SEC Approves New Consolidated FINRA Supervision Rules and FINRA Establishes an Effective Date

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Overview

Last week, FINRA issued a Regulatory Notice describing changes to its supervision rules and announcing an effective date of December 1, 2014.[1] The new rules were approved by the SEC late last year, and will replace NASD Rules 3010 and 3012 and certain incorporated NYSE rules with FINRA Rules 3110 (Supervision) and 3020 (Supervisory Control System) (collectively, the "FINRA Supervision Rules").

The adoption of the FINRA Supervision Rules follows two earlier attempts by FINRA to adopt consolidated supervision rules. First, in May 2008, FINRA published Regulatory Notice 08-24, proposing new FINRA supervision rules that drew a large number of comment letters. FINRA addressed the comments and filed a rule proposal with the SEC in 2011, but withdrew it a little more than three months later.

While the FINRA Supervision Rules incorporate many features of existing NASD and NYSE rules and some provisions are likely to be helpful to firms, certain aspects of the new rules could require significant changes to current supervisory practices. As such, although the effective date is months away, firms should start assessing their current policies and procedures and identifying areas that may require new processes and additional controls. We focus on the key revisions to the FINRA Supervision Rules below that are most likely to require changes in firms' policies and procedures.

New FINRA Rule 3110 (Supervision)

FINRA Rule 3110 will replace NASD Rule 3010, incorporating much of that rule's substance. The principal requirements of Rule 3010(a), namely that members establish and maintain a system to supervise the activities of their associated persons reasonably designed to achieve compliance with applicable laws and regulations, are retained with minor modifications.

Notably, FINRA Rule 3110 does not retain the controversial supplementary material that FINRA proposed in 2011, which would have required members' supervisory systems to provide for supervision of all business lines, including those not related to securities. FINRA did note in its filing, however, that it would continue to apply Rule 2010 (Standards of Commercial Honor and Principles of Trade) to non-securities activities of members and their associated persons.2

Additional requirements imposed by FINRA Rule 3110 are discussed below.

1. Review of Member's Securities Transactions

Similar to NASD Rule 3010(d)(2), and as proposed in 2008, FINRA Rule 3110(b)(2) requires principal review, evidenced in writing, "of all transactions relating to the investment banking or securities business of the member." Supplementary Material .05 states that members may use a risk-based system to comply with this review requirement. In its filing with the SEC, FINRA noted that it intended the term "risk-based" to describe "the type of methodology a member may use to identify and prioritize for review those areas that pose the greatest risk of potential securities laws and SRO rule violations."3 Members may prioritize their review processes "due to the volume of information that must be reviewed by using a review methodology based on a reasonable sampling of information in which the sample is designed to discern the degree of overall compliance, the areas that pose the greatest numbers and risks of violation, and any possible needed changes to firm policies and procedures."

a. Principal Responsibility for Defective Risk-Based Review Criteria

While FINRA Rule 3110(b)(2) permits firms to use risk-based systems to review investment banking and securities transactions, if such review involves certain parameters to assess whether transactions merit further review, firm principals remain responsible for review and documentation of these parameters. Further, under the new rules, all responsibility for deficiencies in a risk-based system's review parameters and criteria remains on firm principals.

b. Parameters for Heightened Risk

At a recent webinar on supervision, FINRA staff noted that parameters for considering whether a heightened risk is present included the size of the transaction, transactions where associated fees are higher than normal, the type of investors, whether the firm conducts and publishes related research, whether there are any factors related to particular brokers and their disciplinary histories, and any other relevant red flags that firms may have noticed.4

2. Internal Investigations

FINRA Rule 3110(d)(1) incorporates and expands upon the requirements of NYSE Rules 342.21 and 351(e). NYSE Rule 342.21 requires member organizations to review proprietary, employee and employee-related trading and conduct "internal investigations" of trades in NYSE-listed securities and related financial instruments that may violate securities laws and rules prohibiting insider trading and use of manipulative or deceptive devices. NYSE Rule 351(e), as interpreted in NYSE Information Memo 06-6, requires member organizations to make quarterly filings to report the commencement of an internal investigation, provide progress reports for ongoing investigations, and report on the conclusion of investigations. If no investigations were active during the preceding quarter, member organizations are nonetheless required to make a filing certifying that they have procedures for reviewing trades pursuant to Rule 342.21 and have no reasonable cause to believe that any trades subject to the rule in the prior quarter violated the laws or rules against insider trading or manipulation.

