objection or comment by FINRA.[8]

D. FINRA Issues RN 09-12 and Sets Forth New Reporting Requirements

Six months after many of the settlements were reached, on February 18, 2009, FINRA posted RN 09-12. It referred to final settlements reached between FINRA and certain firms related to ARS.[9] Like the press releases described above, RN 09-12 described the settled allegations as allegations that the *firms* (not registered representatives) misled investors regarding the liquidity risks of ARS, including the *firms'* reduced ability to support auctions in early 2008. RN 09-12, p. 2. *See* RN 09-12, fn. 3 ("As part of the settlements, the *firms* neither admitted nor denied the charges, but consented to the entry of FINRA's findings.") (Emphasis added.)

After describing the allegations against the firms and the settlements with the firms, RN 09-12 asserts two things about reporting the settlements with the firms:

- Depending on the nature of the claim being settled - civil litigation, arbitration or other claim for damages, such as a customer complaint - and the settlement amount, firms may have reporting or disclosure obligations pursuant to NASD Rule 3070 and NYSE Rule 351 and the requirements of Forms U4 and U5.
- When determining the dollar amount for reporting an ARS settlement, firms must include the full dollar amount that was refunded to the customer. Even though the firm acquires the ARS, "ARS settlement amounts may not be reduced by the actual (if it can be determined) or estimated market value of ARS."

[8] In addition, firms did not file RE-3s (or reports under Rule 3070) every time they repurchased an ARS from a customer who may have made a "claim for damages." When repurchasing the ARS as part of the global settlements, the firms did not settle any individual "claims for damages." They were complying with the global Consents.

[9] On September 18, 2008, FINRA announced settlements in principle with SunTrust Investment Services, Inc., SunTrust Robinson Humphrey, Inc., Comerica Securities, Inc., First Southwest Company of Dallas and WaMu Investments, Inc. On October 23, 2008, FINRA announced settlements in principle with City National Securities, BNY Mellon Capital Markets LLC and Harris Investor Services, Inc.

RN 09-12, p. 2.

Thus, RN 09-12 made the novel, unprecedented and factually unfounded statement that global regulatory settlements with firms should be reported on individual representatives' Forms U4 and U5 as *individual complaint settlements*. It also made the equally novel, unprecedented and factually unfounded statement that notwithstanding that the repurchase transactions involved an *exchange* (payment of par in exchange for a security of value, the ARS), the bilateral nature of the exchange must be ignored and the repurchase price reported as the "settlement" amount.

Pursuant to the existing questions on the Forms BD, U4 and U5, and the definitions of the terms *proceedings*, *findings*, and *orders*, there was no prior basis to report firm regulatory settlements, Consents and the performance of their terms in individual filings. FINRA has not previously required individual filings for firm 'product marketing' settlements. Similarly, "settlements" that involve a transaction whereby the firm pays to take back a security (for example, unauthorized trading claims) have been reported for settlement purposes as the net of the amount paid less the value of the security. There is no prior FINRA statement that by rule, a "settlement" amount does not involve both sides of a bilateral exchange.[10] For reasons set forth below, RN 09-12 and its substantive changes to reporting requirements cannot be and should not be implemented or enforced by FINRA.[11]

[10] NASD Notice to Members 96-85, Question 5 is not to the contrary. That question describes whether the total amount claimed by the customer should be taken into account, when determining *whether* to make a filing under Rule 3070. It did not concern what the reportable settlement amount would be. Furthermore, it concerned Rule 3070 filings, not Forms U4 and U5 filings.

[11] As explained below, the new requirements in RN 09-12 are not only unenforceable by law, but they also impose an extraordinary burden. After months of silence in the face of widely-followed, standard reporting practices, FINRA issued the new requirements after virtually all of the U4 closing filings had been made. To implement the new requirements would require the refiling of thousands of DRP amendments and the review of thousands more ARS repurchases to determine whether RE-3s or U4 amendments should be filed.

II. FINRA'S REQUIREMENTS IN RN 09-12 THAT REGISTERED REPRESENTATIVES REPORT GLOBAL SETTLEMENTS AS INDIVIDUAL SETTLEMENTS ON FORMS U-4 AND U-5 IS UNLAWFUL.

A. The Assertions Set Forth In RN 09-12 Require Rulemaking Pursuant to Section 19(B) of The Securities Exchange Act of 1934.

