

# Notices

## Regulatory Notices

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## Reporting Requirements

### FINRA Reminds Firms of Their Obligation to Electronically Report Specified Events and Quarterly Customer Complaint Information and Provides Additional Guidance on Automated Reporting Under FINRA Rule 4530

#### Executive Summary

FINRA is issuing this *Notice* to remind member firms of their obligation to electronically report specified events and quarterly customer complaint information required under current NASD Rule 3070 and Incorporated NYSE Rule 351, and new FINRA Rule 4530, which is effective July 1, 2011.<sup>1</sup> This *Notice* also provides additional guidance on automated reporting via the Rule 4530 Application for matters that become subject to reporting on or after July 1, 2011.

Questions regarding this *Notice* should be directed to Afshin Atabaki, Assistant General Counsel, Office of General Counsel, at (202) 728-8902.

Technical questions regarding the Rule 4530 Application, including testing, should be directed to the FINRA Help Desk, at (800) 321-6273 (if your question relates to testing, rather than an actual submission, please indicate this to the help desk representative).

#### Background & Discussion

##### Obligation to Report Required Information Electronically

NASD Rule 3070 and Incorporated NYSE Rule 351 require member firms to, among other things, report to FINRA certain specified events (paragraphs (a)(1) through (a)(10) of the rules) and quarterly statistical and summary information regarding written customer complaints (paragraphs (c) and (d) of the rules, respectively). As stated in *Regulatory Notice 11-06*, these rules will remain in effect for matters that become subject to reporting prior to July 1, 2011. Moreover, firms are reminded that they are required to report these matters, including the specified events, electronically via the Regulatory Filings Application on the FINRA Firm Gateway.<sup>2</sup> The current application is named Disclosure Events and Complaints.<sup>3</sup>

March 2011

#### Notice Type

- ▶ Guidance

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Senior Management

#### Key Topics

- ▶ Customer Complaints
- ▶ Disclosure Events
- ▶ Electronic Reporting
- ▶ Reporting Application
- ▶ Technical Changes

#### Referenced Rules & Notices

- ▶ FINRA Rule 4530
- ▶ Incorporated NYSE Rule 351
- ▶ NASD Rule 3070
- ▶ NTM 95-81
- ▶ Regulatory Notice 08-40
- ▶ Regulatory Notice 11-06

For matters that become subject to reporting on or after July 1, 2011, under new FINRA Rule 4530, member firms must continue to report specified events (paragraphs (a)(1)(A) through (a)(1)(H), (a)(2) and (b) of Rule 4530) and quarterly statistical and summary information on written customer complaints (paragraph (d) of Rule 4530) electronically via the Regulatory Filings Application on the FINRA Firm Gateway.<sup>4</sup> The Disclosure Events and Complaints application will be renamed the Rule 4530 Application on July 1, 2011.<sup>5</sup>

### **Automated Reporting via Rule 4530 Application<sup>6</sup>**

Firms logging in to the reporting application on July 1, 2011, will notice the following changes:<sup>7</sup>

- ▶ As noted above, the name of the reporting application will be changed from “Disclosure Events and Complaints” to the “Rule 4530 Application.”
- ▶ Beginning July 1, the drop-down menu in the Rule 4530 Application will provide descriptions of reportable events that correlate with FINRA Rule 4530, and it will no longer include the numeric codes currently in use.<sup>8</sup> (Right now, when reporting specified events, firms are required to select the appropriate event from a drop-down menu that includes a numeric code and description of the event.<sup>9</sup>)

There are no other significant changes to the reporting application.

## Endnotes

- 1 FINRA Rule 4530 takes effect on July 1, 2011, replacing NASD Rule 3070 and the corresponding provisions in Incorporated NYSE Rule 351. See *Regulatory Notice 11-06* (February 2011) (SEC Approves Consolidated FINRA Rule Governing Reporting Requirements).
- 2 See Securities Exchange Act Release No. 35956 (July 11, 1995), 60 FR 36838 (July 18, 1995) (Notice of Filing of Proposed Rule Change; File No. SR-NASD-95-16); *Notice to Members (NTM) 95-81* (September 1995) (SEC Approves Rules For Reporting Customer Complaint Information); and *Regulatory Notice 08-40* (August 2008) (Technology Changes for Reporting Certain Complaint and Disclosure Information).
- 3 The application can be accessed directly through the following hyperlink: <https://regfiling.finra.org>.
- 4 See *Regulatory Notice 11-06*.
- 5 See *supra* note 4.
- 6 Firms with a higher volume of reporting may find that a batch submission is more efficient than reporting matters one at a time using the Regulatory Filings Application on the FINRA Firm Gateway. A batch submission via the file transfer protocol (FTP) allows a member firm to submit multiple reports directly to a secure server. For more information regarding batch submissions, please see the Regulation Filing Applications FTP Submission Fact Sheet at [www.finra.org/web/groups/industry/@ip/@comp/@rf/documents/appsupportdocs/p117146.pdf](http://www.finra.org/web/groups/industry/@ip/@comp/@rf/documents/appsupportdocs/p117146.pdf).  
  
Firms that will submit reports via FTP, rather than via the Rule 4530 Application, must use new event codes (11 through 20) for batch reporting specified events on or after July 1, 2011. See *Regulatory Notice 11-06*, Attachment B.
- 7 Firms should use their existing user ID and password to access the Rule 4530 Application.
- 8 The following will be the available selections in the new drop-down menu as of July 1, 2011: External Finding; Customer Complaint Involving Certain Allegations; Named in a Regulatory Proceeding; Subject to Other Regulatory Actions; Criminal Actions Involving Felonies and Certain Misdemeanors; Associated with a Financial Entity Subject to Certain Actions; Civil Litigation, Arbitration Matters, or Certain Claims for Damages; Statutory Disqualification; Disciplinary Action Taken by a Firm Against an Associated Person; and Internal Conclusion.
- 9 The following are the available selections in the current drop-down menu: 01 – Securities, Law, Rule, or Regulation Violation; 02 - Customer Complaint; 03 - Regulatory or Self-regulatory Proceeding; 04 - Regulatory or Self-regulatory Membership; 05 - Criminal Offense; 06 - Association with Investment Company; 07 - Civil Litigation or Arbitration; 08 - Damages Claim; 09 - Statutory Disqualification; and 10 - Disciplinary Action.

# Regulatory Notice

11-11

## Debt Research Reports

### FINRA Requests Comment on Concept Proposal to Identify and Manage Conflicts Involving the Preparation and Distribution of Debt Research Reports

Comment Period Expires: April 25, 2011

#### Executive Summary

FINRA seeks comment on a concept proposal to apply objectivity safeguards and disclosure requirements to the publication and distribution of debt research reports. The proposal has a tiered approach that generally would provide retail debt research recipients with most of the same protections provided to recipients of equity research, while exempting debt research provided solely to institutional investors from many of those provisions.

Questions concerning this *Notice* should be directed to:

- ▶ Philip Shaikun, Associate Vice President, Office of General Counsel (OGC), at (202) 728-8451; and
- ▶ Racquel Russell, Assistant General Counsel, OGC, at (202) 728-8363.

#### Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 25, 2011.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:  
Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

March 2011

#### Notice Type

- ▶ Request for Comment

#### Suggested Routing

- ▶ Compliance
- ▶ Fixed Income
- ▶ Investment Banking
- ▶ Legal
- ▶ Research
- ▶ Senior Management
- ▶ Trading

#### Key Topics

- ▶ Conflicts of Interest
- ▶ Fixed Income
- ▶ Research
- ▶ Trading

#### Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ FINRA Rule 2020
- ▶ NASD Rule 2711
- ▶ NTM 06-36
- ▶ Regulatory Notice 08-55
- ▶ SEC Regulation AC

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

**Important Notes:** The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this Notice will be made available to the public on the FINRA website. Generally, FINRA will post comments on its site one week after the end of the comment period.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.<sup>2</sup>

## Background and Discussion

FINRA has long been monitoring firms' management of conflicts of interest related to the publication and distribution of debt research. In a 2005 report<sup>3</sup> to the SEC, legacy NASD and the NYSE indicated that they would examine the extent to which firms voluntarily adopted the Guiding Principles of the Bond Market Association (BMA).<sup>4</sup> The self-regulatory organizations (SROs) subsequently surveyed certain firms' debt research supervisory systems and found many instances where firms failed to adhere to the Guiding Principles. More significantly, the SROs found certain cases where firms lacked any policies and procedures to manage debt research conflicts to ensure compliance with applicable SRO ethical and anti-fraud rules. Those findings were published in *Notice to Members (NTM) 06-36*<sup>5</sup> as a means to prompt better conflict management, but FINRA expressly noted that it would continue to consider more definitive rulemaking that might differ from or expand on the Guiding Principles.

The staff believes now is the appropriate time to engage in such definitive rulemaking. Among other things, the staff has observed increased retail investment risk in complex debt securities. The allegations of misconduct in the sale of auction rate securities (ARS) illuminated this fact and provided a very concrete example that potential conflicts of interest in the publication and distribution of debt research can exist just as they do for equity research.

Currently, FINRA's research rules apply only to "equity securities," as that term is defined under the Securities Exchange Act of 1934 (Exchange Act), subject to certain exceptions. In contrast, SEC Regulation Analyst Certification (Reg AC), the SEC's primary vehicle to foster objective and transparent research, applies to both debt and equity research. In addition, several foreign regulators have enacted research rules that apply to debt research, many of which are more extensive than Reg AC.

In consultation with industry members including buy-side, the staff has reviewed the appropriateness of applying the provisions of the equity research rules to debt research, taking into consideration the unique nature of debt trading and its market participants. Based on this review, the staff has developed a conceptual debt research rule that would recognize a bifurcated debt research regulatory approach in which retail investors and institutional investors are treated as customers and counterparties, respectively. Thus, the envisioned rule extends to debt research distributed to retail investors the vast majority of the protections currently afforded to equity research, while debt research distributed solely to institutional investors would require a more general “health warning” in lieu of many of the structural safeguards and disclosures applicable to retail debt research. Importantly, the concept would allow for an institutional investor to choose to receive the full protections accorded retail debt research. The concept further would delineate the permissible communications between debt research analysts and sales and trading personnel. As conceived, the rule would contain the following elements:

### Definitions

First, a “debt security” would be defined as any “security” other than an “equity security,” a “treasury security” or a “municipal security” (as those terms are defined in the federal securities laws). The definition of “debt research report” would closely follow the current definition of research report in NASD Rule 2711 (*i.e.*, a communication that includes an analysis of securities and that provides information reasonably sufficient upon which to base an investment decision). The definition of “debt research report” would be subject to the same exceptions currently in place for equity in NASD Rule 2711 (*e.g.*, discussions of broad-based indices, commentaries on economic, political or market conditions, etc. would be excepted).

The definition of “institutional investor” would be the same as “institutional account” in FINRA’s suitability rule.<sup>6</sup> Thus, the proposed definition generally would cover: (a) a bank, savings and loan association, insurance company or registered investment company; (b) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (c) any other entity (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

### Standards Applicable to Retail Debt Research

The majority of the existing structural safeguards and disclosures in NASD Rule 2711 for equity research would apply to retail debt research.<sup>7</sup> In addition, unlike the equity research rules, the proposal addresses conflicts between debt research and sales and trading personnel.<sup>8</sup>

Thus, the staff envisions that the debt research rule would:

- ▶ Generally require member firms to establish, maintain and enforce policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to:
  - ▶ the preparation, content and distribution of debt research reports;
  - ▶ public appearances by debt research analysts; and
  - ▶ the interaction between debt research analysts and those outside of the research department, including investment banking department personnel, sales and trading department personnel, subject companies and customers.
- ▶ Prohibit prepublication review, clearance or approval of debt research by investment banking and sales and trading, as well as restrict (or prohibit) prepublication review, clearance or approval by a subject company (except for fact checking) or by member firm personnel who are not directly responsible for the preparation, content and distribution of debt research.
- ▶ Prohibit input by investment banking and sales and trading into the determination of the research department budget.
- ▶ Limit the supervision and compensatory evaluation of debt analysts to persons not engaged in investment banking services or sales and trading.
- ▶ Require the review and approval of debt analyst compensation by the same type of committee required to review equity analyst compensation, and prohibit compensation based on specific investment banking or sales and trading transactions or contributions to the member firm's investment banking or sales and trading activities.
- ▶ Restrict or limit debt analyst account trading in the securities, derivatives and funds related to the securities covered by the debt analyst, including to:
  - ▶ ensure that debt analyst accounts, supervisors of such analysts and associated persons with the ability to influence the content of research reports do not benefit in their trading from knowledge of the content or timing of a debt research report; and
  - ▶ prohibit trading contrary to the analyst's recommendations (except in cases of financial hardship). Member firm policies and procedures also would be required.
- ▶ Prohibit promises of favorable debt research coverage.
- ▶ Prohibit retaliation against debt analysts by investment banking personnel or other employees as the result of an adverse, negative or otherwise unfavorable research report or public appearance.
- ▶ Restrict or limit activities by debt analysts that can reasonably be expected to compromise objectivity, including participation in pitches, road shows and certain three-way meetings involving debt analysts and customers where either investment banking personnel or issuer management are present.

- ▶ Prohibit investment banking from directing debt analysts to engage in sales or marketing efforts or any communication with a customer about an investment banking services transaction.

Likewise, the staff envisions that the disclosures applicable to equity research largely should apply to debt. They include disclosure of personal and firm financial interests; the receipt of investment banking services compensation from the subject company; and the meaning of each rating employed in any rating system used by the member firm in the research report.<sup>9</sup> The staff also believes that the supervisory review and disclosure obligations applicable to the distribution of third-party equity research should similarly apply to third-party retail debt research.

### Institutional Investor Exemption

FINRA staff understands that, unlike in the equity market, institutional investors trading in debt securities tend to interact with broker-dealers in a manner more closely resembling that of a counterparty than a customer. Based on discussions with industry participants, the staff further understands that these institutional investors value the timely flow of analysis and trade ideas related to debt securities, are aware of the types of potential conflicts that may exist between a member's recommendations and trading interests, and are capable of exercising independent judgment in evaluating such recommendations (and instead incorporate the research as a data point in their own analytics) and reaching pricing decisions.

Given these unique aspects of the debt market and the needs of its participants, the concept proposal exempts debt research disseminated solely to institutional investors from most of the structural safeguards and disclosures described above for retail debt research. However, firms availing themselves of this institution-only exemption would be required to provide on the first page of a debt research report a prominent "health warning" disclosure, including that:

- ▶ the research is intended for institutional investors only and is not subject to all of the independence and disclosure standards applicable to research provided to retail investors;
- ▶ if applicable, that the firm trades the securities covered in the research for its own account and on behalf of certain clients; such trading interests may be contrary to the recommendations offered in the research and the research may not be independent of the firm's proprietary interests; and
- ▶ if applicable, that the research may be inconsistent with recommendations offered in the firm's research that is disseminated to retail investors.

