

Notices

Regulatory Notices

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Credit Default Swaps

Interim Pilot Program on Margin Requirements for Credit Default Swaps

Effective Date: July 16, 2011

Executive Summary

FINRA Rule 4240 established an interim pilot program (the Interim Pilot Program) with respect to margin requirements for certain transactions in credit default swaps (CDS). This *Notice* addresses FINRA approval of margin methodologies used by clearing agencies or derivatives clearing organizations for purposes of Rule 4240.

FINRA has extended the Interim Pilot Program to January 17, 2012.

The text of FINRA Rule 4240 is available in the online [FINRA Manual](#).

Questions concerning this *Notice* should be directed to:

- ▶ Rudolph R. Verra, Managing Director, Risk Oversight and Operational Regulation, at (646) 315-8811;
- ▶ Glen Garofalo, Director, Credit Regulation, at (646) 315-8464;
- ▶ Steve Yannolo, Project Manager, Credit Regulation, at (646) 315-8621; or
- ▶ Adam H. Arkel, Assistant General Counsel, Office of General Counsel, at (202) 728-6961.

Background & Discussion

In May 2009, the SEC approved FINRA Rule 4240, which established the Interim Pilot Program with respect to margin requirements for CDS and addresses related risk monitoring procedures and guidelines.¹ FINRA has extended the implementation of Rule 4240 so that the rule will expire on January 17, 2012.²

July 2011

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Margin Department
- ▶ Operations
- ▶ Regulatory Reporting
- ▶ Risk Management
- ▶ Senior Management

Key Topics

- ▶ Approved Margin Methodology
- ▶ Credit Default Swaps
- ▶ Margin Requirements

Referenced Rules & Notices

- ▶ FINRA Rule 4240

FINRA Rule 4240(a), as revised effective July 16, 2011,³ provides in part that the Interim Pilot Program applies with respect to margin requirements for any transactions in CDS executed by a member (regardless of the type of account in which the transaction is booked).⁴ The rule's scope includes certain transactions that are cleared through a clearing agency or derivatives clearing organization that provides central counterparty clearing services using a margin methodology approved by FINRA as announced in a *Regulatory Notice* (referred to in the rule as an "approved margin methodology"). Paragraph (c)(1) of the rule addresses margin requirements that apply to CDS cleared through a clearing agency or derivatives clearing organization using such an approved margin methodology.⁵

Currently, FINRA has approved the use of the margin methodology of the central counterparty clearing facilities of the Chicago Mercantile Exchange (CME) for purposes of FINRA Rule 4240. Further, FINRA has approved the use of the margin methodology of ICE Trust (ICE) for purposes of the rule on an interim basis, pending further review by FINRA. FINRA will consider margin methodology proposals from other clearing agencies or derivatives clearing organizations that provide central counterparty clearing services,⁶ and will announce the approval of the use of any such margin methodologies in future *Regulatory Notice(s)* as appropriate. FINRA expects to consider in the future whether to supersede the Interim Pilot Program with a permanent comprehensive rule governing margin requirements for all swap and security-based swap transactions effected by a member.

Endnotes

1. See Securities Exchange Act Release No. 59955 (May 22, 2009), 74 FR 25586 (May 28, 2009) (Notice of Approval of Proposed Rule Change; File No. SR-FINRA-2009-012) ("Approval Order"). See also *Regulatory Notice 09-30* (June 2009) (Credit Default Swaps).
2. See SR-FINRA-2011-034.
3. See note 2.
4. The rule provides that the term CDS includes any product that is commonly known to the trade as a credit default swap and is a swap or security-based swap as defined pursuant to Section 1a(47) of the Commodity Exchange Act and Section 3(a)(68) of the Securities Exchange Act, respectively, or the joint rules and guidance of the CFTC and the SEC and their staff.
5. Paragraph (c)(2) of the rule addresses margin requirements that apply to CDS that are cleared on central counterparty clearing facilities that do not use an approved margin methodology or that settle over-the-counter.
6. See the Approval Order at 74 FR 25589.

Reporting Requirements

FINRA Provides Additional Guidance Regarding Reporting Requirements Under Rule 4530

Executive Summary

In February 2011, FINRA issued [Regulatory Notice 11-06](#) informing member firms of SEC approval of new FINRA Rule 4530 governing reporting requirements. FINRA Rule 4530 became effective on July 1, 2011. In March 2011, FINRA issued [Regulatory Notice 11-10](#) reminding member firms of their obligation to electronically report specified events and quarterly customer complaint information and providing further guidance on automated reporting under the new rule. In this Notice, FINRA is providing questions and answers regarding the application of the new rule to assist member firms in their implementation.

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

Background & Discussion

FINRA Rule 4530 requires member firms to:

1. report to FINRA certain specified events and quarterly statistical and summary information regarding written customer complaints; and
2. file with FINRA copies of certain criminal actions, civil complaints and arbitration claims.

FINRA uses the information for regulatory purposes to identify and initiate investigations of member firms, offices and associated persons that may pose a risk. The requirements of FINRA Rule 4530 are based on similar requirements in NASD Rule 3070 and Incorporated NYSE Rule 351. FINRA Rule 4530 strengthens, clarifies and extends these existing requirements. Among other things, the new rule requires member firms to report certain internal conclusions of violations and financial-related insurance civil litigations and arbitrations and clarifies the obligations of member firms with respect to written customer complaints and former associated persons.

July 2011

Notice Type

- ▶ Guidance

Suggested Routing

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

Key Topics

- ▶ Customer Complaints
- ▶ Financial-Related Insurance Matters
- ▶ Former Associated Persons
- ▶ Internal Conclusions
- ▶ Reporting Requirements

Referenced Rules & Notices

- ▶ FINRA Rule 4530
- ▶ Incorporated NYSE Rule 351
- ▶ NASD Rule 3070
- ▶ Regulatory Notice 08-70
- ▶ Regulatory Notice 10-39
- ▶ Regulatory Notice 11-06
- ▶ Regulatory Notice 11-10

Questions and Answers

To help member firms implement FINRA Rule 4530, FINRA is publishing the following questions and answers relating to its application. This guidance speaks solely to member firms' reporting obligations pursuant to FINRA Rule 4530, and not to other applicable reporting requirements, including under Forms BD (Uniform Application for Broker-Dealer Registration), U4 (Uniform Application for Securities Industry Registration or Transfer) and U5 (Uniform Termination Notice for Securities Industry Registration). FINRA, however, notes that a member firm is not required to report an event otherwise required to be reported under FINRA Rules 4530(a) or (b) if the member firm discloses the event on the Form U5, consistent with the requirements of that form.¹

Internal Conclusions of Violations

Q1. Are member firms required to report internal conclusions of all rule violations under FINRA Rule 4530(b)?

- A1. No. FINRA Rule 4530(b) states that each member firm shall promptly report to FINRA, but in any event not later than 30 calendar days, after the firm has concluded or reasonably should have concluded that an associated person of the firm or the firm itself has violated any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization (SRO).

Further, for purposes of FINRA Rule 4530(b), only those violations that meet the reporting threshold under FINRA Rule 4530.01 are required to be reported. With respect to violations by a firm, FINRA Rule 4530.01 requires the firm to report only conduct that has widespread or potential widespread impact to the firm, its customers or the markets, or conduct that arises from a material failure of the firm's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts. Regarding violations by an associated person, FINRA Rule 4530.01 requires a firm to report only conduct that has widespread or potential widespread impact to the firm, its customers or the markets; conduct that has a significant monetary result on a member firm(s), customer(s) or market(s); or multiple instances of any violative conduct. For instance, if a firm concludes that a violation has occurred and that it has widespread or potential widespread impact to the markets, the firm is required to report that violation.

