Keynote Address – Richard G. Ketchum  
Wednesday, December 2  
10:05 a.m. – 10:35 a.m.

Speaker:
Richard G. Ketchum  
Chairman and Chief Executive Officer  
FINRA

Speaker Biography:

Richard Ketchum is Chairman and Chief Executive Officer (CEO) of FINRA. Prior to becoming CEO of FINRA, Mr. Ketchum was CEO of NYSE Regulation from March 2006 to March 2009. He served as the first chief regulatory officer of the New York Stock Exchange, a position he began in March 2004. From June 2003 to March 2004, Mr. Ketchum was General Counsel of the Corporate and Investment Bank of Citigroup Inc., and a member of the unit's planning group, Business Practices Committee and Risk Management Committee. Previously, he spent 12 years at NASD and The Nasdaq Stock Market, Inc., where he served as president of both organizations. Prior to working at NASD and NASDAQ, Mr. Ketchum was at the Securities and Exchange Commission (SEC) for 14 years, with eight of those years as Director of the division of Market Regulation. In February 2014, Mr. Ketchum was appointed by President Obama to serve on the President's Advisory Council on Financial Capability for Young Americans. In October 2010, he was appointed by President Obama to serve on the President's Advisory Council on Financial Capability—a group established to promote and enhance financial literacy and capability among Americans. He also served on the Joint Advisory Committee on Emerging Regulatory Issues, a committee created by the SEC and CFTC to review emerging regulatory issues, starting with the market events coming out of the May 2010 so-called "flash-crash."
Keynote Address – Richard G. Ketchum
Panelists

Speaker:

- Richard G. Ketchum, Chairman and CEO, FINRA
A Look Back at 2015 Regulatory Priorities and a Preview of 2016
Wednesday, December 2
10:35 a.m. – 11:35 a.m.

Regulators reflect on 2015 regulatory priorities and common examination findings, and look ahead to regulatory initiatives, priorities and developments on the horizon from the viewpoints of their respective organizations. Panelists also respond to audience questions at the end of the session.

Moderator: Erin Vocke
Vice President and District Director
FINRA Dallas and New Orleans District Offices

Panelists: Ronak Patel
Deputy Securities Commissioner
Texas State Securities Board

Michael Rufino
Executive Vice President
FINRA Member Regulation, Sales Practice

Anthony Russell
Senior Regulatory Accountant
U.S. Securities and Exchange Commission
A Look Back at 2015 Regulatory Priorities and a Preview of 2016 Panelist Bios:

Moderator:

**Erin C. Vocke** is Vice President and District Director of the FINRA Dallas and New Orleans District Offices. Ms. Vocke began her career in 1995 as an examiner in the New Orleans District Office. During this time, she conducted numerous routine and cause examinations of member firms and focused examinations in the areas of variable products and mutual funds. In January 2004, Ms. Vocke became Supervisor of Examiners, where she performed supervisory functions, including reviewing examinations and providing guidance to examiners on case development. In August 2004, she relocated to the Florida District Office. At this time, she assumed responsibilities for supervising Continuing Membership Applications and financial surveillance of member firms, in addition to routine and cause examinations. In June 2007, Ms. Vocke transferred to the Dallas District Office as the Associate Director. In this position, she was responsible for overseeing the District Cycle, Cause, Financial Surveillance and Membership Application Programs. In February 2010, she assumed the role of District Director of the Dallas Office. In February 2014, she assumed the role of District Director in the New Orleans Office. Ms. Vocke completed the Accelerated Development Program in 2007 and the Certified Regulatory and Compliance Professional (CRCP) designation in 2003. She received a bachelor's degree in accounting from the University of New Orleans.

Panelists:

**Ronak V. Patel** is the Deputy Securities Commissioner of Texas. He has been with the Texas State Securities Board since December 2002, and held numerous other positions at the agency including Director of the Inspections & Compliance Division. Mr. Patel has extensive experience with compliance issues and enforcement actions related to broker-dealers and investment advisers. He has contributed significantly to numerous multi-jurisdictional efforts. In addition to playing a leadership role in several investigations and settlements related to the 2008 failures in the auction rate securities market, Mr. Patel has served as a Chair for two other national task forces focused on broker-dealer practices. He has twice received the Outstanding Team Service Award from the North American Securities Administrators Association (NASAA). Mr. Patel has participated on various national groups focused on broker-dealer and investment adviser regulation, and he is currently a member of NASAA’s Investment Adviser Section and a member of the Broker Dealer Operations project group. Mr. Patel graduated Baylor University in 1999 with a B.S. in Economics before obtaining his J.D. from Baylor School of Law in 2002.

**Michael Rufino** is Executive Vice President and Head of Member Regulation—Sales Practice. In this capacity, he is responsible for overseeing FINRA’s Sales Practice program, which encompasses 15 District offices across the United States and the Membership Application Program. Mr. Rufino began his regulatory career in 1988 at the New York Stock Exchange. He has been with FINRA since its creation in 2007. Prior to serving in his current capacity, Mr. Rufino was the Chief Operating Officer in Member Regulation—Sales Practice. He has been involved in various industry initiatives throughout his career in regulation. In addition, Mr. Rufino is a representative on FINRA’s Compliance Advisory Committee. He has also served as a member of the Securities Industry Continuation Education (CE) Council, assisted in the creation of Electronic Communications Guidance to the industry and served as a member of the Social Networking Task Force. In addition, he participated in the Financial Action Task Force’s (FATF) initiative to create guidance on the risk-based approach to the prevention of money laundering and terrorist financing as well as the FATF Typology on the Securities Industry. He previously served as FINRA’s representative on International Organization of Securities Commissions’ (IOSCO) Committee 3 on Intermediaries. Mr. Rufino graduated magna cum laude from Iona College with a degree in finance, and received his MBA with honors in management information systems from Iona.

**Anthony Russell** has worked in a variety of roles in the SEC’s Atlanta Regional Office since 1998. He is currently a Senior Regulatory Accountant for the examination program and supports exams of broker-dealers, investment advisers, investment companies, municipal advisers, transfer agents, and other registrants. Mr. Russell is a past recipient of the Chairman’s Award of Excellence, and the Commission’s Supervisory Excellence Award and Examination Award of Excellence. Mr. Russell is a Certified Fraud Examiner and has undergraduate and graduate business degrees.
A Look Back at 2015 Regulatory Priorities and a Preview of 2016
Panelists

Moderator:

• Erin Vocke, Vice President and District Director, FINRA Dallas and New Orleans District Offices

Panelists:

• Ronak Patel, Deputy Securities Commissioner, Texas State Securities Board
• Michael Rufino, Executive Vice President, FINRA Member Regulation, Sales Practice
• Anthony Russell, Senior Regulatory Accountant, U.S. Securities and Exchange Commission
A Look Back at 2015 Regulatory Priorities and a Preview of 2016

- Senior Investors
- Cybersecurity
- Conflicts of Interest
- Sales Practice and Supervision of Alternative / Complex Investments
- AML
- Branch Examinations
- Mutual Fund Share Class
- Excessive trading, churning
- Regulatory requests and responses to regulators
A Look Back at 2015 Regulatory Priorities and a Preview of 2016

2016 – What are our biggest focuses?
EXAMINATION PRIORITIES FOR 2015

I. Introduction

This document identifies selected 2015 examination priorities of the Office of Compliance Inspections and Examinations (“OCIE,” “we” or “our”) of the Securities and Exchange Commission (“SEC” or “Commission”). In general, the priorities reflect certain practices and products that OCIE perceives to present potentially heightened risk to investors and/or the integrity of our capital markets.¹

OCIE serves as the “eyes and ears” of the SEC. We conduct examinations of registered entities to promote compliance, prevent fraud, identify risk, and inform policy.² We selected our 2015 examination priorities in consultation with the five Commissioners, senior staff from the SEC’s eleven regional offices, the SEC’s policy-making and enforcement divisions, the SEC’s Investor Advocate, and our fellow regulators.

This year, our priorities focus on issues involving investment advisers, broker-dealers, and transfer agents and are organized around three thematic areas:

1. Examining matters of importance to retail investors and investors saving for retirement, including whether the information, advice, products, and services being offered is consistent with applicable laws, rules, and regulations;

2. Assessing issues related to market-wide risks; and

3. Using our evolving ability to analyze data to identify and examine registrants that may be engaged in illegal activity, such as excessive trading and penny stock pump-and-dump schemes.

This document does not address OCIE’s examination priorities for exchanges and SROs, which we are addressing separately.

¹ This document was prepared by SEC staff, and the views expressed herein are those of OCIE. The Commission has expressed no view on this document’s contents. It is not legal advice; it is not intended to, does not, and may not be relied upon to create any rights, substantive or procedural, enforceable at law by any party in any matter civil or criminal.

² The registered entities that OCIE examines include investment advisers, investment companies, broker-dealers, exchanges, self-regulatory organizations (“SROs”), clearing agencies, municipal advisors, and transfer agents.
II. Protecting Retail Investors and Investors Saving for Retirement

Retail investors of all ages face a complex and evolving set of options when determining how to invest their money, including retirement funds. Registrants are developing and offering to retail investors a variety of new products and services that were formerly characterized as alternative or institutional, including private funds, illiquid investments, and structured products intended to generate higher yields in a low-interest rate environment. Additionally, as investors are more dependent than ever on their own investments for retirement, the financial services industry is offering a broad array of information, advice, products, and services to retail investors to help them plan for, and live in, their retirement years. We are planning various examination initiatives to assess risks to retail investors that can arise from these trends.

- **Fee Selection and Reverse Churning.** Financial professionals serving retail investors are increasingly choosing to operate as an investment adviser or as a dually registered investment adviser/broker-dealer, rather than solely as a broker-dealer. Unlike broker-dealers, which typically charge investors a commission or mark-up on purchases and sales of securities, investment advisers employ a variety of fee structures for the services offered to clients, including fees based on assets under management, hourly fees, performance-based fees, wrap fees, and unified fees. Where an adviser offers a variety of fee arrangements, we will focus on recommendations of account types and whether they are in the best interest of the client at the inception of the arrangement and thereafter, including fees charged, services provided, and disclosures made about such relationships.

- **Sales Practices.** We will assess whether registrants are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts, especially when they pose greater risks and/or charge higher fees.

- **Suitability.** We will evaluate registered entities’ recommendations or determinations to invest retirement assets into complex or structured products and higher yield securities, including whether the due diligence conducted, the disclosures made, and the suitability of the recommendations or determinations are consistent with existing legal requirements.

- **Branch Offices.** We will focus on registered entities’ supervision of registered representatives and financial adviser representatives in branch offices, including using data

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3 For decades, employers have shifted from offering defined benefit pensions to defined contribution plans, such as 401(k) accounts, that place funding and investment risk directly on participants. Today, it is estimated that approximately $15.8 trillion is invested in defined contribution plans (including individual retirement accounts and annuity reserves), while approximately $8.3 trillion is invested in defined benefit plans. See Nari Rhee, “Retirement Savings Crisis: Is it Worse than We Think” (June 2013), a publication of the NATIONAL INSTITUTE ON RETIREMENT SECURITY, available at: http://www.nirsonline.org/index.php?option=com_content&view=article&id=768&Itemid=48; see also “Retirement Assets Total $24 Trillion in Second Quarter 2014” (Sept. 2014), a publication of the INVESTMENT COMPANY INSTITUTE, available at: http://www.ici.org/research/stats/retirement/ret_14_q2.
analytics to identify branches that may be deviating from compliance practices of the firm’s home office.

- **“Alternative” Investment Companies.** Funds holding “alternative” investments, or those offering returns uncorrelated with the stock market, have experienced rapid and significant growth compared to other categories of mutual funds. We will continue to assess funds offering alternative investments and using alternative investment strategies, with a particular focus on: (i) leverage, liquidity, and valuation policies and practices; (ii) factors relevant to the adequacy of the funds’ internal controls, including staffing, funding, and empowerment of boards, compliance personnel, and back-offices; and (iii) the manner in which such funds are marketed to investors.

- **Fixed Income Investment Companies.** With interest rates expected to rise at some point in the future, we will review whether mutual funds with significant exposure to interest rate increases have implemented compliance policies and procedures and investment and trading controls sufficient to ensure that their funds’ disclosures are not misleading and that their investments and liquidity profiles are consistent with those disclosures.

### III. Assessing Market-Wide Risks

The SEC’s mission includes not only investor protection and capital formation, but also maintaining fair, orderly, and efficient markets. With examination authority over a wide variety of registrants, we intend to examine for structural risks and trends that may involve multiple firms or entire industries. In 2015, we will focus on the following initiatives:

- **Large Firm Monitoring.** We will continue to collaborate with our colleagues in the Division of Trading and Markets and the Division of Investment Management to monitor the largest U.S. broker-dealers and asset managers for the purpose of assessing risks at individual firms and maintaining early awareness of developments industry-wide.

- **Clearing Agencies.** We will continue to conduct annual examinations of all clearing agencies designated systemically important, pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Areas for review will be determined through a risk-based approach in collaboration with the Division of Trading and Markets and other regulators, as applicable.

- **Cybersecurity.** Last year, we launched an initiative to examine broker-dealers’ and investment advisers’ cybersecurity compliance and controls. In 2015, we will continue these efforts and will expand them to include transfer agents.

- **Potential Equity Order Routing Conflicts.** We will assess whether firms are prioritizing trading venues based on payments or credits for order flow in conflict with their best execution duties.
IV. Using Data Analytics to Identify Signals of Potential Illegal Activity

Over the last several years, OCIE has made significant enhancements in data analytics that enable us to efficiently and effectively analyze the data to which we have access. We will use these capabilities to focus on registrants and firms that appear to be potentially engaged in fraudulent and/or other potential illegal activity, including the following examination initiatives:

- **Recidivist Representatives.** We will continue to use our analytic capabilities to identify individuals with a track record of misconduct and examine the firms that employ them.

- **Microcap Fraud.** We will continue to examine the operations of broker-dealers and transfer agents for activities that indicate they may be engaged in, or aiding and abetting, pump-and-dump schemes or market manipulation.

- **Excessive Trading.** We will continue to analyze data obtained from clearing brokers to identify and examine introducing brokers and registered representatives that appear to be engaged in excessive trading.

- **Anti-Money Laundering (“AML”).** We will continue to examine clearing and introducing broker-dealers’ AML programs, using our analytic capabilities to focus on firms that have not filed suspicious activity reports (“SARs”) or have filed incomplete or late SARs. Additionally, we will conduct examinations of the AML programs of broker-dealers that allow customers to deposit and withdraw cash and/or provide customers direct access to the markets from higher-risk jurisdictions.

V. Other Initiatives

In addition to examinations related to the themes described above, we expect to allocate examination resources to other priorities, including:

- **Municipal Advisors.** We will continue to conduct examinations of newly registered municipal advisors to assess their compliance with recently adopted SEC and Municipal Securities Rulemaking Board rules. This initiative will include industry outreach and education.

- **Proxy Services.** We will examine select proxy advisory service firms, including how they make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest. We will also examine investment advisers’ compliance with their fiduciary duty in voting proxies on behalf of investors.

- **Never-Before-Examined Investment Companies.** We will conduct focused, risk-based examinations of selected registered investment company complexes that we have not yet examined.

- **Fees and Expenses in Private Equity.** Given the high rate of deficiencies that we have observed among advisers to private equity funds in connection with fees and expenses, we will continue to conduct examinations in this area.
- **Transfer Agents.** Transfer agents serve as important gatekeepers to prevent violations of Section 5 of the Securities Act of 1933 and other fraudulent activity. We intend to allocate more resources to examine transfer agents, particularly those that are involved with microcap securities and private offerings.

VI. Conclusion

This description of OCIE priorities is not exhaustive. While we expect to allocate significant resources throughout 2015 to the examination issues described herein, our staff will also conduct examinations focused on risks, issues, and policy matters that arise from market developments, new information learned from examinations or other sources, including tips, complaints, and referrals, and coordination with other regulators.

OCIE welcomes comments and suggestions about how we can better fulfill our mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at [http://www.sec.gov/complaint/info_tipscomplaint.shtml](http://www.sec.gov/complaint/info_tipscomplaint.shtml).
January 6, 2015

Introduction
This year marks the tenth edition of the Regulatory and Examinations Priorities Letter. Over the past decade, we have witnessed tremendous change to firms, markets and regulation.

Many changes have been positive. Firms have improved their review of new products by integrating business functions with independent perspectives, such as compliance and risk management, articulating standards, documenting decisions and monitoring product performance. Firms have taken steps to better manage conflicts of interest by aligning compensation more closely with customer interests or through risk-adjusted compensation.

The markets have become more transparent to retail investors with expanded trade report dissemination. FINRA took steps to enhance transparency in “dark pool” trading through the publication of reports on alternative trading systems’ volume on a stock-by-stock basis. Both equity and debt markets have become more open internationally, enabling companies to raise capital where it is most advantageous and investors to diversify their portfolios.

