

MEMO# 28061

April 24, 2014

FINRA Publishes Notice Regarding Its Revised Consolidated Supervision Rules; Effective Date of Rules Is December 1, 2014

[28061]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 21-14
PRINCIPAL UNDERWRITERS WORKING GROUP RE: FINRA PUBLISHES NOTICE REGARDING ITS REVISED CONSOLIDATED SUPERVISION RULES; EFFECTIVE DATE OF RULES IS DECEMBER 1, 2014

As we previously advised you, in December 2013, the Securities and Exchange Commission published an order approving FINRA's new supervisory rules – Rule 3110, Supervision, and Rule 3120, Supervisory Control System. [\[1\]](#) According to the SEC's order, FINRA was to publish a regulatory notice within 90 days that would alert its members to the new rules' requirements and announce their effective date. Consistent with the SEC's order, FINRA recently published its regulatory notice. [\[2\]](#) According to the Notice, which is briefly summarized below, the new rules will be effective on December 1, 2014.

FINRA Rule 3110, Supervision

The Notice summarizes the requirements of new FINRA Rule 3110. Subsection (a) of the rule requires each member to have a supervisory system that is reasonably designed to achieve compliance with the applicable legal and regulatory requirements and that, at a minimum, provides for:

- The establishment and maintenance of written supervisory procedures and the designation of one or more appropriately registered principals with authority to carry out the member's supervisory responsibilities;
- The designation as an branch office or an office of supervisory jurisdiction ("OSJ") for each location, including the home office, that is either a branch office or an OSJ;
- The designation of one or more appropriately registered principals in each OSJ [\[3\]](#) and one or more appropriately registered representatives or principals in each non-OSJ branch office;

- Written supervisory procedures regarding the supervision of all OSJs;
- Appropriate supervision of one-person OSJs;
- The supervision of registered representatives by qualified supervisors; and
- An annual compliance meeting.

Subsection (b) of the Rule 3110 requires each member to establish, maintain, and enforce written procedures to supervise the types of business it conducts and the activities of its registered representatives. Such procedures must be reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules. Among other things, the procedures must provide that the member:

- Reviews all transactions relating to the firm's investment banking or securities business. [\[4\]](#)
- Reviews correspondence and internal communications [\[5\]](#) and evidences such reviews; [\[6\]](#)
- Retains all communications as required by SEC Rule 17a-4(b) under the Securities Exchange Act of 1934;
- Reviews of all written or electronic (but not oral) customer complaints;
- Prohibits supervisory personnel from supervising their own activities and reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising; [\[7\]](#)
- Has procedures to ensure that the rule's supervisory standards do not become compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, such as the supervised person's position, amount of revenue he or she generated, or any compensation the supervisor may derive from the associated person's efforts; and
- Retains and keeps current a copy of the firm's written supervisory procedures at each OSJ and at each location where supervisory activities are conducted on the member's behalf. [\[8\]](#)

The Rule's Inspection Requirements

FINRA Rule 3110(c)(1), which was based on NASD Rule 3010(c)(1), requires a member to review its business at least annually, including the activities of each of its offices, and to conduct a periodic examination of customer accounts to detect and prevent irregularities or abuses. The member must also maintain records documenting its compliance with these requirements. With respect to branch offices, according to the Notice, "there is a general presumption that a non-branch location will be inspected at least every three years, even in the absence of any indicator of irregularities or misconduct." [\[9\]](#) A member may establish a periodic inspection cycle that is longer than three years, so long as it documents in its supervisory and inspection procedures the factors it used to determine that the longer period is appropriate. [\[10\]](#)

In connection with its required inspection, the member must test and verify a location's supervisory policies and procedures in each of the following areas: safeguarding of customer funds and securities; maintaining books and records; supervision of supervisory personnel; transmittal of funds or securities; and changes of customer account information. Importantly, if a location being inspected (such as that of a mutual fund underwriter) does not engage in all of these activities, the member must identify the activities that are not engaged in at the location and document that supervisory policies and procedures must be in place at the location prior to engaging in such activities. Members may either provide

this information in their written supervisory procedures or in a location's written inspection report. [\[11\]](#)

FINRA Rule 3110(c)(3) prohibits the following persons from conducting office inspections: branch managers and supervisors, the persons they directly or indirectly supervise, and associated persons assigned to the office. An exception to this prohibition is made for compliance personnel who are assigned to a firm's separate compliance department and supervised solely by the department to conduct a location's inspection.

The Rule's Transaction Review and Reporting Requirements

To implement the insider trading prohibitions of Section 15(g) of the Securities Exchange Act of 1934 (the "Exchange Act"), FINRA Rule 3110(d) requires members to include in their supervisory procedures a process for reviewing securities transactions. This process must be reasonably designed to identify trades involving the following that may violate the insider trading prohibition: accounts of the firm; accounts introduced or carried by the firm in which a person associated with the firm has a beneficial interest or the authority to make investment decisions; accounts of a person associated with the firm that are disclosed to the firm pursuant to NASD Rule 3050 or NYSE Rule 407 (relating to transactions by associated persons), as applicable; and covered accounts. [\[12\]](#) The rule permits members to monitor transactions using a risk-based approach that takes into account the member's specific business model. Also, once a member identifies a potentially violative trade, it must conduct promptly an internal investigation into the trade to determine whether a violation of the relevant laws or rules has occurred.

