SEC Approves New FINRA Supervision Rules

January 8, 2014

Financial Industry Regulatory Authority ("**FINRA**") rules require broker-dealer members to establish and maintain a system and written procedures to supervise the activities of their personnel, which are reasonably designed to achieve compliance with the federal securities laws and FINRA rules. As part of FINRA's rulebook consolidation process, on December 23, 2013, the SEC **approved** FINRA's proposal to consolidate several existing NASD and NYSE rules and interpretations relating to supervision into new FINRA rules.

New FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) are largely based on and will consolidate and replace existing NASD Rules 3010 and 3012 and various related NASD interpretive material and Incorporated NYSE Rules. The new rules differ in several ways from existing rules, including with respect to: (i) which personnel are permitted to act as supervisors of other personnel; (ii) which personnel may perform office inspections; (iii) requirements for review of certain internal communications; and (iv) obligations to monitor for insider trading, including a requirement to conduct internal investigations and report certain related information to FINRA. These changes will require firms to review and revise their existing supervisory policies and procedures.

FINRA has not yet announced an effective date for the new rules, but is expected to publish a Regulatory Notice before March 22, 2014 announcing an effective date of no later than December 23, 2014.

Office Supervision and Inspections

- ***Supervision of Multiple OSJs.*** Both current NASD Rule 3010 and new FINRA Rule 3110 require that a member's supervisory system include the designation of one or more principals in each of the member's offices of supervisory jurisdiction ("**OSJs**") to supervise the activities of that office. New Supplementary Material .03 to FINRA Rule 3110 clarifies that FINRA expects that each OSJ have an "on-site" principal with a "regular and routine" physical presence at the OSJ. New FINRA Rule 3110 sets forth a new general presumption that, absent certain special circumstances outlined in the rule, a single principal should not be designated to supervise more than one OSJ.
- ***Frequency of Office Inspections.*** Similar to current NASD Rule 3010, new FINRA Rule 3110(c)(1) will continue to require members to inspect OSJs and supervisory branch offices at least annually, non-supervisory branches at least every three years, and non-branch locations on a "regular periodic schedule," based on the activities undertaken at the non-branch location. New Supplementary Material .13 to FINRA Rule 3110, however, creates a new presumption that a non-branch location should be inspected at least every three years, even in the absence of red flags. If a longer periodic inspection schedule is used, the member must document the factors used to determine its appropriateness. FINRA also declined to exempt "home offices" from the periodic inspection requirements, as advocated by some commenters.
- ***Inspection Conflicts of Interest.*** NASD Rule 3010 currently requires "heightened office inspections" if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. New FINRA Rule 3110(c)(3) will impose less prescriptive requirements. Member firms will be obligated to establish policies and procedures reasonably designed to prevent office inspections from being compromised by conflicts of interest. In addition, absent certain special circumstances, members may not allow an associated person to

conduct a location's inspection if the person is either assigned to the location or is directly or indirectly supervised by, or reporting to, a person assigned to the location.

Review of Transactions and Communications

- ***Review of Investment Banking and Securities Transactions.*** New FINRA Rule 3110(b)(2) carries over an existing NASD Rule 3010 requirement that a registered principal conduct a written review of "all transactions" relating to the member's investment banking or securities business. New Supplementary Material .05, however, explains that a member need not conduct detailed reviews of each transaction, if the firm uses a reasonably designed risk-based review system that allows it to focus on the areas of greatest risk of violations.

- ***Review of Communications.*** New FINRA Rule 3110(b)(4) retains requirements under existing NASD Rule 3010 that members have supervisory procedures for the review of incoming and outgoing written and electronic correspondence relating to the member's investment banking or securities business. New FINRA Rule 3110(b)(4), however, adds a new requirement to establish procedures for review of internal communications having a subject matter that may require review for compliance with federal securities laws and rules and FINRA requirements (*e.g.*, communications between research and non-research departments). New Supplementary Material .06 will also require members to undertake a risk-based review of whether other additional types of incoming, outgoing, or internal communications should be subject to review policies and procedures. Certain data from these reviews and specific actions taken in response must be documented, even where a member firm uses lexicon-based screening tools or other electronic review systems. New Supplementary Material .08 would specifically permit a supervisor to delegate certain review functions required under FINRA Rule 3110(b)(4) to unregistered personnel, although the supervisor would remain ultimately responsible.

- ***Insider Trading Investigations and Reporting.*** New FINRA Rule 3110(d) is based on Incorporated NYSE Rule 342.21, which requires procedures for review and investigation of potential insider trading. Specifically, the new FINRA rule will require member firms to have supervisory procedures for the review of transactions effected for the member, its associated persons (whether in an account for the associated person or under his or her control, at the member, or at another FINRA member disclosed to the member), or certain family members of associated persons, to identify potential insider trading or other manipulative or deceptive devices. The new rule will also require members to promptly conduct an internal investigation into questionable trades. In addition, members engaged in investment banking services must provide FINRA with: (i) a report within five days of the completion of an internal investigation in which it was determined that a violation of insider trading or anti-manipulation provisions had occurred, and (ii) a quarterly report describing various information about insider trading and related internal investigations initiated, ongoing, or concluded within the prior quarter. For purposes of the rule, "investment banking services" includes acting as an underwriter or selling group participant for public offerings, acting as an advisor on mergers and acquisitions, providing venture capital or equity lines of credit, or serving as placement agent for private issuers.

Supervisory Structure and Controls

- ***Supervisory Conflicts of Interest.*** New FINRA Rule 3110(b)(6)(C) will require that, absent certain special circumstances, a member firm's supervisory procedures prohibit an associated person from: (i) supervising their own activities, or (ii) reporting to, or having their compensation or continued employment determined by, a person they are supervising. New FINRA Rule 3110(b)(6)(D) will further require policies and procedures reasonably designed to prevent the supervisory system from being compromised by conflicts of interest between the supervisor and supervised person.

- ***Annual Supervisory Control Report.*** New FINRA Rule 3120 will carry over requirements under NASD Rule 3012 that a member test and verify its supervisory procedures and submit a report to senior management, at least annually, detailing the member's supervisory control system, test results, significant exceptions, and any changes to supervisory procedures created in response to the test results. However, new FINRA Rule 3120 will impose a new requirement that, for a member that reports more than $200 million in gross annual revenues, the report to senior management must include, as applicable to the member: (i) a tabulation of reports made to FINRA during the year regarding customer complaints and internal investigations, and (ii) a discussion of the prior year's compliance efforts, including procedures and educational programs, relating to trading and market activities, investment banking, antifraud and sales practices, finance and operations, supervision, and anti-money laundering.

Other Rules

- ***Holding Customer Mail***. New FINRA Rule 3150 will replace NASD Rule 3001(i) regarding the holding of customer mail. Under the current rule, members may hold a customer's mail upon the customer's request, but only up to two or three months, depending on the circumstances. New FINRA Rule 3150 permits customers to request a longer holding period, provided member firms comply with several conditions.

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.

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