JACKO LAW GROUP, PC

Legal Risk Management Tip
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WHAT THE NEW FINRA SUPERVISORY RULES MEAN FOR YOUR BROKERAGE PRACTICES

For those of us who have been in broker-dealer compliance for some time, NASD Rules 3010 and 3012 form the hallmark of our supervision and supervisory control systems. Effective December 1, 2014, however, FINRA's new supervisory rules 3110 (supervision) and 3120 (supervisory control systems) go into effect.   For broker-dealers, this has several impacts, including:

- Expansion of Written Supervisory Procedures
- Insider Trading Controls
- Office Inspection Requirements
- Minimum Requirements for the Annual Compliance Meeting
- Internal Correspondence Reviews
- Additional Supervisory Control Reporting

With the effective date rapidly approaching, this month's Legal Tip will summarize each of these requirements and explore action steps firms may wish to consider for implementation.

Highlights of the New FINRA Supervisory Rules

The following summary is intended to highlight those provisions of that may most directly impact FINRA member firms and is not all-encompassing. To review FINRA Regulatory Notice 14-10 in its entirety, please visit http://www.finra.org/Industry/Regulation/Notices/2014/P465941.

1. Expansion of Written Supervisory Procedures

For years, the SEC has employed a "risk based approach" towards evaluating systemic risks of investment advisers. Now, FINRA has adopted a similar model and suggests that firms consider adopting a risk-based review system for assessing transactions (rather than reviewing each and every transaction). Prior to adoption and implementation, the firm should be able to demonstrate that the system adopted is able to gather meaningful information to capture risks of potential violations. Moreover, in accordance with new FINRA Rule 3110(b)(2), a firm registered principal is required to evidence review of such transactions in writing. Should technology be used for purposes of conducting the review, then the principal must document his or her review of the technology parameters.

2. Insider Trading Controls

If a firm discovers a potential insider trading violation, the broker-dealer must conduct an investigation and then within five (5) business days after completing such investigation, file a written report to FINRA as to the results. The report must be signed by a senior officer of the firm.

3. Office Inspection Requirements

Whenever an on-site principal is responsible for supervising more than one OSJ, care should be given to consider whether that individual has the capacity and ability to handle this. Factors to consider include the principal's current workload, whether the on-site principal is a producing registered representative, proximity of the on-site principal to the OSJ locations, the individual's competency and qualifications and the types of activities conducted at the OSJ locations (including size and number of associated persons, and complexity of products and services).

While the new rule continues the requirement for OSJs and supervisory offices to be inspected annually and nonsupervisory branch offices at least every three years, it does go a step further. Now, however, there is a presumption that the nonsupervisory branch will be inspected no less frequently than every three years. Should that non-branch office be examined less than this, the broker-dealer must document why, with rationales supporting this decision.

4. Minimum Requirements for the Annual Compliance Meeting

Many firms opt to satisfy their annual compliance meeting by various means, including teleconference, video conferences and in-person meetings. To the extent that the broker-dealer allows for participation in such meetings to occur other than through "in-person meetings," pursuant to new FINRA Rule 3110.04, that broker-dealer must be able to demonstrate that such registered persons were present at the meeting for its entirety.

5. Internal Correspondence Reviews

Broker-dealers have long had procedures in place for reviewing outgoing and incoming correspondence. Now, FINRA Rule 3110(b) requires firms to develop policies and procedures related to the review and supervision of internal communications and correspondence of all associated persons. As part of this process, the broker-dealer can take a risk-based approach for conducting such reviews, which much be performed by a registered principal and evidenced in writing. While that registered principal is permitted to delegate the review function to non-registered individuals, the registered principal ultimately is responsible for overseeing that all supervisory reviews are conducted appropriately by the delegee.

6. Additional Supervisory Controls and Reporting

Certain provisions of NASD Rule 3012 are now eliminated relating to the supervision of a producing manager's customer account activities and heightened supervision based on production.[1] New FINRA Rule 3110(b)(6) instead requires the broker-dealer to develop procedures to prohibit its supervisory personnel from supervising their own activities and avoiding conflicts related to supervision of a branch office location, because of, for example, pecuniary interests associated with supervising the associated persons and related business activities. While a limited exception is still available (particularly due to firm size), any broker-dealer relying on such exception must document the reasons why it the firm cannot comply with the rule and describe how their current supervisory structure otherwise complies with FINRA Rule 3110(a).

Finally, in addition to the requirement that broker-dealers designate and identify to FINRA one or more principals who will oversee and enforce the firm's supervisory control system, under new FINRA Rule 3120, firm that reported $200 million or more in annual gross revenue in the prior calendar year must provide the following information to the firm's senior management team on an annual basis:

- Tabulation of all customer complaints and internal investigations reported to FINRA
- A summary of the preceding year's compliance efforts, which should include information relating to:

[1] Production is measured by whether a manager generates 20 percent or more of the revenue of the business units supervised by the branch office manager's supervisor.

- Trading and market activities
- Investment banking activities
- Antifraud and sales practices
- Finance and operations
- Supervision
- Anti-money laundering

How to Prepare

In order to prepare for the new supervisory requirements, consider taking the following action steps:

1. Form a compliance exploratory committee as to how the new rule may affect existing compliance supervisory control systems. For some, the new requirements may only minimally impact the firm.
2. Review your OSJ supervisory system and ensure that documentation is in place for each registered principal's competencies and abilities to supervise, particularly if they oversee more than one OSJ location.
3. Review your Needs Analysis and adjust Annual Meeting requirements as necessary.
4. Take a comprehensive assessment of your written supervisory procedures to ensure that you have addressed all new minimum requirements, including transaction reviews, correspondence and internal communication reviews, customer complaint reviews, supervision of supervisory personnel and maintenance requirements.
5. Evaluate your current inspection reports to ensure that new minimum content requirements are addressed.[2]
6. Assess current protocols for insider trading reviews and enhance, as necessary, to address the new rule requirements.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

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[2] Among other things, RN 14-10 requires that member firms must test and verify a location's supervisory policies and procedures for safeguarding customer funds and securities, maintenance of books and records, supervision of supervisory personnel, transmittals of funds or securities and changes of customer account information.