The staff believes that this approach appropriately acknowledges the arm's-length nature of transactions between trading desk personnel and institutional buyers. The staff also notes that this approach alleviates the need for a firm to determine whether any particular communication sent only to institutional investors meets the definition of "debt research report." Of course, if a communication does not meet the definition of "debt research," these contemplated rules would not apply, irrespective of whether disseminated to retail or institution-only investors. Firms that avail themselves of this institutional carve-out would be required to clearly distinguish such research from debt research disseminated to retail investors. However, the staff believes that not all institutional investors are necessarily alike and therefore an important part of the proposed regulatory scheme is to allow for such investors to opt out of this exemption.

Notwithstanding the sophistication of institutional debt investors, the staff believes certain of the basic safeguards applicable to retail research should apply to all debt research; specifically the prohibitions/restrictions on:

- ▶ promises of favorable research;
- ▶ debt research analyst involvement in pitches, road shows and other marketing;
- ▶ certain three-way meetings about an investment banking services transaction that involve debt analysts and customers where either investment banking personnel or issuer management are present;
- ▶ input into research coverage by investment banking personnel;
- ▶ retaliation against debt research analysts for unfavorable research;
- ▶ review of research by the subject company (beyond fact-checking) or investment banking personnel; and
- ▶ investment banking directing debt research analysts to engage in sales or marketing efforts or any communication with a customer about an investment banking services transaction.

The staff notes that other FINRA rules would continue to apply to member conduct in connection with debt research, including research disseminated pursuant to the institutional investor carve-out (*e.g.*, FINRA Rules 2010 and 2020). In addition, nothing in this concept proposal obviates a member's obligation to comply with the antifraud provisions of the federal securities laws.

### Communication Firewalls Unique to Debt

The staff's discussions with industry members illuminated certain necessary communications between debt analysts and sales and trading personnel to allow each to perform their primary functions.<sup>10</sup> Therefore, the concept proposal delineates the permissible interactions between debt analysts and sales and trading personnel. Expressly permitted communications would include the following:<sup>11</sup>

- ▶ Sales and trading personnel seeking information from debt analysts regarding the creditworthiness of an issuer (and other information regarding a debt issuer that is reasonably related to the price/performance of the debt security), so long as, with respect to any covered issuer, such information is consistent with the debt analyst's published research. All such communications would have to be consistent with the types of communications the analyst might have with customers.<sup>12</sup>
- ▶ Debt analysts seeking information from sales and trading personnel regarding a particular bond instrument, current prices, spreads, liquidity and similar market information relevant to the debt analyst's valuation of a particular debt security.
- ▶ Sales and trading personnel providing input to Research Management regarding debt research coverage decisions, provided that final coverage decisions are made by Research Management.

The following would be expressly prohibited communications:

- ▶ Sales and trading personnel attempting to influence a debt analyst's opinion or views for the purpose of benefiting the trading position of the firm, a customer or a class of customers.
- ▶ Debt analysts identifying or recommending specific potential trading transactions to sales and trading personnel that are not contained in such debt analyst's currently published reports; disclosing the timing of, or material investment conclusions in, a pending debt research report; or otherwise having any communication for the purpose of determining the profile of a customer to whom research should be directed.

## Request for Comment

FINRA welcomes all comments on the concept proposal, and specifically encourages buy-side investors to comment on the proposal's tiered approach. Among other things, FINRA is interested in comments on the following:

### Definitions

- ▶ Is the definition of "debt security" overbroad or under-inclusive?
- ▶ FINRA recognizes that no "institutional investor" definition is a perfect proxy for sophistication and has proposed the same definition as found in FINRA's suitability rule as a starting point for discussion. Are there other definitions more appropriate in the context of debt research conflicts of interest that would better identify those individuals and entities that would benefit from the protections proposed for retail investors?

### Opt-In/Out Provision

- ▶ Should this option be structured as an "opt-in" or an "opt-out" provision? Should fund managers be permitted to opt-in/opt-out on a fund-by-fund basis?

### Effect on Availability of Retail Debt Research

- ▶ How might the institution-only carve-out impact the availability to retail customers of certain types of debt research, such as research on foreign sovereign debt? Would firms with both retail and institutional clients reduce or eliminate debt research provided to retail investors due to the differing regulatory requirements? Are there certain categories of debt research that should be exempted from all of the contemplated rules for both retail and institutional investors?

### Disclosures for Institutional Debt Research

- ▶ Should there be additional disclosures required for members to avail themselves of the institution-only carve-out? For example, should members be required to disclose to institutional investors any substantial proprietary acquisitions or divestments in the covered debt security immediately prior to the issuance of an institution-only report on that security?

Comments must be received by April 25, 2011.

## Endnotes

- 1 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *NASD Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 2 Section 19 of the Securities Exchange Act permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily temporarily suspend these types of rule changes within 60 days of filing. If the SEC takes such action, the SEC shall institute proceedings to determine whether the proposed rule should be approved or disapproved. See Exchange Act Section 19 and rules thereunder.
- 3 Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules (December 2005).
- 4 In 2005, the BMA merged with the Securities Industry Association (SIA) to form the Securities Industry and Financial Markets Association (SIFMA).
- 5 *NTM 06-36* (July 2006).
- 6 See Securities Exchange Act Release No. 63325 (November 17, 2010), 75 FR 71479 (November 23, 2010) (Order Approving File No. SR-FINRA-2010-039 to adopt FINRA Rule 2111 (Suitability) in the consolidated FINRA rulebook) (“Suitability” rule).
- 7 The staff does not envision proposing with respect to debt research the ban on research analysts receiving pre-IPO shares or the imposition of quiet periods around the issuance of research reports.
- 8 The staff notes that *Regulatory Notice 08-55* proposed changes to current NASD Rule 2711. Generally, *Regulatory Notice 08-55* sought to streamline the NASD Rule 2711 provisions and apply several overarching principles for the management of conflicts of interest in connection with member firm research. This concept proposal builds on that approach, and further proposes additional safeguards in connection with debt research not included in current NASD Rule 2711 or *Regulatory Notice 08-55* (e.g., the prohibition on investment banking and sales and trading input into the determination of the research department budget). FINRA will consider whether any of these additional safeguards are appropriate for debt.
- 9 However, the staff believes that certain disclosures must be modified in light of unique characteristics of the debt market. Thus, instead of member firm disclosure if it acts as a market maker in the subject security, the rule would require disclosure if the member firm generally engages in principal trading in the subject debt security. And while the envisioned rule provides that the rating distributions and related disclosures also apply to debt research, the staff believes that minor modifications would be appropriate because the lack of daily closing information may otherwise make a price chart difficult to create for debt securities.
- 10 The staff understands that the uniqueness of the debt market as compared to equities (e.g., limited last sale transparency information) necessitates communication between analysts and traders in certain fundamental regards.

**Endnotes** continued

- 11 Communications between debt research analysts and sales and trading personnel that are not related to sales and trading or research activities may take place without restriction.
- 12 A debt analyst's communications with sales and trading personnel would not be deemed "inconsistent" with the analyst's published research where the investment objectives or time horizons being discussed differ from those underlying the analyst's published views.

## Foreign Corrupt Practices Act

### FINRA Reminds Firms of Their Obligations Under the Foreign Corrupt Practices Act

#### Executive Summary

The Foreign Corrupt Practices Act of 1977 (FCPA) was enacted to prohibit bribery of foreign officials and restore public confidence in the integrity of the American business system. This Notice provides a brief overview of the FCPA and discusses the application of the anti-bribery prohibitions to member firms.