Regulators have adopted more risk-based approaches, increased their use of data and analytics, and improved coordination and information sharing. FINRA’s examination program is now substantially risk-based, enabling us to allocate our resources to higher-risk firms and individuals. For example, we identify registered representatives with higher risk profiles using analytics, resulting in expedited regulatory responses. FINRA is also sharing information more frequently with domestic and international securities and banking regulators, in particular with the U.S. Securities and Exchange Commission (SEC) and the Municipal Securities Rulemaking Board (MSRB).

Recurring Challenges
In addition to the positive changes FINRA has observed, there are a number of lessons learned that firms can find instructive. Over the years, FINRA has observed that challenges in five areas contribute to firms and registered representatives at times compromising the quality of service they provide to customers as well as contribute to compliance and supervisory breakdowns. Addressing these challenges will enable firms to get ahead of many of the concerns that FINRA raises in this letter.
**Putting customer interests first**: A central failing FINRA has observed is firms not putting customers’ interests first. The harm caused by this may be compounded when it involves vulnerable investors (e.g., senior investors) or a major liquidity or wealth event in an investor’s life (e.g., an inheritance or Individual Retirement Account rollover). Poor advice and investments in these situations can have especially devastating and lasting consequences for the investor. Irrespective of whether a firm must meet a suitability or fiduciary standard, FINRA believes that firms best serve their customers—and reduce their regulatory risk—by putting customers’ interests first. This requires the firm to align its interests with those of its customers.

**Firm culture**: Many of the problems we have observed in the financial services industry have their roots in firm culture. A poor culture may arise, for example, if firm management places undue emphasis on short-term profits or pursues rapid growth without a concomitant concern for controls. Beyond creating the proper business environment for a good culture to flourish, firms’ boards and senior executives must articulate and practice high standards of ethical behavior that are expected and visible throughout the organization and are embedded in the firm’s incentives. These standards should come from the board and executives and not be viewed as a compliance task. The absence of stated standards can contribute to failures at the individual broker level (e.g., disregard for customer needs in recommending securities) and can likewise bring about problems with potentially market wide implications (e.g., manipulation of indices or the manufacture and marketing of unsuitable securities). Firms must protect their culture against individual bad actors, as well as firm wide behaviors that can gradually erode that culture. Firm policies should signify that poor practices, whatever the magnitude of the harm caused or potential implications, will not be tolerated.

**Supervision, risk management and controls**: A firm’s systems of supervision, risk management and controls are essential safeguards to protect and reinforce a firm’s culture. Maintaining the right culture includes having robust processes around basic functions such as hiring. Strong supervisory and risk management systems also prevent inadvertent harm to customers (e.g., a firm failing to provide the proper breakpoint), as well as defend against deliberate acts of malfeasance (e.g., a trader concealing position limit breaches or an executive manipulating accounting balances to make the firm’s financial status and results appear stronger than they are). Proactive supervisory programs and controls play a crucial role in this effort and many firms have turned to data analytics to help identify problematic behavior. One indicator that a firm is succeeding in a proactive approach would be that it has already identified and addressed the concerns FINRA identifies in this letter.
Product and service offerings: While firms have improved new-product review processes, the sales of novel products and services remain a regulatory flashpoint. Some of the issues that have caused harm to investors and landed firms in regulatory difficulties include product complexity, opacity in the market for a product or its underlying components, insufficient or generic disclosure, enticing teaser rate fee structures and insufficient training for salespersons to understand the products. These challenges underscore the need for firms to continue to conduct rigorous new product reviews, assess reasonable-basis and customer-specific suitability prior to offerings and permit wealth management to make independent decisions about the products and services that are best for their customers.

Conflicts of interest: Conflicts of interest are a contributing factor to many regulatory actions FINRA (and other regulators) have taken against firms and associated persons. In October 2013, FINRA highlighted effective practices in identifying and managing conflicts of interest. While we have observed positive change since we issued the Report on Conflicts of Interest, FINRA has also recently announced enforcement actions involving firms’ failure to adequately address conflicts of interest by offering favorable research in connection with potential investment banking business.1 We are also reviewing situations where market access customers self-monitor and self-report suspicious trading despite this inherent conflict of interest. And, we continue to focus on fee and compensation structures that lie at the heart of many conflicts and which can at times compromise the objectivity registered representatives provide to customers. FINRA underscores the importance of firms moving to identify and mitigate conflicts of interest.

Areas of Focus in 2015
FINRA’s 2015 priorities focus on key sales practice, financial and operational and market integrity matters. Before discussing the priorities, we highlight an important issue that cuts across all of FINRA’s regulatory programs. Specifically, FINRA has experienced an increasing number of situations where some firms have repeatedly failed to provide timely responses to its information requests made in connection with examinations and investigations. This is particularly troubling as FINRA discusses large and complex information requests with firms and is flexible with respect to due dates, rolling productions, scope and format—as long as the integrity of the regulatory matter is not compromised. These situations are not acceptable, as timely productions of information (as well as oral information through interviews and on-the-record testimony) are critical to FINRA achieving its investor protection and market integrity mission by identifying and shutting down bad practices and bad actors at the earliest possible time. FINRA reiterates firms’ obligation to respond to FINRA inquiries in a full and timely fashion, and cautions firms that production failures expose firms to disciplinary action.

Sales Practice

Products
In this section, FINRA discusses product-focused concerns. These concerns may include features of the product itself as well as sales or distribution practices. Some of the products we address are complex and may be subject to substantial market, credit, liquidity or operational risks. In some cases, products previously available only to sophisticated investors have been modified and are now offered to retail investors. These products require firms and registered representatives to perform due diligence, make sound
suitability decisions and describe product risks in a balanced manner that retail investors can understand. As always, firms and registered representatives should be attentive to changing circumstances—such as the precipitous fall in oil prices or the rapid fall in some emerging and frontier market indices—that may affect suitability decisions and risk descriptions. Training registered representatives about product features, pricing and valuation, and providing guidance around suitability are important steps in meeting these challenges. With these concerns in mind, FINRA’s 2015 surveillance and examination activities that include product-related risk reviews will routinely focus on due diligence, suitability, disclosure, supervision and training.

**Interest Rate-Sensitive Fixed Income Securities**

The United States has experienced a period of sustained and unusually low interest rates. FINRA’s *2014 Regulatory and Examination Priorities Letter* detailed FINRA’s concerns regarding the interest rate environment and the potential harm to customers holding interest rate-sensitive products that could result from shifts in that environment. Those concerns remain unchanged. FINRA also recognizes, however, that fixed income products play an important role in a well-constructed portfolio. What is critical is that firms’ communications discuss the impact of interest rate changes on price when marketing products that are interest rate sensitive. In 2015, FINRA examiners will look for concentrated positions in products that are highly sensitive to interest rates—such as long-duration fixed income securities, high yield bonds, mortgage-backed securities, or bond funds composed of interest rate-sensitive securities—and test for suitability and adequate disclosures. Examiners may also review firms’ efforts to educate registered representatives and customers about such products.

**Variable Annuities**

FINRA’s focus on sales practice issues with variable annuities—both new purchases and 1035 exchanges—will include assessments of compensation structures that may improperly incent the sale of variable annuities, the suitability of recommendations, statements made by registered representatives about these products and the adequacy of disclosures made about material features of variable annuities. FINRA examiners will also focus on the design and implementation of procedures and training by compliance and supervisory personnel to test the level of brokers’ and supervisors’ product knowledge, to prevent and detect problematic sales practices in variable annuities and to assess compliance with requirements that firms file retail communications concerning variable annuities with FINRA within 10 business days of first use. FINRA will particularly focus on the sale and marketing of “L share” annuities as these shares typically have shorter surrender periods, but higher costs.

**Alternative Mutual Funds**

Sales of alternative mutual funds (“alt funds” or “liquid alts”) have increased rapidly over the past several years, with hundreds of new funds launched and currently available. Estimates place assets under management in alternative funds at over $300 billion as of November 2014, up from less than $50 billion at year-end 2008. Net inflows for 2014 through November reportedly exceeded $40 billion.²
Alternative mutual funds are often marketed as a way for retail customers to invest in sophisticated, actively-managed hedge fund-like strategies that will perform well in a variety of market environments. Alternative mutual funds generally purport to reduce volatility, increase diversification, and produce non-correlated returns and higher yields compared to traditional long-only equity and fixed-income funds, all while offering daily liquidity. There is no standard definition of alternative mutual funds, but if a fund’s strategy involves non-traditional asset classes, non-traditional strategies or illiquid assets, the fund could be considered an alt fund. FINRA recommends firms refer to such funds based on their specific strategies, as opposed to bundling them under one umbrella category. In this regard, firms must ensure that their communications regarding alternative funds accurately and fairly describe how the products work, ensuring that the descriptions of the funds are consistent with the representations in the funds’ prospectuses. For example, a retail communication that includes a discussion of an alternative fund’s objectives that is inconsistent with the objectives included in the fund’s prospectus, or that does not clearly indicate there is no assurance that the objectives will be met, would not meet regulatory requirements.³

Despite their possible benefits, alternative mutual funds raise concerns when compared to conventional funds. In particular, FINRA is concerned that registered representatives and customers will not understand how the funds will respond to various market conditions or even the strategy in which the fund’s adviser will engage in various market scenarios. In addition, FINRA has learned that some firms are not reviewing alt funds through their new-product review process, especially if the firm already has an existing agreement with the fund company.

**Non-Traded Real Estate Investment Trusts (REITs)**

FINRA identified several concerns with non-traded REITs in last year’s letter, including general lack of liquidity, high fees and valuation difficulty. FINRA had noted risks to investors who may be attracted to the projected yields of these securities.⁴ These risks remain relevant with respect to customer-specific suitability obligations that firms must perform when recommending non-traded REITs to clients. FINRA also emphasizes that firms should perform due diligence on an ongoing basis on REITs they allow their representatives to recommend. “Red flags” arising from a REIT’s financial statements or management may cause firms to change the types of clients to whom the firm recommends the product or even to discontinue sale of the product.

FINRA also notes that on October 10, 2014, the SEC approved proposed amendments to the Customer Account Statement Rule and the Direct Participation Program (DPP) Rule regarding how these products are valued on customer account statements.⁵ Because the offering price, typically $10 per share, often remains constant on customer account statements during the offering period even though various costs and fees have reduced investors’ capital, FINRA amended the rule to require broker-dealers to provide a more accurate per share estimated value on customer account statements, as well as various important disclosures. Firms that sell REITs should read and understand the full requirements of the amendments in [Regulatory Notice 15-02](#), which also contains the effective date of the rule amendments.
Exchange-Traded Products (ETPs) Tracking Alternatively Weighted Indices

Indexing has continued to expand beyond traditional market capitalization-weighted methods to alternatively weighted strategies, (e.g., using equally weighted, fundamentally weighted, volatility weighted indices). These indices provide exposure to specific investment risk factors or strategies. Products tracking such indices may be marketed as providing superior risk-adjusted performance relative to products tracking more traditional capitalization-weighted indices. The exchange-traded products market, in particular, has seen significant growth in the use of alternatively weighted indices in terms of products and investor assets.

For individual investors, products tracking these indices may be complex or unfamiliar. Moreover, ETPs tracking these indices may be thinly traded and have wide bid-ask spreads, making these funds more costly to trade, in addition to their generally higher expenses. Some alternatively weighted indices may have significantly higher turnover than more traditional indices, leading to greater transaction costs for ETPs that track them. While back-tested results and some academic research have highlighted the potential efficacy and attractiveness of alternatively weighted indices, it remains an open question how the indices and products tracking them will behave in different market environments going forward.

Structured Retail Products (SRPs)

FINRA continues to see firms creating and distributing SRPs, including structured notes, with complex payout structures and using proprietary indices as reference assets. Complex features, long maturities, and linkages to less-traditional or less well-understood reference assets in some structured retail products may present investors with unique or unfamiliar risks. FINRA is concerned that some brokers and retail investors may not be familiar with the complexities of SRPs, compounded by the uncertain impact of a changing interest rate environment. FINRA reminds firms that retail communications concerning derivatives registered under the Securities Act of 1933, including SRPs, must be filed with FINRA within 10 business days of first use.

In addition, we are focused on the incentive to increase revenue from structured (and other) product sales through distribution channels that may not have adequate controls to protect customers’ interests, such as the distribution of structured or complex products through retail distributors that have insufficient expertise to make sound suitability reviews. To mitigate the risk that sales incentives create, wholesalers should have robust Know-Your-Distributor policies and procedures reasonably designed to ensure potential distributors have adequate controls and systems in place. FINRA examiners will focus attention on additional conflict issues that might arise where the distributor and wholesaler are affiliated companies.

Floating-Rate Bank Loan Funds

These products primarily invest in floating-rate bank loans. While such loans are typically geared to institutional investors, retail investors have increased their exposure to these products through mutual funds, closed-end funds and exchange-traded funds (ETFs) in an effort to protect against the threat of rising interest rates. Despite the promise of hedged exposure to interest-rate risk, these loans can carry significant credit and call risk.
In addition, they are difficult to value, have longer settlement times than other investments and are relatively illiquid. As a consequence, funds investing in these loans could face liquidity challenges if a significant number of investors make redemption requests at the same time.

**Securities-Backed Lines of Credit (SBLOCs)**

SBLOCs are revolving, non-purpose loans that allow investors to borrow money from lending institutions using fully paid-for securities held in their brokerage accounts as collateral. FINRA has observed that the number of firms offering SBLOCs is increasing and is concerned about how they are marketed. They are now offered by a large number of firms and we see some clearing firms offering SBLOCs to retail investors via their correspondents. Proceeds are typically used to purchase a second home, luxury items or pay other expenses. Eligible securities collateralizing SBLOCs include stocks, bonds and mutual funds that are held in fully paid, cash accounts.

Broker-dealers offering SBLOCs should have proper controls in place to supervise these programs. Customers should be fully apprised of program features, including loan restrictions and how changing market conditions may affect their brokerage account and their ability to draw on the SBLOC. Moreover, firms should have operational procedures that enable them to interact with the lending institution to monitor the customer’s account, keep adequate records and ensure that customers are promptly notified when collateral shortfalls occur.

**Supervision Rules**

FINRA’s new supervision rules (FINRA Rules 3110, 3120, 3150 and 3170) became effective on December 1, 2014. These new rules modify requirements relating to, among other things: (1) supervising offices of supervisory jurisdiction and inspecting non-branch offices; (2) managing conflicts of interest in a firm’s supervisory system; (3) performing risk-based review of correspondence and internal communications; (4) carrying out risk-based review of investment banking and securities transactions; (5) monitoring for insider trading, conducting internal investigations and reporting related information to FINRA; and (6) testing and verifying supervisory control procedures. FINRA regulatory coordinators and examiners will contact and inspect their assigned firms to address regulatory questions and become familiar with how the firms are implementing the new rule requirements.

**Individual Retirement Account (IRA) Rollovers (and Other “Wealth Events”)**

FINRA is focused on firms’ controls around the handling of wealth events in investors’ lives. Wealth events refer to those situations where an investor faces the decision about what to do with a large amount of money arising from an inheritance, life insurance payout, sale of a business or other major asset, divorce settlement or an IRA rollover, among other events. A broker’s recommendations made in connection with a wealth event can have long-lasting consequences for the customer. In 2015, examiners will focus on the controls firms have in place related to wealth events, with an emphasis on firms’ compliance with their supervisory, suitability and disclosure obligations. Firms’ systems should be reasonably designed to help ensure that financial incentives to the associated person or the firm do not compromise the objectivity of suitability reviews.
Part of FINRA's focus will be IRAs, one of the principal vehicles Americans use to save for their retirement. According to the Investment Company Institute, over one-quarter of Americans' retirement savings are held in IRAs and this percentage is growing. Rollovers from employer plans—such as 401(k) plans—play an important role in funding these IRAs.\(^8\) FINRA has stated that, whether in retail communications or an oral marketing campaign, it would be false and misleading to imply that a retiree's only choice, or only sound choice, is to roll over plan assets to an IRA sponsored by the broker-dealer.\(^9\) Any communications that discuss IRA fees must be fair and balanced,\(^10\) and the broker-dealer may not claim that its IRAs are “free” or carry “no fee” when the investor will incur costs related to the account, account investments or both.

If a broker-dealer does not intend for its registered representatives to recommend securities transactions as part of the IRA rollovers of their customers, then the broker-dealer should have policies, procedures, controls and training reasonably designed to ensure that no recommendation occurs. Similarly, if registered representatives are authorized to provide educational information only, a firm’s written supervisory procedures should be reasonably designed to ensure that recommendations are not made. Without strong oversight, investors may not obtain the information necessary to make an informed decision, and firms may fail to detect recommendations otherwise prohibited by firm policy.

