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# SEC Approves Sweeping Changes to FINRA's Regulatory Reporting Rules

2010-11-22

## I. Introduction of FINRA Rule 4530 (Reporting Requirements)

The U.S. Securities and Exchange Commission ("SEC") recently approved<sup>1</sup> the adoption of new Financial Industry Regulatory Authority ("FINRA") Rule 4530 ("Rule"), which requires members to report to FINRA certain internal and external findings of violative conduct and quarterly statistical and summary customer complaint information.<sup>2</sup> The new Rule replaces National Association of Securities Dealers ("NASD") Rule 3070 in its entirety and most of the provisions of New York Stock Exchange ("NYSE") Rule 351.<sup>3</sup> These legacy self-regulatory organization ("SRO") rules currently contain similar – but in some respects, inconsistent – reporting requirements for findings of violations.

When FINRA originally proposed the Rule in 2008,<sup>4</sup> it generated controversy and concern among commenters who asserted that, rather than harmonizing the existing standards, the proposal imposed more stringent obligations on both NYSE and NASD member firms and raised interpretive issues. In response to these concerns, FINRA filed amended rule proposals in October 2010.<sup>5</sup> On November 5, 2010, the SEC accepted FINRA's amendments and adopted the Rule as amended by FINRA on an accelerated basis.<sup>6</sup> FINRA must issue a regulatory notice regarding the Rule prior to February 3, 2011 and will require compliance with the Rule prior to early July 2011.

The new Rule imposes obligations beyond those set forth in current NASD Rule 3070, requires reporting of internal findings, and does not include the now familiar materiality standard applied to NYSE Rule 351(a). When reviewing and amending their policies and procedures to address the reporting of internal findings to define potentially reportable violations, firms will need to identify an appropriate decision-maker to evaluate potential reporting, create an escalation process, and maintain controls over reporting. Members also may need to consider how best to conduct and record the findings of internal audits and reviews in light of the new reporting obligations related to internal findings of violations.

## II. Overview of FINRA Rule 4530

FINRA Rule 4530 requires members to promptly report findings of internal and external violations and provides interpretive guidance regarding these requirements in Supplemental Materials .01 through .09.

**4530(a).** FINRA Rule 4530(a) requires reporting of certain enumerated external events, including regulatory actions, which include: (1) rule violations; (2) fraud-based customer complaints; (3) securities-, insurance- or commodities-related proceedings initiated by governmental entities and SROs; (4) certain disciplinary actions brought by governmental entities and SROs; (5) felonies and fraud-based misdemeanors; (6) associations with financial-related entities subject to disciplinary actions or convicted of crimes; (7) civil litigations related to financial services with judgments, awards, or settlements over certain thresholds; and (8) involvement in a financial business with any person subject to a "statutory disqualification." Rule 4530(a) also requires reporting of certain types of internal disciplinary action taken by a member against an associated person. Firms are required to report promptly, but in any event, within 30 days of when the member knows or should have known of the existence of the triggering event. Regulatory actions are reportable pursuant to Rule 4530(a)(1)(A) if the regulator has "found" a violation. Supplementary Material 4530.03 defines "found" and provides guidance regarding the circumstances under which regulatory actions are reportable.<sup>7</sup>

**4530(b).** FINRA Rule 4530(b) requires members to report to FINRA internal conclusions of violative conduct. Rule 4530 requires all members to "promptly report to FINRA, but in any event not later than 30 calendar days, after *the member has concluded or reasonably should have concluded* that an associated person of the member or the member itself has violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization." (emphasis added) Supplementary Material 4530.01 provides guidance regarding when members must report internal conclusions. Reporting is required if the misconduct has a widespread (or potential widespread) impact to the member, its customers, or the markets.

### **III. Analysis of Key Provisions of FINRA Rule 4530**

#### **A. Differences between Legacy NASD and NYSE Reporting Rules and New FINRA Rule 4530**

The new Rule is based primarily on NASD Rule 3070, but incorporates concepts from NYSE Rule 351 and introduces new obligations as well. Major changes include:

1. Introduction of a requirement for all members to report internal conclusions of violations pursuant to Rule 4530(b), a requirement which previously only applied to NYSE members subject to NYSE Rule 351;
2. Limitation on reporting findings of external violations to violations of "*securities-, insurance-, commodities-, financial- or investment-related* laws, rules, regulations or standards of

conduct of any domestic or foreign regulatory body, self-regulatory organization or business or professional organization," rather than the current requirement in 3070(a) to report findings of violations of "any provision of any securities laws or regulations or any rule or standards of conduct of any governmental agency, self-regulatory organization, or financial business or professional organization") (emphasis added)<sup>8</sup>; and

3. Adoption of the 30-day reporting period currently set forth in NYSE Rule 351(b),<sup>9</sup> which represents an extension of the existing 10-day reporting period under NASD Rule 3070(b).