Member firms that are considered to be “issuers” under the FCPA also must comply with the FCPA’s accounting provisions, which generally require an “issuer” to make and keep books and records that accurately and fairly reflect the company’s transactions and to devise and maintain an adequate system of internal accounting controls.

FINRA advises member firms to review their business practices to ensure they are complying with all of their obligations under the FCPA. A member firm’s failure to comply with its FCPA obligations will be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade in violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).

Questions concerning this *Notice* should be directed to Patricia Albrecht, Associate General Counsel, Office of General Counsel, at (202) 728-8026.

#### Background and Discussion

The FCPA was enacted to prohibit bribery of foreign officials and to restore public confidence in the integrity of the American business system. The FCPA includes anti-bribery and accounting provisions. The anti-bribery provisions make it unlawful to bribe foreign officials to obtain or retain business in a foreign country. The accounting provisions generally require each company considered to be an “issuer” under the FCPA to make and keep books and records that accurately and fairly reflect the company’s transactions and to devise and maintain an adequate system of internal accounting controls.

March 2011

#### Notice Type

- ▶ Guidance

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Risk
- ▶ Senior Management

#### Key Topics

- ▶ Accounting
- ▶ Anti-Bribery
- ▶ Books and Records
- ▶ Domestic Concerns
- ▶ Foreign Corrupt Practices Act
- ▶ Foreign Members
- ▶ Internal Controls
- ▶ Issuers

#### Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ NASD Rule 3110
- ▶ SEA Rule 17a-3
- ▶ SEA Rule 17a-4

## I. Anti-Bribery Provisions

### A. Applicability

The FCPA's anti-bribery prohibitions apply to "issuers" and "domestic concerns" (and their officers, directors, employees, agents and any stockholders acting on their behalf).<sup>1</sup> An "issuer" is any company that is registered pursuant to Section 12 (Registration Requirements for Securities) of the Securities Exchange Act of 1934 (Exchange Act or SEA)<sup>2</sup> or that is required to file reports with the SEC pursuant to Exchange Act Section 15(d) (Supplementary and Periodic Information).<sup>3</sup> A "domestic concern" is any U.S. citizen, national, resident or business (other than an issuer).<sup>4</sup> The FCPA also contains an anti-bribery provision that applies to foreign nationals or businesses (other than an issuer) (and their officers, directors, employees, agents and any stockholders acting on their behalf) while they are in the territory of the U.S.<sup>5</sup>

### B. Enforcement

The FCPA's anti-bribery provisions for issuers are incorporated into the federal securities laws as Exchange Act Section 30A (Prohibited Foreign Trade Practices by Issuers), and the SEC is responsible for its civil enforcement. The FCPA's anti-bribery provisions for domestic concerns and for foreign nationals and businesses are not incorporated into the Exchange Act. The U.S. Department of Justice is responsible for all criminal enforcement of the FCPA and for civil enforcement of the anti-bribery provisions regarding domestic concerns and foreign nationals and businesses.<sup>6</sup>

### C. General Prohibitions

An (1) issuer, (2) domestic concern or (3) foreign national or business while it is in the territory of the U.S. (and their officers, directors, employees, agents and any stockholders acting on their behalf) generally violates the FCPA's anti-bribery prohibitions when it makes use of the mails or any means or instrumentality of interstate commerce:<sup>7</sup>

- ▶ corruptly;<sup>8</sup>
- ▶ in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give or authorization of the giving of anything of value to any:
  - foreign official;
  - foreign political party or party official;
  - candidate for foreign political office; or
  - person, while knowing that all or a portion of such money or thing of value will be offered, given or promised, directly or indirectly, to any foreign official, political party, party official or candidate;

- ▶ for the purpose of:
  - influencing any act or decision of the foreign official, political party, party official or candidate in his or its official capacity;
  - inducing the foreign official, political party, party official or candidate to do or omit to do an act in violation of his or its lawful duty;
  - securing any improper advantage;<sup>9</sup> or
  - inducing the foreign official, political party, party official or candidate to use his or its influence with a foreign government or instrumentality to affect or influence any act or decision of such government or instrumentality;
- ▶ in order to assist in obtaining or retaining business for or with, or directing business to, any person.<sup>10</sup>

#### **D. Affirmative Defenses and Exception for Facilitating Payments for “Routine Governmental Actions”**

The FCPA provides two affirmative defenses to an anti-bribery violation. One is if a payment, gift, offer or promise of anything of value that was made to a foreign official, political party, party official or candidate was lawful under the written laws and regulations of the foreign official’s, political party’s, party official’s or candidate’s country.<sup>11</sup> The other is if the payment, gift, offer or promise of anything of value that was made was a reasonable and bona fide expenditure (*e.g.*, travel and lodging expenses) incurred by or on behalf of the foreign official, political party, party official or candidate and was directly related to the promotion, demonstration or explanation of products or services or the execution or performance of a contract with a foreign government or agency.<sup>12</sup>

The FCPA also provides an exception to the anti-bribery prohibitions for facilitating or expediting payments to a foreign official, political party or party official to expedite or secure performance of a “routine governmental action” by a foreign official, political party or party official.<sup>13</sup> Examples include:

- ▶ obtaining permits, licenses or other official documents to qualify a person to do business in a foreign country;
- ▶ processing governmental papers (*e.g.*, visas and work orders);
- ▶ providing police protection, mail pickup and delivery or scheduling inspections associated with contract performance or related to transit of goods across country;
- ▶ providing phone service, power and water supply, loading and unloading cargo or protecting perishable products or commodities from deterioration; or
- ▶ actions of a similar nature.<sup>14</sup>

A “routine governmental action” does not include any decision by a foreign official whether, or on what terms, to award new business to or continue business with a particular party or any action taken by a foreign official involved in the decision-making process to encourage a decision to award new business to or continue business with a particular party.<sup>15</sup>

## II. FCPA Accounting Provisions

Exchange Act Section 13 codifies the FCPA's accounting provisions for issuers,<sup>16</sup> and the SEC is responsible for their civil enforcement. Generally, these provisions require every issuer that has securities registered pursuant to Exchange Act Section 12 to file:

- ▶ such information and documents as the SEC shall require to keep reasonably current the information and documents required to be included in or filed pursuant to Exchange Act Section 12; and
- ▶ such annual reports (certified by independent public accountants if required by the SEC's rules and regulations) and quarterly reports as the SEC may prescribe.<sup>17</sup>

The accounting provisions also require every issuer that has securities registered pursuant to Exchange Act Section 12 or that is required to file reports pursuant to Exchange Act Section 15(d) to:

- ▶ make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the issuer's assets; and
- ▶ devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:
  - transactions are executed in accordance with management's authorization;
  - transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or other applicable criteria, and to maintain accountability for assets;
  - access to assets is permitted only in accordance with management's authorization; and
  - the recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences.<sup>18</sup>

## III. Application of the FCPA to FINRA Member Firms

The FCPA's anti-bribery prohibitions apply to every FINRA member firm (and its officers, directors, employees, agents and any stockholders acting on its behalf). Specifically, FINRA member firms that are considered issuers pursuant to the FCPA must comply with both the FCPA's anti-bribery provisions for issuers and the accounting provisions that are incorporated into the Exchange Act.<sup>19</sup> FINRA member firms meeting the definition of "domestic concern" and that are not considered issuers must comply with the FCPA's anti-bribery provisions for domestic concerns. Any FINRA member firms that are foreign broker-dealers registered with the SEC may be considered foreign businesses that must comply with the FCPA anti-bribery provisions for foreign businesses.<sup>20</sup> Member firms that are considered either domestic concerns or foreign businesses should be aware that

the FCPA's anti-bribery prohibitions apply to them under the statutory terms of those provisions even though they are not incorporated into the Exchange Act, as is the case for members that are issuers.