**Excessive Trading and Concentration Controls**

FINRA has observed shortcomings in firms’ supervision of quantitative suitability and concentration, for example, through the failure to supervise for compliance with issuer concentration guidelines (such as those contained in the prospectus for some REITs).\(^11\) In 2015, FINRA examiners will focus on firms’ supervisory processes, systems and controls concerning how firms monitor for excessive trading and product concentration. FINRA examiners will review the criteria for exception reports firms use and the adequacy of firms’ follow-up on such exceptions. FINRA has provided firms with practices that may help bolster their supervision of suitability determinations.\(^12\) FINRA examiners will also review customer communications and account activity to determine whether aggressive trading strategies were recommended, and whether broker-recommended transactions, or series of transactions, constitute excessive trading or result in a customer’s portfolio becoming over-concentrated.

**Private Placements**

Private placements continue to raise concerns and will be an area of focus in 2015. Broker-dealers participate in private offerings in a number of capacities, and common concerns across these capacities include inadequate due diligence and suitability analysis. These concerns remain relevant regardless of the investment sector, investment type (e.g., EB-5 investment funds, pre-Initial Public Offering investment funds, virtual currency funds), or the type of investor. Firms must file most private placement materials with FINRA pursuant to Rules 5122 or 5123. FINRA reviews firms’ private placements to determine whether broker-dealers performed sufficient due diligence on the issuer and the offering prior to recommendations to customers. We have learned that in some cases, the level of due diligence 1) did not comply with the broker-dealer’s procedures, and 2) appeared to be inadequate to support a suitability determination. Furthermore, FINRA staff has identified offering documents and communications containing misrepresentations, omissions of material information or inconsistencies with FINRA’s communication rules.
FINRA’s review of private placement filings has also revealed a number of problems associated with contingency offerings and escrow procedures. Pursuant to Securities Exchange Act of 1934 (SEA) Rule 10b-9, a broker-dealer selling an offering pursuant to a contingency is required to return investor funds if the terms of the contingency are not met or have been materially amended. SEA Rule 15c2-4(b) requires broker-dealers to ensure that investor funds are properly segregated. In a number of instances, an offering’s terms were amended and a rescission offer was not properly conducted. In other instances, broker-dealers participating in an offering with a contingency failed to either establish escrow procedures or had deficient procedures such as not employing an independent bank as the escrow agent.

FINRA also notes that amendments to Rule 506 of Regulation D13—which, pursuant to the Jumpstart Our Business Startups Act, became effective September 23, 2013—permit general solicitation and advertising when offering private placements, provided that all purchasers of the offering are accredited investors. FINRA and the SEC have reminded investors to be prudent when evaluating the risks of these types of investments, especially as, under the new rules, it is expected that investors will be more exposed to private placement sales pitches and advertising.14

**High-Risk and Recidivist Brokers**

The activities of certain high-risk brokers cause outsized risk to investors, including the heightened potential to become a fraud victim. FINRA devotes substantial attention to brokers that may pose greater risk to the investing public and to quickly stopping those engaged in actual misconduct. To do this, FINRA is expanding its use of data mining, analytics, specially targeted examinations, and expedited investigations and enforcement actions to remove from the securities industry unscrupulous registered representatives who prey on investors.

Firms that hire or seek to hire high-risk brokers, including statutorily disqualified and recidivist brokers, can expect rigorous regulatory attention. FINRA will cover all aspects of this topic, including hiring and supervision practices. With respect to hiring, FINRA will review firms’ due diligence on prospective hires. Examiners will also assess the supervision of high-risk registered representatives to determine whether it is tailored to specifically address the risks associated with the particular individual based on prior misconduct and regulatory disclosures. We will also assess whether a firm implements and documents a stated supervisory plan.

**Sales Charge Discounts and Waivers**

FINRA has observed that in some instances customers do not receive the volume discounts (breakpoints) or sales charge waivers to which they are entitled when purchasing products like non-traded REITs, Unit Investment Trusts, Business Development Corporations and mutual funds.15 FINRA addressed this issue through examinations and enforcement actions in the last few years and will make it a priority again in 2015. FINRA will determine if firms have an adequate system to ensure breakpoints and sales charge waivers are provided to their customers for products they sell that possess these features. Further, as some products offering volume discounts can have a direct impact on a broker’s compensation, FINRA examiners will consider whether brokers disclose that the volume discount is available and make appropriate recommendations to customers.
Senior Investors
The population of senior investors is large and growing; between 2012 and 2020, the number of Americans aged 65 or greater is projected to increase from 43 million to 56 million, and to 73 million by 2030. The consequences of unsuitable investment advice can be particularly severe for this investor group since they rarely can replenish investment portfolios with fresh funds and lack time to make up losses. Reflecting concern about the treatment of senior investors, FINRA recently completed an examination initiative on senior issues. Preliminary findings show that many firms are increasingly proactive in dealing with senior investors by developing specific internal guidelines to strengthen suitability decisions and providing training on the needs of these investors, including, in some cases handling individuals experiencing diminished capacity or elder abuse. FINRA urges firms to review their procedures to identify ways they may be able to improve their treatment of senior investors. FINRA examiners will continue to review communications with seniors; the suitability of investment recommendations made to seniors, including with respect to the products discussed above; the training of registered representatives to handle senior-specific issues; and the supervision firms have in place to protect seniors. Firms that conduct seminars directed to senior investors must ensure that the presentations are fair, balanced and not misleading. Protecting senior investors also means compliance with requirements apart from the federal securities laws and FINRA rules that, for example, require reporting or the intervention of court-appointed guardians when elder abuse is detected.

Anti-Money Laundering (AML)
FINRA will focus on certain types of accounts, including Cash Management Accounts (CMAs) and certain Delivery versus Payment/Receipt versus Payment (DVP/RVP) accounts. CMAs are brokerage accounts used for activity typically associated with bank accounts. FINRA will review the adequacy of firm surveillance systems and processes to identify potentially suspicious transfers to and from CMA accounts, and to verify the business purpose of activity conducted through these accounts. FINRA will also focus on DVP/RVP accounts of foreign financial institutions. FINRA has observed an increase in microcap activity and foreign currency conversion activity in DVP/RVP accounts, which may be based in jurisdictions with weak regulatory regimes. DVP/RVP accounts may provide less transparency as to the source of the shares being sold. FINRA has observed that some firms are not monitoring activity in DVP/RVP accounts for suspicious activity, and are not conducting adequate due diligence to ensure that securities being sold are registered under Section 5 of the Securities Act of 1933 or the transaction is subject to an exemption from registration.

FINRA examiners will also focus on the adequacy of firms’ surveillance of customer trading. Firms should tailor customer trading surveillance around the AML risks inherent in their business lines, products and customer bases. Customer trading activity can involve different types of suspicious activity reportable on Suspicious Activity Reports, including market manipulation, insider trading and microcap fraud. FINRA examiners will evaluate whether firms have systems to monitor for red flags indicative of suspicious customer trading activity. In fact, FINRA has found that firms’ due diligence in microcap securities for AML and Section 5 compliance is at times inadequate, regardless of whether they receive shares from another broker-dealer or transfer agent, and whether in physical form or electronically. FINRA’s continued emphasis on microcap fraud and insider trading is evident.
through the more than 700 referrals to the SEC and other federal or state law enforcement agencies in 2014, involving potential fraudulent conduct through insider trading, private investment in public equity transactions, microcap fraud and market manipulation.

Municipal Advisors and Securities

Municipal Advisor Registration

In 2015, FINRA examiners will focus on current SEC and MSRB municipal advisor requirements, reviewing for proper application of exclusions and exemptions, and potential unregistered activity. Examiners will adjust their reviews to include new rules as they become effective.

In addition to statutory requirements promulgated under Dodd-Frank Act amendments to the SEA, the SEC’s municipal advisor registration rules became effective July 1, 2014. FINRA has observed through onsite examination and regulatory coordinator outreach that some firms do not realize that the activities in which they engage subject them to municipal advisor registration requirements. Specifically, any firm that provides advice to customers that are municipal entities or obligated persons, whether with respect to an issuance of municipal securities or to the investment of proceeds from such an issuance (or municipal escrow investments) may be required to register as a municipal advisor. The SEC has published a set of frequently asked questions providing guidance about statutory exclusions and rule-based exemptions from the municipal advisor registration requirement. Further, the MSRB has developed a regulatory framework for municipal advisors and is currently developing municipal advisor rules regarding standards of conduct, supervision requirements, professional qualification requirements, pay-to-play, gifts and gratuities, and duties of solicitors.

Minimum Denomination Bonds

In 2015, FINRA will focus on firms that sell municipal bonds in less than the minimum denomination, in violation of MSRB Rule G-15. Issuers often set high minimum denominations for lower-rated bonds that may make the investments inappropriate for retail investors. Investors who buy the bonds in smaller denominations may find limited liquidity, and thus poor pricing, when they choose to sell the bonds.

Financial and Operational Priorities

Funding and Liquidity: Valuing Non-High-Quality Liquid Assets

Broker-dealers need to develop and monitor funding and liquidity risk management programs. A cornerstone of any such programs is the accuracy of the price firms assign to securities. FINRA has observed that at times firms’ funding and liquidity plans rely on being able to sell or enter into repurchase transactions at or very near to the prices at which the firms have marked their inventory to market. The issue of mark-to-market pricing is particularly acute with respect to infrequently traded positions in corporate, asset-backed and municipal debt securities. Accordingly, FINRA will examine for the integrity of marks-to-market for such securities and for supervisory controls surrounding the overall valuation process.
Sales to Customers Involving Tax-Exempt or Federal Deposit Insurance Corporation (FDIC)-Insured Products

Firms that sell tax-exempt securities or FDIC-insured instruments, or products with similar characteristics, should be aware that in certain circumstances firm actions may cause customers to lose the tax-exempt status on interest payments or the FDIC protection they believe they have. These risks can arise if a firm is in a short position with respect to the security (e.g., if a firm sells more securities to customers than it has purchased or holds in inventory, or it has a fail-to-receive allocated to a customer position). In the case of tax-exempt securities, the short position creates a situation where a customer expecting tax-exempt income will, in fact, receive taxable “substitute interest” from the firm.

Similarly, for FDIC-insured certificates of deposit, the firm’s short position may create a situation where the customer’s certificate of deposit may be denied status as an insured deposit from the FDIC if the issuing bank or savings and loan association becomes insolvent. Thus, the customer is at risk with respect to both FDIC insurance and with respect to priority of his or her claim in the event of an insolvency of the issuing depository institution. FINRA will examine for the creation and resolution of such short positions, including compliance with the SEA Rule 15c3-3(d) possession or control requirements and the adequacy of supervisory processes in place for the expeditious resolution of these positions.

Cybersecurity

FINRA examiners will review firms’ approaches to cybersecurity risk management, including their governance structures and processes for conducting risk assessments and addressing the output of those assessments. In January 2014, FINRA initiated a sweep to understand better the type of threats to which member firms are subject, as well as their responses to those threats. FINRA expects to publish the results of that sweep in early 2015. That report will include principles and effective practices firms should consider in developing and implementing their cybersecurity programs, for example, with respect to their overall approach to cybersecurity, the use of frameworks and standards, the role of risk assessments, the identification of critical assets, and the implementation of controls to protect those assets based on the scale and business model of the firm.

In addition, FINRA observes that recent events have highlighted the potential adverse consequences of cyber attacks that destroy data. In accordance with SEA Rule 17a-4(f), firms are permitted to store records electronically, provided that the media “(p)reserve the records exclusively in a non-rewriteable, non-erasable format.” In a 2003 Interpretation to SEA Rule 17a-4, the SEC noted that the rule does not specify the type of storage technology that may be used, but rather sets forth standards that the electronic storage media must meet to be considered an acceptable method of storage. In its 2003 interpretation, the SEC clarified that firms may use integrated hardware and software control codes to store data, provided “the electronic storage system prevents the overwriting, erasing or otherwise altering of a record during its required retention period.” Given the widespread use of electronic storage media for record storage and the fundamental importance of firms’ books and records to their ability to conduct business, a cyber attack that permanently destroys data may severely impact a firm’s ability to continue operating. In 2015, FINRA examiners will review firms’ approaches to ensuring compliance with Rule 17a-4(f) in the event of a cyber attack.
Outsourcing
As firms continue to outsource key operational functions to reduce expenses and focus on core business activities, FINRA reminds firms that outsourcing covered activities in no way diminishes a broker-dealer’s responsibility for 1) full compliance with all applicable federal securities laws and regulations, and FINRA and MSRB rules, and 2) supervising a service provider’s performance.¹⁹ Outsourcing will be a priority area of review during 2015 examinations, and will include an analysis of the due diligence and risk assessment firms perform on potential providers, as well as the supervision they implement for the outsourced activities and functions.

Investor Protection Requires Timely Reporting of Disclosable Information
Through its BrokerCheck® and Central Registration Depository (CRD®) systems, FINRA provides comprehensive information on firms and associated persons as a key part of its investor protection mission. Investors, regulators and firms rely on this information and depend on it to be complete and accurate. Much of this information is derived from Form U4 and Form U5 registration filings. The FINRA By-Laws require that associated persons of member firms promptly disclose to FINRA reportable U4 and U5 events, including, but not limited to, regulatory actions, customer complaints, bankruptcy filings, liens, judgments and criminal charges.

Despite its importance, FINRA has found that in a number of instances firms do not report this information, or do not do so in a timely manner. FINRA is making changes to its registration review process, rules and examination program to address this noncompliance. This includes a public records review of all active registered persons. FINRA will continue this review process on a periodic basis for all registered persons.

In addition, FINRA has filed amendments to its Rule 3110 that requires firms to perform public records checks when registering associated persons to verify the accuracy and completeness of initial or transfer Form U4 filings. In 2015, FINRA examiners will review whether required disclosures are complete, accurate and made within the required time periods; determine whether firms have controls, processes and procedures in place to ensure timely filings; and determine whether public records reviews are occurring. Finally, FINRA expects firms to investigate representatives that fail to report appropriately.

Market Integrity
Maintaining fair and orderly markets is a central objective for FINRA and is critical to restoring and preserving investor confidence in the U.S. capital markets. FINRA is adapting its surveillance program to identify potentially violative conduct made possible by advances in technology and changes in market structure, (e.g., abusive algorithms). Firms also must be more vigilant in detecting and preventing misconduct. Firms are well positioned to serve as the first line of defense in identifying bad actors through, among other things, the analysis of market participants’ activities on their systems.
Supervision and Governance Surrounding Trading Technology
Maintaining a robust technology governance framework for electronic trading is a key responsibility for broker-dealers. FINRA has identified a number of concerns in this area, and in 2015, FINRA examination teams will review firms’ technology and related controls with an emphasis on the development and ongoing supervision of algorithms. For example, FINRA examiners will review the adequacy of firms’ formal supervisory processes — and related controls — for the development and testing of technology changes. Part of this review is a heightened focus on unscheduled trading technology changes that may not have benefitted from offline testing before handling live trades. FINRA examiners also will review the segregation of duties for technology staff performing various functions, namely, developing, testing, deploying, and modifying new and existing technologies. Examiners will also focus on firms’ risk management and financial and operational controls, with a focus on firms’ net capital, because the speed with which orders enter the market and are executed, often in numerous symbols on multiple markets, can introduce risk to the financial soundness of high-frequency trading firms.

Abusive Algorithms
FINRA views abusive trading algorithms and deficient supervision for potential manipulation as among the most significant risks to the integrity of the markets. For that reason, FINRA will continue to pursue firms whose traders or customers use algorithms to manipulate the markets, including through layering, spoofing, wash sales and marking the close, among other means. In addition, FINRA will continue to further enhance its surveillance program to detect new types of potentially manipulative trading activity brought about through the use of abusive trading algorithms. FINRA will also continue to review whether firms’ supervisory and other controls failed to appropriately detect abusive activity by the firm’s traders or its customers.

Cross-Market and Cross-Product Manipulation
Fragmented markets provide opportunities for market participants to disguise misconduct by trading in multiple markets. In 2015, FINRA will continue to enhance both its equities and options cross-market surveillance patterns. FINRA’s cross-market surveillance now covers over 99 percent of the U.S. equity markets. Along with identifying potentially manipulative activity by single market participants on either a single or multiple markets, the cross-market surveillance patterns also identify potential relationship trading activity, that is, activity involving two or more market participants apparently acting in concert through one or more markets to engage in manipulative activity. These patterns mark a material step forward in promoting market integrity.

With the Chicago Board Options Exchange and C2 Options Exchange outsourcing most of their regulatory functions to FINRA starting in January 2015, FINRA will also now provide surveillance services to approximately 65 percent of the options market. As with equities, FINRA will continue to enhance its cross-market options surveillance capabilities in 2015 by addressing new threat scenarios.