Section 19(b) of The Securities Exchange Act of 1934 (the "Exchange Act") prohibits FINRA from promulgating any new rule, or changing any existing rule, unless such new or amended rule is filed with and approved by the SEC after notice and opportunity for public comment. *See Standard Investment Chartered, Inc. v. National Association of Securities Dealers, Inc.*, No. 07-3372-CV (2d Cir. March 18, 2009) ("An SRO's proposed rules, and any proposed rule changes, must be filed with the SEC.") Section 19(b) of the Exchange Act requires that every SRO, including FINRA, file with the SEC copies of any proposed rule or any proposed change in, addition to or deletion from the rules of such SRO, accompanied by a concise general statement of the basis and purpose of such proposed rule change. The SEC is then required to publish notice of the filing of a proposed rule change and to give interested persons an opportunity to submit written data, views and arguments. Section 19(b) provides that the SEC shall approve an SRO's proposed rule change if it is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to the SRO. *See also* Rule 19b-4.

The only exception to the above-referenced Exchange Act requirement is set forth in Section 19(b)(3)(A) of the Exchange Act and Rule 19b-4(f)(1). The exception permits an SRO to declare a rule change effective upon filing with the SEC if the SRO designates the rule change to be a "stated policy, practice or interpretation with respect to the meaning, administration, or enforcement of an existing rule" of the SRO. Exchange Act Rule 19b-4(b) defines the term "stated policy, practice or interpretation" to mean, in pertinent part:

> Any statement made generally available to the membership of, to all participants in, or to persons having or seeking access (including, in the case of national securities exchanges or registered securities associations, through a member) to facilities of, the self-regulatory organization ("specified persons"), or to a group or category of specified persons, that establishes or changes any standard, limit, or guideline with respect to: i. the rights, obligations, or privileges of specified persons or, in the case of national securities exchanges or registered securities associations, persons registered with specified persons; or ii. the meaning, administration, or enforcement of an existing rule.

Rule 19b-4(b)(2). Rule 19b-4 goes on to state, however, that a "stated policy, practice, or interpretation" of the SRO "shall be deemed" to be a proposed rule change unless it is "reasonably and fairly implied by an existing rule of the self-regulatory organization." Moreover, even this exception requires a rule-making filing with the SEC.

The reporting requirements which FINRA seeks to enforce in RN 09-12 have not been promulgated in accordance with statutory requirements of the Exchange Act nor the Rules promulgated by the Commission. Indeed, this point cannot be disputed because RN 09-12 was not preceded by any announcement or rule-making process whatsoever. It was announced *after* the regulatory settlements were reached, *after* many of the Consents in question entered and *after* the filings on thousands of representatives' Forms U4 and U5 had been submitted to CRD.

Presumably, FINRA's response has to be that rule-making was not required for FINRA to assert the filing requirements in RN 09-12. That response, however, is incorrect. Changes to the Forms U4 and U5 must be made pursuant to the rule-making process. The two fundamental changes required by RN 09-12 are:

1. Consent *orders* and firm product settlements, to which registered representatives are not even parties, must be reported by the representatives as individual settlements, when the firms perform the terms to which the firms consented in *proceedings*, *findings*, and *orders* that did not involve the representatives.

2. In bilateral exchanges, firms cannot account for or offset the customer-side of the exchange in reporting a "settlement" amount.

The first change effectively brings into the reporting requirements an entirely new category. The second change drastically and fundamentally alters the reporting of the "settlement" amount.

Even "technical changes" to Forms U4 and U5 must proceed through the rule-making process. *See* SEC Release No. 34-52544, SR-NASD-2005-030 (September 3, 2005). In that rule proposal, FINRA sought to have changes made to Form BR and Forms U4 and U5. For example, they sought to add a question to the Form U4 to elicit whether an individual had an independent contractor relationship with the member firm. They also sought to reorganize "...the electronic filing representations on the Form U4 Section 6 for submitting a fingerprint for registration with an affiliated firm, so that the representations would follow a more logical order (the content of the representations would not change)." *Id.*, at 10. Thus, even "technical" changes to the Forms such as reordering must be made pursuant to rule-making. Clearly, substantive changes to require individuals to report regulatory settlements by their firms or to do away with the bilateral nature of a transaction for purposes of calculating a "settlement" amount must be made by rule-making.