FINRA advises all member firms to review the FCPA's provisions and their business practices to ensure they are complying with their applicable obligations under the FCPA. A member firm's failure to comply with its FCPA obligations will be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade in violation of FINRA Rule 2010.

## Endnotes

- 1 *See generally* 15 U.S.C. §§ 78dd-1 (Prohibited foreign trade practices by issuers) & 78dd-2 (Prohibited foreign trade practices by domestic concerns).
- 2 15 U.S.C. § 78l.
- 3 15 U.S.C. § 78o(d). Certain foreign companies are considered "issuers" within the meaning of the FCPA, and therefore subject to the FCPA provisions applicable to issuers. *See, e.g., In the Matter of Statoil*, Securities Exchange Act Release No. 54599, 2006 SEC LEXIS 2321, at \*3-4 (Oct. 13, 2006) (cease-and-desist order against foreign issuer found to be violating the FCPA's anti-bribery and books and records provisions).
- 4 *See* 15 U.S.C. § 78dd-2(h)(1)(B) (defining "domestic concern" to mean "(A) any individual who is a citizen, national, or resident of the United States; and (B) any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship which has its principal place of business in the United States, or which is organized under the laws of a State of the United States or a territory, possession, or commonwealth of the United States").
- 5 *See generally* 15 U.S.C. § 78dd-3 (Prohibited foreign trade practices by persons other than issuers or domestic concerns); *see also* 15 U.S.C. §§ 78dd-3(f)(1) (the foreign national or business anti-bribery provisions apply to "any natural person other than a national of the United States ... or any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship organized under the law of a foreign nation or a political subdivision thereof") and 78dd-3(a) (requiring compliance while a foreign national or business is "in the territory of the United States").
- 6 *See* U.S. Department of Justice, *Lay-Person's Guide to FCPA* (overview of the FCPA's anti-bribery provisions, including enforcement authority).
- 7 A foreign national or business (and its officers, directors, employees, agents and any stockholders acting on its behalf) may also violate the FCPA while in the territory of the U.S., irrespective of whether it makes use of the mails or any means or instrumentality of interstate commerce. *See* 15 U.S.C. § 78dd-3(a). In addition, the FCPA's provisions for issuers and domestic concerns include provisions addressing

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- alternative jurisdiction for acts taken by U.S. issuers and domestic concerns outside of the U.S. irrespective of whether such parties make use of the mails or other means or instrumentality of interstate commerce. *See* 15 U.S.C. §§ 78dd-1(g) and 78dd-2(i).
- 8 *See Stichting Ter Behartiging Van de Belangen Van Oudaandeelhouders In Het Kapitaal Van Saybolt Int'l B. V. v. Schreiber*, 327 F.3d 173, 183 (2d Cir. 2003) (referring to the FCPA's legislative history to conclude that the term "corruptly," as used in the FCPA, signifies, in addition to the element of "general intent" present in most criminal statutes, a bad or wrongful purpose and an intent to influence a foreign official to misuse his official position). *See also* Department of Justice, *Lay-Person's Guide to FCPA*, *supra* note 6 (explaining that the person making or authorizing the payment must have a corrupt intent, and the payment must be intended to induce the recipient to misuse his official position to direct business wrongfully to the payor or to any other person).
  - 9 *See U.S. v. Kay*, 359 F.3d 738, 743 (5th Cir. 2004) (noting that the FCPA criminalizes payments that are intended to: (1) influence a foreign official to act or make a decision in his official capacity; (2) induce such an official to perform or refrain from performing some act in violation of his duty; (3) or secure some wrongful advantage to the payor).
  - 10 *See* 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a).
  - 11 *See* 15 U.S.C. §§ 78dd-1(c)(1), 78dd-2(c)(1), 78dd-3(c)(1).
  - 12 *See* 15 U.S.C. §§ 78dd-1(c)(2), 78dd-2(c)(2), 78dd-3(c)(2).
  - 13 *See* 15 U.S.C. §§ 78dd-1(b), 78dd-2(b), 78dd-3(b).
  - 14 *See* 15 U.S.C. §§ 78dd-1(f)(3), 78dd-2(h)(4), 78dd-3(f)(4) (defining "routine governmental action").
  - 15 *Id.*
  - 16 *See* 15 U.S.C. §§ 78m(a), (b)(2)(A)-(B), (b)(3)-(7).
  - 17 *See* Exchange Act Section 13(a).
  - 18 *See* Exchange Act Section 13(b)(2)(A)-(B).
  - 19 Member firms are reminded that they must comply with FINRA's books and records obligations and other applicable federal securities laws and regulations, including NASD Rule 3110 (Books and Records) and SEA Rules 17a-3 (Records to Be Made By Certain Exchange Members, Brokers, and Dealers) and 17a-4 (Records to be Preserved by Certain Exchange Members, Brokers, and Dealers), irrespective of their compliance obligations under the FCPA's books and records provision. *See also* Securities Exchange Act Release No. 63784 (January 27, 2011), 76 FR 5850 (February 2, 2011) (Order approving the adoption of certain paragraphs of NASD Rule 3110 as FINRA Rules in the Consolidated FINRA Rulebook; File No. SR-FINRA-2010-052). FINRA will announce the effective date of the consolidated books and records rules in a *Regulatory Notice*.
  - 20 A foreign FINRA member firm also may need to consider whether it would be an issuer for purposes of FCPA compliance.

## Sanction Guidelines

### FINRA Revises Sanction Guidelines

Effective Immediately

#### Executive Summary

FINRA has revised two sections of its *Sanction Guidelines*—the General Principles Applicable to All Sanctions Determinations and the Principal Considerations in Determining Sanctions—to reflect recent developments in FINRA disciplinary cases. Specifically, the revisions:

- ▶ clarify the causation standard for when FINRA adjudicators order restitution;
- ▶ recognize that FINRA adjudicators may order that a respondent's ill-gotten gains be paid to those injured by the respondent's misconduct, where appropriate;
- ▶ reflect that not every factor listed in the principal considerations has the potential to be aggravating and mitigating; and
- ▶ direct adjudicators to consider sanctions imposed by another regulator for the same misconduct when determining a sanction.

The revised *Sanction Guidelines* are effective immediately and available on FINRA's website at [www.finra.org/Industry/Enforcement/SanctionGuidelines](http://www.finra.org/Industry/Enforcement/SanctionGuidelines).

You may direct questions concerning this *Notice* to:

- ▶ Gary Dernelle, Office of General Counsel, at (202) 728-8255, and
- ▶ Jennifer Brooks, Office of General Counsel, at (202) 728-8083.

March 2011

#### Notice Type

- ▶ Guidance

#### Key Topics

- ▶ FINRA Sanction Guidelines

#### Suggested Routing

- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management

## Background & Discussion

The *FINRA Sanction Guidelines* address a wide variety of potential violations of FINRA's rules and provide fact-specific guidance for crafting sanctions. FINRA adjudicators rely on the guidelines to determine appropriate remedial sanctions, and FINRA's Departments of Market Regulation and Enforcement and the defense bar rely on them when negotiating settlements in disciplinary matters. In order to promote consistency in their application, the *Sanction Guidelines* outline certain General Principles Applicable to All Sanctions Determinations and the Principal Considerations in Determining Sanctions. These general principles and principal considerations enumerate certain factors for consideration in all cases. The National Adjudicatory Council approved the revisions to the general principles and principal considerations discussed below.