In 2014, on behalf of some of FINRA’s options exchange clients, FINRA also brought an action against a firm for cross-product manipulation. The case involved multiple instances of coordinated equity and options market activity designed to create momentary, artificial options prices that enabled the trader to purchase or sell options at more favorable prices. In 2015, FINRA plans to continue to expand its cross-product reviews and potentially bring additional actions.
Order Routing Practices, Best Execution and Disclosure

Last year, FINRA began the process to assess whether trading-fee rebates create conflicts of interest that compromise the execution quality of customer orders. Specifically, FINRA is presently conducting a sweep of firms that route a significant percentage of their unmarketable customer limit orders to trading venues that provide the highest trading rebates for providing liquidity. The concern is that firms may receive inferior executions of their customers’ unmarketable limit orders because of market movements during the pendency of the orders, while the firm still collects a trading rebate. As part of the sweep, FINRA is in the process of reviewing routing decisions for marketable versus non-marketable orders and how such decisions are impacted by rebates. While the review is ongoing, the assessment has revealed that some firms do not have active best execution committees or other supervisory structures in place to meet their obligation to regularly and rigorously evaluate the quality of customer order executions. We will use the knowledge of our 2014 efforts to enhance our approach in determining whether firms base routing decisions on benefits to the firms without thoroughly evaluating the potential conflicts presented and the quality of execution they receive for customer orders.

We have also seen evidence of firms failing to meet their duty of best execution in routing some customer options orders. We have initiated reviews of firms that appear to have ignored a better market on one options exchange to achieve a clean cross on another market. FINRA will continue to review whether options floor brokers meet their best execution obligations and conduct appropriate reviews of the execution quality they receive on their customers’ behalf.

Regarding fixed income, the evolution of market structure and the related expansion in electronic trading of debt securities has contributed to firms having access to improved data and tools to evaluate best execution and mark-ups. In 2015, FINRA will increase its emphasis on reviewing firms’ pricing practices, including whether firms have the supervision and controls in place to ensure they are using reasonable diligence and employing their market expertise to achieve best execution for their customers and avoiding excessive mark-ups (and mark-downs).

In addition, in our fair pricing reviews, we are looking for instances in which firms that are intermediating transactions in structured products may not have disclosed information to their customers about how they would charge the customer. Dealers that position a trade for the purpose of taking a spread when their customer has agreed to pay the dealer an explicit fee for the transaction, should look closely at whether they are meeting the customer’s expectations about how the dealer should execute the trade and be compensated.

Lastly, starting in 2015, FINRA will launch a pilot program to conduct fixed income-based examinations focusing on trading issues, including related controls. As with other trading examination programs, the fixed income program will focus on areas that complement FINRA’s surveillance program. Among other things, the fixed income examinations will focus on the operation of alternative trading systems trading fixed income instruments, books and records, supervision and order execution practices.
Market Access
While the four years since the SEC adopted Rule 15c3-5 (the “Market Access Rule”) have seen improvements in firms’ risk management controls, we continue to find examples of firms’ inadequate market access controls in both the equities and options markets related to potential rules violations (e.g., manipulation) and erroneous activity (e.g., erroneous quotes). Similarly, we have observed confusion regarding the applicability of the Market Access Rule to the fixed income markets. We have frequently found that firms have not developed sufficient financial controls around fixed income market access with respect to principal trading activity.

FINRA recognizes the control challenges firms face when customers conduct potentially manipulative activity through multiple broker-dealers. Therefore, beginning in 2015, FINRA plans to commence a pilot program to leverage the relationship trading alert activity detected in its cross-market surveillance program to provide firms with information intended to supplement firms’ supervision efforts with respect to detecting and preventing manipulative trading activity.

Audit Trail Integrity
FINRA will continue to focus on late reporting in TRACE-eligible and municipal securities that appears to result from inadequate processes and procedures on trading desks. In many cases, firms appear to report larger-sized trades up to several hours late. These delays in reporting potentially affect FINRA’s audit trail and its ability to assess whether a firm was at risk when executing a trade.

FINRA has created a new team to focus on identifying potential equity audit trail issues not typically detected through routine compliance sweeps and reviews. An important objective of this group is to resolve reporting errors promptly so that surveillance patterns can scan the most accurate data possible, reducing the risk of false alerts and potentially unnecessary inquiries to firms. The team looks at Order Audit Trail System, trade reporting and exchange audit trail data to identify potential reporting errors.

Conclusion
FINRA urges firms to review their business in light of the concerns addressed in this letter. Serving the interests of the investing public and entities raising capital in a fair manner should be a guiding principle as firms pursue their business in 2015. It is also important for firms to stay current on new and existing priorities and developments as they arise throughout the year. As always, we urge you to contact your firm’s regulatory coordinator with specific questions or comments. In addition, if you have general comments regarding this letter or suggestions on how we can improve it, please send them to Daniel M. Sibears, Executive Vice President, at dan.sibears@finra.org.
Endnotes

1 See FINRA press release, FINRA Fines 10 Firms a Total of $43.5 Million for Allowing Equity Research Analysts to Solicit Investment Banking Business and for Offering Favorable Research Coverage in Connection With Toys”R”Us IPO, Dec. 11, 2014.

2 Based on data from Morningstar.

3 See FINRA Rule 2210.

4 See FINRA Investor Alert, Public Non-Traded REITs—Perform a Careful Review Before Investing.


6 These funds are referred to using a variety of terms, including smart beta, strategic beta, and alternative beta.

7 These rules revise and consolidate NASD Rules 3010, 3012 and 3110(i) and other corresponding NYSE rule provisions. Firms can find more information about the rules in Regulatory Notice 14-10.


9 See Regulatory Notice 13-45.

10 See Regulatory Notice 13-23.

11 See FINRA press release, FINRA Fines LPL Financial LLC $950,000 for Supervisory Failures Related to Sales of Alternative Investments, Mar. 24, 2014; and FINRA Fines Berthel Fisher and Affiliate, Securities Management & Research $775,000 for Supervisory Failures Related to Sales of Non-Traded REITs and Leveraged and Inverse ETFs, Feb. 24, 2014.


15 See FINRA press release, FINRA Fines Merrill Lynch $8 Million; Over $89 Million Repaid to Retirement Accounts and Charities Overcharged for Mutual Funds, June 16, 2014.


18 MSRB Municipal Advisor Resources.

19 FINRA’s Notice to Members 05-48 provides guidance on this subject.
State Regulatory Requests: Using a Measured Approach to Manage a Broker-Dealer’s Objections
Ronak V. Patel
August 28, 2015

State securities regulators have various tools to obtain information and documents from a broker-dealer. Requests are made under subpoena or pursuant to an alternative authority to request documents and information. Whatever the method, such requests require a firm to dedicate resources to responding in a timely, accurate, and complete manner. Significant objections or refusals to provide requested information can result in time-consuming litigation with significant risks. Conversely, the amount of cooperation exhibited in a firm’s response can play a significant role in the resolution of an investigation.

At the same time, regulators share a responsibility towards ensuring efficient and fruitful investigations. State laws provide regulators broad authority, but a thoughtful use of the powers will ultimately advance regulatory objectives. Investigations often feel adversarial, but both sides can promote an investigation’s efficiency and effectiveness by recognizing common concerns and seeking practical solutions through cooperative communication.

Understanding the Request Authority

State regulators generally have extensive authority to obtain records from broker-dealers registered in their jurisdictions. Under the subpoena powers, the administrator (or a delegate) is generally

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1 Ronak Patel is the Deputy Securities Commissioner of Texas. However, the views expressed in this article represent the author’s only, and should not be regarded as opinions of the Texas State Securities Board or any other member of the agency.
authorized to issue a subpoena requiring the production of records or compelling witness testimony.²

In addition to subpoena powers, state laws also authorize state regulators to access the records of a broker-dealer through inspections, which are increasingly conducted through records requests instead of on-site visits. Notably, the inspection authority is generally not restricted to records located within the state.³

An important, but often underappreciated, aspect of the investigative powers under state law is the express ability of state securities regulators to assist other states.⁴ Pursuant to such explicit authority, a state regulator can request records from a broker-dealer in connection with efforts to assist and/or cooperate with another regulator. These types of provisions not only foster uniformity, but also support the efficient use of limited resources to conduct effective investigations of potentially systemic problems at broker-dealers.

The Serious Consequences of Limiting the Response

Failing to respond to a request, even partially, can carry significant consequences. A broker-dealer may face litigation even before the underlying investigation is completed. The consequences of such litigation are not limited to the compelled production of information and records, but instead could involve an enforcement action related to a broker-dealer’s license. Even short of litigation demanding production, a firm must account for the potential loss of goodwill with the regulator as well as the loss of any

² For example: Alabama Securities Act, Section 15 and Florida Securities and Investor Protection Act, Chapter 517.201.

³ For example, Illinois Securities Law of 1953, Section 8.I(3).

⁴ For example: South Carolina Uniform Securities Act of 2005, Section 35-1-602(f) and Texas Securities Act, Section 28.C.
cooperation credit from which the firm may have otherwise benefitted.

**Subpoena Enforcement Action**

If a subpoena was issued to request information, a standard recourse available to the regulator is a subpoena enforcement action. The forum for such an action will vary by state and would require a jurisdiction specific analysis. Case-law helps define the likely issues in an action to enforce a subpoena. For example, in Texas, a court is likely to utilize a five-step analysis in assessing whether an administrative subpoena violates rights under the Fourth amendment of the United States Constitution and the corresponding provision of the Texas Constitution. The factors include determining:

1. If the agency’s investigation is being conducted pursuant to an authorized purpose and whether the subpoena is relevant to that purpose;
2. If the agency has followed necessary statutory procedures, if any;
3. Whether the subpoena describes the documents sought with adequate particularity;
4. Whether the subpoena unnecessarily or excessively seeks information which the agency already possesses; and
5. Whether the party responding to the subpoena can show that the subpoena is unnecessarily burdensome.\(^6\)

\(^5\) Sinclair v. Savings and Loan Commissioner of Texas, 696 S.W. 2d 142, 151-152 (Court of Appeals of Texas, Dallas - 1985).

\(^6\) Id.
Federal courts have used a similar approach in analyzing such challenges to subpoenas.\(^7\) In general, regulators must remain steadfast in exercising subpoena powers judiciously. Broker-dealers should recognize that regulators acting within legislatively authorized jurisdiction are likely to receive significant deference with respect to the language and scope of the requests as well as the burden in responding.

The primary relief in an action to enforce a subpoena is the production of information and documents responsive to the subpoena. Of course, the state is likely to seek attorney's fees and any other relief the court may be able to provide. While a brokerage may feel comfortable with the litigation risk and cost associated with refusing to comply with a subpoena, other remedies under state laws present a much higher risk to broker-dealers challenging a subpoena. For example, the Florida Securities and Investor Protection Act authorizes the relevant circuit court to grant injunctive relief restraining various investment activities, including the sale or distribution of securities from offices in Florida.\(^8\)

**Administrative Action on License**

In a similar vein, state securities laws provide grounds for an action against a registered broker-dealer refusing to provide requested information. Sanctions pursuant to such provisions can include suspension or revocation of the broker-dealer’s registration

\(^7\) Securities and Exchange Commission v. OKC Corp., 474 F. Supp. 1031 (1979)

\(^8\) Florida Securities and Investor Protection Act, Chapter 517.201(4)(a). Similar provisions found in other jurisdictions where the state laws are based on the Uniform Securities Act (2002).
in the jurisdiction.\textsuperscript{9} In some states, the firm’s registration may be \textit{summarily} suspended.\textsuperscript{10} Thus, the risk in failing to respond to a state regulator’s request for information or access to records is very significant.

Notably, the request at issue in such a case may be pursuant to the regulator’s subpoena powers or other authorized methods of obtaining information from broker-dealers. Therefore, refusing to provide information or documents responsive to a request letter or during an inspection may constitute a basis for the filing of an action against the brokerage.

It is conceivable that a court will analyze factors similar to those considered in a subpoena enforcement action in assessing Constitutional challenges to such requests.\textsuperscript{11} Therefore, brokerages should remain mindful of the degree of deference a regulator will receive so long as it has complied with applicable statutory requirements.

When requesting information or other documents, regulators should take certain measures to account for the possibility that a brokerage might refuse to respond completely. First, the request should be communicated in writing and delivered in a method where delivery can be proven.

\textsuperscript{9} For example: Illinois Securities Law of 1953, Section 8.E(1)(r) and Vermont Uniform Securities Act (2002), Section 5412(d)(8).

\textsuperscript{10} For example, South Carolina Uniform Securities Act of 2005, Section 35-1-412(f). A summary suspension is when a license is suspended by the administrator before a hearing. The licensee will have the opportunity for a hearing, but the suspension is effective immediately upon issuance of the suspension Order.

\textsuperscript{11} Schade v. Texas Workers’ Compensation Commission, 150 S.W.3d 542, 551 (Court of Appeals, Austin – 2004)
Second, it is advisable to include language providing clear notice of the relevant facts and legal provisions. For example, the Texas Securities Act provides that a registration may be suspended or revoked if a broker-dealer refuses to furnish “any information deemed necessary by the Commissioner or Board” to determine a dealer’s financial responsibility or “the business repute or qualifications” of a dealer or its agents.\textsuperscript{12} Therefore, Texas request letters to registered broker-dealers specifically notify the firm of both the fact that information sought is “deemed necessary” to make the requisite determinations and the legal ramifications of refusing to respond.

Finally, in cases where the brokerage is objecting to all or some requests, the regulator should take steps to have the firm confirm it is \textit{refusing} to provide the requested information. A clear refusal may be useful evidence in connection with an enforcement action. Of course, even if the firm is careful to say it is not refusing production, its actions may establish a “constructive refusal” or other impediment to the investigation.

Various factors, including the potential for a negative impact on clients and/or financial markets, will affect a regulator’s willingness to pursue any case involving the suspension or revocation of a broker-dealer. Furthermore, many broker-dealers possess far more resources to dedicate towards litigation compared to a state agency. Thus, regulators would be wise to not use potential sanctions as simple threats nor file such actions every time a firm refuses to produce a subset of requested records or requests for an extension of time. A judicious use of these powers will serve the regulator well in each case they are used and, ultimately, will justify the continued need for such statutory remedies.

\textsuperscript{12}Texas Securities Act, Section 14.A(7).
**Loss of Cooperation Credit**

Whether or not the regulator pursues an action to compel production and/or suspend the brokerage’s registration, a refusal to produce requested information in a timely manner will almost certainly result in the firm losing cooperation “credit.” Cooperative efforts towards providing responsive information in a timely manner not only establish potentially useful good-will with the regulator, but may even require the regulator to account for the cooperation if the investigation uncovers any violations.\(^\text{13}\)

Self-reporting violations may deserve the most cooperation credit, but responding to requests for information and documents in a timely, accurate, and complete manner normally warrants meaningful credit. However, it may be difficult for businesses to assess a specific amount of benefit generated by material cooperation in the face of significant costs associated with large requests for information.

To this end, regulators must recognize cooperative efforts, especially significant ones, by highlighting them in filings or settlements. More importantly, regulators should diligently differentiate between relative levels of cooperation by broker-dealers. In doing so regulators will incentivize cooperative actions by broker-dealers while also recognizing the financial and institutional costs associated with voluminous responses.

\(^\text{13}\) For example, Florida Administrative Code, Chapter 69W-1000.001 Disciplinary Guidelines, Section 5(l); Rules and Regulations of the Texas State Securities Board, Section 106.1; Utah Administrative Code, R164-31-1.(B)(1)(d).
Recognize Common Issues to Develop Practical Solutions

While it is easy to be cynical about the reasons behind objections by a brokerage or pressure from a regulator, there are often logical and reasonable concerns on both sides.

Each investigation presents unique issues requiring tailored solutions, but some issues frequently manifest in connection with regulatory requests. Two significant ones are the scope of the request and the timing of the response. Finding workable solutions to objections related to scope and timing is more feasible if both regulators and industry lawyers are mindful of underlying concerns on the other side.

Broker-Dealer Issues in Responding

Some issues brokerages commonly face in responding to regulatory requests include:

- The requests require extensive research and/or the collection of voluminous records;
- The requests include terminology or references that are not used at the broker-dealer;
- Responsive records may be located in various business units and/or locations across a large organization requiring extensive internal coordination to respond;
- The subject matter of the investigation is complex and the broker-dealer does not have a handle on the scope of any potential violations;
- Responsive records, especially e-mails, may include privileged attorney-client communications;
- Although the broker-dealer has responsive information, it is not maintained in the format specified by the regulator;
- Responsive material includes sensitive client information, such as account numbers, account values and holdings, social security numbers, and birthdates; and

- There may be a time delay between delivery of the request and when it is received by the appropriate personnel.