- Q2. FINRA Rule 4530.01 requires a member firm to report, among other things, violations that have widespread or potential widespread impact to the markets. Is the term "markets" referring only to the securities markets?**

- A2. No. The term “markets” should be read in the context of the enumerated violations under FINRA Rule 4530(b), which requires a member firm to report violations of any securities-, insurance-, commodities-, financial- or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or SRO. Accordingly, the term “markets” in FINRA Rule 4530.01 refers to any organized market relating to any securities, insurance, commodities, financial or investment product.
- Q3. FINRA Rule 4530.01 requires a member firm to report, among other things, if it concludes that an associated person has engaged in multiple instances of any violative conduct. What does the phrase “multiple instances of any violative conduct” mean?**
- A3. It generally means multiple instances of the same violative conduct by an associated person that are not administrative or operational in nature. Among other things, such violations may evidence a pattern of behavior on the part of the associated person. Member firms also are required to report multiple instances of different violative conduct by an associated person where such violations are significant in nature or result in significant customer harm. Additionally, member firms should note that certain disciplinary actions taken by firms against associated persons, such as when an associated person is fined by a member firm in excess of \$2,500, must be reported under FINRA Rule 4530(a)(2), rather than as an internal conclusion of violation under FINRA Rule 4530(b).
- Q4. FINRA Rule 4530(b) requires a member firm to report to FINRA within 30 calendar days after the firm has concluded, or reasonably should have concluded, that an enumerated violation has occurred. For purposes of the “reasonably should have concluded” requirement, how will FINRA determine whether a firm’s conclusions are correct?**
- A4. FINRA will apply a “reasonable person” standard to determine whether a violation should have been reported. If a reasonable person, considering the available facts, would have concluded that a violation occurred, then the matter would be reportable. If a reasonable person, considering the available facts, would not have concluded that a violation occurred or would have been unable to conclude whether a violation occurred, then the matter would not be reportable. Further, FINRA Rule 4530(b) is not intended to hinder a member firm’s ability to carry out effective supervision of its associated persons and address issues with appropriate remediation. Consequently, FINRA recognizes that a member firm may take remedial steps with respect to its associated persons where the firm nevertheless reasonably does not determine a violation has occurred. It is also the case that a member firm’s

determination not to take remedial action in respect of certain conduct is not by itself a basis for asserting a reasonable conclusion that a violation has not occurred, and, where a reasonable person would have determined that a violation has occurred, the firm would potentially be in violation of both FINRA Rule 4530(b) and the firm's duty to reasonably supervise its associated persons.

Q5. With respect to the reporting of internal conclusions of violations under FINRA Rule 4530(b), what should member firms' procedures address?

- A5. Member firms should review existing procedures and develop any necessary enhancements and review processes to address the requirements of FINRA Rule 4530(b). Some firms may find that their existing procedures are adequate. At a minimum, firms' procedures should:
- (1) clearly identify the person(s) responsible for determining whether a violation has occurred and whether it is of a nature that requires reporting under FINRA Rule 4530(b), as well as the level of seniority of such person(s) (*e.g.*, General Counsel, Chief Compliance Officer or a senior staff committee);
 - (2) provide a protocol for escalating violations, and potential violations, to such person(s); and
 - (3) provide a protocol regarding the reporting of internal conclusions of violations subject to FINRA Rule 4530(b) to FINRA within 30 calendar days after the firm has concluded, or reasonably should have concluded, that an enumerated violation has occurred.

Q6. Are member firms eligible to receive credit for extraordinary cooperation for matters that are required to be reported pursuant to FINRA Rule 4530(b)?

- A6. Depending on the facts and circumstances and on a case-by-case basis, FINRA will consider credit for self-reporting of violations that are required to be reported pursuant to the new rule. However, the type of self-reporting contemplated as extraordinary and deserving of credit would have to go significantly beyond the requirements of the rule.² For credit for self-reporting, it would, at a minimum, have to include a detailed account of the discovered conduct and an offer to explain in complete detail all aspects of the conduct and provide relevant documents and witnesses.³ Furthermore, additional factors to be considered in evaluating credit for cooperation include, but are not limited to: (1) extraordinary steps to correct deficient procedures and systems; (2) extraordinary remediation to customers; and (3) other substantial assistance to FINRA investigations.⁴

Customer Complaints

- Q7. Are text messages and tweets received from member firm customers complaining about the member firm or its associated persons subject to reporting under FINRA Rule 4530?**
- A7. Yes. FINRA Rule 4530(a)(1)(B) requires that a member firm report within 30 calendar days after the firm knows or should have known⁵ that it or an associated person is the subject of any written customer complaint alleging theft or misappropriation of funds or securities or forgery. FINRA Rule 4530(d) requires that a member firm also report quarterly statistical and summary information regarding written customer complaints that have been received. Received text messages and tweets are in a written format. Thus, a member firm must report text messages and tweets received from firm customers expressing complaints about the firm or its associated persons consistent with the requirements of FINRA Rules 4530(a)(1)(B) and 4530(d). For example, if a firm customer sends a tweet to the firm alleging that an associated person sold him unsuitable securities, the firm must report it pursuant to FINRA Rule 4530(d).
- Q8. A member firm's registered representative is also an insurance agent working for an affiliated insurance company. The member firm recently found out through its affiliate that the registered representative is the subject of a written complaint from an insurance customer alleging that the representative did not adequately disclose the surrender charge in connection with the sale of a fixed annuity. After further inquiry, the member firm also found out that the representative had recommended some securities to the insurance customer when he sold the fixed annuity, but the individual decided not to purchase any securities. Does the member firm have to report the complaint under FINRA Rule 4530?**
- A8. No. For purposes of FINRA Rules 4530(a)(1)(B) and 4530(d), a person with whom a member firm has sought to engage in securities activities is considered a customer of the firm. However, the firm is only required to report any securities-related written grievance by such person under FINRA Rule 4530(d) and any written complaints alleging theft or misappropriation of funds or securities, or forgery involving the firm or an associated person under FINRA Rules 4530(a)(1)(B) and 4530(d).⁶ Here, for purposes of FINRA Rules 4530(a)(1)(B) and 4530(d), the complainant is considered a customer and there is a written grievance involving the representative, but it is not securities-related as the matter involves a fixed annuity insurance product, and it does not allege theft or misappropriation of funds or securities or forgery.

- Q9.** In Question 8 above, what if the person complaining about the fixed annuity was someone to whom the member firm had sold securities? Would the complaint then be subject to reporting under FINRA Rule 4530?
- A9. Yes. If a firm has engaged in securities activities with a person, the firm is required to report any written grievance by such person involving the firm or an associated person under FINRA Rule 4530(d).⁷
- Q10.** A registered representative who is also a mortgage broker recently obtained a home loan for a person to whom the representative had sold securities through a member firm. The mortgage is financed and serviced by an unaffiliated bank. The member firm recently received an email from the person complaining about the bank that services his mortgage account. Is the member firm required to report the complaint under FINRA Rule 4530?
- A10. No. As noted in Answer 9 above, if a firm has engaged in securities activities with a person, the firm is required to report any written grievance by such person involving the firm or an associated person. Here, because the complaint does not involve the firm or registered representative, the firm does not have to report it under FINRA Rule 4530. However, the firm may want to inform the bank of the complaint so that the bank can address it.
- Q11.** In Question 10 above, what if the person was complaining that the registered representative made some misleading statements during the loan process? Would it then be subject to reporting under FINRA Rule 4530?
- A11. Yes. It would be subject to reporting under FINRA Rule 4530(d) since it would be a written grievance from a customer of the firm involving an associated person.

