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## FINRA Proposes Consolidated Supervision Rules; Comments Due July 29

2013-07-15

On June 21, 2013, FINRA filed with the SEC a proposal to adopt consolidated FINRA supervision rules (the Proposal).<sup>1</sup> Comments are due July 29. The Proposal would adopt new FINRA Rules 3110 (Supervision) and 3020 (Supervisory Control System), which would reorganize and replace NASD Rules 3010 (Supervision) and 3012 (Supervisory Control System), as well as certain other NASD and incorporated NYSE rules, most notably NYSE Rules 342.21 and 351(e). The Proposal 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,<sup>2</sup> but withdrew it a little more than three months later.<sup>3</sup> The Proposal represents a revision of, and addresses comments received on, the 2011 filing.

While the rules discussed in the Proposal incorporate many features of existing NASD and NYSE rules and some provisions are likely to be helpful to firms, certain aspects of the Proposal could require significant changes to current supervisory practices. We focus on these aspects of the Proposal below.<sup>4</sup>

### **I. Proposed Rule 3110 (Supervision)**

Proposed Rule 3110 would 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, the Proposal 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, 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.<sup>5</sup>

One notable change in Rule 3110(a) and throughout proposed Rule 3110 generally is that reference is made to compliance not only with applicable laws, regulations and FINRA rules, but also with the rules of the MSRB. Additional requirements that would be introduced by subsections (b) and (c) of

proposed Rule 3110 are discussed below.

#### A. Review of Member's Securities Transactions

Similar to NASD Rule 3010(d)(2), and as proposed in 2008, proposed Rule 3110(b)(2) would require principal review, evidenced in writing, "of all transactions relating to the investment banking or securities business of the member." Proposed Supplementary Material .06 states that members may use a risk-based system to comply with this review requirement. Some commenters requested clarification regarding the tension between the requirement to review "all" transactions and the statement that a risk-based system of review is sufficient. FINRA responded 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."<sup>6</sup> 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."<sup>7</sup>

With this statement and the proposed Supplementary Material, FINRA seems to be acknowledging the impossibility for most members of reviewing literally "all" transactions. The statement regarding sampling is somewhat unclear, however. While FINRA appears to be endorsing review of a sampling of trades, with particular focus on activities that may pose a heightened risk, the Proposal does not expressly indicate that a "risk-based" methodology could include use of automated surveillance to identify particular trades that may present a risk of improper trading (such as by identifying large trades that occur close in time before large price moves in the traded security). We presume, however, that such a surveillance-based transaction review system would be permissible if the surveillance system was sufficiently broad in scope and included all or a reasonable sample of trades.<sup>8</sup>

#### B. Internal Investigations of Transactions and FINRA Reporting Requirements

Proposed Rule 3110(d)(1) would incorporate and expand 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.

## 1. Proposed Requirements for Covered Accounts

The proposed 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 would also apply to all FINRA members; not just NYSE member firms. Under proposed Rule 3110(d)(1), members would be required to have supervisory procedures to review transactions that are effected 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 would be required to promptly conduct an internal investigation into any identified trade that appears to be violative.<sup>9</sup>

The definition of "covered accounts" would expand the universe of accounts that members would be required to review to include all accounts owned by family members of a member's associated persons, including adult children, if the accounts are held at or introduced by the member.<sup>10</sup> Specifically, members would be required to review trading in (1) all accounts held at or introduced by the member that are owned by an associated person or his or her family members (including spouses, children (including adult children living apart from the employee), and siblings), and (2) any accounts held away from the member that the associated person is required by FINRA rules to disclose to the member. FINRA has not proposed to exclude from this requirement accounts of which the member or associated person was not aware or that were held at a branch other than the associated person's branch. Because associated persons may not be aware of where all of their adult relatives hold securities accounts, members may have to require associated persons to provide the names of all relatives potentially covered by the rule and use the list to determine whether the member carries or introduces any covered accounts. This process would need to be repeated on a periodic basis.

## 2. Proposed Internal Review and Reporting Requirements

Under Proposed Rule 3110(d)(2)(A), members that engage in investment banking services would be required to make written reports of internal investigations similar to those required by NYSE Rule 342.21 and Information Memo 06-6. The proposed rule would require 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.<sup>11</sup> Accordingly, any time an "internal investigation" is undertaken, firms would be required to report it even if an innocuous explanation for the trade giving rise to the investigation is ultimately identified. This aspect of the proposed rule represents a step back from FINRA's 2011 proposal, which would have required members to file a report within 10 days of the initiation of an internal investigation. The Proposal would not require members to file a certification following quarters in which no internal investigations were active.

Firms should consider implementing clear policies describing the circumstances in which they will commence an "internal investigation," a term left undefined by the Proposal (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). NASD-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 proposed rule. Firms will also need to consider the inter-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.

The proposed rule would also require 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 and manipulative and deceptive devices.<sup>12</sup> As FINRA noted in the Proposal, 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 proposed Rule 3110(d)(2)(B). FINRA made no indication that making a filing under proposed Rule 3110(d)(2)(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.

