Ellenoff Grossman & Schole LLP

Client Alert
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Broker-Dealer Compliance Officers and Counsel Take Note:

NEW FINRA SUPERVISION RULES APPROVED BY SEC

Effective Date December 1, 2014

Background

FINRA's new Consolidated Supervision Rules 3110 and 3120 were announced March 19, 2014 in Regulatory Notice 14-10 with an effective date of December 1, 2014. This announcement ends a nearly six year process begun in May 2008 by FINRA *Regulatory Notice 08-24.*

It may be tempting to ignore the new Rules as simply the latest iteration of FINRA's seemingly never-ending rule consolidation process. *This would be ill-advised*: much in the new Rules does indeed carry forward prior rules or industry practice, but new FINRA Rules 3110 and 3120 and new related Supplementary Material from FINRA also include areas of significant change that will affect all sizes and types of firms. The new requirements undoubtedly will be front and center in FINRA's 2015 risk control assessments and examinations.

Individual firms may be required to do some or all of the following:

- change some or all of their office and individual supervisory structure;
- modify their inspection and supervisory control review programs and procedures;
- adopt new supervisory transaction reviews; and/or
- make new periodic reports to FINRA and add to existing reports.

Key Changes

➢ ***Office Supervision, Supervisory Controls, Inspections, Testing and Reporting***

The new Supervision and Supervisory Control rules although renumbered, respectively, Rules 3110 and 3120 carry forward many familiar provisions from prior NASD Rules 3010 and 3012, and NYSE Rules 342 and 351, but also contain the following significant changes:

Office Supervisory Structure: There are significant changes to supervision of multiple offices of supervisory jurisdiction (or OSJs), the main office OSJ and non-OSJ offices of convenience, including residence offices:

- Supervision of More Than One OSJ: A bedrock requirement of both current NASD Rule 3010 and **new FINRA Rule 3110** is that a member's supervisory system designate one or more principals to supervise each business line, each of the member's OSJs and each branch office or location. Under **Rule 3110(a)(4)**, FINRA will now expect that an "on-site" principal with a "regular and routine" physical presence be designated for each and every OSJ (**New Supplementary Material .03 to FINRA Rule 3110**).

As originally proposed, supplementary material to FINRA Rule 3110 set a "rebuttable presumption" that only one on-site principal could be assigned to each OSJ and that assigning two OSJs to one supervisor was "unreasonable." In response to comments, the final supplementary material abandons the proposed rule's rebuttable presumption of unreasonableness and substitutes a guideline general presumption.

Practically, if a member firm wants to assign two or more OSJs to one principal, the firm will still have to justify the reasons for this in writing and can expect close scrutiny from FINRA. **New Supplementary Material .03** lists non-exclusive but mandatory factors to be considered such as: the principal's qualifications; if the supervisor is non-producing; the time available to supervise each location; and geographic proximity.

Eliminating the proposed rule's rebuttable presumption of a rule violation is notable and laudable. Furthermore, as now written, the Rule does seem to give flexibility to both smaller independent firms and large independent contractor "network" firms with many small OSJs. It remains to be seen how flexible FINRA examiners and other staff will be in practice.

- "Main Office" Supervision: Since the adoption of amended NASD and NYSE supervision and supervisory control rules in 2004, there have been lingering questions about supervision of the main office OSJ, especially "supervision" of senior-most management, as well as the need to inspect the *main office OSJ* annually as part of a member firm's program. **Supplementary Material .01 to new Rule 3110** confirms that the main office will usually meet the requirements to be an OSJ or a branch, and accordingly must be supervised and reviewed like an OSJ or branch office. This is offset to some degree by the member firm's ability to define the supervisory requirements and tailor the procedures, inspections and testing to the people and business actually conducted and supervised at the main office.

- Residence offices and other offices of convenience: Home (residence) offices and offices of convenience, if OSJs, must be treated as such. This is of significance to firms such as insurance company-affiliated broker-dealers, who unsuccessfully opposed this provision during the notice and comment process. Of significance to all broker-dealers is that it is now clear that *all* activities in even non-branch locations such as residences must be inspected periodically, generally no less than every three years, unless an alternative is justified in writing. See *Branch Office Inspections and Frequency* below for further information.

➢ ***Supervisory Control Systems and Reports***

Branch Office Inspections: In addition to clarifying that main and small office OSJs, residences and other offices of convenience are subject to mandatory inspection, the Rules affect the timing of these inspections and adopt revised standards for inspectors' conflicts of interest:

- Frequency. **New FINRA Rule 3110(c)(1)**, like present NASD Rule 3010, requires members to inspect OSJs and supervisory branch offices every calendar year and non-supervisory branches at least every three years. FINRA decided not to exempt non-branch office locations and offices of convenience, including residences, from the periodic inspection requirements. As a result, non-branch locations must be visited on a "regular periodic schedule," based on the business done at the location. Even if a particular activity is subject to regular inspection because of factors like certain businesses' higher risk profile this does not completely satisfy the requirement: *all* activities at a location must be inspected within the applicable one or three year cycle. The presumption will be non-branch locations are inspected at least every three years (**new Supplementary Material 3110.13**) even those lacking any indicators of irregularities or misconduct (*red flags*). A longer periodic inspection cycle *can* be adopted but the member must document the factors used to determine its appropriateness both in its WSPs and its inspection procedures. As with multiple small OSJ supervision above, it remains to be seen in to what extent FINRA will permit such exceptions in actual practice.