Indeed, at virtually the same time that FINRA issued RN 09-12, FINRA and the SEC were involved in the rule-making process to amend Forms U4 and U5 (1) to raise the threshold reporting amounts for settlements; (2) to revise the "Date of Termination" and "Reason for Termination" sections of the Form U5; (3) to add new questions covering certain "willful violations" of the securities laws; (4) to change the arbitration question to require individuals to report arbitration claims in which they are allegedly *involved* in a *sales practice violation*, even if they are not named as respondents to the arbitration and (5) to make additional technical changes to the Forms. *See* Proposed Rule Change to Amended Form U4, Form U5 and FINRA Rule 8312, SR-FINRA-2009-008 (March 6, 2009).[12]

By comparison, it cannot successfully be argued that the registered person's reporting requirements set forth in Regulatory Notice 09-12 are not themselves significant enough to be treated as rule changes within the meaning of Section 19(b) of the Exchange Act. By requiring global, firm, regulatory settlements to be reported as individual settlements on Forms U-4 and U-5, FINRA has significantly changed the reporting requirements for settlements on these Forms. In effect, an *entirely new category of regulatory proceedings (i.e. proceedings* in which the individual is not even named) and *orders* to which the individuals are not even parties (*i.e.* the firms' Consents) would now be reportable by individuals when they have not previously been. If FINRA seeks to change what events are reportable, as RN 09-12 does, FINRA must engage in rule-making, as it is currently doing to implement the change to make some arbitration claims reportable, when the representative is not named as a respondent.

[12] FINRA has previously implicitly acknowledged that changes to Rule 3070 may constitute a "rule change" as contemplated by Section 19 of the Exchange Act. *See* Notice to Members 96-85 stating "on October 1, 1995, the NASD adopted, with SEC approval, a customer complaint reporting rule. The Rule significantly strengthens NASD Regulation's regulatory and surveillance efforts by requiring member firms to report to NASD Regulation the occurrence of certain specified events, within 10 business days…"

In addition, the aspect of RN 09-12 that eliminates the bilateral aspects of a transaction to require reporting of the par amount without offset for the value of the repurchased security is also a significant alteration of how to report a "settlement" amount. FINRA considers changes related to settlement amounts subject to rule-making because FINRA is currently engaging in rule-making to change the settlement amount thresholds from $10,000 to $15,000. Indeed, it is difficult to imagine that FINRA would not consider these types of substantive changes to the Form U4 and U5 to be subject to the rule-making process, particularly where they have considered even technical changes to a Form U4 and U5 to require FINRA to file with the SEC for proposed rule-making.

When FINRA fails to comply with the rule-making process, its actions are invalid. *See General Bond & Share Co. v. SEC*, 39 F.3d 1451 (10th Cir. 1994). In *General Bond*, a case that closely mirrors the present matter, the Tenth Circuit vacated an SEC order that a market-maker violated Article III, Section 1 of the NASD's Rules of Fair Practice by accepting compensation, and remanded the matter to the SEC for reconsideration of the sanctions imposed. In *General Bond*, the Tenth Circuit held that at the time of the transactions at issue petitioner's conduct did not violate Article III, Section 1 of the NASD's Rules of Fair Practice, which requires members to "observe high standards of commercial honor and just and equitable principles of trade." It concluded that the prohibited nature of the conduct was not "clearly implied" by Article III, Section 1, and that when the NASD specifically warned against the conduct in Notice to Members 75-16, it constituted a rule change adding new duties not already contained in Article III, Section 1. The Tenth Circuit held that the 1975 Notice to Members was not binding because it was a change in the NASD's rules that had not been submitted for review by the SEC.

The SEC is subject to stringent statutory requirements with respect to approval of a FINRA rule, including the requirements of notice, comment and that the SEC find that such rule "is consistent with the requirements of this title and the rules and regulations thereunder . . . ." Exchange Act Section 19(b). The SEC must find, for example, that the rule is not anticompetitive, that it does not impose any undue burden upon or discriminate against any entity or group, and that it does not frustrate any other purposes of the Exchange Act. As various Circuit Courts of Appeals make clear, the failure by the SEC to actually render such a finding after a thorough investigation (as opposed to its mere awareness of the rule) renders that rule invalid since all SEC orders approving SRO rules must include an analysis of the proposed rule's compliance with the Exchange Act. *Timpinaro v. SEC*, 2 F.3d 453 (D.C. Cir. 1993); *Higgins v. SEC*, 866 F.2d 47 (2d Cir. 1989); *Clement v. SEC*, 674 F.2d 641 (7th Cir. 1982).

FINRA's Regulatory Notice 09-12 contains substantive changes to reporting firm global regulatory settlements and "settlement" amounts that are required to proceed through the rule-making process. Furthermore, as shown below, the proposed changes do implicate serious issues with respect to due process that will be subject to comment and substantive review, if or when the rule-making process is pursued. In other words, this is not just procedural; it is substantive. In any event, because FINRA did not follow the required rule-making process, the new requirements of RN 09-12 cannot lawfully be effective.