#### C. Review of Customer Complaints

As it did in 2008, FINRA proposes to require all members to “capture, acknowledge, and respond” to written customer complaints.<sup>13</sup> The requirement to acknowledge receipt of complaints, before responding to the issues raised in the complaint, is incorporated from NYSE Rule 401A and may be new to NASD-only members.<sup>14</sup> The Proposal does not, however, include NYSE Rule 401A’s requirement to acknowledge complaints within 15 days. FINRA also did not propose a requirement for members to acknowledge or respond to oral complaints, but did note that failure to respond to any complaint, including an oral complaint, may be a violation of FINRA Rule 2010.<sup>15</sup>

#### D. Review of Internal Communications

Proposed Rule 3110(b)(4) would require members to have supervisory procedures to “review internal communications to properly identify communications that are of a subject matter that

require review under FINRA and MSRB 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). This provision codifies and formalizes a requirement enunciated in Regulatory Notice 07-59 (other than with respect to MSRB rules).<sup>16</sup> Firms that have not already done so may need to identify FINRA, MSRB and other securities rules that require review of communications and adjust their review protocols accordingly.

#### E. Documentation and Supervision of Supervisory Personnel

Proposed Rule 3110(b)(6) tracks the substance of NASD Rule 3010(b)(3) and adds two new requirements. First, subject to an exception for firms too small to comply, members’ procedures would be required to prohibit a supervisor from supervising his or her own activities or having his or her compensation or continued employment determined by someone they supervise.<sup>17</sup> Second, members would be required to implement procedures to prevent any reduction in the standards of supervision required by proposed Rule 3110(a) as a result of any conflicts of interest supervisors may have with respect to supervised individuals.<sup>18</sup> Commenters expressed concern that the requirement to prevent a reduction in standards of supervision resulting from conflicts of interest would be interpreted as a requirement to eliminate all conflicts of interest, subject to a strict liability standard.<sup>19</sup> FINRA declined to adopt a requested reasonableness standard for this specific provision but noted that all procedures required by proposed Rule 3110(b) are subject to a general reasonableness standard, which “does not recognize a strict liability obligation requiring identification and elimination of all conflicts of interest.”<sup>20</sup>

#### F. Communicating Written Supervisory Procedures

With proposed Rule 3110(b)(7), FINRA would make two changes to the current requirement that members maintain copies of their written supervisory procedures at each Office of Supervisory Jurisdiction (OSJ), update them with changes in applicable laws or regulations, and distribute the updated procedures. Under the proposed rule, members would be required to “promptly” amend their procedures “to reflect” changes in applicable laws or regulations. FINRA clarified that the use of “promptly” means “prior to the effective date of any changes (or as expeditiously as possible following any immediately effective changes) in the securities laws or regulations or FINRA and MSRB rules necessitating the amendments.”<sup>21</sup> This is in contrast to the current requirement of NASD Rule 3010(b)(4) that procedures be amended “as appropriate within a reasonable time after” such changes occur. In addition, under the proposed rule, members must distribute the procedures not only to supervisory personnel, but “to all associated persons to whom [the] procedures and amendments are relevant based on their activities and responsibilities.” Accordingly, members should consider the effect of distributing written supervisory procedures to non-supervisory personnel who are affected by those procedures.

FINRA also proposes to supplement the requirements of proposed Rule 3110(b)(7) with new

supplementary material. Proposed Supplementary Material .12 would provide additional requirements for members that distribute their written supervisory procedures electronically by, for example, posting them to an Intranet site. Among other things, such members would be required to “monitor and maintain the security of material posted to ensure that it cannot be altered by unauthorized persons.”

#### G. Office Inspections

FINRA’s proposed rule regarding annual review of a member’s businesses and regular inspection of each of a member’s offices retains much of the substance of NASD Rule 3010(c)(1). The proposed rule would also add a requirement that members prevent the inspection standards required by the Rule “from being reduced in any manner due to any conflicts of interest that may be present, including but not limited to, economic, commercial, or financial interests in the associated persons and businesses being inspected.” FINRA again disagreed with commenters that suggested the proposed Rule would create a strict liability regime with respect to eliminating conflicts of interest, noting again that members’ supervisory procedures must be “reasonably designed” to achieve compliance.<sup>22</sup> The requirement to eliminate conflicts of interest, FINRA stated, “defines a standard around which inspections must be conducted,” presumably when read in conjunction with the actual review requirements set forth in proposed Rule 3110(c)(1).<sup>23</sup>

The Proposal would also establish, in proposed Supplementary Material .14, a presumption that non-branch locations will be inspected at least every three years. If a member wishes to establish a longer inspection cycle, it must document in its written supervisory and inspection procedures the factors used in determining that the longer cycle is appropriate.

#### H. Supervision of Small OSJs

Two provisions of the Supplementary Material to proposed Rule 3110 would impact the supervision of small OSJs. Proposed Supplementary Material .03 (One-Person OSJs) would provide that, in an OSJ with only one registered person, the registered person must be a registered principal and may not supervise his or her own activities if they include business activities other than supervision. Instead, members must designate a “senior principal” who must conduct on-site supervision of the OSJ “on a regular and periodic schedule to be determined by the member.”