**Common Regulatory Concerns**

Regulatory considerations underlying the scope of requests and specified deadlines include:

- Desire to ensure that all relevant records are covered by the time period and types of records included in the request language;

- A need to identify potentially ongoing violations and/or investor harm in an efficient manner;

- The investigation involves a review of potentially systemic violations. A broader review of records helps to identify whether certain violations are relatively isolated events or reflective of a wider breakdown in controls at the broker-dealer;

- The requesting agency is coordinating with other regulators in an effort to investigate potentially nationwide violations in a uniform and efficient manner;

- The request may relate to a pending application for registration. Many states conduct extensive reviews of individuals applying for registration in their states, including persons not based in the state. The registration process is a gateway for persons to access investors throughout the state. Furthermore, delays in completing the registration review inhibit a broker's ability to conduct business;
- The request may relate to time-sensitive investigations involving violations by persons other than the broker-dealer. For example, the regulator is verifying assets purportedly managed by a third-party investment adviser or is looking for financial records under a business records affidavit for trial purposes; and

- State securities regulators generally have very limited resources. As a result, the investigation may not include any lawyers and/or the request may be modeled on a template request.

**Objections to Scope and Practical Approaches**

While the considerations above are neither comprehensive nor applicable in all cases, understanding them will help both sides focus on developing practical solutions to recurrent issues. Consider for example how an understanding of the concerns above might guide productive solutions to objections related to the scope of a regulatory request.

*Objection: The request resembles a “fishing expedition”*

In presenting concerns about the breadth of a regulatory request, a broker-dealer should be prepared to discuss why the request goes beyond the material that may be relevant to the investigation. But, in order to do so, the firm must understand the focus of the investigation. So, when faced with a request calling for extensive records over a long time period, counsel for a brokerage should contact the regulator as soon as possible.

To that end, the regulator should be willing to discuss the rationale behind the relevant time period and each type of record requested. There may be reasons to not discuss the focus of an investigation, but silence may be harder to justify when a request is wide-ranging. Moreover, broad requests should be scrutinized carefully to determine whether narrower requests would be sufficient.
A regulator undertaking a broad investigation should develop an investigative plan and be prepared to identify which requests are priorities. Although this requires significant planning, it will pay dividends because it will allow the regulator to ensure that its investigation is handled in a reasonable manner and is not stymied by the scope of its own requests.

Counsel should use communication with the regulator to help the regulator develop priorities that are consistent with the brokerage’s ability to produce responsive information. As importantly, the firm should respect identified priorities and respond in a timely manner. Failing to do so threatens loss of goodwill and will likely limit productive agreements and concessions in the future.

**Objection: The request is beyond the regulator’s jurisdiction**

A state securities regulator’s investigative powers generally extend to preventing or detecting violations of the state’s securities laws. Therefore, information requested must be useful towards the authorized purposes. However, it would be a mistake to assume that records related to transactions outside of the state are beyond the regulator’s jurisdiction. There are numerous reasons why “out-of-state” transaction records may be relevant to a state’s efforts to prevent and detect violations of its own securities laws.

Foremost an investigation may involve whether a broker-dealer’s supervisory systems and procedures comply with state law. Regulations related to supervisory systems and procedures may require that systems and procedures be reasonably designed to achieve compliance with all applicable securities laws. As a result, an assessment of a brokerage’s supervisory systems could

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14 For example: Alabama Securities Act, Section 15 and Texas Securities Act, Section 28.

be furthered by a review of transactions both in and out of the state. Reviewing out of state transactions would provide the regulator a broader sample by which to assess systemic issues.

Another important fact about state securities regulators to keep in mind is that many conduct material reviews of individuals applying for registration in their jurisdictions. To that end, if a broker living in California is applying for registration in Texas, the Texas regulators may be interested in reviewing the records related to a complaint filed in connection with California based trading activity.

Finally, a state may be assisting another regulator or cooperating with a group of jurisdictions pursuant to the type authority discussed previously. Such efforts not only support investor protection but create significant efficiencies in connection with investigations into systemic violations of state laws. There is extensive evidence of state securities regulators participating in multi-jurisdictional investigations and settlements. Whether or not a brokerage is interested in participating in a global settlement, a state regulator is likely authorized to obtain out-of-state transaction records in assisting other regulators.

A broker-dealer should consider the possible rationale in support of a request for information before objecting to the state’s jurisdiction. After all, claiming that a request reaches beyond a regulator’s jurisdiction can be inflammatory. Instead, the brokerage may be served better by addressing underlying issues with the request, such as the breadth of the request or enhancing the privacy of client information. For example, the regulator and firm can work together to identify what, if any, sensitive client information is necessary at the outset of an investigation.

Information provided during investigations is generally subject to confidentiality provisions under state law, but the protections vary state-to-state.\textsuperscript{17} Therefore, it is a good idea to discuss how information will be kept confidential especially if a state is obtaining sensitive client information on a broad scale.

**Conclusion**

Clearly brokerages and state regulators have various tools and resources available to them in connection with regulatory requests. Select cases will require, undoubtedly, some form of adversarial action. After all, effective lawyers know how to leverage available remedies to best serve their clients.

But, in responding to regulatory requests, the most effective lawyers utilize strong communication and creative problem-solving skills. Counsel for regulators and broker-dealers should identify and communicate priorities and concerns in order to first attempt to develop practical solutions. Such measures foster efficiency and cooperation that maximize the regulator’s ability to protect investors and provide appreciable benefits to the broker-dealer in the response and resolution stages of an investigation.

\textsuperscript{17} For example, Texas Securities Act, Section 28.A.
Identifying and Addressing Conflicts of Interest
Wednesday, December 2
12:45 p.m. – 1:45 p.m.

This panel focuses on some of the primary types of conflicts firms’ face, and measures they take to identify, manage and mitigate those conflicts, as well as how firms stay abreast of emerging conflicts. Panelists discuss factors firms consider important to their framework for managing conflicts of interest, as well as factors to consider in establishing a conflict management program.

Moderator: Steven Polansky
Senior Director
FINRA Office of Regulatory Programs

Panelists: James Stephen (Jim) Jones
President and Chief Compliance Officer
Crews & Associates, Inc.

James McHale
Chief Compliance Officer
Wells Fargo Advisors, LLC

Thomas Mellett
Deputy Director
FINRA San Francisco District Office
Identifying and Addressing Conflicts of Interest Panelist Bios:

Moderator:

**Steven Polansky** is a Senior Director in FINRA’s Office of Regulatory Programs. He is responsible for leading cross-firm reviews—including the recent conflicts and ongoing cybersecurity reviews—and special projects. Previously, Mr. Polansky worked in FINRA’s International Department, where he was responsible for analyzing international regulatory developments and leading FINRA’s relationships with select financial regulators in Europe and Asia, as well as international financial institutions. In addition, Mr. Polansky led advisory projects in a number of jurisdictions related to, among other things, risk-based supervision (including associated training), prudential oversight and market surveillance. Prior to joining FINRA, Mr. Polansky was a management consultant with PricewaterhouseCoopers, and he served for seven years as a Professional Staff Member on the Committee on Foreign Relations in the United States Senate. Mr. Polansky received his MBA in finance from The Wharton School at the University of Pennsylvania, his M.P.A. from the Kennedy School of Government at Harvard University, and his bachelor’s degree in history from Colgate University.

Panelists:

**James Stephen (Jim) Jones** is one of the original founders of Crews & Associates, Inc., the Arkansas based broker-dealer specializing in fixed income securities. He currently serves as Crews’ President, Chief Compliance Officer, and member of its Board of Directors. Jones began his career as a retail and institutional broker. During his tenure at Crews, he has headed the general market underwriting department and participates in all aspects of the company which includes sales, trading, public finance, compliance/legal, and management. Mr. Jones has been active on various NASD/FINRA committees, serving as chairperson of the District 5 Business Conduct Committee and National Advisory Council in 2000. He recently completed his term on the FINRA Fixed Income Committee, and has served on the Small Firm Advisory Board (SFAB). Mr. Jones received a Bachelor of Arts in Communications from the University of Arkansas (Fayetteville) in 1976, a Master of Arts in Communications from the University of Oklahoma in 1978, and his Certified Regulatory and Compliance Professional (CRCP) designation from the FINRA Institute-Wharton Certificate Program in 2005.

**Jim McHale** is the Chief Compliance Officer of Wells Fargo Advisors, LLC. In this role, he leads the compliance function for Wells Fargo’s retail brokerage business, including responsibility for retail compliance, products and regulatory compliance, regulatory affairs, internal controls, compliance implementation teams and anti-money laundering compliance. Mr. McHale sits on the Wells Fargo Advisors Operating Committee. Mr. McHale joined Wells Fargo Advisors in October 2014. Previously, he was the global head of brokerage compliance for E*TRADE Financial Corporation, where, among other responsibilities, he helped design and implement an enterprise compliance program consistent with the expectations of the federal banking regulators. Prior to E*TRADE, he served as managing director and associate general counsel with the Securities Industry and Financial Markets Association (SIFMA), where he led advocacy efforts on proposed rules and regulations issued by the SEC, CFTC and FINRA, including several Dodd Frank Act implementation initiatives. Mr. McHale was also a member of the SIFMA working group responsible for updating SIFMA’s White Paper: “The Evolving Role of Compliance” (March 2013). Earlier in his career, Mr. McHale was associate general counsel with E*TRADE, an associate in the Securities Industry Practice Group of the law firm of Morgan, Lewis & Bockius and prior to that served as special counsel with the U.S. Securities and Exchange Commission’s Division of Trading and Markets. Mr. McHale holds a J.D. from the University of South Carolina School of Law and a bachelor’s degree from the University of South Carolina School of Business Administration. He is a frequent speaker on legal and compliance topics impacting the securities industry.

**Thomas Mellett** is Deputy Director of FINRA’s San Francisco District Office, where he is responsible for the day-to-day leadership of the office. He also supports the Regional Director in managing the regulatory programs and administration of the district offices within the West Region. Prior to this role, Mr. Mellett was the Surveillance Director of FINRA’s Denver and Seattle District Offices. He supervised regulatory coordinators who plan examinations and conduct financial/operational surveillance of member firms. From 2010 through 2012, Mr. Mellett was an examination manager in San Francisco and was responsible for supervising routine examinations of member firms. He transitioned into management after working as an examiner in the New York District Office, where he contributed to many high-profile and complex investigations. Mr. Mellett is designated
as a Certified Regulatory and Compliance Professional (CRCP) through the FINRA Institute at Wharton. Mr. Mellett holds a bachelor’s in finance from Bentley University.
Identifying and Addressing Conflicts of Interest
Panelists

Moderator:

• Steven Polansky, Senior Director, FINRA Office of Regulatory Programs

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• James Jones, President and Chief Compliance Officer, Crews & Associates, Inc.
• James McHale, Chief Compliance Officer, Wells Fargo Advisors, LLC
• Thomas Mellett, Deputy Director, FINRA San Francisco District Office
Conflict of Interest Framework

The 4 “D’s”
- Define
- Discover
- Disclose
- Document
EXECUTIVE SUMMARY

Conflicts of interest can arise in any relationship where a duty of care or trust exists between two or more parties, and, as a result, are widespread across the financial services industry. While the existence of a conflict does not, per se, imply that harm to one party’s interests will occur, the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly. Indeed, many of the foundational pieces of legislation governing financial services in the United States contain provisions crafted precisely to address conflict situations.1

This report focuses solely on broker-dealers, the entities the Financial Industry Regulatory Authority (FINRA) regulates. Broker-dealers are subject to comprehensive regulation under the federal securities laws, Securities and Exchange Commission (SEC) rules and FINRA rules.2 Conflicts of interest are an SEC and FINRA priority and have been addressed through rulemaking, oversight and enforcement action.3 (See Appendix I for a non-exhaustive list of conflicts-related rules.)

This report carries those efforts forward. It recognizes that many broker-dealer firms have made progress in improving their conflicts management practices, but emphasizes that firms should do more to manage and mitigate conflicts of interest in their businesses.

To assist in these efforts, FINRA launched its conflicts initiative in July 20124 to review firms’ approaches to conflicts management and to identify effective practices.5 We used firms’ responses to FINRA’s conflicts review letter, in-person meetings and a follow-up compensation questionnaire to develop the observations detailed in this report.

The report is not intended as an inventory of conflicts that firms face, nor does it cover many conflicts that federal securities laws and SEC and FINRA rules already address, such as investment banking-research separation, outside business activities, soft dollars, payment for order flow or securities allocations to customers. Instead, FINRA’s objective is to focus on firms’ approaches to identifying and managing conflicts in three critical areas—firms’:

- enterprise-level frameworks to identify and manage conflicts of interest;
- approaches to handling conflicts of interest in manufacturing and distributing new financial products; and
- approaches to compensating their associated persons, particularly those acting as brokers for private clients.
The enterprise-level framework discussion examines how firms address conflicts across their business lines from a top-down perspective. The new product and new business discussion explores how firms address conflicts related to the introduction of new products and services. Together, these areas play critical “gatekeeper” roles. Specifically, if firms are effective with enterprise-level frameworks and handling conflicts with new products, they can be proactive in identifying and managing conflicts. The focus on compensation provides insight on financial incentive structures that may create, magnify or mitigate conflicts of interest.

The report identifies effective practices that FINRA observed at firms or that, based on experience and analysis, FINRA believes could help firms improve their conflicts management practices. It also contains more general observations and commentary on firms’ practices that we share for the industry’s information. FINRA recognizes that the effective practices and observations in this report are drawn from discussions with large firms and, as a result, will not in all cases be directly applicable to small firms.

This report is a point-in-time review of several facets of conflicts of interest. Given conflicts’ pervasiveness and potential to cause customer harm, FINRA will continue to assess firms’ conflicts management practices and the effectiveness of those practices in protecting customers’ interests. FINRA will also monitor the effectiveness of approaches to conflicts regulation used internationally. FINRA expects firms to consider the practices presented in this report, and to implement a strong conflict management framework. If firms do not make adequate progress on conflicts management, FINRA will evaluate whether rulemaking to require reasonable policies to identify, manage and mitigate conflicts would enhance investor protection.

FINRA stresses that this report is not intended to express any legal position, and does not create any new legal requirements or change any existing regulatory obligations. Throughout the report, we identify conflicts management practices that we believe firms should consider and tailor to their business model as they strengthen their own conflicts frameworks.

Conflicts of Interest Framework

The first focus of this report is firms’ enterprise-level conflicts of interest frameworks. We use the term framework to mean the combination of underlying ethics culture, organizational structures, policies, processes and incentive structures that, in their totality, shape a firm’s management of conflicts of interest.

An effective practice is for firms to implement an articulated, firm-wide framework to manage conflicts of interest, and FINRA observed a number of firms that implemented many facets of such a framework. The key to making such a framework effective begins with the tone from the top. To be effective, firm leadership should require not only adherence to the letter of the law, but a commitment to the highest ethical standards and to putting customers’ interests first. Of course, reliance on the tone from the top to address conflicts of interest is insufficient by itself. As appropriate to the scale and complexity of a firm’s business, elements of an effective practice framework for managing conflicts of interest include:

- defining conflicts of interest in a way that is relevant to a firm’s business and which helps staff identify conflict situations;
- articulating employees’ roles and responsibilities with respect to identifying and managing conflicts;
- establishing mechanisms to identify conflicts in a firm’s business as it evolves;
defining escalation procedures for conflicts of interest within and across business lines;

- avoiding severe conflicts, even if that avoidance means foregoing an otherwise attractive business opportunity;

- disclosing conflicts of interest to clients, taking into consideration the different needs of retail and institutional clients;

- training staff to identify and manage conflicts in accordance with firm policies and procedures; and

- reporting on significant conflicts issues, including on a firm’s own measures to identify and manage conflicts, to the Chief Executive Officer (CEO) and board.

New Product Conflicts

The second focus of this report is the introduction of new financial products. Firms at the forefront of financial innovation are in the best position, and are uniquely obligated, to identify the conflicts of interest that may exist at a product’s inception or that develop over time.

There are a number of effective practices firms can adopt to address such conflicts. First, firms can use a new product review process—typically through new product review committees—that includes a mandate to identify and mitigate conflicts that a product may present.

Second, firms should disclose those conflicts in plain English, with the objective of helping ensure that customers comprehend the conflicts that a firm or registered representative have in recommending a product. These conflicts may be particularly acute where complex financial products are sold to less knowledgeable investors, including retail investors.

Third, product manufacturing firms can implement effective Know-Your-Distributor (KYD) policies and procedures. These KYD measures help mitigate the incentive to increase revenue from product sales by using distribution channels that may not have adequate controls to protect customers’ interests.

Fourth, firms can perform post-launch reviews of new products to identify potential problems with a product that may not have been readily apparent during the initial review—or that may have arisen as a result of economic events—and take remedial action.

Fifth, firms can carefully evaluate and decline to offer products to customers when the conflicts associated with those products are too significant to be mitigated effectively.

