

## FINRA Proposes New Operations Personnel Qualification and Registration Requirements

---

On May 26, 2010, the Financial Industry Regulatory Authority (“**FINRA**”) proposed for public comment new rules (the “**Proposed Rules**”) that would require, for the first time, that certain “back-office” operations personnel who serve in supervisory capacities qualify and register with FINRA.<sup>1</sup> According to FINRA, the Proposed Rules would enhance the regulatory structure surrounding firms’ back-office operations by helping to ensure that investor protection mechanisms are in place in all areas of a member’s business that could potentially harm customers, the firm or the marketplace.

### Scope of the Proposal

Under the proposal, persons with supervisory, management or decision-making authority over certain back-office functions would be required to register as an “Operations Professional,” as well as pass a qualifying examination and be subject to continuing education (“**CE**”) requirements. Many persons already registered under other categories, however, would be exempt from the exam requirement.

### Covered Persons

The Proposed Rule would apply to three categories of persons: (i) senior management with responsibility over a “Covered Function” (as defined below); (ii) supervisors, managers or other persons responsible for approving work in furtherance of a Covered Function; and (iii) persons with authority to commit the member’s capital to, or commit the member to a contract in furtherance of a Covered Function. Persons employed by an affiliate or third-party may also be required to register as an Operations Professional with the FINRA member if they perform Covered Functions in a supervisory capacity on behalf of the member – irrespective of their employing entity. However, persons who merely perform Covered Functions (rather than have some supervisory responsibility), ancillary or support functions (e.g., Legal or Compliance), or clerical or ministerial activities would not be required to register as Operations Professionals.

### Covered Functions

The Proposed Rule defines “**Covered Functions**” as fifteen specific back-office activities:

1. Development and approval of pricing models used for valuations;
2. Trade confirmation, account statements, settlement, margin;
3. Stock loan/securities lending;
4. Prime brokerage (services to other broker-dealers and financial institutions);
5. Client on-boarding (customer account data and document maintenance);
6. Capturing of business requirements for sales and trading systems and any other systems related to the covered functions, and validation that these systems meet such business requirements;

---

<sup>1</sup> FINRA Regulatory Notice 10-25, *Registration and Qualification Requirements for Certain Operations Personnel*, available at <http://www.finra.org/Industry/Regulation/Notices/2010/P121533> (the “**Regulatory Notice**”).

7. With respect to the covered functions, defining and approving business security requirements and policies for information technology (including, but not limited to, systems and data);
8. Defining information entitlement policy in connection with the covered functions;
9. Financial Controller (including general ledger);
10. Collection, maintenance, re-investment (i.e., sweeps) and disbursement of funds;
11. Bank, custody, depository and firm account management and reconciliation;
12. Segregation, possession and control, fail control, buy ins;
13. Receipt and delivery of securities and funds, account transfers;
14. Financial regulatory reporting; and
15. Posting entries to the books and records of a member in connection with the covered functions.

### Qualifying Examination and Continuing Education Requirements

A person registering as an Operations Professional would be required to pass a new FINRA qualifying examination, unless the person falls within an exception, as described below. Once registered, Operations Professionals would also be subject to CE requirements relevant to Covered Functions.

#### *Proposed Exam Coverage*

According to the Regulatory Notice, the qualifying exam would seek to assure that Operations Professionals understand key regulatory and control themes and the importance of identifying and escalating red flags. The exam would test broad principals, including professional conduct and ethical considerations, basic product and market knowledge, and broad understanding of the Covered Functions and the rules governing these activities.

#### *Exemptions from Examination and CE*

A person required to register as an Operations Professional would be exempt from the examination requirement (but not the requirement to register) if the person holds one of a broad range of other representative or principal registrations, or reactivates a registration held during the prior two years. Registration categories that qualify for the exam exemption include general securities representatives, general securities principals, general securities sales supervisors, compliance officers, supervisory analysts, financial and operations principals, and registered options principals. Because persons who would be required to register as Operations Professionals typically already act in a supervisory capacity, many will already be otherwise registered in one of the above categories and exempt from further examination. Persons seeking to avail themselves of the exemption would be required to opt-in to the Operations Principal registration by amending their Form U4. If eligible for the exemption and otherwise in good standing, the new registration would be automatically approved.

Persons who qualify from an exemption from the examination requirement would also be exempt from special Operations Professional CE requirements, so long as they complete the CE requirements for their other registration.

### Potential Impact of Proposed Rule

Currently, registration, CE and supervision requirements are mainly focused on those persons who deal with customers, rather than those performing back-office functions. Responding to recent scandals involving back-office failures, however, the Securities and Exchange Commission (“**SEC**”) and FINRA have focused on enhancing the supervisory system and regulatory oversight of back-office operations. As one of its post-Madoff reforms, SEC staff have highlighted in public statements the need for enhanced

licensing and oversight of back-office personnel, including those involved in custody, accounting, transfer agency and account maintenance. The additional registration requirements are likely intended to cause a shift in the culture and mindset toward increased back-office supervision within firms.

The proposal would also affect the way firms supervise back-office personnel. Because FINRA's by-laws define "associated person" to include any "person who is registered or has applied for registration," persons who become required to register as Operations Professionals will become associated persons of the firm, subject to the full gamut of FINRA rules and firms' policies and procedures. For example, persons with certain disciplinary histories that are currently permitted to function in an operations capacity may be statutorily disqualified from becoming an associated person. Moreover, firms will have to set up a supervisory structure to manage these persons and businesses, which will give the SEC and FINRA greater control over these back office functions.

As persons employed by affiliates or third-parties performing Covered Functions in a supervisory capacity for a FINRA member will be required to register as Operations Professionals with the member, these persons would also have to be treated as associated persons of the member. For example, where a senior credit officer or a operations person employed by a bank affiliate currently has supervisory responsibility for Covered Functions for a FINRA member in addition to their duties with the bank, that person would be required to register as an Operations Professional with the member and be subject to all the rules and policies relating to members' associated persons.

## Transition Period

The proposal anticipates a transition period of between six to nine months after the Proposed Rule becomes effective. Persons acting in a capacity that would require registration on the effective date would have to register and either pass the examination or qualify for an exemption by the end of the transition period. However, any Operations Professional hired after the effective date, or a person whose responsibilities change after the effective date, would be required to register as an Operations Professional before engaging in the activities that require registration.



FINRA requests comments on the proposal by July 12, 2010. The Proposed Rules will not become effective until the rule changes are filed with and approved by the SEC following a second comment period.

---

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

<b>Annette L. Nazareth</b>	202 962 7075	<a href="mailto:annette.nazareth@davispolk.com">annette.nazareth@davispolk.com</a>
<b>Lanny A. Schwartz</b>	212 450 4174	<a href="mailto:lanny.schwartz@davispolk.com">lanny.schwartz@davispolk.com</a>
<b>Gerard S. Citera</b>	212 450 4881	<a href="mailto:gerard.citera@davispolk.com">gerard.citera@davispolk.com</a>
<b>Robert L.D. Colby</b>	202 962 7121	<a href="mailto:robert.colby@davispolk.com">robert.colby@davispolk.com</a>

---