

**DAVIS POLK & WARDWELL**

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Date: June 9, 2008  
To: Interested Persons  
Re: **FINRA Proposes Amendments to Supervision Rules**

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On May 14, 2008, the Financial Industry Regulatory Authority (“**FINRA**”) issued four rule proposals (the “**Proposals**”) for member comment, including a very significant series of proposed changes to its supervision rules (the “**Supervision Proposal**”).<sup>1</sup> FINRA is seeking comments on the Proposals by **June 13, 2008**.<sup>2</sup>

The stated purpose of the Supervision Proposal is to consolidate the various NASD and NYSE rules on supervision while at the same time providing member firms greater flexibility to tailor their supervisory systems to reflect their business, size and organizational structure. FINRA proposes to incorporate these changes by adopting new Rules 3110 and 3120 and consolidating and/or deleting many of the existing NASD and NYSE rules on supervision.

Notable proposed changes to existing supervisory standards include:

- Requiring firms to designate supervisors for all areas of the firm’s activities, not just to those requiring broker-dealer registration;
- Changing the supervisory requirements for communications, including (i) requiring review of internal communications and correspondence directed to all firm employees, not just registered representatives, and (ii) allowing risk-based review of communications;

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<sup>1</sup> The Proposals are: (i) FINRA Regulatory Notice 08-23, which proposes consolidated rules governing financial responsibility; (ii) FINRA Regulatory Notice 08-24, the Supervision Amendment, which proposes consolidated rules governing supervision and supervisory controls; (iii) FINRA Regulatory Notice 08-25, which would amend certain books and records requirements; and (iv) FINRA Regulatory Notice 08-26, which addresses investor education and protection. The Proposals are part of the overall process by FINRA to create a unified rulebook that consolidates various provisions of the National Association of Securities Dealers, Inc. (“**NASD**”) and the New York Stock Exchange (“**NYSE**”) rulebooks.

<sup>2</sup> After reviewing member comments, FINRA presumably will submit revised rule proposals to the SEC for approval. The SEC will publish the proposed rules for public comment.

- Mandating that firms engaged in investment banking services provide FINRA with written reports detailing the results of internal investigations relating to insider trading; and
- Imposing stricter requirements for supervising outside securities activities of associated persons irrespective of whether the associated person receives compensation for the activities.

### *Designation of Supervisors*

Proposed Rule 3110 would consolidate NASD Rule 3010 and NYSE Rule 342 relating to, among other things, supervisory systems, written procedures, internal inspections and review of correspondence. Proposed Rule 3110(a) would require that a member firm designate an appropriately registered principal to supervise each type of business the member firm engages in, regardless of whether registration as a broker-dealer is required for that activity. This would constitute a major change for broker-dealers that currently do not have registered supervisory principals or FINRA-mandated supervisory structures set up for their non-securities business activities. This change may be regarded by the industry as a controversial expansion of FINRA's jurisdiction. While it is well settled that self-regulatory organization rules concerning "high standards of commercial honor just and equitable principles of trade" extend to all member activities, including non-securities businesses, many rules (such as those concerning recommendations and "mark-ups") currently apply, by their terms, only to securities activities.

### *Review of Transactions*

Proposed Rule 3110(b)(1) would retain the current requirement to evidence in writing principal review of all member firm transactions, with two significant changes. First, the requirement would specifically apply to all transactions relating to the investment banking and securities businesses of the member firm. In the past, this was not an explicit requirement and some member firms may not have applied the same level of review to investment banking and financial advisory services as they did to trade executions. Second, proposed Supplementary Material to Proposed Rule 3110 ("**Supplementary Material**") would clarify that review of such investment banking and securities business may be "risk-based." There is some ambiguity in the language of the proposal. The rule calls for review of "all" transactions while the Supplementary Material allows for a "risk-based" approach. FINRA may have intended that the scope of transactions subject to review must be comprehensive and include all transactions, but the risk-based approach would allow review of a sampling or subset of transactions based on the nature of the business and the risks to the firm.

*Supervision of Supervisors*

Proposed Rule 3110 would require member firms to adopt procedures regarding the monitoring of supervisors while at the same time removing certain specific requirements. Proposed Rule 3110(b)(2) would eliminate, for example, the requirements regarding the supervision of a producing manager's customer account activity, including related revenue thresholds. FINRA would continue to prohibit a supervisor from supervising his own securities activity or supervising the activities of any person that he reports to or who controls his compensation or continued employment, unless the member firm could document the specific reason for such supervisory structure.

*Supervision of Branch Offices and Offices of Supervisory Jurisdiction*

Proposed Rule 3110 would retain the current definitions of Branch Office and Office of Supervisory Jurisdiction (“OSJ”) and codify existing FINRA staff guidance regarding supervisory requirements for those offices.<sup>3</sup> In addition, in a more flexible approach, FINRA recognizes that there are situations where a member firm may have to designate one principal to supervise more than one OSJ. Nonetheless, under the Supplementary Material, FINRA would impose a high level of scrutiny on member firms that assign multiple OSJs to a single principal.