Proposed Supplementary Material .04 (Supervision of Multiple OSJs by a Single Principal) would create a presumption that one principal will not be designated as the on-site supervisor for more than one OSJ. This presumption flows from the need for principals to have a physical presence at each OSJ that they supervise on a “regular and routine basis” in order to carry out their supervisory responsibilities. Any time a member designates one principal to supervise more than one OSJ, they would be required to document the factors used to determine that such a supervisory structure is appropriate. Proposed Supplementary Material .04 would create a further presumption that any determination by a member to assign one principal to supervise more than two OSJs is unreasonable.

## II. Proposed Rule 3120 (Supervisory Control System)

Proposed Rule 3120 would replace NASD Rule 3012. It retains the requirements of Rule 3012(a) relating to testing and verification of a member's supervisory procedures, including the required annual report to senior management.<sup>24</sup> Proposed Rule 3120(b) would add 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 its prior year's FOCUS reports, based largely on requirements in NYSE rule 342.30. These firms would be 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.

## III. Conclusion

Although many aspects of the Proposal would result in little or no change to firms' supervisory obligations and some aspects are in fact helpful, certain of the proposed rules could require firms to carefully review and consider amendments to their written supervisory procedures. We have highlighted several such aspects of the Proposal here, but firms should carefully review it and consider its potential impact on their supervisory system.

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<sup>1</sup> The notice was published in the Federal Register on July 8, 2013. 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).

<sup>2</sup> See 76 Fed. Reg. 38245 (Jun. 29, 2011).

<sup>3</sup> See 76 Fed. Reg. 62890 (Oct. 11, 2011).

<sup>4</sup> While we focus here on proposed Rules 3110 and 3020, the Proposal also includes proposed Rule 3150 (Holding of Customer Mail), which would replace NASD Rule 3110(i), and proposed Rule 3170 (Tape Recording of Registered Persons by Certain Firms), which would include the text of NASD Rule 3010(b)(2) without change.

<sup>5</sup> Proposal at 40801.

<sup>6</sup> Proposal at 40803.

<sup>7</sup> *Id.*

<sup>8</sup> In an analogous context, supervision of electronic communications, FINRA has permitted members to choose between random sampling and lexicon-based identification of communications for supervisory review. See Regulatory Notice 07-59 (Dec. 2007). Proposed Rule 3110(b)(4) and Supplementary Material .07 -- .10 are intended to codify the guidance provided in Regulatory Notice 07-59.

<sup>9</sup> Proposed Rule 3110(d)(1)(B).

<sup>10</sup> Proposed Rule 3110(d)(3)(A)(i) (defining “covered account” to include “any account held by the spouse, domestic partner, child, parent, sibling, son-in-law, daughter-in-law, father-in-law, or mother-in-law of a person associated with the member where such account is introduced or carried by the member”).

<sup>11</sup> Proposed Rule 3110(d)(2)(A).

<sup>12</sup> Proposed Rule 3110(d)(2)(B).

<sup>13</sup> Proposed Rule 3110(b)(5).

<sup>14</sup> MSRB Rule G-10 requires prompt delivery of an investor brochure to a customer upon receipt of a municipal securities-related complaint.

<sup>15</sup> Proposal at 40805.

<sup>16</sup> Regulatory Notice 07-59 (Dec. 2007) (“[M]embers must have policies and procedures for the review by a supervisor of employees’ incoming, outgoing and internal electronic communications that are of a subject matter that require review under FINRA rules and federal securities laws.” (internal citation omitted)).

<sup>17</sup> Proposed Rule 3110(b)(6)(C). Proposed Supplementary Material .11 would provide that the small-firm exception may be relied on generally only by sole proprietors in single-person firms or when a supervisor is a very senior executive.

<sup>18</sup> Proposed Rule 3110(b)(6)(D).

<sup>19</sup> Proposal at note 70 and associated text.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 40807.

<sup>22</sup> Proposal at 40808.

<sup>23</sup> *Id.*

<sup>24</sup> NASD Rule 3012(a)(2), relating to supervision of producing managers, would be replaced by proposed Rule 3110(b)(6)(C).

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## *Authors*



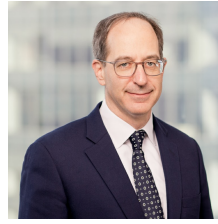


**Yoon-Young Lee**

SENIOR COUNSEL

✉ [yoonyoung.lee@wilmerhale.com](mailto:yoonyoung.lee@wilmerhale.com)

☎ +1 202 663 6720



**Bruce H. Newman**

PARTNER

✉ [bruce.newman@wilmerhale.com](mailto:bruce.newman@wilmerhale.com)

☎ +1 212 230 8835



**Stephanie Nicolas**

PARTNER

✉ [stephanie.nicolas@wilmerhale.com](mailto:stephanie.nicolas@wilmerhale.com)

☎ +1 202 663 6825