## Revisions to General Principles Applicable to All Sanction Determinations

To address federal court, SEC and NAC precedent in recent FINRA disciplinary cases, FINRA amended the general principles concerning the use of restitution and disgorgement to remediate misconduct.

General Principle 5 of the *Sanction Guidelines* recognizes that FINRA adjudicators may order restitution where necessary to remediate misconduct. Restitution is a traditional remedy used to restore the status quo ante where a respondent's victim would otherwise unjustly suffer loss. General Principle 5 instructs adjudicators to calculate orders of restitution based on the actual amount of the loss sustained because of a respondent's misconduct. Such orders may thus exceed the amount of a respondent's ill-gotten gain.

As a result of a recent FINRA disciplinary matter, the SEC, upon remand from the United States Court of Appeals for the District of Columbia Circuit, requested that FINRA articulate the causation standard required under General Principle 5 when its adjudicators order restitution.<sup>1</sup> Revised General Principle 5 makes clear that "proximate causation" is the causation standard required for restitution orders in FINRA disciplinary proceedings.

General Principle 6 of the *Sanction Guidelines* instructs FINRA adjudicators to consider the disgorgement of a respondent's ill-gotten gain where the respondent has obtained a financial benefit from his wrongdoing. Disgorgement seeks to remediate misconduct by depriving a respondent of his or her unlawful profits irrespective of the actual losses suffered by the respondent's victims.

General Principle 6 traditionally recognized the ability of adjudicators to require the disgorgement of ill-gotten gains by fining away the amount of some or all of the financial benefit derived, directly or indirectly, through a respondent's misconduct. Although compensation of injured victims is not a primary purpose of disgorgement, the NAC and the SEC recognized that it nevertheless is a valid secondary purpose.<sup>2</sup> The amendments to General Principle 6 therefore reflect that FINRA adjudicators may order, where appropriate, the use of disgorged funds to remedy harms suffered by customers, rather than adding that amount of money as a fine payable to FINRA.

## Revisions to Principal Considerations in Determining Sanctions

FINRA amended the introductory section of the Principal Considerations in Determining Sanctions to reflect that not every enumerated factor has the potential to be aggravating and mitigating.<sup>3</sup> The relevancy and characterization of a factor depends on the facts and circumstances of a case and the type of violation.<sup>4</sup>

Principal Consideration 14 directs adjudicators to consider whether individual respondents were disciplined by their firms for the misconduct before regulatory detection. FINRA amended Principal Consideration 14 to direct adjudicators also to consider sanctions imposed by another regulator, such as a state regulator, for the same misconduct and determine whether that sanction was sufficiently remedial.

## Endnotes

- 1 See *Michael Frederick Siegel*, Exchange Act Rel. No. 62324, 2010 SEC LEXIS 2015, at \*3 (June 18, 2010).
- 2 See *Dep't of Enforcement v. Mission Secs. Corp.*, Complaint No. 200600378501, 2010 FINRA Discip. LEXIS 1, at \*47-48 (FINRA NAC Feb. 4, 2010), *aff'd*, Exchange Act Rel. No. 63453, 2010 SEC LEXIS 4053, at \*54-55 (Dec. 7, 2010).
- 3 See, e.g., *Siegel v. SEC*, 592 F.3d 147, 157 (D.C. Cir. 2010) (“[N]ot every consideration listed in the [G]uidelines has the potential to be mitigating...” (internal quotation omitted)).
- 4 See, e.g., *Rooms v. SEC*, 444 F.3d 1208, 1214-15 (10th Cir. 2006) (explaining that while the existence of a disciplinary history is an aggravating factor when determining the appropriate sanction, its absence is not mitigating).

## Third-Party Service Providers

### FINRA Requests Comment on Proposed New FINRA Rule 3190 to Clarify the Scope of a Firm's Obligations and Supervisory Responsibilities for Functions or Activities Outsourced to a Third-Party Service Provider

Comment Period Expires: May 13, 2011

#### Executive Summary

FINRA is requesting comment on a proposed new rule to clarify a member firm's obligations and supervisory responsibilities regarding outsourcing arrangements. Specifically, proposed FINRA Rule 3190 (Use of Third-Party Service Providers) makes clear that:

- ▶ when a member firm outsources a function or activity related to its business as a regulated broker-dealer to a third-party service provider, it does not relieve the firm of its obligation to comply with applicable securities laws and regulations and FINRA and Municipal Securities Rulemaking Board (MSRB) rules; and
- ▶ the firm cannot delegate its responsibilities for, or control over, any outsourced functions or activities.

The proposal also requires a member firm to have supervisory procedures, including due diligence measures, to ensure that its arrangements with third-party service providers are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA and MSRB rules. Further, the proposed rule imposes additional restrictions and obligations that apply solely to a clearing and carrying member firm and its third-party service provider arrangements.

The text of the proposed rule is set forth in Attachment A.

Questions concerning this *Notice* should be directed to Patricia Albrecht, Associate General Counsel, Office of General Counsel, at (202) 728-8026.

March 2011

#### Notice Type

- ▶ Request for Comment

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Risk
- ▶ Senior Management

#### Key Topics

- ▶ Clearing and Carrying Activities
- ▶ Due Diligence
- ▶ Outsourcing
- ▶ Supervisory Responsibilities
- ▶ Third-Party Service Providers

#### Referenced Rules & Notices

- ▶ FINRA Rule 4311
- ▶ FINRA Rule 8210
- ▶ Incorporated NYSE Rule 382
- ▶ NTM 99-45
- ▶ NTM 03-73
- ▶ NTM 05-48
- ▶ NASD Rule 3010
- ▶ NASD Rule 3230
- ▶ SEA Rule 17a-4

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by May 13, 2011.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:

Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments on its site one week after the end of the comment period.<sup>1</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.<sup>2</sup>

## Background and Discussion

Recognizing member firms' increasing use of outside entities—both regulated and unregulated—to perform certain activities and functions related to their business operations and the compliance risks that can accompany the use of such outside entities, FINRA has provided substantial guidance regarding member firms' responsibilities when outsourcing activities to third-party service providers.<sup>3</sup> However, FINRA has continued to receive inquiries regarding outsourcing and the scope of the guidance, including, among other things, requests to identify specific functions that a clearing or carrying member firm may outsource to a third-party service provider and the appropriateness of any member firm outsourcing activities to a third-party service provider that is not registered as a broker-dealer.

In view of these questions and continued concerns regarding the risks related to outsourcing, FINRA is proposing new Rule 3190 to clarify a member firm's obligations and supervisory responsibilities regarding its outsourcing arrangements, including imposing additional restrictions and obligations that would apply solely to a clearing and carrying member firm and its third-party service provider arrangements.

**I. Member Firms' Responsibilities for Activities Outsourced to Third-Party Service Providers and Activities Requiring Registration and Qualification**

Proposed FINRA Rule 3190(a)(1) clarifies that a member firm's use of a third-party service provider (including any sub-vendor) to perform functions or activities related to the member firm's business as a regulated broker-dealer does not relieve the firm of its obligation to comply with applicable securities laws and regulations and with applicable FINRA and MSRB rules. Proposed Supplementary Material .01 (Scope of Third-Party Service Provider) clarifies that the term "third-party service provider (including any sub-vendor)" shall include any person controlling, controlled by or under common control with a member firm, unless otherwise determined by FINRA.<sup>4</sup> The proposed provision also prohibits a member firm from delegating its responsibilities for, or control over, any functions or activities performed by a third-party service provider. Proposed FINRA Rule 3190(a)(1) is consistent with FINRA's current guidance that a member firm's use of a third-party service provider for such activities does not relieve the firm of its ultimate responsibility to achieve compliance with all applicable securities laws and regulations and FINRA and MSRB rules, and that the ultimate responsibility for supervision of outsourced activities lies with the firm.<sup>5</sup>

Additionally, FINRA Rule 3190(a)(3) clarifies that nothing in the proposed rule's provisions shall be construed to permit any person to engage in activities that require registration and qualification under FINRA rules without obtaining the necessary registrations and qualifications.