- Examiner Conflicts of Interest. Current NASD Rule 3012 prescribes "heightened office inspections" only in specific circumstances (if the branch office manager generates 20% or more of the revenue of the business units supervised by the manager's supervisor and the inspector either reports to the same supervisor as the manager being reviewed or works in another office supervised by the branch manager's supervisor). **New FINRA Rule 3110(c)(3)** adopts a less specific but broader conflict standard. Firms will now have to establish policies and procedures reasonably designed to prevent inspectors from being compromised by "economic, commercial or financial" conflicts of interest. **Rule 3110 (c)(3)(B)** explicitly prohibits only one conflict –– if the inspector is either assigned to the location or is directly or indirectly supervised by, or reporting to, a person assigned to the location. This conflict can be only be overcome by a firm's determination its size or business model make this "not possible" (Rule 3110 (c)(3)(C)). FINRA intends this exception to be confined to very limited situations like one office firms, or larger firms following the independent contractor model where multiple small or one person offices report directly to an OSJ manager who is also considered the branch manager of each office.

The use of the word "indirectly" could, of course, logically lead to the question if *anyone* employed by the member firm can ever conduct inspections untainted by a potential conflict. FINRA, in fact, explicitly rejected one commenter's suggestion that it require outsiders be hired to perform inspections on the theory only they are completely "independent."

Generally, non-producing persons such as compliance officers or internal auditors *can* perform inspections. This helps larger firms but a significant challenge still remains for smaller firms without large support functions.

Supervisor's Conflict of Interest. **New FINRA Rules 3110(b)(6)(C) and (D)** deal with supervisors' conflicts. **New FINRA Rule 3110(b)(6)(D)** generally mandates adoption of specific policies and procedures reasonably designed to prevent the supervisory system from being compromised by supervisor/supervised person conflicts of interest. Under new subsection **3110(b)(6)(C)** a member firm's supervisory procedures must prohibit an associated person from: (i) supervising their own activities or (ii) reporting to, or having their compensation or continued employment determined by, a person they are

supervising. The only exception is analogous to the inspector conflict exception above -- a documented determination it is "not possible" for the firm to avoid the conflict due to its size or the supervisor's role, based on a list of the factors relied upon justifying that an alternative arrangement is necessary and a showing how the alternate arrangement complies with Rule 3110(a).

Annual Supervisory Control Report. Not surprisingly, **new FINRA Rule 3120** adopts NASD Rule 3012's annual testing and review requirements: a member must annually test and verify its supervisory procedures and controls; and report the results to senior management in writing describing in detail the member's supervisory control system, test results, significant exceptions taken, and changes to supervisory procedures made in response to the testing.

FINRA Rule 3120 imposes a new reporting requirement on large firms. **New Rule 3120(b)** requires firms that report more than $200 million in annual gross revenues (as shown by FOCUS reports) to meet requirements patterned closely on former NYSE Rule 342.30. These large firms' Rule 3120 report to senior management must contain, (as applicable to the member): (i) a tabulation of reports made to FINRA during the year regarding customer complaints and internal investigations, and (ii) a discussion of the prior year's compliance efforts, including procedures and educational programs relating to trading and market activities, investment banking, antifraud and sales practices, finance and operations, supervision, and anti-money laundering.

Investigations and Reporting of Potential Insider Trading, Manipulative Devices or Practices. In another return to NYSE practice, **new FINRA Rule 3110(d)** incorporates former NYSE Rule 342.21's requirement *all* member firms adopt procedures for review, investigation and reporting of transactions involving potential violations of the 1934 Act and SEC rules and FINRA 1934 Act Rules prohibiting insider trading, and manipulative or deceptive acts, practices or devices. This provision broadly applies to *all* securities, unlike the former NYSE Rule which applied only to transactions involving NYSE-listed securities. All member firms must have supervisory procedures to review transactions effected for the member or for customers by the member, and by its associated persons and certain family members at the member or at another FINRA member disclosed to the employing member. Members are also required to *promptly* conduct an internal investigation into questionable trades.

Those (*members engaged in investment banking services*[1]) must go one step further and provide FINRA with: (i) a report within five days after the completion of an internal investigation in which it was determined that a violation of insider trading or anti-manipulation provisions had occurred, and (ii) a quarterly report within 10 business days after quarter-end summarizing insider trading and other covered internal investigations begun, continuing or concluded during the quarter. If there are none, no report needs to be filed.