Financial-Related Insurance Civil Litigation

- Q12.** During a routine annual branch inspection, a member firm's registered representative informed the firm that he was sued a few days ago by one of his insurance customers in connection with the sale of a term life insurance policy and that the insurance company settled the matter immediately on his behalf for \$20,000. The lawsuit alleged common law fraud. Is the member firm required to report the settlement under FINRA Rule 4530?
- A12. Yes. FINRA Rule 4530(a)(1)(G) requires a member firm to report, among other things, if an associated person is a defendant in any financial-related insurance civil litigation that has been settled for an amount exceeding \$15,000. The term "financial-related" means related to the provision of financial services.⁸ The term excludes certain insurance products, such as traditional auto and health insurance. However, its scope is not limited to insurance products that are securities. A term life insurance policy would be considered "financial-related."

Former Associated Persons⁹

Q13. A member firm finds out that a registered representative has been indicted, while in the employ of the member firm, on a misdemeanor charge involving the sale of a stock at his previous employer, Firm A. For purposes of FINRA Rule 4530(a)(1)(E), does the member firm have an obligation to report the indictment or does Firm A have to report it?

A13. In general, the member firm with which the person is associated at the time an event occurs and becomes subject to reporting is responsible for reporting it to FINRA. Consequently, in this example, the employing member firm is responsible for reporting the indictment when it becomes aware of the matter.¹⁰

Moreover, under FINRA Rule 4530.07, member firms should report an event that is required to be reported under the rule relating to a former associated person if the event involves conduct that occurred while the individual was associated with the firm and the firm becomes aware of the event. Here, because the indictment involves the sale of stock by the registered representative at Firm A (his prior employer), Firm A also should report the indictment if Firm A becomes aware of the action.

Q14. A member firm receives a customer complaint regarding a former registered representative alleging that the representative churned the customer's account. Is the member firm required to report the complaint under FINRA Rule 4530?

A14. Yes. Under FINRA Rule 4530.07, where a member firm receives or becomes aware of a customer complaint under FINRA Rules 4530(a)(1)(B) or 4530(d) involving a former associated person and the underlying conduct occurred while the individual was associated with the firm, the firm is expected to report the customer complaint.

Q15. A member firm is in the process of internally investigating a registered representative's involvement in violative conduct when the representative terminates her association with the firm. Following her departure, the member firm reaches an internal conclusion that the former representative violated several securities laws that had a significant monetary result for customers. Is the member firm required to report the conclusion under FINRA Rule 4530 since it reached the conclusion after the representative left the member firm?

A15. Yes. Notwithstanding that a firm reaches a conclusion of violation regarding an individual after he or she leaves the firm, the firm remains obligated to report that internal conclusion of violation if it meets the reporting thresholds in FINRA Rule 4530(b).

Endnotes

1. See FINRA Rule 4530(e). The exception does not extend to the reporting of quarterly statistical and summary complaint information under FINRA Rule 4530(d).
2. See [Regulatory Notice 08-70](#) (November 2008) (FINRA Provides Guidance Regarding Credit for Extraordinary Cooperation).
3. See note 2 above.
4. See note 2 above.
5. The purpose of the “should have known” standard is to ensure that member firms do not intentionally avoid becoming aware of a reportable event.
6. See FINRA Rule 4530.08.
7. See note 6 above.
8. See FINRA Rule 4530.09.
9. Firms should note that Form U5 requires them to disclose specified events regarding former associated persons, including certain criminal matters, customer complaints and internal reviews. See also [Regulatory Notice 10-39](#) (September 2010) (Obligation to Provide Timely, Complete and Accurate Information on Form U5). Moreover, as noted above, a firm is not required to report an event otherwise required to be reported under FINRA Rules 4530(a) or (b) if the firm discloses the event on Form U5, consistent with the requirements of that form. See FINRA Rule 4530(e). Consequently, if a member firm discloses the matters described in Questions 13, 14 and 15 on Form U5, that member firm is relieved of the obligation to report the matters under FINRA Rules 4530(a) or (b).
10. The employing member firm would also have to promptly file with FINRA copies of the indictment pursuant to FINRA Rule 4530(f).

Operations Professionals

SEC Approves Operations Professional Registration Category and Consolidated FINRA Continuing Education Rule

Effective Date: October 17, 2011

Executive Summary

The SEC approved FINRA's proposal to establish a registration category and qualification examination requirement for certain operations personnel.¹ The proposal also adopts continuing education requirements for such operations personnel and adopts NASD Rule 1120 (Continuing Education Requirements) as FINRA Rule 1250 (Continuing Education Requirements) in the consolidated FINRA rulebook² with certain changes.³

The amended rule text is available at www.finra.org/notices/11-33. The rules become effective on October 17, 2011.

Questions regarding this *Notice* should be directed to:

- ▶ Joe McDonald, Senior Director, Testing and Continuing Education Department, at (240) 386-5065; or
- ▶ Erika L. Lazar, Counsel, Office of General Counsel, at (202) 728-8013.

Background & Discussion

FINRA Rule 1230(b)(6) establishes a new representative registration category and qualification examination for certain operations personnel (Operations Professionals).⁴ FINRA is expanding its registration provisions to require registration of certain individuals (covered persons) who are engaged in, responsible for or supervising certain member firm operations functions (covered functions) to enhance the regulatory structure surrounding these areas. Covered persons play an integral role in the business of the member firm, and their activities often have a meaningful connection to customer funds, accounts and transactions.

July 2011

Notice Type

- ▶ Consolidated FINRA Rulebook
- ▶ Rule Approval

Suggested Routing

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

Key Topics

- ▶ Continuing Education
- ▶ Examination
- ▶ Operations Professionals
- ▶ Qualification
- ▶ Registration

Referenced Rules & Notices

- ▶ FINRA Rule 1230
- ▶ FINRA Rule 1250
- ▶ FINRA Rule 4311
- ▶ FINRA Rule 8310
- ▶ FINRA Rule 8311
- ▶ FINRA Rule 8320
- ▶ NASD Rule 1021
- ▶ NASD Rule 1031
- ▶ NASD Rule 1050
- ▶ NASD Rule 1070
- ▶ NASD Rule 1120
- ▶ NASD Rule 3010
- ▶ NTM 05-48
- ▶ NYSE Rule 345A
- ▶ Regulatory Notice 09-70
- ▶ Regulatory Notice 11-14
- ▶ Regulatory Notice 11-26

Although FINRA's registration regime historically has focused on "front office" personnel who have contact with customers or are otherwise directly involved in effecting securities transactions, persons who perform "back office" functions, such as recordkeeping, trade confirmation, transaction settlement, internal auditing, and securities lending operations are also important to a member firm's ability to comply with its responsibilities under the federal securities laws and regulations, and the rules of FINRA. Moreover, FINRA believes registration, qualification and continuing education requirements for covered persons are needed to help ensure that investor protection mechanisms are in place in all areas of a member firm's business that could harm the firm, a customer, the integrity of the marketplace or the public. FINRA Rule 1230(b)(6) is intended, among other things, to increase covered persons' awareness and knowledge that they are operating in a regulated environment designed to protect investors' interests and the integrity of the operations of a broker-dealer.