B. Regulatory Notice 09-12, As Applied, Violates Registered Representatives' Rights to Due Process.

When Congress authorized NASD to regulate the business activities of its members, Congress made it plain that it expected NASD (and now FINRA) to adhere to "fundamental standards of due process." *See Harwell v. Growth Programs, Inc*, 315 F. Supp. 1184, 1188 (W.D. Tex. 1970), *reversed on other grounds*, 451 F.2d 240 (5th Cir. 1971), *cert. denied*, 409 U.S. 876 (1972) (NASD is "effectively a Congressionally-created regulatory organization"). The 1975 amendments to the Exchange Act sought to bolster the Commission's oversight of the NYSE and the NASD to ensure that the SROs treated all members and registered persons fairly in connection with investigations and disciplinary proceedings. Since the 1975 amendments, recognizing that NASD (now FINRA) wields the Commission's disciplinary power, federal courts have identified NASD as the Commission's disciplinary "agent or arm." *Bruan, Gordon & Co. v. Hellmers*, 502 F. Supp. 897, 903 (S.D.N.Y. 1980) ("the court is willing to characterize NASD as an agent or arm of the SEC with respect to the conduct of disciplinary proceedings"); *Mandelbaum v. NYMEX*, 894 F. Supp. 676, 679 (S.D.N.Y. 1995) ("NASD disciplinary officers serve as surrogates for the SEC"); *Austin_Municipal Securities v. NASD*, 757 F.2d 676, 690-91 (5th Cir. 1985) (same). In the words of one federal judge: "As the SEC's 'handmaiden,' [FINRA's actions] must be considered a 'valid exercise of the rightful authority of the Government.'" *Harwell*, 315 F. Supp. at 1191. FINRA, like its predecessor NASD, is obligated to abide by certain fundamental protections of due process in the treatment of registered persons.

Under the Exchange Act, disciplinary rules must provide for a "fair procedure" which includes, among others, bringing specific charges, notifying a person subject to discipline and *giving him or her an opportunity to defend against such charges*. As pointed out by the Senate Committee on Banking, Housing and Urban Affairs when the 1975 Act Amendments were drafted, since FINRA "exercise[s] government power . . . by imposing a disciplinary sanction, broadly defined, on a member or person affiliated with a member . . . [FINRA] must be required to conform [its] activities to fundamental standards of due process." S. COMM ON BANKING, HOUSING & URBAN AFFAIRS, SECURITIES ACT AMENDMENTS OF 1975, S. Rep. No. *94-75*, at 24-25 (1975).

Regulatory Notice 09-12's reporting requirements for registered persons on Forms U-4 and U-5 fail to meet the fundamental standards of due process because the individual registered representatives impacted by the U-4 and U-5 entries have not had the opportunity to defend themselves against the charges giving rise to the reporting obligations, nor did they have input into the global settlements reached by regulators and the member firms. Indeed, as discussed more fully above, registered persons did not even have the opportunity to be heard during the rule-making process because FINRA circumvented that fundamental due process protection.

Here again, the facts cannot be disputed. As evidenced by the CGMI Consent, the UBS Consent and the Wachovia Consents, Exhibit B, the *proceedings* that led to the Consents were formal federal court civil actions in which the SEC was the plaintiff and CGMI and UBS, respectively, were defendants. Other regulatory settlements involve similar civil actions *against the firms.* The individual representatives had no due process opportunity to participate in the *proceedings* or the Consent process. Furthermore, the negotiations that led to the ARS settlements and, therefore, to *all* of the ensuing eligible ARS repurchases, did not involve the registered representatives (or the customers). There was no opportunity for the representatives to defend themselves, at a hearing or otherwise. The effect of FINRA's guidance is that these representatives would be required to report as a "settlement" an agreement which arose in a regulatory *proceeding* in which they were not involved.

In addition, if FINRA were to engage in the rule-making process as required, it would not be able to give the new rule retroactive effect to alter representatives' existing CRD records.[13] That would be a violation of due process.