## **B. New Standards for Self-Reporting Internal Findings of Violations**

During the rulemaking process, commenters raised the most concerns about the new standards imposed on members when reporting internal findings of violations. Below are descriptions of some of the commenters' primary areas of concern and FINRA's response.

### **1. Internal Determinations Regarding Violative Conduct**

Commenters were concerned that, pursuant to Rule 4350(b), the requirement to report violative conduct where a member "reasonably should have concluded" a violation occurred creates uncertainty regarding when reporting is required. In addition, commenters worried that FINRA could use the Rule with the benefit of hindsight to bring an enforcement action if it were to conclude after the fact that the firm should have identified and reported the violation. In response, FINRA states that it will use a "reasonable person" standard for evaluating member reporting practices under the new Rule and will not "engage in second guessing."<sup>10</sup>

### **2. Seniority of Decision Maker Assessing Potential Violation**

As with NASD Rule 3070, the new Rule and related guidance does not address the appropriate level of seniority of the person making internal determinations about violative conduct. In fact, FINRA states that it may be possible that a department within a firm determines that a reportable violation has occurred, but on review, senior management reaches a different conclusion, and the Rule would allow the firm to rely on senior management's decision as long as it was "reasonable."<sup>11</sup> That said, FINRA further states that a member may not justify its failure to report merely because the violation was not properly escalated to the responsible person nor may a firm argue that the determination was "reasonable" based solely on its escalation procedure.<sup>12</sup>

### **3. Different Materiality Standard for Assessing Internal Findings**

FINRA Rule 4530 incorporates a different materiality standard for self-reporting internal findings of violations compared to the standard set forth in NYSE Information Memo 06-11 ("NYSE IM 06-11"). NYSE IM 06-11 requires reporting of an internal finding of violative conduct by the firm if there are "systemic firm failures involving numerous customers, multiple errors or significant dollar amounts" or non-systemic violative conduct which "has widespread or potential widespread impact to the firm,

its customers, or the industry." NYSE IM 06-11 also requires reporting for employee conduct if the firm imposes discipline that falls under NYSE Rule 351(a)(10), the firm discharges a non-registered employee, or the firm finds that the employee engages in "recidivist or ongoing violative conduct."

FINRA Rule 4530.01 uses a similar standard that is intended to reflect FINRA's belief that the standard set out in NYSE IM 06-11 is too narrow.<sup>13</sup> Supplementary Material 4530.01 requires reporting of findings of violations relating to "conduct that has widespread or potential widespread impact to the member, its customers or the markets, or conduct that arises from a material failure of the member's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts." The new Rule also requires reporting for internal findings of violations by associated persons that have "widespread or potential widespread impact to the member, its customers or the markets, conduct that has a significant monetary result with respect to a member(s), customer(s) or market(s), or multiple instances of any violative conduct."

In addition, Supplementary Material 4530.01 confirms that if an associated person is subject to any disciplinary action "involving suspension, termination, the withholding of compensation or of any other remuneration in excess of \$2,500, the imposition of fines in excess of \$2,500 or is otherwise disciplined in any manner that would have a significant limitation on the individual's activities on a temporary or permanent basis," reporting would also be required pursuant to FINRA Rule 4530(a)(2).

The new Rule differs from the NYSE's previous materiality standard because under the new Rule, reporting is triggered if violations are "widespread" and "material." In contrast, NYSE Rule 351(a) requires reporting if violations are "systemic," "numerous," "multiple," or "significant." Further, the new Rule does not limit reporting regarding employee misconduct to "recidivist or ongoing violative conduct."