To reduce conflicts, firms’ private wealth businesses should operate with appropriate independence from other business lines within a firm. FINRA is encouraged by firms’ general adoption of open product architectures (i.e., the sale of third party in addition to proprietary products). Nonetheless, firms involved in both the manufacture and distribution of products should maintain effective safeguards to alleviate pressure to prefer proprietary products to the detriment of customers’ interests. This is particularly important as firms seek to leverage their brokerage and other platforms to cross-sell products and services. Equally important, firms with revenue sharing or other partnering arrangements with third parties should exercise the necessary diligence and independent judgment to protect their customers’ interests.
Compensation Practices

The final focus of this report is compensation. Although the primary focus is on brokerage compensation (and related supervisory and surveillance systems), the report also addresses the application of tools to mitigate conflicts of interest in compensation for associated persons more generally. Many firms have considered and taken steps to mitigate these conflicts directly through changes to compensation arrangements and through supervision of registered representatives’ sales activities.

The use of “product agnostic” compensation grids (also referred to as “neutral grids”) can be an effective practice to reduce incentives for registered representatives to prefer one type of product (e.g., equities, bonds, mutual funds, variable annuities) over another. These grids typically pay a flat percentage of the revenue a registered representative generates, regardless of product recommended. FINRA notes, however, that while this eliminates one variable that may influence recommendations, registered representatives still have an incentive to favor products with higher commissions because these produce larger payouts. Consequently, to reduce conflicts, firms should take measures to mitigate biases that differences in compensation by product may create.

Another effective practice is for firms to link surveillance of registered representatives’ recommendations to thresholds in a firm’s compensation structure to detect recommendations, or potential churning practices, that may be motivated by a desire to move up in the compensation structure and, thereby, receive a higher payout percentage.

Enhancing supervision and surveillance of a registered representative’s recommendations as that person approaches other significant compensation or recognition milestones is a related effective practice. A number of firms perform specialized supervision and surveillance of recommendations as a registered representative approaches the end of the period over which performance is measured for receiving a back-end bonus. In addition, some firms perform additional surveillance to assess the suitability of recommendations as a registered representative approaches the threshold necessary for admission to a firm recognition club (e.g., a President’s Club or similar).

An effective practice is enhancing supervision and surveillance of a registered representative’s recommendations around key liquidity events in an investor’s lifecycle, such as the point where an investor rolls over her 401(k). The recommendations a representative makes at this stage of an investor’s life have profound implications for the investor and deserve thorough scrutiny and review.

Another effective practice is for firms to reduce the incentive for a registered representative to prefer one mutual fund or variable annuity family over another by capping the credit a registered representative may receive for a comparable product across providers. For example, different mutual fund families might offer gross dealer concessions (GDC) of 5, 4 and 3.5 percent on a comparable fund. Some firms cap the GDC for that particular type of fund at 4 percent, which reduces the incentive for the registered representative to recommend the fund that pays a 5 percent GDC to enhance his compensation. FINRA observed several firms that implement this practice.

Finally, imposing compensation adjustments on registered representatives who do not properly manage conflicts of interest is an effective practice.

Questions/Further Information

Inquiries regarding the Report may be directed to Daniel M. Sibears, Executive Vice President, Regulatory Operations/Shared Services, at (202) 728-6911; George Walz, Vice President, Regulatory Programs/Shared Services, at (202) 728-8462, or Steven Polansky, Senior Director, Regulatory Programs/Shared Services, at (202) 728-8331.
ENTERPRISE-LEVEL CONFLICTS GOVERNANCE FRAMEWORK

Introduction

Virtually every financial firm, including those regulated by FINRA, faces potential conflicts of interest in its business. In order to address those conflicts, a firm should be able to recognize conflict situations and take measures to manage them appropriately. Firms should address conflicts through proactive decision making, not ad hoc responses to conflicts-related events. The framework for this proactive decision making depends on the scope and scale of a firm’s business. It will look vastly different for a small introducing broker than for a large firm with multiple affiliates engaged in a broad range of businesses on a national or global scale.

Large firms may address conflicts of interest through their enterprise risk management or operational risk frameworks. Components of such programs, such as risk and control self-assessments, may provide an opportunity to identify conflicts of interest within a firm’s business and evaluate their possible impacts. Efforts to quantify those impacts might still be in their early stages, but as operational risk techniques advance, these efforts may provide firms with additional tools to help focus their conflicts of interest management efforts.

By contrast, the conflicts management framework at a small firm selling basic products might rely largely on the ethical tone set by the firm owner coupled with required supervisory controls, especially those related to suitability, and the firm’s compensation structure.

Although conflicts management frameworks may differ among firms, small and large firms alike often face some of the same basic conflicts. For example, a firm or its registered representatives may have an incentive to recommend one product over another. Conflicts may exist between an associated person’s activities as a broker and their outside business activities. Firms may be tempted to hire an associated person in spite of a poor regulatory history, if they believe that the individual can boost firm profitability.

Effective Practices Summary: Comprehensive Conflicts Governance Framework

An effective practice FINRA observed at a number of firms is implementation of a comprehensive framework to identify and manage conflicts of interest across and within firms’ business lines that is scaled to the size and complexity of their business. Without such a framework, firms are more likely to experience situations where conflicts cause harm to customers or the firm. Key features of a robust conflicts management framework that were observed include:

- a “tone from the top” that emphasizes the importance of ethical treatment of customers and the fair handling of conflicts of interest;
- articulated structures, policies and processes to identify and manage conflicts of interest that include:
  - a working description of conflicts of interest that enables employees to understand and identify conflicts of interest that may arise in a firm’s business;
  - adoption of a best interests of the customer standard in a firm’s code of conduct;
  - a delineation of employees’ responsibilities with respect to identifying and managing conflicts of interest;
  - defined escalation procedures for handling potential conflict situations;

continued
An effective practice for all firms is the establishment of a “tone from the top” that stresses the importance of ethical decision making and fair treatment of customers. This tone is set by a firm’s executive management in their day-to-day actions and decisions. It is incumbent upon them to consistently communicate and demonstrate the values to which they expect their employees to adhere, and to monitor employees’ behavior to ensure that it aligns with the firm’s stated values. Without the proper tone from the top, many of the measures discussed later in this report will be ineffective. Leadership that singlemindedly drives the distribution of proprietary products may undermine the effectiveness of new product review processes intended to protect customer interests. Conflict management frameworks cannot be expected to succeed without the strong support of a firm’s leaders.

Boards can play an important role in setting the tone from the top. Providing the board with visibility on significant conflicts a firm faces, as well as the firm’s overall approach to conflicts management, signals the importance the highest levels of the firm attach to addressing conflicts issues. Several firms report on conflicts issues to their boards, sometimes within the context of the firm’s risk management reporting.

It is important to note, though, that reliance on the “tone from the top” and a good culture is a first line of defense. To protect customers and the firm from the potential negative consequences of conflicts of interest, supporting structures, policies, processes, controls and training are critical.

Conflicts Management Structures

A number of firms with which FINRA met manage conflicts at the enterprise level using either a distributed or centrally managed approach. Another group of firms neither defines conflicts management structures nor articulates the roles and responsibilities of senior management, firm committees and staff with respect to conflicts management.
An effective practice is for a firm to establish carefully designed and articulated structures to manage conflicts of interest that arise in its business. This includes clearly defining the roles and responsibilities of the individuals, committees and other bodies that play key roles in that structure. Both the distributed and centrally managed approaches may be appropriate for a firm depending on its specific circumstances. FINRA underscores that a firm’s conflict management structure does not need to be complex, but it needs to be effective.

An approach where a firm simply relies on its existing structures to manage conflicts, without having considered their effectiveness for the task is likely to be ineffective. Put differently, simply adding conflicts management as one more task for the compliance or legal departments—without a clear delineation of expectations, roles and responsibilities—is insufficient.

Distributed Model

The most common approach to conflicts management is a distributed model where responsibility for identification and oversight is spread within a firm with no single office or department having overall ownership. In this model, the business lines typically bear front-line responsibility for identifying and managing conflicts. Various senior-level committees address conflicts specific to their scope of responsibilities and the control functions support both the business lines and the committees in varying degrees. Policy ownership for conflicts issues is diffused among these same functions. The complexity of this approach increases as a function of the complexity of a firm’s business.

One benefit of this approach is that it places responsibility for identifying and managing conflicts with those individuals most directly familiar with the details of a firm’s business and who are in a position to take measures to mitigate those conflicts. In addition, a firm does not need to create new structures or reporting lines which can be a challenging and time-consuming process.

One potential downside to the distributed approach is that individuals within a business line may be unaware of conflicts in their business that arise because of activities in other business lines. In addition, individual business lines may handle similar types of conflicts in different ways without a conscious decision that those differences are appropriate for the specific situation. Furthermore, firms’ management teams may have difficulty remaining focused on conflicts issues among the myriad other issues competing for their time and attention. Finally, varying degrees of commitment to identifying and mitigating conflicts may exist across the firm.

Centralized Model

The second approach uses a centralized conflicts office to manage a firm’s conflicts framework. Firms that take this approach emphasize that although they operate a centralized office, responsibility for identifying conflicts rests first and foremost with the business. FINRA observed this model in two versions. In one version, a dedicated conflicts office is part of firm management. The office has both a transactional and business practice focus. In the former role, the office oversees the firm’s conflict management framework and works with business units to manage potentially significant conflicts within, and across, business units. In the latter role, the office works with business units to review and assess business practice conflicts on an ongoing basis, as well as to support presentation of thematic conflicts reviews to a senior firm management committee.
In the second version of the centralized approach, conflicts management is integrated into an existing, compliance-related group. This office is responsible for, among other things, the firm’s Code of Ethics and certain other enterprise-level conflicts policies. The office coordinates line-of-business “conflicts officers” (discussed below) and works with business units to identify and manage unique conflict situations. The office maintains a log of non-standard conflicts, in part to help identify areas where training may be needed. In contrast to the dedicated conflicts office approach, the integrated conflicts office does not operate the firm’s transactional review process.

Both centralized models use a network of “conflicts officers” in the business units to help address conflicts that may arise in the normal course of business. The “conflicts officers” act as a resource to the business unit in managing conflicts issues, are a point of contact for individuals who wish to raise potential conflicts concerns and can also escalate conflicts as warranted. These individuals may be part of either the risk or compliance functions.

There are several potential benefits of a centralized, enterprise-level approach to conflicts management. First, the office creates a platform to maintain a sustained, firm-wide focus on conflicts issues. A similar focus may be difficult to achieve when driven by multiple firm-level management committees. Second, creating a dedicated office sends a strong message to firm employees about the importance of conflicts issues to executive management. Third, if established at an appropriate level within a firm, the office provides visibility on conflicts issues to executive management and, as appropriate, the board. Fourth, a centralized office can help ensure a consistent approach to conflicts management across the enterprise.

The centralized model is not without potential downsides. First, it may diminish the sense of responsibility for conflicts in the business lines. Firms using the centralized model acknowledge that potential, but also emphasize that their approaches are designed to prevent this from happening. One firm explicitly places front-line responsibility for identifying conflicts with the business lines. Second, establishing a centralized model can be a significant undertaking. Firms will likely need to create new policies and processes and implement technology programs to support the operation of the conflicts office. In particular, the conflicts office may need a broad array of information about a firm’s business activities to evaluate the conflicts the firm may face.

The centralized approach to conflicts management is relatively new, and its advantages and limitations may be more fully evaluated once the approach matures.

**No Defined Structure**

Several firms with which FINRA met did not define the structures, and related roles and responsibilities, for managing conflicts in the firm. Instead, these firms address specific conflicts in the business area in which they occur, but do so primarily in a compliance context. This makes it challenging to identify and manage conflicts that are not specifically addressed in statute or regulation, or that may arise as the firm’s business model evolves over time—for example, through acquisitions or new business initiatives.

The lack of a comprehensive approach does not mean that firms were incapable of addressing potential conflicts of interest. Several of the firms had taken commendable steps to limit the distribution of more complex and risky products to retail customers. In some cases, disclosure of potential conflicts was particularly clear and concise.

Nevertheless, as a firm’s scale and complexity increase, the lack of articulated structures, policies and processes to manage conflicts exposes a firm’s customers (and the firm itself) to an increased risk of harm arising from conflicts of interest.
Committees and Other Ad Hoc Bodies

In addition to the conflicts review structures mentioned above, most firms also use various committees or ad hoc groups on an as-needed basis to address conflicts issues as they arise. These can include senior firm management committees, such as a reputational risk committee or similar body. One firm established a cross-divisional conflicts forum for compliance personnel. This group meets quarterly to share information about internal, external and regulatory developments, as well as business division specific items. The group provides a forum to share effective practices and lessons learned.

Conflicts Management Policies

An effective practice is for firms to articulate ethical standards to guide employees in managing conflicts of interest, as well as firm-wide policies on conflicts management, as appropriate to a firm’s size and complexity. Firms generally establish enterprise-level conflicts of interest policies in two places: a firm-wide code of conduct or equivalent document (e.g., a Code of Ethics), and, in some cases, a firm-wide conflicts policy.

Code of Conduct

Firms’ codes of conduct typically establish the broad context within which employees make decisions about how to handle conflicts situations. The code of conduct generally contains a broad commitment to fair treatment of customers and requirements to avoid or manage conflict situations. One firm’s code states that the firm “is committed to identifying and managing or avoiding potential conflicts of interest in its business” and is committed to “treating our clients fairly and with integrity.” Another firm’s code states “(i)n dealing with these potential conflicts, we require integrity and the use of good judgment and discretion exercised in a manner expected by this Code, our policies, and our values.”

One dually registered broker-dealer and investment advisory firm’s code states that the firm and covered staff “have an affirmative duty of care, honesty and good faith to act in the best interest of its clients.” Covered staff, the code continues, “(s)hould avoid even the appearance of a conflict of interest and should fully disclose all material facts concerning any conflict that does arise with a client.”

An effective practice is to add to a firm’s code of conduct, or other appropriate documents, a best-interest-of-the-customer standard that applies to registered representatives’ personalized recommendations to retail customers. Under this Code standard, a broker should make only those recommendations that are consistent with the customer’s best interests. A firm’s code establishes an essential starting point—a yardstick against which the behavior of employees may be measured. Of course, to be meaningful, the rhetoric of a code should be supported by firm policies and procedures and implementation by firm leadership.

Enterprise-level Conflict Policy

In addition to the code of conduct, some firms use a dedicated, enterprise-level conflict of interest policy. Those policies typically contain the following elements:

- **A statement on objectives, policy or rationale:** These elements typically acknowledge that the firm operates in a business where it faces actual and potential conflicts of interest, and that a failure to manage these conflicts effectively may result in reputational damage to the firm.
A discussion of the types of conflicts a firm may face: Firms’ enterprise-level conflicts policies typically provide general guidance on the factors that can lead to a conflict of interest, in some cases supported by examples of specific conflicts relevant to a firm’s business. (See Conflicts of Interest Examples from Firms’ Enterprise-level Conflicts Policies, below, for a description and examples of common conflict categories some firms use.)

A description of roles and responsibilities: Most firms’ policies articulate the role of senior management and, in some cases, employees in managing conflicts. Firms with both a distributed and centralized approach to conflicts management use this section of the policy to place responsibility for identifying and addressing conflicts with the business lines. For example, the policy of one firm with a distributed approach to conflicts management states “(s)enior management of each Division is responsible for ensuring that Conflicts relating to its business are identified and addressed”; other firms have similar statements in their policies. Similarly, the policy of a firm with a centralized approach states, “(s)enior management of each Business Unit...is responsible for ensuring that Conflicts relating to its business are identified and addressed including escalating, as appropriate to the Franchise Committee process.”

A description of conflict escalation procedures: Most firms’ policies describe an escalation process for handling those conflicts of interest that cannot be handled through other firm policies, including a description of individuals’ roles and responsibilities and appropriate organizational contact points for escalation.

One firm takes a different approach to establishing an enterprise-level conflicts policy. It maintains enterprise-level content standards for conflicts policies and requires each line of business to create its own conflict of interest policy in line with the corporate standard. In essence, this creates a “policy on policies.” Part of the rationale for this approach is to ensure firm-wide consistency of approach while allowing business lines to tailor their policies to their specific requirements.

Conflicts of Interest Examples From Firms’ Enterprise-level Conflicts Policies

In their conflicts policies, some firms amplify general conflict categories with specific examples of conflicts that may arise in their business:

Firm vs. client conflicts

The firm offers or recommends products for which the firm receives greater fees/compensation than other products, or that may not be suitable for certain clients.

The firm performs multiple roles with respect to a client or transaction (e.g., advisor, underwriter, lender, principal counterparty, derivative counterparty).

The firm engages in business and trading activities for its own account or client accounts while other clients are active in relevant markets at the same time.

The firm may provide investment advice or discretionary portfolio management services to its clients, and the firm may also recommend or sell products that it or affiliated companies issue.

Client vs. client conflicts

The firm is the discretionary portfolio manager for more than one client or fund, in particular with respect to issues related to allocation.

The firm has multiple clients interested in acquiring the same company or assets.

The firm charges clients in the same investment strategy or program different fees.