In addition, NASD Rule 1120 (Continuing Education Requirements) has been adopted as FINRA Rule 1250 (Continuing Education Requirements) in the Consolidated FINRA Rulebook with certain changes, including a requirement that Operations Professionals be subject to both Regulatory Element and Firm Element Programs.

I. Operations Professional Registration

A. Covered Persons

FINRA Rule 1230(b)(6)(A) sets forth three categories of persons who are subject to the registration, qualification and continuing education requirements as an Operations Professional. Persons who perform a covered function, but whose responsibilities are below these specified levels, are not required to register as Operations Professionals. Member firms must determine, based on a person's activities and responsibilities, whether such person would be considered a covered person and subject to the requirements for Operations Professionals. The three categories are:

1. senior management with direct responsibility over the covered functions;
2. any person designated by senior management specified in FINRA Rule 1230(b)(6)(A)(i) as a supervisor, manager or other person responsible for approving or authorizing work, including work of other persons, in direct furtherance of each of the covered functions, as applicable, provided that there is sufficient designation of such persons by senior management to address each of the applicable covered functions; and
3. persons with the authority or discretion materially to commit a member firm's capital in direct furtherance of the covered functions or to commit a member firm to any material contract or agreement (written or oral) in direct furtherance of the covered functions.

Under FINRA Rule 1230.06 (Scope of Operations Professional Requirement), the determination as to what constitutes “materially” or “material” in the third category of covered persons is based on a member firm’s pre-established spending guidelines and risk management policies. Generally, persons who do not have the authority or discretion to commit a member firm’s capital, or to commit a member firm to a contract or agreement, above such pre-established spending guidelines and risk management policies are not subject to registration as an Operations Professional under this provision.

Consistent with FINRA guidance, persons subject to the new Operations Professional registration category are considered associated persons of a member firm insofar as they are performing regulated broker-dealer functions on behalf of the member firm, irrespective of their employing entity, and are subject to all FINRA rules applicable to associated persons and/or registered persons.⁵ Associated person status is not determined at the discretion of a member firm based on the location from which particular personnel are performing functions on behalf of the firm; associated person status attaches to persons who are involved in the securities and investment banking business of a member firm and the covered functions represent a part of that business of a firm. Moreover, FINRA notes that the scope of covered persons and covered functions set forth in FINRA Rule 1230(b)(6) is not exhaustive in terms of who may be considered an associated person of the member firm based on the nature of the operational activities being conducted on behalf of a member firm. Rather, FINRA has made a determination that the persons subject to the new requirements are engaged in members’ operational activities of such significance to require registration, qualification and continuing education requirements.

FINRA notes that a person’s job title and/or employer may not be clearly indicative of his or her obligation to register as an Operations Professional. Firms must view each person’s responsibilities in connection with the covered functions described below in Section B independently to determine who must register. The Operations Professional registration category is function-based and, therefore, not conditioned upon an individual’s relationship to a particular department within a firm.

B. Covered Functions

Any person who meets the definition of a covered person in one of the three categories in FINRA Rule 1230(b)(6)(A) and engages in one or more of the following covered functions in FINRA Rule 1230(b)(6)(B) on behalf of a member firm (regardless of their employing entity, *e.g.*, a member firm, an affiliate or a third-party service provider) must register as an Operations Professional:

1. client on-boarding (customer account data and document maintenance);
2. collection, maintenance, re-investment (*i.e.*, sweeps) and disbursement of funds;
3. receipt and delivery of securities and funds, account transfers

4. bank, custody, depository and firm account management and reconciliation;
5. settlement, fail control, buy ins, segregation, possession and control;
6. trade confirmation and account statements;
7. margin;
8. stock loan/securities lending;⁶
9. prime brokerage (services to other broker-dealers and financial institutions);
10. approval of pricing models used for valuations;
11. financial control, including general ledger and treasury;
12. contributing to the process of preparing and filing financial regulatory reports;
13. defining and approving business requirements for sales and trading systems and any other systems related to the covered functions, and validation that these systems meet such business requirements;
14. defining and approving business security requirements and policies for information technology, including, but not limited to, systems and data, in connection with the covered functions;
15. defining and approving information entitlement policies in connection with the covered functions; and
16. posting entries to a member's books and records in connection with the covered functions to ensure integrity and compliance with the federal securities laws and regulations and FINRA rules.

FINRA Rule 1230.06 provides that any person whose activities are limited to performing a function ancillary to a covered function, or whose function is to serve a role that can be viewed as supportive of or advisory to the performance of a covered function (*e.g.*, internal audit, legal or compliance personnel who review but do not have primary responsibility for any covered function), or who engages solely in clerical or ministerial activities in a covered function is not required to register as an Operations Professional.

As noted above, as registered persons, Operations Professionals will be subject to all FINRA rules applicable to associated persons and/or registered persons. Accordingly, pursuant to NASD Rule 3010(a)(5), each Operations Professional must be assigned to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities. Additionally, FINRA expects that each member firm will have at least one registered Operations Professional, who often may be the member firm's Financial and Operations Principal. In this regard, neither principal registration, nor representative registration in another category, obviates the requirement for a covered person to register as an Operations Professional.

With respect to small firms, the impact of FINRA Rule 1230(b)(6) is expected to be minimal as the majority of the covered functions are typically performed by a carrying and clearing firm pursuant to a clearing arrangement. In such cases, it may be possible for a small firm to rely on limited persons, perhaps the Financial and Operations Principal, to liaise with the carrying and clearing firm regarding those covered functions. Also, a covered person would not be considered an associated person of both the introducing and clearing firms based solely on functions performed pursuant to a carrying agreement approved under FINRA Rule 4311 (Carrying Agreements).⁷ FINRA would not expect dual registration as an Operations Professional in such cases.

C. Operations Professional Qualification Examination (Series 99)⁸

FINRA Rule 1230(b)(6)(C), subject to the exceptions in subparagraph (D) (described in Section D below), requires any person who must register as an Operations Professional to pass a new Operations Professional qualification examination before the registration may become effective. The examination will provide reasonable assurance that the individuals understand their professional responsibilities, including key regulatory and control themes, as well as the importance of identifying and escalating red flags that may harm a member, a customer, the integrity of the marketplace or the public.⁹ The Operations Professional qualification examination will test applicants on general securities industry knowledge and its associated regulations and rules.

In general, given the diversity of functions performed by covered persons, the Operations Professional qualification examination is a principles-based qualification examination with a regulatory focus to test for a broad understanding of a broker-dealer's business at a basic level, a basic understanding of the operations functions that support a broker-dealer's business and the regulations designed to achieve investor protection and market integrity that drive the operations processes and procedures conducted at a broker-dealer. As further detailed in Section E, the continuing education components associated with the Operations Professional registration category will provide competency training specific to the covered functions, as applicable.

The key content themes of the Operations Professional qualification examination are:

- ▶ **Professional Conduct and Ethical Considerations:** This section of the examination assesses a candidate's core knowledge addressed on other FINRA examinations that are appropriate for an Operations Professional. The questions assess knowledge of what are considered serious violations of securities industry rules. This section includes ethics-based questions that address issues such as data integrity, escalation of regulatory red flags and separation of duties.