a. Requirements for Covered Accounts

The new rule differs from Rule 342.21 in several respects, including broadening the requirement to review all trading in all securities—not only NYSE-listed securities and related financial instruments. It also applies to all FINRA members—not just NYSE member firms. Under Rule 3110(d)(1), members must have supervisory procedures to review transactions that are affected for the member's account or the accounts of associated persons or certain other "covered accounts" for potential insider trading or use of manipulative or deceptive devices. As under NYSE Rule 342.21, members are required to promptly conduct an internal investigation into any identified trade that appears to be violative.

The term "covered account" includes 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, provided that the child resides in the same household as 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.

b. Internal Review and Reporting Requirements

Under FINRA Rule 3110(d)(3)(A), members that engage in investment banking services are required to make written reports of internal investigations similar to those reports required by NYSE Rule 342.21 and Information Memo 06-6. The rule requires members that engage in investment banking services to file written quarterly reports providing details of any internal investigations opened or remaining open during the quarter, and the resolution of any investigations closed during the quarter, with or without any finding of a violation.

Accordingly, any time an "internal investigation" is undertaken, firms are required to report it even if an innocuous explanation for the trade giving rise to the investigation is ultimately identified. Members do not need to file a certification following quarters in which no internal investigations were active.

The Rule also requires members that engage in investment banking services to make a written report within five business days of the completion of any internal investigation that identifies a violation of Exchange Act provisions or rules thereunder, or FINRA rules prohibiting insider trading or manipulative and deceptive devices. As FINRA noted in its filing, FINRA Rule 4530(b) also requires such a filing, but only if the violation is committed by the member or an associated person (and not by an associated person's family members). The timeframe for the Rule 4530 filing, however, is 30 days, rather than the five-day requirement of Rule 3110(d)(3)(B). FINRA did not indicate that making a filing under Rule 3110(d)(3)(B) would excuse firms from being required to also make a filing under Rule 4530(b), but firms may wish to seek clarification of this point.

Firms should consider implementing clear policies describing the circumstances in which they will commence an "internal investigation," a term left undefined (as it is under NYSE Rule 342.21). Presumably, not every routine follow-up or inquiry into the circumstances surrounding a trade should constitute an internal investigation. These inquiries generally develop along a continuum from informal to formal as they become more serious and at some point along that continuum will be considered "internal investigations" for Rule 3110(d)(1) purposes.

Information Memo 06-6 provides some guidance for firms with respect to developing criteria that indicate circumstances in which the steps taken to conduct a follow-up inquiry will be deemed an "internal investigation" for Rule 342.21 purposes, and this guidance may be useful to firms making this determination under proposed Rule 3110(d)(1). FINRA-only members—for whom this requirement will be new—may also want to consider, by analogy, the factors they review when answering Question 7B on Form U5, which asks whether a terminated individual is or was at termination under internal review for certain kinds of misconduct.

Firms will not only need to have policies that clearly indicate which inquiries will be deemed internal investigations, they will also need processes to track internal investigations to ensure that they are reported properly, as required by the new rule. Firms will also need to consider the relationship between reporting required by Rule 3110(d)(2)(A), Rule 4530(b) and Form U5 Questions 7B and 7F. For example, while a filing on Form U5 would obviate the need for a filing pursuant to Rule 4530(b), it would not obviate the need for quarterly filings under Rule 3110(d)(2)(A). Note too that unlike Rule 4530(b), the Rule 3110(d)(2)(A) filing with respect to a particular "internal investigation" needs to be updated each quarter through the quarter in which the "internal investigation" is terminated. Conceivably, firms could be required to make quarterly and closing reports under Rule 3110(d)(2)(A) while at the same time providing information in response to Rule 8210 requests triggered by the 4530(b) or U5 filings.