The firm may be in initial discussions with clients on both sides of a deal.

continued
There is no consistent relationship between firms with centralized conflicts management structures and a centralized conflicts policy. Several of the firms with enterprise-level policies do not have enterprise-level conflicts offices and not all the firms with an enterprise-level conflicts office have an enterprise-level conflicts policy.

Business Activity and Other Policies

Some firms address conflicts management, including escalation procedures, in a variety of policies beyond those at the enterprise level. For example, firms maintain a wide variety of business line or topic-specific policies that focus either wholly or in part on specific conflicts issues. These include policies on outside business activities, products, confidentiality of information, information barriers, business selection and handling of customer trades.

Conflicts Management Processes

Two of the key processes firms identified that support their enterprise-level conflicts frameworks relate to conflicts escalation and conflicts inventories. In addition, several firms discussed the importance of monitoring and assessment processes through risk control self-assessments and internal audit reviews, to evaluate the effectiveness of a firm’s overall conflicts framework. These latter processes are part of firms’ risk management programs and fall outside the scope of this report, but their relationship to conflicts management is worth noting.
Escalation Procedures

Having clear and robust processes for escalating conflicts of interest is an effective practice. Many firms use a combination of topic or business activity-specific escalation procedures—for example, procedures for escalating conflicts that may arise in a firm’s merger and acquisition advisory activities—coupled with an enterprise-level “catch-all” escalation process. This “catch-all” process is intended to capture conflicts that do not fit neatly into a firm’s other, existing escalation procedures. Firms with enterprise-level conflicts policies typically articulate these “catch-all” processes in that policy. In one instance, a firm’s policy provides a template/flowchart to help employees evaluate if and how they should escalate a conflict. Firms with more developed escalation procedures plainly articulate employees’ roles and responsibilities as well as the circumstances and manner in which they should invoke the escalation processes.

The approaches firms take to their “catch-all” processes vary considerably. Firms with a centralized conflicts management office use the conflicts office, the related conflicts officer network (discussed below), and the legal and compliance departments as primary points of contact for employees who are unsure about whether an issue constitutes a conflict. From there, employees can raise issues to the central conflicts office or other offices, as appropriate.

Firms with a distributed model take a variety of approaches. For example, one firm relies on employees escalating potential conflicts within the business line to the compliance department. Another firm encourages employees to escalate any issue that raises reputational risks, including conflicts, first to the business and, as warranted, to the risk management or legal departments.

In several firms, it was unclear what avenue an employee would take to escalate a conflict concern. Some firms’ institutional compliance or trading personnel did not have effective escalation processes for potentially problematic market or trading practices. FINRA encourages firms to examine whether escalation processes for these practices should be more broadly incorporated into the firm’s conflicts management infrastructure, particularly in light of recent enforcement matters related to trading practices (e.g., research huddles, expert networks, research analyst practices, initial public offering practices/ spinning and laddering).

Conflicts Inventory Reviews

FINRA believes that it is an effective practice to use both regular, ongoing processes and periodic reviews, to identify and create an inventory of conflicts in a firm’s business. While we observed that some firms perform ongoing or periodic reviews—as well as some firms that do not perform reviews at all—none performed both. FINRA believes that the two types of reviews are complementary. The ongoing review helps firms identify conflicts in near real-time and allows firms to address them quickly. The periodic review permits firms to step back and consider conflicts issues in a structured, comprehensive way. That could be particularly valuable for firms that use a decentralized approach to conflicts management where there may be a less consistent focus on conflicts issues.

Firms that engage in conflicts reviews—on either a periodic or ongoing basis—stated that the process was extremely useful, both in identifying conflicts and in establishing or refining conflicts-related structures, policies and processes. Some firms conduct regular, periodic reviews of conflicts within their business, sometimes in the context of a broader annual risk assessment, and record this information in a conflicts register. Firms conduct these reviews annually or biennially. In another instance, a firm shifted from conducting periodic reviews to an ongoing conflicts review process. This firm finds the ongoing review process more effective than the periodic approach.
FINRA observed one firm that included, as part of its enterprise-level conflicts policy, a template of issues—e.g., changes in business, organizational and informational structure and compensation/incentive structures—business lines should consider in conducting their conflicts review.

As part of effectively creating an inventory of conflicts, firms should consider whether conflicts can be categorized—or assigned attributes—that would facilitate future review and analysis. For example, a firm may sell complex products containing call features (see Structured and Complex Products and Embedded Conflict, page 21). These features may create potential conflicts between the interests of the issuer and investors. If a firm determined it could handle disclosure of the potential conflict in a way that was more effective, it could—with appropriate categorization—identify other products where a similar conflict might exist and assess the appropriateness of the improved disclosure practice to those other products.

**Disclosure**

The U.S. regulatory regime relies heavily on disclosure to customers as a tool to mitigate conflicts that may arise in the course of a firm’s business. The specific nature of a firm’s disclosure obligations depends on the facts and circumstances of a given situation, and these obligations are established in various places in statute, regulation and case law. A broker-dealer’s duty under the anti-fraud provisions of the federal securities laws to disclose material information depends upon the nature of its relationship with a customer. When recommending a security, a broker-dealer may be liable if it does not “give honest and complete information” or does not disclose “material adverse facts of which it is aware”. Broker-dealers have also been found liable for failures to disclose conflicts, such as their role as a market maker; their trading in a principal capacity; the existence of multiple share classes of a recommended mutual fund; and their receipt of revenue sharing payments. FINRA rules require extensive disclosure to customers in a number of circumstances (see Table 2: Examples of conflicts-related disclosure requirements and regulatory prohibitions, page 37).

State law also may impose disclosure obligations on broker-dealers. The Delaware Court of Chancery emphasized the importance of conflicts disclosure in mergers and acquisitions where a firm involved in advising and financing a transaction represents multiple clients, or has a proprietary interest in the transaction.

FINRA believes that to make disclosure effective, firms should look beyond minimum disclosure obligations under statute, regulation and case law, to identify practices that are effective in helping customers make informed decisions. In selling new products, effective disclosure may help a customer understand the factors that may affect a product’s financial outcome. To this end, firms should consider whether the use of scenarios and graphics could help customers achieve this level of understanding.

A test to evaluate the effectiveness of their disclosure is asking, in the event of a reasonably foreseeable adverse product outcome, could an investor legitimately say, “I did not realize that could happen” on the basis of information the firm provided apart from the prospectus. If the answer is “yes,” the firm should reconsider how it presents information about that product to customers. In the context of an advised sale where the firm provided its own sales materials, it is not sufficient that the relevant risk information was contained solely in the product prospectus.

A further effective practice is to require investors to attest to their understanding of more complex products before purchase. The process of going through this attestation may reinforce to customers the need to understand the products they purchase.
For firms representing multiple institutional clients, or with a proprietary interest in an advisory or financing transaction, the firm should make the customer aware of the multiple roles the firm plays and seek consent, preferably in writing, from the customer to the firm serving multiple parties’ interests.

**Hiring Practices**

Employing ethical individuals is an integral part of maintaining a culture of compliance and integrity in which conflicts of interest are addressed fairly. Several firms identified conflicts in personnel processes that could undermine efforts to hire appropriately qualified individuals. First, the firm might seek to hire a candidate with a problematic financial or regulatory history because of the book of business she could bring to a firm. Second, firms may establish hiring targets, such as hiring three new registered representatives per month or filling a vacancy within 45 days. In order to mitigate the pressure to hire associated persons who may have problematic backgrounds, some firms give their compliance department veto rights over all hires. This is intended to mitigate incentives for hiring personnel to fill a position with a potentially ethically compromised individual in order to meet a hiring target.

As part of screening applicants for employment, an effective practice is to review those individuals’ employment and regulatory history as well as their financial standing and credit history. This review includes whether the applicant was associated with disciplined firms, exhibited poor compliance behavior or engaged in sales practices that posed risks to customers. This type of review can help identify individuals who may be prone to engage in inappropriate activity.

In light of the negative impact individuals with poor ethical standards can have on a firm, FINRA remains concerned about the number of firms willing to hire associated persons with problematic disciplinary histories. This creates risks for customers as well as reputational risk to firms. FINRA’s concerns are heightened when we see firms hiring multiple individuals with these problematic backgrounds and FINRA reiterates firms’ obligations to use hiring practices that may help mitigate conflicts of interest.

**Hiring Associated Persons With a Problematic Disciplinary History**

A firm hiring an associated person must affirmatively determine that the associated person satisfies FINRA’s qualification requirements and is not subject to a “statutory disqualification” (whether or not that individual is required to be a registered person). In addition to determining the eligibility of all potential associated persons, firms have a duty to investigate the character, business repute and experience of any person prior to submitting a Form U4 on behalf of the individual. There are a number of questions firms should consider before hiring an associated person. In the case of registered representatives, firms should consider how that potential employee’s book of business will fit with the firm’s current business mix. Is the firm sufficiently familiar with all of the securities products the representative intends to offer? Does the representative engage in the sale of penny stocks and, if so, is the firm adequately equipped to supervise those transactions or recommendations? Is the firm comfortable that the products the representative intends to recommend to customers meet suitability requirements? Does the firm have the appropriate supervisory and compliance infrastructure (principals, licenses, operational personnel) to support any new business being brought on by the representative? Does the representative’s financial background (e.g., credit or bankruptcy history) raise concerns about the individual’s financial probity and potential pressure to generate revenue through excessive trading or unsuitable recommendations?

continued
Firms should pay particular attention to, and exercise due care before hiring an individual with a problematic disciplinary history. If an individual has an employment history that includes items such as a large number of customer complaints, recent terminations for cause/permitted to resign, arbitration proceedings, disciplinary actions, frequent changes in employer, and a disproportionate number of disclosures of liens and judgments, firms should carefully assess the prudence of hiring such a person. In making this assessment, a firm should weigh its ability to appropriately supervise the individual with heightened procedures. In addition, firms should assess the likelihood of the individual repeating his or her past actions in the future, which could result in possible customer harm. And, if a person is statutorily disqualified, firms must ensure that applications for association are completed that contain heightened supervisory plans and that the individual is appropriately supervised.

Hiring individuals who were previously associated with a “disciplined firm” can also have an adverse impact on a firm’s compliance culture and supervisory systems. A disciplined firm is one that in connection with sales practices misconduct involving the offer, purchase or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the SEC revoking its registration as a broker-dealer. When hiring registered representatives from a disciplined firm, the hiring firm should evaluate whether it must adopt and implement special supervisory requirements that include taping systems to monitor the actions of these associated persons.

Training

Training on ethics and conflict of interest policies is an important practice for all firms. Training prepares staff, first, to recognize where a potential conflict situation exists and, second, to make appropriate decisions about handling the conflict consistent with a firm’s policies, procedures and ethical standards.

The firms we met with broadly shared this view. For the firms, training is an important vehicle to communicate firm culture, specific requirements of a firm’s code of conduct and its conflicts management framework. Several firms emphasized the value of linking conflict management and ethics training. The latter provides staff a broader context within which to frame their conflicts-related decision-making. At firms with a centralized conflicts management approach, the conflicts offices are involved in conflicts-related training.

Firms generally preferred face-to-face training where possible, but large firms by necessity relied primarily on computer-based training to reach their dispersed employees. In the context of conflicts, several firms highlighted the effectiveness of interactive, situation-based training to help guide employee decision-making.

One firm noted that the conflicts inventory, discussed earlier, is a useful tool in providing conflicts-related training across the organization. This firm found that training staff on how conflicts arise in other business units helped them understand better how conflicts arise in the firm’s business as a whole as well as in their own business unit. In addition, the firm found that the inventory helped identify situations where the firm had failed effectively to manage conflicts in the past. These situations provided valuable training materials and learning opportunities.
In addition to broad conflicts management and ethics training, firms noted that they may provide targeted conflicts training to address conflicts issues that may arise in a particular business area, for example on a trading desk. Some firms also require registered representatives to complete specialized training on structured or complex products—including on the conflicts that may be associated with such products—before advising customers on these products.

Information Technology

For many firms, particularly larger more complex firms, a robust information technology infrastructure and associated governance mechanisms are essential components of an effective conflicts management framework. A number of processes that firms use to identify, track and manage conflicts—for example, the conflicts clearance process described below, the post product launch review discussed in the next section of this report, the delivery of conflicts training discussed above—all are critically dependent on technology. Indeed, virtually every firm that FINRA met with referred repeatedly to technology-dependent conflicts management processes.

Conflicts Clearance and Business Selection

An example of an area that a firm should consider carefully in developing its overall conflicts management framework is conflicts clearance and business selection. The conflicts that arise in this area present some of the more complex and nuanced conflicts FINRA observed during its review and illustrate the need for firms to tailor their conflicts management frameworks to the particular nature of their business.

In recent years, firms’ decisions about how to manage conflicts arising from the roles they play in transactions have been repeatedly called into question. In some cases, these decisions have had serious adverse implications for the firms involved and the reputation of the industry as a whole. Below, we highlight some of the questions firms should consider in designing their conflicts clearance and business selection process and share approaches some firms are taking to address these challenges.

Structures

Firms use divergent structures for conflicts clearance and business selection. In most firms, the conflicts clearance function is part of and supports the business line, tracking potential transactions through their lifecycle (from business opportunity through execution) to identify potential conflicts. The conflicts clearance office typically also works closely with a firm’s control room as well as the legal and compliance departments.

Depending on the firm, the conflicts group, the business line or the two working together decide how to address individual conflicts and also make the business selection decision. In situations that involve more significant conflicts or reputational risk—for example in a hostile takeover transaction—the business line may elevate the conflict to higher-level firm committees for review, such as a reputational risk committee.

A different approach combines conflicts clearance and business selection functions fully or partially outside the business line with a direct reporting line to enterprise-level executive management. FINRA observed this approach at some large firms that may compete for multiple facets of a potential transaction.
Process

From a process perspective, each of the firms emphasized the importance of communication between the conflicts office and control room, clearly defined deal-logging policies and procedures as well as clear communications with potential customers throughout the transaction development process. Implicit in the discussion with firms was the need for the combination of the conflicts clearance and control room functions to have a comprehensive view of relevant firm activities, potentially across multiple legal, business and regional entities. Technology can be an essential tool in developing this view.

A key question firms should evaluate is which of their potentially many activities should be captured in the scope of their conflicts review processes. A firm’s investment and merchant banking activities may give rise to potential conflicts, but the question may be less clear-cut in other cases. For example, if a firm acquires an entity, what element of the acquired entity’s business activities should be included in the conflicts clearance process?

The activities to be covered through conflicts clearance can be nuanced. Some firms require their sales and trading staff to consider the intent of their customers and to report those customer trading activities the staff identifies as strategic, i.e., reflecting a customer’s interest in accumulating a position in an issuer’s securities to become an activist shareholder or engage in a hostile takeover attempt. Thus, a transaction involving the acquisition of a 1 percent share in an issuer may be treated differently depending on whether the customer is an activist or passive hedge fund investor.

Given the variety of areas in a firm’s business in which a conflict can arise, several firms emphasized the importance of the conflicts clearance office having multiple sources of information about firm activity and not simply relying on one source such as deal-logging. One firm’s conflicts office reviews potentially relevant committee agendas and includes conflicts office staff on many transaction review committees to help ensure the conflicts clearance and business selection function does not miss key conflicts situations.
NEW BUSINESS AND NEW PRODUCT CONFLICTS REVIEW

Introduction

Financial services is a highly competitive industry in which new business initiatives, including new products and services launches, are important elements in many firms’ business strategies. A firm must determine which products and services it offers, the markets in which it does so, the customers to whom the product or service is offered, and the terms and conditions that may apply. These decisions, which often involve conflicts of interest, can have far-reaching implications for firm customers. Unfortunately, the financial services industry has frequently shown limited ability effectively to manage conflicts of interest that may arise in the course of product innovation.

To be effective, identifying and managing conflicts of interest associated with new business initiatives should be a key component of firms’ new business planning and implementation efforts. FINRA reviewed firms’ approaches to two central conflicts management-related questions:

► How do firms identify and manage conflicts that may be present in a new business or product?
► How do firms resolve conflicts that may exist in their own review process?

FINRA evaluated firms’ new business conflicts frameworks primarily through the lens of firms’ new product assessments. This product focus reflects FINRA’s concerns about the increased sale of complex products to retail investors who may struggle to understand the features, risks and conflicts associated with these products. The firms with which FINRA met, manufacture, distribute, or both manufacture and distribute financial products. FINRA explored firms’ new product reviews in each of these capacities.

Effective Practices Summary: New Product Conflicts Review

FINRA observed firms engaging in a number of effective practices to identify and manage conflicts of interest that may arise through the launch of a new product or service:

► Firms’ new product review committees include a mandate to identify and mitigate conflicts of interest that may be associated with a new product. This mandate is supported by a “tone from the top” and firm culture that encourages robust analysis and debate with the objective of protecting customer interests.

► Where a conflict of interest poses the potential for serious harm to customers, and the firm cannot effectively mitigate that conflict, firms decline to offer the product to customers.