*Supervision of Outside Securities Activities of Associated Persons*

FINRA is proposing to delete NASD Rule 3040 and instead require associated persons to obtain approval before engaging in any outside business activities relating to securities or investment banking, irrespective of whether the associated person receives compensation. Proposed Rule 3110(b) would also apply specific supervisory requirements to these types of activities. In particular, Proposed Rule 3110(b) would provide that once a member firm gives approval to an associated person to engage in outside securities or investment banking activity, the activity would be viewed as within the scope of the firm's business and must be supervised in accordance with the firm's supervisory procedures. This is in contrast to the current requirement of NASD Rule 3030 that does not impose any specific level of supervisory control over outside securities activity. The proposal expands upon the requirement of current NASD Rule 3040, which imposes supervisory control over outside investments for which a broker has received selling compensation. This raises significant issues about dual employment and the intermingling of business activities of affiliated and

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<sup>3</sup> An OSJ is defined as any office of a member firm at which certain activities, such as order execution and/or market making or structuring of public offerings or private placements (*i.e.*, investment banking) are conducted. A branch office is any location identified to the public or customers—by any means—as a location at which the member conducts an investment banking or securities business. Unlike an OSJ, a branch office does not require a principal to be present at every location.

unaffiliated entities. One example would be a dual employee who works in an overseas branch office of a U.S. registered broker-dealer and is also an employee of an overseas affiliate. A technical reading of the proposed language would require that a broker-dealer supervise all of the securities activities of the dual employee, including that activity engaged in solely for the overseas affiliate. In addition, this provision may raise questions about FINRA's ability to exercise jurisdiction over the activities of non-member firms.

To address concerns surrounding the functional regulation of banks and broker-dealers under this aspect of the Supervision Proposal, Proposed Rule 3110(b)(3) proposes an exception from the above supervisory requirement for bank-related securities activities conducted pursuant to an exemption from broker-dealer registration. The proposed exception would impose certain procedural requirements upon banks and member firms. In particular, member firms would have to obtain written notice from the bank and approve the dual employee's investment banking or securities activities in the bank. Furthermore, the member firm would have to obtain a written assurance from the bank that it will: (i) have a comprehensive view of the dual employee's securities activities; (ii) employ policies and procedures reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws; and (iii) notify the member firm promptly of any violation of the policies and procedures by the dual employees. Proposed Rule 3110(b)(3) further requires that in the event that a dual employee violates such policies and procedures, the member firm must determine whether the bank's policies and procedures are reasonably designed to achieve compliance with the anti-fraud rules. If a member firm cannot reach such assurance, Proposed Rule 3110 would require that the member firm revoke the approval of the dual employee's bank-related securities activities. In addition, Proposed Rule 3110 would impose a practical burden on member firms in requiring them to assess the bank's policies and procedures.

#### *Review of Correspondence and Internal Communications*

Proposed Rule 3110 generally incorporates the substance of existing NASD rules on review of communications. In addition, the proposed Supplementary Materials contain detail on how these reviews should be done. The text of Proposed Rule 3110, however, explicitly broadens member firms' responsibilities with respect to such reviews. NASD Rule 3010(d) currently requires the review of incoming and outgoing written correspondence of registered representatives with the public relating to the investment banking or securities business of the member firm. Proposed Rule 3110 would not only require the review of incoming correspondence directed to registered representatives, but would also require the review of correspondence directed to all member firm employees. In addition, Proposed Rule 3110 would require member firms to review internal communications relating to its investment banking or securities business. Finally, the Supplementary Material would require that a firm evaluate whether to review correspondence in other areas of the firm, such as operations, IT and other support areas. Certain additional

procedures, including training and surveillance, must be implemented if a firm's procedures do not require that all correspondence be reviewed for use before distribution. The Supervision Proposal would therefore greatly expand the volume of e-mail required to be reviewed and, in many firms, would require capture and review of e-mails in areas not previously subject to review. The Supplementary Material would, however, allow members to conduct risk-based reviews of internal and external communications and would allow a supervisory principal to delegate review of communications to non-registered personnel as long as the supervisory principal maintains ultimate responsibility for the performance of the reviews.

#### *Customer Complaints*

Proposed Rule 3110 would incorporate current NYSE requirements to capture, store and respond to all customer complaints, but would limit the requirement to "written (including electronic) customer complaints." This would remove the ambiguity that some in the industry consider to currently exist under the NYSE rules with respect to capturing and reporting oral customer complaints.

#### *Insider Trading Procedures*

The Supplementary Material would incorporate a current NYSE requirement that member firms' insider trading procedures specifically include a review of trades that are effected in firm proprietary accounts, or for accounts of employees or family members for potential insider trading violations. The Supplementary Material would also require member firms to promptly conduct internal investigation into transactions the firm identifies as having violated insider trading regulations. In a significant, and potentially controversial, departure from the more flexible risk-based approach described elsewhere, the proposed Supplementary Material would also require that member firms that engage in investment banking services provide FINRA with written reports detailing the results of internal investigations relating to insider trading, and include if there were any referrals to FINRA, the SEC, or another SRO as a result of the internal investigation. While this requirement currently exists for NYSE member firms, former NASD member firms are not required to provide these reports.

#### *Testing of Supervisory and Compliance Program*

FINRA is proposing to replace current NASD Rule 3012 with Proposed Rule 3120. Proposed Rule 3120 would retain current testing and verification and report to senior management requirements, but would also adopt the current NYSE provision that would require member firms to file supplemental reports to senior management of the member for firms having more than \$150 million in gross revenue (based on their FOCUS reports). In particular, the supplemental report to senior management would have to include a tabulation of the prior year's reports relating to customer complaints and internal investigations made to

FINRA, as well as a discussion of the firm's prior year's compliance efforts with respect to specified areas, including anti-money laundering, supervision and investment banking. Although the requirement to include these areas in the senior management report would provide a better overall picture for senior management to allow them to adequately allocate resources, it would also impose on member firms a specific requirement to address areas that may not pose a significant risk to their business.

### **Conclusion**

The Supervisory Proposal contains many substantive changes to current requirements. Member firms should consider commenting on several aspects of the Proposal, including the expansion of the scope of the supervisory requirements for non-securities activities, the guidance regarding supervision of communications, and the increased supervisory responsibilities for outside securities activities, which all could potentially impose new burdens on member firms.

Please call your primary contact at Davis Polk if you would like to discuss these issues further.