3. Review of Correspondence, Including Internal Communications

FINRA Rule 3110(b)(4) requires a firm to have supervisory procedures to review incoming and outgoing written (including electronic) correspondence and internal communications relating to its investment banking or securities business. The new rule explicitly requires monitoring of internal communications. The procedures must require review of incoming and outgoing correspondence and internal communications that are of a subject matter that require review under FINRA rules and federal securities laws. These include, without limitation, certain communications between research and non-research personnel (NASD Rule 2711(b)(3) and NYSE Rule 472(b)(3)), certain communications with the public that require a principal's preapproval (FINRA Rule 2210), and identification and reporting of customer complaints (FINRA Rule 4530). Firms that have not already done so may need to identify FINRA and other securities rules that require review of communications and adjust their review protocols accordingly.

Note that consistent with existing FINRA guidance in Regulatory Notice 07-59 on supervising internal communications, a supervisor or principal may delegate certain review functions to persons who need not be registered.

4. Reporting of Customer Complaints

The new FINRA Rule 3110(b)(5) requires a firm to have supervisory procedures to capture, acknowledge and respond to all written (including electronic) customer complaints. In line with prior pronouncements, FINRA recognized that oral complaints are "difficult to capture and assess, and may raise competing views as to the substance of the complaint being alleged," and did not include oral complaints in the new requirements. In addition, FINRA is encouraging firms to facilitate reporting of written customer complaints.

5. Supervision of Supervisory Personnel

The FINRA Supervision Rules eliminate explicit producing manager supervisory requirements in favor of procedures designed to address conflicts more generally. Instead, a firm must have procedures to prohibit its supervisory personnel from (1) supervising their own activities; and (2) reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising. FINRA noted that it believes addressing the supervision of all supervisory personnel, rather than just producing managers, is better designed to prevent supervisory situations from occurring that would not lead to effective supervision.

FINRA Rule 3110(b)(6) also requires a firm to have procedures reasonably designed to prevent the required standards of supervision from being compromised by conflicts of interest. Conflicts of interest may arise from the supervised person's position, the amount of revenue such person generates for the firm or any compensation that the supervisor may derive from the associated person being supervised. Importantly, FINRA noted that this provision does not impose a strict liability obligation to eliminate all conflicts of interest, but rather requires that the supervisory procedures be reasonably designed despite the firm's conflicts of interest.

At the Supervision Webinar, FINRA personnel explained that for small firms, multiple principals should review key firm documents such as FOCUS reports to ensure compliance with the new rule.

New FINRA Rule 3120 (Supervision)

For firms with $200 million or more in gross revenue, the new rules added specific topics that must be covered in supervisory control reports. New FINRA Rule 3120(b) adds specific content requirements for the annual report to senior management for members with reported gross revenues of more than $200 million (total revenue less, if applicable, commodities revenue) on their prior year's FOCUS reports, based largely on requirements in NYSE rule 342.30. These firms are required to include in the report detailed information about customer complaints and internal investigations made to FINRA during the preceding year, as well as the year's compliance efforts in a number of specific areas, and supervision and anti-money laundering efforts.

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[1]In addition, new FINRA Rules 3150 (Holding of Customer Mail) and 3170 (Tape Recording of Registered Persons by Certain Firms) replace NASD Rules 3110(i) and 3010(b)(2) (often referred to as the "Taping Rule"), respectively. Consolidated Supervision Rules; Regulatory Notice 14-10, March 2014, available at:
http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p465940.pdf

[2] Financial Industry Regulatory Authority; Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, 78 Fed. Reg. 40792 (Jul. 8, 2013) ("Proposal"), at 40801.

[3] Proposal at 40803.

[4] See http://www.finra.org/Industry/Education/OnlineLearning/Webinars/P441139 ("Supervision Webinar").

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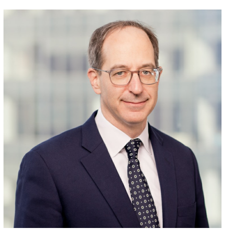

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