- ***Review of Transactions and Communications***

In addition to required insider trading reviews and reporting, the new Rules also: (1) add *investment banking services* to required transaction reviews (*see* note 1); and (2) modify communications supervisory review standards, especially for electronic communications, in significant respects:

[1] For purposes of the Rule, "investment banking services" includes acting as an underwriter or selling group participant for public offerings, acting as an advisor on mergers and acquisitions, providing venture capital or equity lines of credit, or serving as placement agent for private issuers.

- Review of Investment Banking and Securities Transactions. **New FINRA Rule 3110(b)(2)** carries over NASD Rule 3010's requirement that a registered principal conduct a written review of "all transactions" relating to the member's business. The Rule now specifies that review of investment banking services is within its scope. Some flexibility is provided by **new Supplementary Material .05**, which expressly permits a member to avoid detailed reviews of every transaction if the firm uses a reasonably designed and documented risk-based review system that allows it to focus on the areas of its business posing the greatest risk. The principal who signs off on this system, however, bears the risk of liability for any deficiency that causes a system to not be "reasonably designed."

Review of Communications. The long-standing requirement that members have supervisory procedures for principal review of incoming and outgoing written and electronic correspondence relating to the member's businesses is retained in **new FINRA Rule 3110(b)(4)**. That rule also adds a new express requirement that firms adopt procedures for review of *internal* communications "that are of a subject matter that require review for compliance under FINRA rules and federal securities law" (like information barriers and possible customer complaints). **New Supplementary Material .06** mandates a risk-based analysis to determine if other types of incoming, outgoing, or internal communications should be reviewed. Recognizing the practice at many firms, **new Supplementary Material .08** specifically permits a supervisor to delegate certain review functions required under FINRA Rule 3110 to other personnel like compliance officers so long as the supervisor retains ultimate responsibility. Records of the specific communications reviewed now must be created and retained, including evidence of each supervisory review, its date and by who performed, including preset reviews using a lexicon-based or similar tool. Like transaction reviews, a supervisor must sign off on the risk-based methodology and system adopted, with attendant personal liability for deficiencies.

➢ ***Other Significant Items***

Status of Supplementary Material. Why some items are in a Rule's text but others are in Supplementary Material has been somewhat confusing. While not resolving that confusion, FINRA clarified in its filings during the administrative approval process that both have the binding effect of a rule.

Oral customer complaints. Both the customers' arbitration bar and NASAA strongly argued that member firms should be obligated to record, acknowledge and respond to both *oral* and written complaints. In effect, they argued that FINRA should adopt the requirements of former NYSE Rule 351, and not the former NASD rule. In **new Rule 3110(b)(5)**, FINRA stuck to the prior NASD requirement that only *written* customer complaints have to be reported. It did add a requirement adapted from the NYSE Rule that receipt of a written complaint must be acknowledged to the customer promptly in writing. *Regulatory Notice 14-10* also suggests but does not require that member firms provide a complaint form for customers to use (such as on their websites).

WSP Delivery. **New FINRA Rule 3110(b)(7)** carries forward the existing commonsense requirement that each OSJ and each location where supervisory activities are conducted must retain and keep current a copy of the firm's written supervisory procedures (or WSPs). FINRA also updated the requirement that members communicate their WSPs to their associated persons by permitting this to be done by electronic communication. Initially, FINRA had also proposed that a firm using electronic distribution verify at least once per calendar year that each associated person received the WSPs (proposed Supplementary Material 3110(b)(12)). After negative comments, FINRA eliminated the

annual verification in favor of requiring a documented system and procedure to ensure "prompt" delivery to relevant persons based on their activities and responsibilities. *Regulatory Notice 14-10* also carries forward the SEC's clarification in the adopting release that not every part of the WSPs must be sent to every associated person -- selected parts can be circulated on a more limited basis, such as those items which define and explain supervisory reviews may be sent only to supervisors.

Record Retention Periods. The customer's arbitration bar argued that the record retention period for supervisory reviews should be changed from three to six years to conform to the arbitration eligibility cut-off. FINRA declined to make this change based on cost and burdensomeness concerns as well as to be consistent with the SEC's requirements for the same types of records.

"Held" Customer Mail. **New FINRA Rule 3150** adopted with Rules 3110 and 3120 governs the holding of customer mail. Under current NASD Rule 3010(i), a customer's mail may be held at the customer's request but only up to a maximum of two or three months. New FINRA Rule 3150 permits a longer holding period, if the customer requests it and the firm follows various safeguards prescribed in the Rule.

We look forward to addressing any questions or comments you may have regarding these new rules.

ELLENOF GROSSMAN & SCHOLE LLP
BROKER-DEALER REGULATION PRACTICE GROUP

Joan Adler, Esq., (212) 370-1300 x 7123, jadler@egsllp.com
William B. Peterson, Esq., (212) 370-1300 x 7121, bpeterson@egsllp.com
Adrienne Ward , Esq. , (212) 370-1300 X 7101, award@egsllp.com
Irwin Weltz, Esq., (212) 370- 1300 x 7138, iweltz@egsllp.com

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