- ▶ **Essential Product and Market Knowledge for an Operations Professional:** This section of the examination assesses a candidate's basic product and market knowledge, including definitions and characteristics of major product categories (*i.e.*, equities, debt, packaged securities and options). An Operations Professional is not expected to know the same level of detail about the products and markets as a product specialist or a representative selling products to customers.
- ▶ **Knowledge Associated with Operations Activities:** This section of the examination assesses a candidate's broad-based knowledge regarding the covered functions in Section B that support a broker-dealer's business and the underlying rules that drive the processes associated with these activities (*i.e.*, customer account set-up and transfers, recordkeeping requirements, rules associated with the protection of customer assets and transaction processing, uniform practices associated with making good delivery of securities, making payments for securities and meeting settlement requirements, and credit and margin rules). This section of the examination also includes professional conduct and ethics-based questions in the context of operations activities.

Consistent with FINRA practice, the content outline for the Operations Professional examination was developed by FINRA staff in conjunction with industry subject matter expert volunteers. FINRA staff conducted several focus panels in mid-2010 with operations professionals working in one or more of the covered functions and from a wide range of FINRA member firms. FINRA then convened an Operations Professional examination committee consisting of more than 40 individuals with significant experience in broker-dealer operations. Such individuals are associated with broker-dealers that fairly represent the FINRA membership in terms of size, geographical location and business model. Both FINRA staff and committee members placed an emphasis on creating a content outline and questions that would be appropriate across all the covered functions and test the appropriate level of knowledge for a person subject to the requirements as an Operations Professional.

D. Exceptions to Operations Professional Examination Requirement

FINRA Rule 1230(b)(6)(D)(i) sets forth an exception to the Operations Professional qualification examination requirement for persons who currently hold certain registrations (each an "eligible registration") or have held one during the two years immediately prior to registering as an Operations Professional.¹⁰ The exception also applies to persons who do not hold an eligible registration, but prefer an alternative to taking the Operations Professional examination. Such persons may register in an eligible registration category (subject to passing the corresponding qualification examination or obtaining a waiver) and use the registration to qualify for Operations Professional registration. FINRA believes the eligible registrations (and corresponding examinations based on their broad content coverage) serve as a valid proxy for the Operations Professional examination requirement.

Persons who hold the following representative-level registration categories, or who have held such registration categories within the two years immediately prior to registering as an Operations Professional, are qualified to register as an Operations Professional without passing the Operations Professional qualification examination:

- ▶ Investment Company Products/Variable Contracts Representative (Series 6)
- ▶ General Securities Representative (Series 7)
- ▶ United Kingdom Securities Representative (Series 17) or Canada Securities Representative (Series 37 or 38)

Also, persons who hold (or have held) certain principal-level registration categories are qualified to register as an Operations Professional without passing the Operations Professional examination. Most principal-level qualification examinations have a prerequisite examination requirement that is satisfied with one of the representative qualification examinations listed above; however, FINRA Rule 1230(b)(6)(D) also includes principal-level qualification examinations that do not have a prerequisite, or have a prerequisite that can be met with a qualification examination not on the above list (*e.g.*, Series 62), because it is likely such principals are familiar with the content to be covered in the Operations Professional qualification examination as a result of the requirements of their positions. Specifically, persons who hold the following principal-level registration categories, or who have held such registration categories within the two years immediately prior to registering as an Operations Professional, are qualified to register as an Operations Professional without passing the Operations Professional qualification examination:

- ▶ Registered Options Principal (Series 4)
- ▶ General Securities Sales Supervisor (Series 9/10)
- ▶ Compliance Officer (Series 14)
- ▶ Supervisory Analyst (Series 16)
- ▶ General Securities Principal (Series 24)
- ▶ Investment Company Products/Variable Products Principal (Series 26)
- ▶ Financial and Operations Principal (Series 27)
- ▶ Introducing Broker-Dealer Financial and Operations Principal (Series 28)
- ▶ Municipal Fund Securities Limited Principal (Series 51)
- ▶ Municipal Securities Principal (Series 53)

A person who wishes to obtain Operations Professional registration under the exception in FINRA Rule 1230(b)(6)(D)(i) will not be automatically waived-in, but must opt-in by requesting Operations Professional registration¹¹ via Form U4 (the Uniform Application for Securities Industry Registration or Transfer) in the Central Registration Depository system (CRD[®] system).¹² If there are no other deficiencies (*e.g.*, fingerprints), the Operations Professional registration will be approved automatically at the time of the request. FINRA will not assess a separate registration fee for persons relying on the exception to register as Operations Professionals.

The exception does not apply to persons whose eligible registrations are revoked pursuant to FINRA Rules 8310 (Sanctions for Violation of the Rules) or 8320 (Payment of Fines, Other Monetary Sanctions, or Costs; Summary Action for Failure to Pay), suspended or otherwise deemed inactive.¹³

FINRA anticipates that many persons subject to the new Operations Professional registration category may qualify for the exception from the qualification examination based on existing registrations, since they are generally acting in a supervisory position, and FINRA would not assess a separate registration fee for persons relying on the exception to register as Operations Professionals. As noted in Section A, entry-level operations personnel typically are not going to be subject to the requirements for Operations Professionals.

FINRA Rule 1230(b)(6)(D)(ii) provides that the staff may accept as an alternative to the Operations Professional qualification examination requirement any domestic or foreign qualification if it determines that acceptance of the alternative qualification is consistent with the purposes of the rule, the protection of investors and the public interest.

E. Continuing Education Requirements for Operations Professionals

Individuals registered as Operations Professionals are subject to FINRA's Regulatory Element and Firm Element Continuing Education requirements as set forth in FINRA Rule 1250 (Continuing Education Requirements).¹⁴ The continuing education elements for this registration category provide more specific learning materials appropriate for an Operations Professional, given the diversity of covered functions.

The Regulatory Element Program for Operations Professionals, the S901, focuses on instruction to:

- ▶ maintain and improve understanding of the regulatory and ethical aspects associated with the covered functions;
- ▶ identify suspicious activities and/or red flags that could harm a customer, a firm, issuers of securities or the integrity of the marketplace;
- ▶ maintain and improve knowledge and understanding of the covered functions; and
- ▶ assist the Operations Professional in keeping up with changes in the industry and regulations that impact their work.

Operations Professionals are required to complete scenario-based modules based on the key content themes of the Operations Professional qualification examination described in Section C. The breadth and depth of coverage of the modules is determined through the use of existing industry standards currently used to develop continuing education content and include input and advice from operations professionals active in the securities industry. Individuals are expected to complete the Regulatory Element Continuing Education requirement two years after passing the qualification examination and then every three years thereafter.

Individuals who avail themselves of the exception to the Operations Professional qualification examination requirement in FINRA Rule 1230(b)(6)(D)(i) with an eligible registration are subject to the Regulatory Element Program appropriate for the other registration category. For example, a person who registers as an Operations Professional by holding a General Securities Representative registration (Series 7) under the exception is subject to the S101 Regulatory Element Program in lieu of the S901 Regulatory Element Program, and a person who registers by holding a General Securities Principal registration (Series 24) is subject to the S201 Regulatory Element Program in lieu of the S901 Regulatory Element Program.