If a member that engages in "investment banking services" [\[13\]](#) opens or completes an investigation during a calendar quarter, it must file a report with FINRA within ten business days of the end of each calendar quarter. This report must be signed by a senior officer of the member and describe such internal investigation. It must also include the firm's identity, the commencement date of each internal investigation, the status of each open internal investigation, the resolution of the investigation reached during the previous calendar quarter and, with respect to each internal investigation under review, the identity of the security, trades, accounts, firm's associated persons or family members holding a covered account, and a copy of the firm's insider trading review policies and procedures. If the firm determines after its internal investigation that a trade has violated insider trading prohibitions, the firm must, within five business days of completing the investigation, file a written report with FINRA detailing completion of the investigation, including its results, any internal disciplinary action taken, and any referral of the matter to regulatory authorities. [\[14\]](#)

According to the Notice, "FINRA understands that some types of 'investment banking services' may present less risk of insider trading than others, and firms should take these risks into account when developing their policies and procedures." The Notice also states as follows: "FINRA does not expect that every trade highlighted in an exception or other report would require a firm to conduct an internal investigation;" instead, "a firm's procedures should include establishing guidelines or criteria for taking reasonable follow-up steps to determine which trades are potential violative trades and, therefore, merit further review via an internal investigation." [\[15\]](#)

FINRA Rule 3120, Supervisory Control System

New FINRA Rule 3120 requires each firm to designate and identify to FINRA one or more principals who must establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the member's supervisory procedures are reasonably designed with respect to the firm's and its associated persons' activities to achieve compliance with applicable securities law requirements and FINRA's rules. The designated principals must also create or revise additional supervisory procedures where necessary and prepare and submit a report at least annually to the firm's senior management summarizing the test results and any necessary amendments to its procedures.

A member that reports \$200 million or more in gross revenue on its FOCUS report in the prior calendar year must include in its report to senior management the following information "to the extent applicable to the firm's business": (1) a tabulation of the reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year and (2) a discussion of the preceding year's compliance efforts, including procedures and educational programs in each of the following areas:

- Trading and market activities;
- Investment banking activities;
- Antifraud and sales practices;
- Finance and operations;
- Supervision; and
- Anti-money laundering.

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endnotes

[1] See Institute Memorandum No. [27811](#) (December 24, 2013). FINRA's new rules also include Rule 3150, relating to holding of customer mail, and Rule 3170, relating to those firms that are required to tape record the conversations of their registered persons who engage in telemarketing. Neither of these would appear to be relevant to mutual fund underwriters.

[2] See FINRA Regulatory Notice 14-10 (March 2014) (the "Notice"), which is available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p465940.pdf>.

[3] The designated on-site principal must have who have a physical presence in the office on a regular and routine basis. Notice at p. 2.

[4] FINRA Rule 3110.05, Risk-based Review of Member's Investment Banking and Securities Business, permits a firm to use a risk-based system to review its transactions. According to the Notice, "a firm that does not engage in any transactions relating to its investment banking business (e.g., a firm conducting only a mutual fund underwriting business that does not effect transactions) does not have any review obligations pursuant to FINRA Rule 3110(b)(2)." Notice at p. 4.

[5] Rule 3110.06 permits the use of risk-based reviews subject to certain conditions. Rule 3110.07 permits the use of lexicon-based screening tools or systems. A member using such tools, however, “must have an understanding of the limitations of those tools or systems and should consider what, if any, further supervisory review is necessary in light of those limitations.” Notice at p. 6. FINRA Rule 3110.08 permits a supervisor or principal to delegate review functions to an unregistered person, though the supervisor or principal remains ultimately responsible for compliance with the rule’s requirements.

[6] For those communications reviewed by electronic surveillance tools that are not selected for further review, a member may demonstrate compliance with FINRA’s rule by evidencing that those communications have been reviewed by that system. Notice at p. 6.

[7] A limited exception is provided from this prohibition if the member determines, with respect to any of its supervisory personnel, that compliance with the prohibitions is not possible because of the firm’s size or a supervisory personnel’s position within the firm. See FINRA Rule 3110(b)(6).

[8] FINRA Rule 3110.11 permits a firm to satisfy this obligation with electronic media subject to certain conditions (e.g., the procedures are readily accessible by all associated persons). Notice at p. 8 and fn. 26.

[9] Notice at p. 9.

[10] Members may also inspect non-OSJs on a more frequent cycle than every three years to look at targeted areas so long as the member inspects all required areas listed in FINRA Rule 3110(c)(2) within the three-year cycle. Notice at p. 9.

[11] Notice at p. 10.

[12] “Covered account” is defined by FINRA Rule 3110(d) to include any account introduced or carried by the firm that is held by: (1) the spouse of a person associated with the firm; (2) a child of the person associated with the firm or such person’s spouse if the child resides in the same household or is financially dependent upon the person associated with the firm; (3) any other related individual over whose account the person associated with the firm has control; or (4) any other individual over whose account the associated person of the firm has control and to whose financial support such person materially contributes.

[13] It should be noted that the rule defines “investment banking services” to include a mutual fund underwriter. See Notice of Filing a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, SEC Release No. 34-69902; File No. SR-FINRA-2013-025 (July 1, 2013) at pp. 75-76. The Institute’s comment letter on FINRA’s proposal recommended that mutual fund underwriters be excluded from the term “investment banking services” due to the limited nature of their operations, which would not appear to raise the conflicts of interest this provision in the rule is intended to address. Notwithstanding our recommendation, mutual funds underwriters are included within the term.

[14] The reports required by the rule are to be filed with the member’s Regulatory Coordinator.

[15] Notice at p. 13.

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