**II. Member Firms' Supervision and Due Diligence Analysis of Third-Party Service Providers**

Proposed FINRA Rule 3190(a)(2) requires each member firm, pursuant to its obligations under FINRA rules, to establish and maintain a supervisory system and written procedures for any functions or activities performed by a third-party service provider that are reasonably designed to achieve compliance with applicable securities laws and regulations and applicable FINRA and MSRB rules.

Additionally, proposed FINRA Rule 3190(b) requires that a member firm include in these supervisory procedures an ongoing due diligence analysis of each current or prospective third-party service provider to determine, at a minimum, whether: (1) the third-party service provider is capable of performing the activities being outsourced; and (2) with respect to any activities being outsourced, the member firm can achieve compliance with

applicable securities laws and regulations and applicable FINRA and MSRB rules. These provisions are consistent with existing guidance noting that, if a member firm outsources activities, its supervisory system and written supervisory procedures required by NASD Rule 3010 (Supervision) must include supervisory procedures for its outsourcing practices to ensure such compliance and that those procedures should include, without limitation, conducting a due diligence analysis of all of its current or prospective third-party service providers to determine whether they are capable of performing the outsourced activities.<sup>6</sup>

### **III. Clearing or Carrying Member Firms' Restrictions and Obligations Regarding Outsourced Activities**

In addition to the requirements discussed above in proposed FINRA Rule 3190(a) and (b), the proposed rule imposes certain heightened requirements on a clearing or carrying member firm's outsourcing arrangements. Given the additional responsibilities of a clearing or carrying member firm to protect customer funds and securities, these heightened requirements are designed to address concerns regarding the great potential harm that could result from its third-party service providers' non-compliance (either accidental or intentional) with the federal securities laws and FINRA and MSRB rules. The involvement by improperly authorized or inadequately supervised persons may cause systemic risk and undermine investor confidence in the securities industry. As detailed further below, FINRA believes these concerns can be mitigated by requiring a clearing or carrying member firm to limit certain enumerated activities to persons directly subject to the control and supervision of the member firm, have additional supervisory procedures to oversee third-party service providers and notify FINRA of its outsourcing arrangements.

#### *A. Restrictions Applicable to Certain Clearing or Carrying Member Firms' Activities*

Specifically, proposed FINRA Rule 3190(c) requires a clearing or carrying member firm to vest an associated person of the firm with the authority and responsibility for the following activities:

- (1) the movement of customer or proprietary cash or securities;
- (2) the preparation of net capital or reserve formula computations; and
- (3) the adoption or execution of compliance or risk management systems.

However, pursuant to proposed FINRA Rule 3190(a)(3), the clearing or carrying member firm would have to vest authority and responsibility for any functions related to these activities that would require registration and qualification under FINRA rules with an associated person of the firm who has the necessary registrations and qualifications.

With respect to the movement of customer or proprietary cash or securities, FINRA has found this area to be subject to additional risk for errors, fraud or other violative conduct. The involvement of improperly authorized persons could, in certain circumstances, cause

systemic risk and undermine investor confidence in the securities industry. FINRA believes these concerns would be mitigated by expressly limiting authority and responsibility for this activity to an associated person directly subject to the clearing or carrying member firm's supervision and control. Accordingly, the proposed rule would require that persons responsible for the handling, transfer or disposition of cash or securities as they enter and flow from the firm be associated persons of the member firm.

Proposed Supplementary Material .02 (Posting to Books and Records) clarifies that the restriction regarding the movement of funds or securities would not preclude a designated third-party service provider from posting items to a clearing or carrying member firm's books or records, provided the firm reviews each posting prior to the close of the business day following the posting. In this regard, FINRA generally would permit the prompt supervisory review required by proposed Supplementary Material .02 to be performed by substantiation of financial balances and spot-check reviews of individual entries, rather than an actual sign off on each individual entry. FINRA believes that the proposed approach balances the need to protect the integrity of the clearing or carrying member firm's books and records with the efficiencies of having the work performed by a third-party service provider.<sup>7</sup>

FINRA also has concerns about the use of third-party service providers in the preparation of net capital or reserve formula computations. The execution of the SEC's financial responsibility rules<sup>8</sup> enables firm management and regulators to ascertain the financial state of a firm and helps to ensure protection of customer assets. Accordingly, FINRA believes that a properly registered associated person of the clearing or carrying member firm should be directly responsible for this function. For purposes of proposed FINRA Rule 3190(c), FINRA would consider the performance of calculations in aid of the preparation of these computations to be ministerial functions that could be performed by a third-party service provider; however, the review and understanding of the computations and the ability to explain the mechanics and rationale of the computations to FINRA staff would reside with the firm's properly registered associated person vested with authority and responsibility for this function.

With respect to the adoption or execution of compliance or risk management systems, the proposed rule does not prohibit a firm from using a third-party service provider or its systems as part of the member firm's compliance and risk management solutions, provided the member firm adopts such services and systems in a manner consistent with the regulatory requirements as they apply in light of the firm's size, businesses and business model, retains control over their implementation and use within the firm, and independently determines that they achieve compliance with the applicable securities laws and FINRA and MSRB rules. Further, basic calculations, logging or maintaining lists that are preparatory to creating related books and records and review of output from these systems could be performed by a third-party service provider; however, any analysis or conclusions based upon the data would have to be performed by an associated person of the firm.

*B. Oversight of Third-Party Service Providers by Clearing or Carrying Member Firms*

Proposed FINRA Rule 3190(d) requires that a clearing or carrying member firm include additional supervisory procedures that would: (1) enable the firm to take prompt corrective action where necessary to achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules; and (2) require the firm to approve any transfer of duties by a third-party service provider to a sub-vendor. As with the restrictions in proposed FINRA Rule 3190(c), FINRA believes that these supplementary procedures will help prevent potential harm that could result from possible non-compliance by a clearing or carrying member firm's third-party service provider with the federal securities laws and FINRA and MSRB rules.

*C. Notifications by Clearing or Carrying Member Firms*

Proposed FINRA Rule 3190(e) requires a clearing or carrying member firm to notify FINRA within 30 calendar days after entering into any outsourcing agreement with a third-party service provider to perform any functions or activities related to the firm's business as a regulated broker-dealer that is permitted to be outsourced pursuant to the proposed rule.<sup>9</sup> Pursuant to proposed FINRA Rule 3190, a clearing or carrying member firm's notification must include:

- (1) the function(s) being performed by the third-party service provider;
- (2) the identity and location of the third-party service provider;
- (3) the identity of the third-party service provider's regulator (if any); and
- (4) a description of any affiliation between the firm and the third-party service provider.