Operations Professionals also are subject to a Firm Element Continuing Education requirement. To implement this change, as further discussed in Section II, Operations Professionals have been added to the definition of “covered registered persons” in FINRA Rule 1250(b)(1), which requires member firms to deliver Firm Element training to such persons.¹⁵

F. Implementation

As noted in Section B, any person who meets the definition of a covered person in one of the three categories in FINRA Rule 1230(b)(6)(A) and engages in one or more of the covered functions in FINRA Rule 1230(b)(6)(B) on behalf of a member firm must register as an Operations Professional. Such persons must register by requesting Operations Professional registration via Form U4 in the CRD system and doing one of the following, as applicable:

- ▶ passing the Operations Professional qualification examination;
- ▶ opting in to such registration based on their holding, or having held within the past two years at the time of such request, an eligible registration;¹⁶ or
- ▶ registering with FINRA in an eligible registration category and opting in to Operations Professional registration based on such eligible registration.¹⁷

Member firms must identify those persons required to register as an Operations Professional as of October 17, 2011 (Day-One Professionals) (*i.e.*, persons who meet the depth of personnel criteria and are engaged in one or more covered functions as of the effective date of the rule). Day-One Professionals are required to register on or before December 16, 2011 (*i.e.*, a 60-day identification period beginning on the effective date of the rule, during which Day-One Professionals must request registration as an Operations Professional via Form U4 in the CRD system).¹⁸ During this 60-day period, a Day-One Professional may function in the capacity of an Operations Professional. Day-One Professionals who are identified during the 60-day period and must pass the Operations Professional examination (or an eligible qualification examination) to qualify (*i.e.*, persons who do not hold, and have not within the past two years held, an eligible registration) must pass such examination on or before October 17, 2012 (*i.e.*, a period of 12 months beginning on the effective date of the rule, during which time such persons may function as an Operations Professional).¹⁹

To be eligible to function as an Operations Professional for the 12-month transition period, Day-One Professionals subject to an examination requirement must request Operations Professional registration via Form U4 in the CRD system on or before December 16, 2011.²⁰ If a Day-One Professional does not pass an acceptable examination on or before October 17, 2012, the individual must cease functioning as an Operations Professional on October 17, 2012.

The 60-day identification period and the 12-month transition period to pass a qualification examination only apply to Day-One Professionals. Any person who is not subject to the registration requirements for Operations Professionals as of October 17, 2011 (*i.e.*, a person who does not meet the depth of personnel criteria and/or is not engaged in one or more covered functions as of the effective date, or persons hired after October 17, 2011, who will be subject to the registration requirements) (non-Day-One Professionals) must register as an Operations Professional and, if applicable, pass the Operations Professional qualification examination (or an eligible qualification examination), *prior to engaging in* any activities that require such registration. However, any such person who must pass the Operations Professional qualification examination (or an eligible qualification examination listed in Section D) to qualify for Operations Professional registration shall be allowed a period of 120 days beginning on the date such person requests Operations Professional registration via Form U4 in the CRD system to pass such qualifying examination, during which time such person may function as an Operations Professional.

Member firms are responsible for tracking and monitoring their associated persons to ensure that they are registered, and conducting their activities, in compliance with the time frames described above.

II. FINRA Continuing Education Rule

NASD Rule 1120 (Continuing Education Requirements) has been adopted as new FINRA Rule 1250 (Continuing Education Requirements). In addition to the change noted in Section E, which expands the scope of “covered registered persons” subject to the Firm Element Continuing Education requirement to include persons registered as Operations Professionals, FINRA made additional minor changes to NASD Rule 1120 to update cross-references and reflect the conventions of the Consolidated FINRA Rulebook.

NASD Rule 1120 and Incorporated NYSE Rule 345A were adopted in 1995 in response to the recommendation of a task force, which subsequently became the Securities Industry Regulatory Council on Continuing Education (Council),²¹ to create uniform continuing education requirements in the securities industry. As advised by the Council, the continuing education requirements include a Regulatory Element Program and a Firm Element Program. NASD and Incorporated NYSE rules are nearly identical in keeping with the goals of the Council to create uniform continuing education requirements.²²

The Regulatory Element Program consists of periodic computer-based training on regulatory, compliance, ethical, supervisory subjects and sales practice standards. A registered person is required to participate and complete a designated Regulatory Element Program within a 120-day period that commences with the second anniversary of such person’s initial securities registration, and recurs every three years thereafter for as long as such person remains in the securities business. Failure to complete the Regulatory Element Program will result in a registered person’s registration becoming inactive and such person cannot conduct a securities business on behalf of the member firm until the requirement is met.²³

The Firm Element Continuing Education requirement currently applies to any person registered with a member firm who has direct contact with customers in the conduct of the firm’s securities sales, trading and investment banking activities, any person registered as a research analyst pursuant to NASD Rule 1050, and to the immediate supervisors of such persons (collectively, covered registered persons). However, as noted above, the scope of “covered registered persons” subject to the Firm Element requirement has been expanded to include persons registered as Operations Professionals. The Firm Element Program consists of annual, firm-developed and administered training programs designed to keep covered registered persons current regarding securities products, services and strategies offered by the member firm. The Firm Element Program requires member firms to annually evaluate and prioritize their training needs by conducting a Needs Analysis and developing a written plan.

In planning, developing and implementing the Firm Element Program, each member firm must take into consideration its size, organizational structure, scope of business, types of products and services it offers, as well as regulatory developments and the performance of its covered registered persons in the Regulatory Element Program. FINRA may require a member firm to provide specific training to its covered registered persons as FINRA deems appropriate. Each member firm must administer its Firm Element Program in accordance with its annual Needs Analysis and Written Plan, and must maintain records documenting the content of the program and completion of the program by covered registered persons.

III. Effective Date

FINRA Rule 1230(b)(6) and FINRA Rule 1250 take effect on October 17, 2011. FINRA reminds member firms that Day-One Professionals must request Operations Professional registration via Form U4 in the CRD system on or before December 16, 2011 (*i.e.*, 60 days following the effective date of FINRA Rule 1230(b)(6)). Those Day-One Professionals must then pass any necessary examination on or before October 17, 2012.

Endnotes

1. See Securities Exchange Act Release No. 64687 (June 16, 2011), 76 FR 36586 (June 22, 2011) (Order Approving Proposed Rule Change; File No. SR-FINRA-2011-013).
2. The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the Transitional Rulebook). While the NASD Rules generally apply to all FINRA member firms, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see [Information Notice 03/12/08](#) (Rulebook Consolidation Process).
3. FINRA Rule 1250 replaces NASD Rule 1120. Accordingly, effective October 17, 2011, NASD Rule 1120 will be deleted from the Transitional Rulebook.
4. The remainder of FINRA Rule 1230 (Registration Categories) is being addressed as part of a separate rule proposal. See [Regulatory Notice 09-70](#) (December 2009) (FINRA Requests Comment on Proposed Consolidated FINRA Rules Governing Registration and Qualification Requirements).
5. See [Notice to Members 05-48](#) (July 2005) (Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers). The Notice reminds members that "in the absence of specific NASD [or FINRA] rules, MSRB rules, or federal securities laws or regulations that contemplate an arrangement between members and other registered broker-dealers with respect to such activities or functions (*e.g.*, clearing agreements executed pursuant to NASD Rule 3230), any third-party service providers conducting activities or functions that require registration and qualification under NASD [or FINRA] rules will generally be considered associated persons of the member and be required to have all necessary registrations and qualifications."