#### 4. Self-Reporting Based on Audit Findings

FINRA Rule 4530(b) requires members to report certain internal audit conclusions of violative conduct. In the Proposing Release for Rule 4530, FINRA noted that internal audit findings create a "strong presumption" that the matter is reportable pursuant to Rule 4530(b).<sup>14</sup> Commenters raised concerns that this reporting standard for audit findings ran counter to the notion of voluntary self-reporting and could impede the creation of robust compliance programs intended to identify and fix problems. In the Adopting Release for the new Rule, FINRA revised its prior position and stated that an internal audit finding does not create a strong presumption of a reportable finding, but rather "serve[s] only as one factor, among others, that a firm should consider in determining whether a violation occurred."<sup>15</sup>

#### C. Insurance Products Covered by Rule 4530

While commenters argued that insurance products should be excluded from the reporting requirements set forth in Rule 4530, FINRA confirmed in the Adopting Release that members must

report internal and external findings of violations related to insurance matters.

#### **IV. Next Steps for Members**

The new Rule will require members to enhance their policies and procedures to address the reporting of internal findings to define potentially reportable violations, identify decision-makers to assess potential violations, create or modify reporting escalation procedures, and institute appropriate controls over reporting. Members also may want to review their internal audit processes to reflect the new guidance regarding reporting based on internal findings of violations. Members also should ensure that insurance products are adequately covered by new or existing policies. Finally, members may want to begin assessing potential violations using the new materiality standard set forth in 4530.01 as well as the current NYSE materiality standard until the new Rule is deemed effective by FINRA and replaces NYSE Rule 351(a).

<sup>1</sup> Exchange Act Rel. 63,260 (Nov. 5, 2010), 75 Fed. Reg. 69,508-01 (Nov. 12, 2010) ("Adopting Release").

<sup>2</sup> FINRA Rule 4530 is being adopted as part of the continuing process to develop a new Consolidated FINRA Rulebook. The current Transitional FINRA rulebook includes: (1) FINRA Rules; (2) NASD Rules; and (3) Incorporated NYSE Rules. The FINRA and the NASD Rules generally apply to all FINRA members, but the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE ("Dual Members").

<sup>3</sup> The new Rule does not incorporate attestation requirements currently set forth in NYSE Rule 351(e), NYSE Rule Interpretation 351(e)/01, and NYSE Rules 351(f), 351.11 and 351.12. These provisions will remain in the Incorporated NYSE Rules. However, FINRA states that these provisions will be addressed as part of its future rules on supervision and research analyst conflicts of interest. See Exchange Act Rel. 62,621 (Jul. 30, 2010), 75 Fed. Reg. 47,863, 47,863 fn. 5 (Aug. 9, 2010) ("Proposing Release"); FINRA Regulatory Notice 08-24 (May 2008); FINRA Regulatory Notice 08-55 (Oct. 2008).

<sup>4</sup> See FINRA Regulatory Notice 08-71 (Nov. 2008).

<sup>5</sup> FINRA's first amendment was filed on October 18, 2010 and the second amendment was filed October 22, 2010. Both amendments are available at [www.finra.org/Industry/Regulation/RuleFilings/2010/P121715](http://www.finra.org/Industry/Regulation/RuleFilings/2010/P121715).

<sup>6</sup> Comments regarding the amendments, however, will continue to be accepted by the SEC until December 3, 2010.

<sup>7</sup> Supplementary Material 4530.03 defines "found" to include among other formal findings, adverse final actions, including consent decrees in which the respondent has neither admitted nor denied the findings, Letters of Acceptance, Waiver and Consent, and Offers of Settlement. The term "found" includes any formal finding, regardless of whether the finding will be appealed. The term "found" does not include informal agreements, deficiency letters, examination reports, memoranda of understanding, cautionary actions, admonishments and similar informal resolutions of matters, or

violations of SRO rules designated as "minor" where the sanction imposed consists of an uncontested fine of \$2,500 or less.

<sup>8</sup> This clarification "limit[s] the scope of the rule" to "make it more effective and relevant to FINRA's program, as well as enhance firms' ability to more accurately report such information." Proposing Release at 47,864.

<sup>9</sup> See also NYSE Information Memo 90-17 (defining "prompt" filing to mean within 30 days of the reportable event).

<sup>10</sup> Adopting Release at 69,512 and Amendment No. 1 to the Rule at 33.

<sup>11</sup> Adopting Release at 69,512.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> Proposing Release at 47,867.

<sup>15</sup> *Id.*

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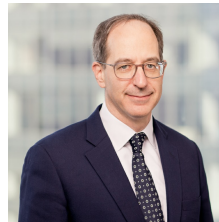
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