Clearly, the individual representatives are aggrieved and suffer a loss of business or property as a result of the RN 09-12 requirements. Reports of customer settlements are *not* subject to archiving by CRD. Thus, the reported "settlements" would remain on an individual's CRD records indefinitely. Moreover, state regulators, SRO's and prospective employers use CRD records to make such weighty determinations as (1) whether an individual may become or remain registered in a state; (2) whether an individual should be subjected to heightened supervision or other disciplinary action and (3) whether even to hire an individual. Registered representatives have their very livelihoods at stake. For example, states can deny registration to individuals based on a cluster of customer complaint settlements. With RN 09-12's new requirements, registered representatives could end up with a cluster of disqualifying settlements, due to a regulatory *proceeding* and *order* to which they were not even parties and due to an underlying matter which, according to FINRA, involved allegations that "*firms* [not registered representatives] misled investors regarding the liquidity risks associated with ARS." RN 09-12 at 2 (emphasis supplied). That is a fundamental deprivation of property without due process.[14]

Furthermore, since settlements are subject to public disclosure through Brokercheck, the general public may consider those reported "settlements" as negatives for purposes of deciding

[13] While RN 09-12 is silent on the point, upon information and belief, FINRA has asserted it intends to give the guidance retroactive effect.

[14] As explained above, if the representatives were the subject of a reportable complaint, that was reported. However, complaints themselves are archived after twenty-four months. The fundamental unfairness here is creating a record of an individual settlement that will remain indefinitely, where there were no individual settlements.

whether to do business with a registered representative. This risk is compounded by the assertion in RN 09-12 that the "settlement" amount must be reported in CRD as the par value paid, without regard for the bilateral nature of the exchange and the value of the ARS. That requirement gives inflated "settlement" amounts with the implication that the "settled" wrong-doing came at a much steeper cost than is actually the case.

The Exchange Act rule-making process is intended to require FINRA to observe procedural due process relating to disciplinary proceedings and rule-making. In the promulgation of Regulatory Notice 09-12, FINRA has failed to meet the basic fundamental fairness contemplated by the 1975 amendments to the Exchange Act. To the extent that FINRA has not and will not afford individual registered person(s) subject to Regulatory Notice 09-12 reporting requirements fundamental fairness and due process FINRA is, by fiat, overriding the due process protections guaranteed to thousands of registered person(s), undermining the legitimacy of FINRA's actions and potentially subjecting itself to adverse court review.

III. REPORTING THE GLOBAL SETTLEMENTS AS INDIVIDUAL SETTLEMENTS AGAINST REPRESENTATIVES IS MISLEADING.

If accurate public disclosure is the goal of the CRD system, the current state of public disclosure is much more accurate than the state envisioned in RN 09-12. That is, the firms' global settlements were the subject of public press releases and the terms are still accessible through public websites. *See* Appendix, Exhibit A. Combine that accurate public disclosure with the widely followed approach of reporting pending reportable (U4/U5) complaints as "closed" because the ARS was repurchased as part of the global settlement and the resulting CRD record is the most accurate record of what in fact happened. To require a report of an individual "settlement" in an amount equal to the par value of the ARS implies that an individual claim of wrong-doing was settled *by individual agreement for that amount* which is not what factually happened. This factual distortion cannot be justified by reference to public need to know because the public does not have a need to know something that did not actually happen. In addition, the label "settlement" is factually inaccurate because under the global, regulatory settlements, the customers retain the right to pursue individual claims, either through the special arbitration process or through any other available forum. The offers to purchase the ARS are material developments with respect to the open complaints, giving grounds to "close" (*i.e.,* take no further action on) them. However, they are *not* factually settlements.

In addition, on the flip-side, many registered representatives whose customers were entitled to participate in the global, firm settlements would not have to report the repurchases as "settlements" in CRD because there were no open DRPs on preexisting complaints. Thus, for what is essentially the same result (a global buy back) the two categories of representatives receive vastly different treatment. One group has to report global buy backs as "settlements;" the other group does not. Moreover, the issue that determines how they get treated in CRD (whether they had an open DRP) has *nothing* to do with the global buy backs. This is another example of the inherent unfairness in the new requirements.

CONCLUSION

RN 09-12 requires individual brokers, for the first time ever, to report regulatory settlements entered into by their firms, and to report settlement amounts that ignore the economic reality of the transactions being reported. As a result, RN 09-12 encourages inaccurate, incomplete and misleading CRD disclosure that will disserve investors, regulators, brokers, and prospective employers alike. These entirely new, unilaterally imposed and unvetted requirements constitute improper rulemaking without notice or opportunity to comment, and violate individual brokers' due process rights by requiring them to report on CRD (forever) settlements to which they are not even parties. Accordingly, SIFMA, on behalf of certain of its members, respectfully requests that FINRA reconsider and withdraw RN 09-12.

Yours truly,

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Enclosure