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6. Persons engaged in or supervising stock loan/ securities lending activities that meet the depth of personnel as a covered person in Section A are required to register as Operations Professionals. FINRA also is proposing separate registration categories for a "Securities Lending Representative" and a "Securities Lending Supervisor." In [Regulatory Notice 09-70](#), FINRA generally proposes to adopt the NYSE registration requirements for Securities Lending Representatives and Securities Lending Supervisors, requiring an associated person who has discretion to commit a member to any contract or agreement (written or oral) involving securities lending or borrowing activities with any other person, and the direct supervisor of the associated person to register as a Securities Lending Representative and Securities Lending Supervisor, respectively. These individuals would be required to register as such for tracking and oversight purposes, regardless of whether they are registered in other categories. However, solely for purposes of registering as a Securities Lending Representative or Securities Lending Supervisor, an individual will not be subject to a qualification examination at this time.
7. The SEC recently approved new FINRA Rule 4311, which becomes effective on August 1, 2011. See [Regulatory Notice 11-26](#).
8. FINRA will issue a separate *Regulatory Notice* addressing the initial rollout of the Series 99 examination, the examination content outline and the fee associated with the examination.
9. Any individual whose activities go beyond those for the Operations Professional registration category is required to separately qualify and register in the appropriate category or categories of registration attendant to such activities.
10. FINRA notes that NASD Rule 1070 (Qualification Examinations and Waiver of Requirements), as well as other applicable provisions regarding registration and qualification set forth in FINRA's rulebook, such as NASD Rule 1031(c) regarding requirements for examination on lapse of registration, applies to the Operations Professional qualification examination and registration category.
11. A person who qualifies for the exception based on having held an eligible registration within the two years immediately prior to registering as an Operations Professional must first re-activate such eligible registration prior to requesting Operations Professional registration.
12. CRD is a registered trademark of the Financial Industry Regulatory Authority, Inc.
13. If a person's registration in an eligible registration category was revoked within the prior two years, but such person re-qualifies and re-registers in such eligible registration category, he or she may rely on this eligible registration to qualify for the exception to the Operations Professional qualification examination requirement. Further, a suspended registration may not be relied upon as an eligible registration during the suspension period. Similarly, a registration deemed inactive for any reason (*e.g.*, failure to complete continuing education requirements) may not be relied upon as an eligible registration during the inactive period. See also FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar).
14. See Section II for further discussion of the adoption of NASD Rule 1120 (Continuing Education Requirements) as FINRA Rule 1250.

15. NASD Rule 1120(b) (Continuing Education Requirements) is currently limited to registered persons who have *direct contact with customers* in the conduct of the firm's securities sales, trading and investment banking activities, any person registered as a research analyst pursuant to NASD Rule 1050, and to the immediate supervisors of such persons. The amendments are reflected in the new FINRA rule governing continuing education, FINRA Rule 1250. See Section II of this *Notice*.
16. Persons with an active eligible registration who request Operations Professional registration will be automatically granted Operations Professional registration once they submit the request via Form U4 in the CRD system, regardless of when they apply for Operations Professional registration (provided there are no existing deficiencies). See also *supra* note 11.
17. If a person elects to register with FINRA as an Operations Professional by newly qualifying in an eligible registration (*i.e.*, the person wants to obtain an eligible registration and use the registration to qualify for Operations Professional registration), the individual must first submit a Form U4 to request the eligible registration. After the candidate has passed the qualification examination associated with the eligible registration, the individual may then submit an amended Form U4 to request the Operations Professional registration.
18. FINRA believes that the current Web-based Electronic File Transfer (Web EFT) functionality will enable subscribers to efficiently request Operations Professional registration via batch file uploads to the CRD system.
19. When a person requests Operations Professional registration via Form U4 in the CRD system during the 60-day identification period, an examination window for the Operations Professional qualification examination will open in the CRD system that expires on October 17, 2012. After the 60-day identification period, the examination window for the Operations Professional qualification examination will open for the standard 120 days.
20. Member firms should note that the standard examination window in the CRD system applicable to a particular registration category will apply notwithstanding the 12-month examination window established for purposes of the transition period. The 12-month examination window is only for the Operations Professional qualification examination. Thus, a person who elects to qualify, for example, by passing the Series 7 examination would have only 120 days to take and pass the Series 7 examination once the window for such examination is opened in the CRD system. Member firms should plan accordingly so that associated persons are prepared to take the requisite examination within the prescribed window for that registration category, and that the associated persons pass any requisite examination before the expiration of the 12-month transition period for Day-One Professionals.
21. The Council is comprised of up to 20 industry members from broker-dealers, representing a broad cross section of industry firms, and representatives from self-regulatory organizations (SROs) as well as liaisons from the SEC and the North American Securities Administrators Association (NASAA).

22. FINRA expects to address Incorporated NYSE Rule 345A (and its Interpretation) and propose additional changes to FINRA Rule 1250 as part of the consolidated registration and qualification rules. See [Regulatory Notice 09-70](#) (December 2009).
23. A registered person will be required to retake the Regulatory Element Program in the event such person is: (1) subject to a statutory disqualification as defined by Section 3(a)(39) of the Exchange Act; (2) subject to a suspension or imposition of a fine of \$5,000 or more by an SRO or other securities governmental agency; or (3) ordered to do so as a sanction in a disciplinary action by an SRO or other securities governmental agency.

Soliciting Business Internationally

FINRA Reaffirms Its Guidance in *NTM 00-02* on Soliciting Business in Foreign Jurisdictions and Withdraws *NTM 98-91*

Executive Summary

FINRA is reaffirming its guidance in [Notice to Members \(NTM\) 00-02](#) concerning the solicitation of business in foreign jurisdictions.¹ FINRA also is withdrawing *NTM 98-91* in light of changes to the legal and regulatory framework in the United Kingdom (U.K.).

Questions concerning this *Notice* should be directed to:

- ▶ Paul Andrews, Vice President, International, at (202) 728-8235; or
- ▶ Matthew E. Vitek, Counsel, OGC, at (202) 728-8156.

Background & Discussion

In [NTM 00-02](#), FINRA alerted member firms and persons associated with firms to their obligations concerning the solicitation of business in foreign jurisdictions. FINRA reminded firms and associated persons of their obligations to comply with applicable U.S. and foreign laws when soliciting business in any foreign jurisdiction. FINRA is publishing this *Notice* to reaffirm its guidance and remind firms that solicit business or are proposing to solicit business in foreign jurisdictions to carefully review and comply with all applicable U.S. and foreign laws.

At the same time, FINRA is withdrawing *NTM 98-91*. In that *Notice*, FINRA alerted firms and associated persons to their obligations concerning cold calling and advertising to persons in the U.K. by briefly summarizing the legal and regulatory framework in the U.K. regarding these activities. In view of changes to the legal and regulatory framework in the U.K., FINRA believes that it is prudent to formally withdraw *NTM 98-91*.

July 2011

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Advertising
- ▶ Compliance
- ▶ Internal Audit
- ▶ Legal
- ▶ Senior Management
- ▶ Training

Key Topics

- ▶ Advertising
- ▶ Foreign Regulators
- ▶ Soliciting Business
- ▶ Telemarketing

Referenced Rules & Notices

- ▶ NTM 98-91
- ▶ NTM 00-02

Endnotes

1. This *Notice* does not address whether soliciting business in a foreign jurisdiction in violation of that jurisdiction's laws may constitute a violation of FINRA rules.

