

The Consolidated FINRA Rulebook: The Conduct Rules

Copyright 2009, Matthew Bender & Company, Inc., a member of the LexisNexis Group.

The Consolidated FINRA Rulebook: The Conduct Rules

Text & Analysis

Introduction

DUTIES AND CONFLICTS

TRANSACTIONS WITH CUSTOMERS

1-1 FINRA Rulebook: Conduct Rules Rule 2114

**Rule 2114 Recommendations to Customers in OTC Equity Securities**

*Preliminary Note: The requirements of this Rule are in addition to other existing member obligations under FINRA rules and the federal securities laws, including obligations to determine suitability of particular securities transactions with customers and to have a reasonable basis for any recommendation made to a customer. This Rule is not intended to act or operate as a presumption or as a safe harbor for purposes of determining suitability or for any other legal obligation or requirement imposed under FINRA rules and the federal securities laws.*

**History**

Amended by SR-FINRA-2008-055 and SR-FINRA-2009-033 eff. June 15, 2009, SEC Release No. 34-59605, 74 Fed. Reg. 13,283 (March 26, 2009).

Adopted by SR-NASD-99-04 eff. Oct. 30, 2002.

FINRA Regulatory Notices: 02-66, 09-20.

**Analysis**

FINRA Rule 2114, which is based on NASD Rule 2315, addresses potential fraud and abuse in transactions that involve securities that are not listed on an exchange and other higher risk securities. In adapting the NASD rule for the Consolidated FINRA Rulebook, FINRA made four important substantive changes that:

- broadened the scope of the rule to include *any* OTC equity security;
- added a definition of *current material business information*;
- eliminated an exemption for securities with worldwide daily trading volumes of at least \$100,000; and
- allowed the due diligence review to be conducted by a General Securities Principal (Series 24) *or* a General Securities Sales Supervisor (Series 8 or 9/10) *or* someone supervised by either of the above.

Under NASD Rule 2315, a member must conduct a due diligence review of an issuer's current financial and business information before recommending the purchase or short sale of a security that is published or quoted in a "quotation medium" and which is not listed on Nasdaq or a national securities exchange, or are listed on regional securities exchange and do not qualify for the dissemination of

transaction reports via the Consolidated Tape. FINRA, seeking to address what it sees as a similar risk of fraud and manipulation, expanded the rule by applying it to any "OTC Equity Security" regardless of whether it is published on a quotation medium--basically, FINRA Rule 2114 applies to any non-exchange-listed security and certain exchange-listed securities that do not otherwise qualify for real-time trade dissemination.<sup>1</sup> FINRA also discounted complaints that the due diligence review would result in processing delays in purchasing OTC Equity Securities since the due diligence should be completed before the recommendations are even made. Finally, FINRA rejected a suggestion that firms who generate less than 5 percent of their commission revenue from OTC Equity Securities transactions and do not make a market in such securities be exempted from Rule 2114. FINRA believed this proposed exemption would allow a significant number of OTC Equity Securities to avoid the due diligence review and thereby undermine FINRA's investor protection goals.

New Rule 2114 adds a definition of *current material business information* as "information that is ascertainable through the reasonable exercise of professional diligence and that a reasonable person would take into account in reaching an investment decision."

FINRA, seeking to redress what it perceived to be a new inability to screen out less risky securities as a result of the Internet and the increased number of trading venues, has eliminated the exemption that was in NASD Rule 2315 for securities with worldwide average daily trading volume values of \$100,000 or more during the previous six months.<sup>2</sup> In response to comments that opposed eliminating the exemption believing it would require due diligence reviews to be conducted for "large, well-capitalized companies" whose securities, the commenter opined, are not likely to pose that type of risk, FINRA noted that bringing certain larger companies within Rule 2114 did not dissipate the investor protection concern.<sup>3</sup>

Finally, in response to comments on the proposed FINRA Rule 2114, FINRA expanded the acceptable persons for conducting the due diligence review from just a General Securities Principal (Series 24) to either a Series 24 principal, a General Securities Sales Supervisor (a Series 8 or 9/10 supervisor), or someone supervised by a General Securities Principal or General Securities Sales Supervisor. Further, members must keep written records of the information reviewed, the date of the review, and the name of the person conducting the review. FINRA added the requirement that if the review is being conducted by someone who is not a Series 24 principal or the Series 8 or 9/10 supervisor, but who is being supervised by one of those persons, the member must document the name of the person who supervised the designated person. With this change, FINRA sought to facilitate the documentation of the person with supervising responsibility for the due diligence review.<sup>4</sup>

The SEC approved the rule change and the amendment to the rule change noting that it will help protect investors against fraud in trading unlisted and certain other securities and will clarify and streamline NASD Rule 2315.<sup>5</sup>

### ***Cross-References***

3-26 Securities Law Techniques § 26.07, *FINRA Rules*

**FOOTNOTES:**

Footnote 1. 74 Fed. Reg. 13,283, at 13,284. Note that the due diligence required by Rule 2114 applies only to recommendations, not to unsolicited transactions. Therefore Rule 2114 would not deny investors access to the OTC Equity Securities market as some commenters believed.

Footnote 2. 74 Fed. Reg. 13,283, at 13,284. In addition, a related exemption for a convertible security when the underlying security satisfies the trading volume exemption requirements was also eliminated.

Footnote 3. 74 Fed. Reg. 13,283, at 13,285. In addition, FINRA noted that certain larger companies may qualify for a different exemption that applies to the securities of issuers that have at least \$50 million of total assets and \$10 million in shareholders' equity.

Footnote 4. 74 Fed. Reg. 13,283, at 13,284.

Footnote 5. SEC Release No. 34-59605, 74 Fed. Reg. 13,283, at 13,285 (March 26, 2009).