

Client Alert

Current Issues Relevant to Our Clients

June 23, 2015

FINRA Proposes New Discretionary Accounts and Transactions Rule

The Financial Industry Regulatory Authority (“FINRA”) is requesting comment on a revised proposal to adopt a new FINRA rule that would consolidate and clarify former National Association of Securities Dealers (“NASD”) and New York Stock Exchange (“NYSE”) rules regarding discretionary accounts and transactions. The NASD and NYSE rules set forth the obligations of a firm and its associated persons regarding the exercise of any discretionary power over a customer’s account, including the obligation of the firm to detect and prevent unauthorized and excessive transactions, and address the obligations of a firm when accepting an order for a customer’s account from someone other than the customer. The proposed rule would consolidate the two rules and provide clarifications regarding approval of such transactions. In addition, the proposal addresses the treatment of customers’ free credit balances, sweep programs, bulk transfers of customers’ accounts and change of broker-dealer of record. The comment period expires on August 17, 2015. A copy of the FINRA regulatory notice can be found [here](#).

Background

Proposed FINRA Rule 3260 would incorporate NASD Rule 2510 and NYSE Rule 408 into the consolidated FINRA rulebook. NASD Rule 2510 (i) prohibits a firm from effecting for a customer’s account over which the firm has any discretionary power any transactions that are excessive in size or frequency; (ii) prohibits firms and their registered representatives from exercising any discretionary power in a customer’s account unless the customer has given prior written authorization to a stated individual or individuals and the account has been accepted by the firm; and (iii) requires that the firm or designated partner, officer or manager approve promptly in writing each discretionary order entered and review all discretionary accounts at frequent intervals to detect and prevent transactions that are excessive in size or frequency. NYSE Rule 408 includes similar requirements and addresses the obligations of a firm when accepting an order for a customer’s account from someone other than the customer. In 2009, FINRA originally proposed to revise and consolidate the NASD and NYSE rules. FINRA received several comments asking it to clarify the scope of the rule, among other things. FINRA has revised the proposed rule in light of these comments and requests comments on the revised proposal.

Discretionary Transactions by Member Firms and Their Associated Persons

Proposed FINRA Rule 3260(a) would require that no member or associated person of the member exercise any discretionary power in a customer’s account unless the

customer has given a signed, dated prior written authorization to exercise discretionary power to a named associated person or persons. The rule would require that the account documentation be signed by a partner, officer or manager designated by the member, other than the associated person vested with discretionary power, and denote that the account has been accepted in accordance with the member’s policies and procedures for acceptance of such discretionary accounts. The associated person’s discretionary power would be limited in the manner, and under the terms and conditions, specified in the customer’s prior written authorization.

The proposed rule maintains NASD Rule 2510’s prohibition on effecting any transactions that are excessive in size or frequency in view of the financial resources and character of the customer’s account. Consistent with NYSE Rule 408(b), the proposed rule would also require that a partner, officer or manager designated by the member, other than the associated person vested with discretionary power, approve promptly and in writing each discretionary order entered in a discretionary account and review discretionary accounts at frequent intervals to detect and prevent transactions that are excessive in size or frequency. FINRA stated in its proposal that such transactions may be approved in bulk as long as such transactions are approved promptly. The requirements of proposed Rule 3260(a) would not apply to fee-based discretionary accounts, including accounts with a flat fee or a fee based on assets. FINRA also stated in its regulatory notice that the signature and approval requirements of Rule 3260(a) could be satisfied through use of electronic means.

Transactions by Agents of Customers

Proposed FINRA Rule 3260(b) would require that members or associated persons of a member only accept an order for a customer's account from a person other than the customer (such as a family member or investment adviser) if the customer has given a signed, dated prior written authorization to such person. The order would also need to be consistent with the agent's authority as specified in the customer's prior written authorization. FINRA stated in its regulatory notice that this signature could be satisfied through use of electronic means. Under the proposed rule, a member would also need to obtain the prior manual dated signature of the named natural person or, if the named agent is an entity, of a natural person authorized to act on behalf of the entity. For purposes of compliance with this requirement, FINRA stated in its regulatory notice that firms must obtain a "wet signature" (*i.e.*, handwritten signature) or a copy of a wet signature, such as a scanned or faxed copy of a handwritten signature.

The requirements of proposed FINRA Rule 3260(b) would not extend to a customer that is a legal entity and that has authorized its personnel to trade on behalf of the entity. The obligations of firms with respect to entity customers are set forth in FINRA Rule 4512(a)(1)(E), which requires firms to maintain a record with the names of such authorized persons.

Specific Discretionary Activities Permissible under the Rule

Proposed FINRA Rule 3260 also contains certain exceptions to authorization procedures described in FINRA Rule 3260(a). The exceptions, in part, consolidate existing exceptions found in the NASD and NYSE rules but also respond to amended rules under the Securities Exchange Act of 1934 (the "1934 Act") that impact FINRA rules relating to sweep programs and the use of negative response letters for a bulk transfer of customers' accounts. Notwithstanding the requirements of proposed FINRA Rule 3260(a), a member may engage in the following activities under the terms set forth in the proposed rule:

- A member may exercise temporary time or price discretion in connection with execution of an order for the purchase or sale of a definite dollar amount or quantity of a specified security in certain cases as long as it is reflected on the order ticket;
- A member may effect bulk exchanges at net asset value of money market mutual funds using negative response letters, provided that the bulk exchange is limited to situations involving mergers and acquisitions of money market mutual funds and the negative response letter contains certain disclosures;
- A member may effect a bulk transfer of customers' accounts using negative response letters, provided that the bulk transfer occurs under certain limited

circumstances;

- A member named as broker-dealer of record on directly held mutual fund and variable insurance product accounts may use negative response letters to change the broker-dealer of record on the accounts to another member, provided that the change in broker-dealer of record occurs under certain limited circumstances;
- A member may invest, or transfer to another account or institution, free credit balances in a customer's account outside of a sweep program only upon a specific order, authorization or draft from the customer, and only in the manner, and under the terms and conditions, specified in the order, authorization or draft consistent with the related 1934 Act rule;
- A member may transfer free credit balances held in a customer's securities account to a product in the member's sweep program or transfer a customer's interest in one product in a sweep program to another product in a sweep program, provided that the member sends a negative response letter and provides certain other disclosures; and
- A member may redeem money market mutual funds for payment of securities purchases, or effect transactions to satisfy an indebtedness to the member provided such transactions are disclosed in a written, signed agreement.

Submitting Comments

FINRA is requesting comments on the proposed rule including, but not limited to, any potential costs and burdens of the rule. A list of particular questions is included in the FINRA notice linked above. You may submit comments to FINRA by hard copy or by sending an e-mail to pubcom@finra.org. Comments must be received by August 17, 2015.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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