Options

FINRA Modifies the Process for Firms to Designate Their Allocation Methodology for Options Exercise Assignment Notices

Effective Date: August 8, 2011

Executive Summary

FINRA is updating the procedures for firms to designate their method of allocating options exercise assignment notices. Effective August 8, 2011, firms initiating an options business, or changing their allocation method, must use the application form in Attachment A of this *Notice*. FINRA also has updated the designated random selection allocation procedures, which are described in Attachment B.

Questions concerning this *Notice* should be directed to:

- ▶ Max Tourtelot, Director, Options Regulation, at (917) 281-3133; or
- ▶ Casey McMahon, Associate Director, Options Regulation, at (917) 281-3042.

Background & Discussion

FINRA Rule 2360(b)(23)(C) requires member firms conducting transactions in exchange-listed options to establish fixed procedures for allocating options exercise notices to short options positions in its customer accounts. Firms may elect to allocate exercise assignment notices on: (1) a “first in-first out” basis (FIFO); (2) a random selection basis, as described in Attachment B of this *Notice*; or (3) another equally random selection basis determined by the firm. However, firms must receive prior FINRA approval for the method selected. Any changes to a firm’s allocation method must be reported to and approved by FINRA.

Effective August 8, 2011, firms initiating an options business, or changing their allocation method, must use the application form in Attachment A of this *Notice*. The revised form updates FINRA rule references and contact information.

July 2011

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Institutional
- ▶ Legal
- ▶ Operations
- ▶ Options
- ▶ Risk
- ▶ Senior Management
- ▶ Systems

Key Topics

- ▶ Exercise Assignment Notice
- ▶ Options

Referenced Rules & Notices

- ▶ FINRA Rule 2360

FINRA also has updated its designated procedures for firms employing a random method of allocating options exercise assignment notices. Firms using the random method must ensure that they follow these updated procedures, or seek approval from FINRA for an alternative allocation method. The revised procedures are described in Attachment B.

FINRA also reminds firms that they must inform customers in writing of the method used to allocate options exercise assignment notices, including explanations of how the system operates and the consequences of that system. Firms also must preserve sufficient work papers and other documentary materials relating to the allocation of options exercise assignment notices to establish the manner in which allocation of the exercise assignment notices is in fact being accomplished.

Attachment A

Market Regulation Department Options Surveillance

Option Exercise Assignment Allocation Method Application

Submit completed form by email to *allocation@finra.org* or by fax to (301) 339-7687.

Firm Name: _____

Firm CRD No.: _____

Contact Person for Assignment Allocation: _____

Address: _____

Phone Number: _____

Email: _____

Please complete either section 1 or 2, as applicable, below:

1. If your firm has a clearing arrangement on a fully disclosed basis with an OCC member firm, please indicate the OCC member firm name: _____.
2. **A.** If your firm has a clearing arrangement on an omnibus basis with an OCC member firm, please indicate the OCC member firm name _____, and the method of options exercise allocation below:
 - a. First In, First Out (FIFO)
 - b. Random Method as designated in FINRA *Regulatory Notice 11-35*
 - c. Other Random Method (please describe and attach methodology)
- B.** If your firm is a self-clearing member of the Options Clearing Corporation, please list all OCC Allocated Clearing Member No.(s) _____ and the method of options exercise allocation below:
 - a. First In, First Out (FIFO)
 - b. Random Method as designated in FINRA *Regulatory Notice 11-35*
 - c. Other Random Method (please describe and attach methodology)

For firms that have multiple clearing numbers and use different allocation methods, please attach a separate sheet for each Clearing Member Number.

Authorization

Requested by:

Authorized Person (Print or Type)

Title

Signature

Date

CRD No. of Authorized Person

For questions regarding this form, or the allocation process, please contact:

Casey McMahon (917) 281-3042 *casey.mcmahon@finra.org*

Max Tourtelot (917) 281-3133 *max.tourtelot@finra.org*

Attachment B

Random Exercise Allocation Procedure

A firm may elect to allocate exercise assignments to its short option holders using a random allocation method. A firm electing a random allocation method must use the methodology outlined below.

Step 1: Sequencing of accounts—Identify and list all customer and firm accounts with open short positions in the option series for which exercise notices have been received.

Step 2: Assigning Sequence Numbers—Assign a range of sequential numbers to each account based on the number of short contracts held in the account. For example:

XYZ Jan 50 Calls

Account No.	# of Contracts Short	Assigned Sequential Numbers
1	5	1 through 5
2	8	6 through 13
3	2	14 through 15
4	10	16 through 25
5	11	26 through 36
Total: 36 Short Contracts		

In this example, all accounts having a short position in XYZ Jan 50 calls, the series for which exercise notices have been received, are arranged in order according to their account numbers. The number of contracts short in each account is noted, and shows that there are a total of 36 contracts short in all customer and firm accounts. Account #1 is assigned a range of numbers that begins with 1 and ends with the number reflecting the total contracts short in that account, which in this case is 5. Thus, the sequential numbers assigned to Account #1 are 1 – 5. The sequential numbers for Account #2 must begin with 6 and encompass eight numbers representing the 8 contracts short in that account. This results in the sequential numbers of 6 – 13 being assigned to Account #2. Account #3 is short 2 contracts and similarly is assigned sequential numbers beginning with 14 and ending with 15. This process continues until all accounts in the sequence have been assigned unique sequential numbers. By assigning sequential numbers in this manner, the likelihood that a particular account will be selected for exercise will be proportional to its share of the total short position.

Step 3: Random Number Generation—After completing the assignment of sequential numbers, choose a random decimal number using either of the methods described below:

- ▶ A firm may use any automated application, including Microsoft Excel, which contains a random number generator, to obtain a random number greater than zero and less than or equal to one that contains four decimal places; or
- ▶ A firm may obtain the NYSE or NASDAQ consolidated stock volume for the previous trading day, and follow these steps:
 - Select the four digits corresponding to the hundred thousands, ten thousands, thousands, and hundreds positions of the volume figure.
 - Place a decimal point to the left of the first digit to create a number ranging from .0000 to .9999. Add .0001 to this number to obtain a random number ranging from .0001 to 1.¹

Using either of the above methods, the firm should now have a number that lies in the range from .0001 to 1.

Step 4: Selection of Starting Point Using the Random Number—Multiply the random number generated above by the total number of contracts short in all accounts and if not a round number, round to the next highest integer. This number will determine the starting point of the exercise assignment.

Returning to the example, assume that there are 13 contracts for which the firm has received exercise notices, and that the random number .4855 is selected. The result of the multiplication of 36 (the total number of short XYZ Jan 50 Calls) and .4855 is 17.478, which is then rounded to the next highest integer, 18. The starting point for the first contract assigned is 18, which falls in Account #4.

Step 5: Allocation of the Exercise Notice—The assignment of exercise notices proceeds until all exercise notices have been assigned by continuing down the list of accounts from the starting point determined in Step 4 (returning to the top of the list if additional notices need to be allocated).

Continuing with the example, since the exercise notice specifies that 13 contracts are to be assigned, and 18 is the starting point, the firm selects the remaining 8 contracts from Account #4. The firm then advances to the next account in the sequence, Account #5, to assign the remaining 5 contracts. If the exercise notice related to more than 13 contracts, the assignment would continue to be absorbed by succeeding accounts in the sequence established in Step 1 until the entire assignment is absorbed. If additional notices need to be allocated after reaching the bottom of the list, continue with the first account at the top to complete the assignment.

1. This number is generated daily and used for all series in which exercise notices have been received.