The clearing or carrying member firm also would be required to maintain a copy of each notification and any underlying written agreement(s) with the third-party service provider, in accordance with SEA Rule 17a-4(b).<sup>10</sup>

FINRA notes that proposed FINRA Rule 3190 and its heightened requirements for clearing or carrying member firms does not necessarily require a clearing or carrying member firm to alter any contracts with its third-party service providers. Nonetheless, a clearing or carrying member firm remains responsible for maintaining control over any outsourced activity and effecting any necessary changes to achieve compliance with the proposed rule's requirements. Consequently, upon approval of proposed FINRA Rule 3190, FINRA would expect each clearing or carrying member firm to consider whether amendments or addendums to any such contracts would be necessary to comply with the rule's requirements.<sup>11</sup>

#### IV. Exceptions to Proposed FINRA Rule 3190's Requirements

Proposed FINRA Rule 3190 excepts from its requirements ministerial activities performed on behalf of a member firm, unless otherwise prohibited by applicable securities laws and regulations or applicable FINRA and MSRB rules, and clarifies that its provisions would not restrict activities performed pursuant to a carrying agreement approved under FINRA Rule 4311 (Carrying Agreements).<sup>12</sup>

#### Endnotes

- 1 FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members (NTM) 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 2 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily temporarily suspend these types of rule changes within 60 days of filing. If the SEC takes such action, the SEC shall institute proceedings to determine whether the proposed rule should be approved or disapproved. *See Exchange Act Section 19* and rules thereunder.
- 3 *See NTM 05-48* (April 2005) (Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers); *see also* FINRA Office of General Counsel Interpretive Memorandum, dated August 15, 2006 (A Member's Responsibilities Regarding the Outsourcing of Certain Activities). Among other things, the guidance notes that parties conducting activities or functions requiring registration under FINRA rules generally will be considered associated persons of the member firm, absent the service provider separately being registered as a broker-dealer and such arrangement being contemplated by FINRA rules (such as in the case of carrying arrangements), MSRB rules or applicable federal securities laws or regulations. *See NTM 05-48* (April 2005).
- 4 Although proposed FINRA Rule 3190 uses "third-party service provider (including any sub-vendor)" throughout the rule text, for readability, this *Notice* generally uses the term "third-party service provider" without the reference "including any sub-vendor."
- 5 *See NTM 05-48* (April 2005); *see also NTM 99-45* (June 1999).
- 6 *See NTM 05-48* (April 2005).
- 7 Member firms are reminded that SEA Rule 17f-2 (Fingerprinting of Securities Industry Personnel) mandates that persons with regular access to the keeping, handling or processing of securities, money or original books and records relating to securities or money must be fingerprinted and have those fingerprints submitted to the U.S. Attorney General or its designee for identification and appropriate processing.

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- 8 *See, e.g.*, SEA Rule 15c3-1 (Net Capital Requirements for Brokers or Dealers) and SEA Rule 15c3-3 (Customer Protection – Reserves and Custody of Securities).
- 9 The proposed rule also requires that, within three months of the effective date of the rule, a clearing or carrying member firm must notify FINRA of all outsourcing arrangements related to the firm’s business as a regulated broker-dealer in effect as of that effective date.
- 10 *See generally* SEA Rule 17a-4(b) (requiring a member firm to preserve certain enumerated records for a period of not less than three years, the first two years in an easily accessible place). Additionally, as with all member firm books and records, such notifications and underlying written agreements would be subject to inspection by or production under FINRA Rule 8210 (Provision of Information and Testimony and Inspection and Copying of Books).
- 11 Additionally, although not required by proposed FINRA Rule 3190, a clearing or carrying member firm may want to consider submitting prospective outsourcing arrangements for FINRA for review prior to entering into such outsourcing arrangements.
- 12 FINRA Rule 4311 replaces NASD Rule 3230 (Clearing Agreements) and NYSE Rule 382 (Carrying Agreements) and will govern the requirements applicable to member firms when entering into agreements for the carrying of customer accounts. *See* Securities Exchange Act Release No. 63999 (March 1, 2011), 76 FR 12380 (March 7, 2011) (Order Approving File No. SR-FINRA-2010-061). FINRA will announce the new rule’s effective date in a future *Regulatory Notice*.

## Attachment A

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### 3000. SUPERVISION AND RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS

#### 3100. SUPERVISORY RESPONSIBILITIES

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##### 3190. Use of Third-Party Service Providers

###### (a) General Requirements

(1) The use by a FINRA member of a third-party service provider (including any sub-vendor) to perform functions or activities related to the member's business as a regulated broker-dealer does not relieve the member of its obligation to comply with applicable securities laws and regulations and with applicable FINRA and MSRB rules. No member shall delegate its responsibilities for, or control over, any functions or activities performed by a third-party service provider (including any sub-vendor).

(2) Pursuant to its obligations under FINRA rules, a member shall establish and maintain a supervisory system and written procedures for any functions or activities performed by a third-party service provider (including any sub-vendor) that are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules.

(3) Nothing in this Rule shall be construed to permit any person to engage in functions or activities that require registration and qualification under FINRA rules without obtaining the necessary registrations and qualifications.

###### (b) Due Diligence Analysis of Third-Party Service Providers

The procedures required by paragraph (a)(2) shall include an ongoing due diligence analysis of each current and prospective third-party service provider (including any sub-vendor) to determine, at a minimum, whether:

(1) the third-party service provider (including any sub-vendor) is capable of performing the activities being outsourced; and

(2) the member can achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules with respect to any functions or activities being outsourced.

**(c) Restrictions Applicable to Clearing or Carrying Members**

A clearing or carrying member shall vest an associated person of the member with the authority and responsibility for:

- (1) the movement of customer or proprietary cash or securities;
- (2) the preparation of net capital or reserve formula computations; and
- (3) the adoption or execution of compliance or risk management systems.

**(d) Oversight of Third-Party Service Providers by Clearing or Carrying Members**

In the case of a clearing or carrying member, the procedures required by paragraph (a) (2) shall include procedures that:

- (1) enable the member to take prompt corrective action where necessary to achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules; and
- (2) require the member to approve any transfer of duties by a third-party service provider to a sub-vendor.

**(e) Notifications by Clearing or Carrying Members**

(1) A clearing or carrying member entering into any outsourcing agreement with a third-party service provider (including any sub-vendor) to perform any function or activities related to the member's business as a regulated broker-dealer that is permitted to be outsourced by this Rule shall notify FINRA within 30 calendar days after the date the member enters into such outsourcing agreement.

(2) Within three months of [insert effective date of the proposed rule change], a clearing or carrying member shall notify FINRA of all outsourcing arrangements in effect as of [insert effective date of the proposed rule change].

(3) All notifications provided pursuant to this paragraph (e) shall include:

(A) the function or functions being performed by the third-party service provider (including any sub-vendor, if known);

(B) the identity and location of the third-party service provider (including any sub-vendor, if known);

(C) the identity of the third-party service provider's regulator (including any sub-vendor's regulator, if the identities of sub-vendors are known), if any; and

(D) a description of any affiliation between the member and the third-party service provider (including any sub-vendor).

(4) A copy of each notification provided pursuant to this paragraph (e) and the underlying written agreement(s) with the third-party service provider (including any sub-vendor) shall be maintained by the member, in accordance with SEA Rule 17a-4(b).

**(f) Exceptions**

(1) The provisions of this Rule shall not apply to ministerial activities performed on behalf of a member, unless otherwise prohibited by applicable securities laws and regulations or applicable FINRA or MSRB rules.

(2) The provisions of this Rule shall not restrict activities performed pursuant to a carrying agreement approved under FINRA Rule 4311.

**• • • Supplementary Material: -----**

**.01 Scope of Third-Party Service Provider.** The term "third-party service provider (including any sub-vendor)" shall include any person controlling, controlled by, or under common control with a member, unless otherwise determined by FINRA.

**.02 Posting to Books and Records.** The provisions of paragraph (c)(1) of this Rule do not preclude a designated third-party service provider (including any sub-vendor) from posting items to a member's books or records, provided that the member reviews each posting prior to the close of the business day following the posting.