► Firms differentiate product eligibility between institutional and retail clients. With respect to the latter, some firms restrict eligibility to purchase more complex products to customers whose accounts have been approved for options trading or establish other criteria that enable the firm to ascertain an individual’s ability to understand and evaluate the risks associated with the product.

► Product manufacturing firms implement strong KYD policies and processes to assess potential distributors’ financial soundness, marketing and sales controls, sales practice and compliance mindset, quality of distribution network and technical capabilities before allowing them to sell a manufacturer’s products.

► Firms conduct post-launch reviews to assess whether a product has performed as expected.

continued
Manufacturing

Conflicts Reviews and New Product Review Committees

An effective practice for product manufacturers is to include as part of their new product review process a careful analysis of the conflicts of interest a product may raise and to establish measures to eliminate or mitigate those conflicts. The manufacturers with which FINRA spoke typically review new products in their firms’ new business initiative review committees.

Although there are nuances across firms, from a definitional perspective, a “new” business initiative is viewed as encompassing a new business, new market, new product or new service, as well as the offering of an existing product or service in a new jurisdiction, through a new distribution channel or to a new customer segment. In at least one firm, the risk management department decides whether a business is “new” and when the new business review process should be invoked.

From a process and structural perspective, most manufacturing firms require the business unit initiating the new business to prepare a business case that includes an analysis of possible risks, including those arising from conflicts of interest, and mitigating measures for those risks. The firm’s new business committee, and potentially sub-committees thereof, reviews these documents and may impose restrictions or conditions to address conflicts of interest or other concerns. A review committee may limit access to a product to distributors with stringent suitability frameworks, restrict the customers to whom a product may be sold, or prescribe minimum knowledge requirements for registered representatives who may recommend the product.

In part to reduce the conflict of interest that would exist if a business unit were responsible for vetting its own initiative, a new business initiative committee typically includes business, support and control functions, including information technology, operations, finance, legal, compliance and risk management. The participation of the latter functions is intended to provide a view independent from the proposing business unit on the new business initiative. The vetting process may involve various levels of seniority in the firm, depending on the perceived risk and complexity in the new product approval and can include senior firm executives. In several firms, the risk management department has final sign-off authority on a product launch and in at least one instance, risk management is responsible for coordinating the review process.

Typically the new product review addresses two aspects of a new product launch: 1) Is the firm prepared to introduce the new business and 2) Will the new business adversely affect the firm’s broader business and reputation? Each manufacturing firm emphasized the importance it attaches to identifying and thoroughly assessing conflicts that may be present in a product. One firm’s new business review policy calls for escalating all proposals that involve conflicts of interest, reputational risk or suitability concerns. In addition, and as noted earlier, other firm committees may review a new business initiative and include conflicts within their scope of responsibility.
These approaches to mitigating potential conflicts in firms’ internal processes are highly dependent for success on the culture of the firm and the specific committees involved. Reliance on the committees, and relevant control functions’ nominal independence, to help mitigate conflicts of interest will be ineffective without a culture that encourages robust debate with the objective of protecting customer interests.

Expanding Product Availability

A key challenge for manufacturing firms in the context of their new product, or other new business, reviews is to monitor the conflicts of interest that may arise as they expand product availability, for example, when expanding the range of customers to which a product is offered, loosening controls that may exist around a product’s distribution, or incrementally changing existing product features to make the product available to a broader range of investors.

To maintain effective control over conflicts when a firm changes its distribution channels from primarily institutional to also include a broader range of customers, the firm should evaluate the change process and whether it included an assessment of the appropriateness of retail distribution.

Reverse Inquiry

In addition to manufacturing firms that developing new products, a common practice (frequently referred to as “reverse inquiry”) is for distributors to request the manufacture of a structured product designed to the distributor’s specifications. Some manufacturers are developing sophisticated automated platforms to facilitate reverse inquiries, allowing select product types to be issued more quickly and in smaller notional amounts. A potential benefit of this product creation process is that it enables distribution firms to provide customers with a product customized to their needs and market outlook on economic terms that may be more favorable than otherwise obtainable. It is especially important for manufacturers supporting reverse inquiries to rigorously apply good KYD practices (discussed below) in the context of their reverse inquiry business.

Know-Your-Distributor Policies and Procedures

An effective practice is for firms that manufacture structured and complex products to implement strong KYD policies and processes to assess potential distributors for their products. These measures can help mitigate the incentive to maximize product revenue through the widest possible distribution of a product regardless of the capability of a distributor to perform effective due diligence and suitability analyses.

The following elements of a KYD process reflect effective practices:

- conducting background checks on the distributor and relevant employees (e.g., through FINRA BrokerCheck®, compliance databases), including looking for complaints or litigations;
- reviewing the financial soundness of the distributor;
- requiring distributors to complete a detailed questionnaire to help the manufacturer assess a distributor’s sales practices, marketing strategy, registered representative training, investor education, compliance culture, product classification, trade review and sign-off process and distribution strength;
- interviewing the distributor to develop an understanding of the firm’s compliance culture; experience, particularly with more complex products; and capability and willingness effectively to discharge its suitability obligations;
- obtaining information about the composition and nature of the distributor’s customer base (e.g., age, retail/institutional percentage, experience with complex products);
reviewing a distributor’s relevant compliance manuals, written supervisory procedures and other relevant materials;

- reviewing and approving the distributor through a cross-functional committee that brings relevant perspectives to bear on the potential merits and limitation of the distributor;
- reviewing sub-distributors/sub-dealers annually; some firms require them to complete an abbreviated version of the on-boarding questionnaire annually; and
- requiring distributors/sub-distributors to sign an agreement, committing to ensure adherence to relevant rules and regulations (such as suitability and due diligence).

As an example of how some manufacturers’ KYD processes work in practice, several manufacturers divide distributors into tiers—generally three levels—based on criteria such as a distributor’s product expertise and experience, the quality of its control environment, and the strength of its sales practices. Firms that are rated more highly in these areas have access to a broader range of products, including more complex products, while firms with lower ratings have access to a narrower range of simpler or more “plain vanilla” products. One firm takes a binary view of its distributors, approving them to offer all or none of the products it manufactures.

**Post-launch Product Reviews**

An effective practice for product manufacturing firms is to implement post-launch reviews to identify potential issues with a product that may not have been apparent during the initial review process, which could lead to conflicts of interest or reputational risk. Such issues could include unexpected product performance, subsequent activity by the manufacturer that may specifically influence the performance of the product, use by investors for whom the product was not intended, or use that is inappropriate or unanticipated. Firms may want to consider how they would react to these potential issues, and what actions they may want to take—such as informing distributors. The frequency and timing of firms’ post-launch reviews varies. One firm evaluates product performance within nine months of product launch and reviews existing products on a one-, two- or three-year cycle. Other firms use different approaches to identify products for review.

**Embedded Conflicts**

In addition to conflicts related to selling, FINRA is also concerned with how manufacturing firms handle conflicts of interest that may be inherent in a product. These conflicts arise where a manufacturer or its affiliates play multiple roles in determining a product’s economic outcome and where firm and investor interests may diverge (see Structured and Complex Products and Embedded Conflicts, below). Each of the manufacturing firms addresses those conflicts through disclosure.

**Structured and Complex Products and Embedded Conflicts**

Embedded conflicts may arise in products for which the issuer or an affiliate makes a variety of critical, and potentially subjective, decisions that affect the value of a product and where those decisions may cause the economic interests of the issuer and investors to diverge. These decisions are frequently performed by entities referred to as “calculation agent” and “index calculation agent.” (These can be separate entities with distinct roles; a product can have both a calculation agent affiliated with the issuer and an unaffiliated index calculation agent.)

*continued*
An index calculation agent may have discretion in how it calculates the value of an index it uses in a complex product, including, potentially, the authority to change the calculation methodology.

The calculation agent also performs a valuation function and may have broader authorities as well. Some products contain an “escape clause” relating to “hedging disruption events” that allows the calculation agent to call a product at any time if it believes the issuer or its affiliates may be unable to initiate, maintain or unwind hedges related to the product. It also may determine the value of the product to be returned to investors in the event of such a disruption, which may not be a transparent undertaking. In other instances, these escape clauses can be interpreted to effectively transfer to investors a significant portion of an issuer’s operational risk. In other instances, a product issuer has the flexibility to extend the maturity of the product at its sole discretion. In each of these instances, the calculation agent, which is an affiliate of the issuer, also determines the value of the payout to investors.

Using an affiliated calculation agent is not necessarily problematic, particularly if the calculation is simple and based on readily accessible data. However, to be effective, disclosures should clearly articulate—in terms understandable to the target customer—the multiple conflicts of interest that may arise with an affiliated calculation agent and the roles that it plays. In addition, the disclosure should make clear if the agent will make its determinations using data not easily obtainable by the target customer. The disclosure should also include any subjective aspects of the agent’s role, such as the degree of discretion the agent may exercise in determining how to calculate the index, payouts to customers or the declaration of a hedging disruption event. If the tenor of the product can be changed, the circumstances in which that could occur should be explained. As discussed elsewhere in this report, firms should consider the use of illustrative scenarios to help customers understand the situations that would trigger different possible financial outcomes from the product.

In addition, to mitigate conflicts, issuers with affiliated calculation agents should establish governance and supervisory review processes for those agents’ decisions, particularly if the agent may exercise discretion in its decision-making. These processes should be transparent and provide for the balancing of investor and firm interests.

Other potential conflicts of interest associated with complex and structured products may arise in a variety of circumstances, including in the following cases.

The use of proprietary indices by structured retail products including notes and CDs

FINRA has noted concerns with structured products in the past, including complexity and potentially high or hidden costs. In general, the increased complexity of such debt products can favor issuers over investors, and this could become a more serious issue for a structured product the performance of which is linked to a proprietary index (created and maintained by the product issuer), as additional fees associated with the use of the index can be high and in some cases difficult to assess. Some proprietary indices reflect sophisticated or complicated trading algorithms or investment strategies, which may subject investors in products linked to these indices to fee structures that can be conditional or path dependent, require detailed analysis to understand and estimate, and be very costly under certain conditions. Moreover, some proprietary indices have limited histories, and so their behavior in different market environments—and the costs associated with the exposures they offer—may be harder to estimate.

continued
Debt issues with early or automatic termination features and notes linked to decaying assets

Over the last few years, debt issuance in the form of exchange-traded notes (ETNs) with longer maturities (e.g., 10 or 30 years) has expanded investor access to non-traditional asset classes and more advanced investment strategies. Some ETNs can be reasonably viewed by investors as packaged investment strategies representing buy-and-hold, longer-term investments rather than shorter-term trading vehicles. A number of such ETNs have call provisions giving the issuers the ability to buy back these unsecured debt obligations at their discretion at prevailing market values. A conflict of interest could exist in the issuance of what is ostensibly a buy-and-hold investment strategy packaged in a callable debt wrapper: The issuer could terminate the notes prematurely at a significant discount to the principal amount, likely negatively and possibly unexpectedly impacting buy-and-hold investors. It is important that investors are clearly made aware of and understand the call risk associated with such investments, especially relative to competing products for which issuers would not appear to have such an incentive.

Distribution

One of the fundamental potential conflicts in the securities industry occurs in the distribution channel: the sale of products or services to generate revenue or profit without proper regard to suitability standards. This conflict affects both the registered representative and the firm. This conflict is magnified when a firm favors proprietary products or engages in revenue-sharing with third parties to the detriment of customer interests.

Conflicts Reviews and New Product Review Committees

As with product manufacturers, an effective practice for product distributors is to include as part of their new product review process a robust analysis of the conflicts of interest a product may raise and establish measures to eliminate or mitigate those conflicts. Distribution firms typically use new product vetting structures similar to those discussed above for manufacturers. (In the case of firms that engage in both product manufacturing and distribution, they typically use two, separate committees.) These committees include line of business representatives as well as support and control functions (e.g., technology, finance, risk, compliance, legal). Some firms use a multi-layered committee review approach.

In the context of firms that engage in both product manufacturing and private wealth management businesses, FINRA underscores the importance for conflicts controls of the private wealth business operating with appropriate independence from other business lines within a firm. Firms should maintain effective safeguards, including through the use of new product review committees in the private wealth business, against pressure to prefer proprietary products to the detriment of customers’ interests. This is particularly important as firms seek to leverage their brokerage and other platforms to cross-sell products and services. Equally important, firms with revenue sharing or other partnering arrangements with third-party product (or service) providers should exercise the necessary diligence and independent judgment to protect their customers’ interests.
Some retail distribution firms use new product review departments separate from the business line. In one instance, a firm’s research department makes recommendations about which products are brought onto the firm’s distribution platform. Compensation for the research staff is at least partially based on how well the products they recommend perform. These recommendations are subject to further review by other firm committees. In another instance, a separate legal entity makes recommendations about mutual funds to be brought onto a firm’s list of recommended mutual funds; this structure is intended to make these decisions independent of the firm’s relationship with the fund providers. Several firms identified products they do not offer to customers because of suitability concerns, including leveraged exchange traded funds and structured products.

Some firms with a primarily institutional customer base are implementing technology systems in which they comprehensively catalogue customers and the products those customers are eligible to purchase. These systems may block the sale of a product for which a customer is not approved unless a manager or supervisor provides an override. In one firm, both the business line and compliance department must approve the products a customer is eligible to purchase. This broader review may mitigate the incentive for an individual registered representative to push a product that may be unsuitable for a customer.

Open Product Architecture and Revenue Sharing

Conflicts can arise when a firm distributes proprietary products or investment company products for which a firm receives revenue sharing payments. The funds for which a firm receives revenue-sharing payments often will be placed on a “preferred” list of funds the firm offers. Proprietary products and revenue sharing arrangements may involve significant financial incentives for firms to favor these products over others. Although registered representatives do not share in the revenue sharing payments directly, they still may favor funds on preferred lists, because of training the issuer provides or because the mechanics of order processing are, in some cases, easier for funds on the preferred list. This can limit customer choice or may, in some cases, adversely affect the independence of a firm’s new product review process or a registered representative’s recommendations. Nevertheless, many firms disclose the arrangements, and their written disclosures related to revenue sharing were, in many cases, clear and direct.

FINRA is encouraged to see distributors shift towards open product architecture, i.e., the distribution of both proprietary and non-proprietary products. FINRA observed some firms that engage in both manufacturing and distribution—or which have affiliated product providers, such as, mutual funds—including on their distribution platforms both proprietary and competing third party products. These firms offer competitors’ products across a variety of product types—such as, mutual funds, structured products, and alternative investments—but not necessarily in every product type. (For example, a firm might not offer competitors’ money market mutual funds, but include competitors’ structured products and alternative investment vehicles on its platform.) Third party products make up a significant percentage of sales volumes in most cases.

In the context of a recommended transaction, an effective practice is for a registered representative to inform a customer if a recommended product is proprietary or from a preferred provider. As part of this practice, the registered representative should provide this information in advance of executing the transaction. Providing this type of disclosure will enable a customer to make a decision about whether to proceed with a transaction in the presence of a conflict relevant to that particular transaction. This disclosure supplements existing written disclosures that firms provide, frequently in account opening documents, but places the disclosure in the context of a specific customer decision.
Reverse Inquiry

The “reverse inquiry” process discussed earlier effectively integrates distributors in the product manufacturing process by allowing them to determine product features such as product structure, coupon rate, maturity and fees. While this integration is not inherently problematic, it raises potential conflicts concerns. The distributor basically acts as a “co-manufacturer” and may have incentives to incorporate features such as high selling concessions or potential higher returns at the cost of a riskier product structure.

An effective practice for distributors—and one in which many firms engage—is to put product requirements out for competitive bid across multiple firms. Factors that firms should consider in selecting a product manufacturer include competitiveness and pricing, service, innovation and credit diversification.

FINRA observed distributors taking different approaches to handling reverse inquiries with in-house manufacturing counterparts. Some firms provide the in-house supplier the opportunity to match the most competitive bid (in which case the in-house part of the firm wins the majority of the business while the competitive outside bid wins a minority portion of the product). Other firms do not provide such a second look.
INTRODUCTION

Financial compensation is a major source of conflicts of interest. The rewards firms offer associated persons may influence their behavior in ways that affect customer interests. In this section, FINRA focuses on four areas that may create, exacerbate or mitigate compensation-related conflicts of interest. These areas are:

- compensation for brokers;
- surveillance and supervision of registered representatives as they approach compensation thresholds;
- compensation for supervisory personnel; and
- deterrence to poor conflict management.

The first three areas focus on firms’ retail and private wealth activities; the discussion of deterrence encompasses a firm’s business more broadly.

As an initial matter, the federal securities laws and FINRA rules require broker-dealer mark-ups, commissions and fees for services to be fair and reasonable. The SEC and the courts have held that the antifraud provisions of the federal securities laws require broker-dealers to sell securities at prices reasonably related to the market price.

EFFECTIVE PRACTICES SUMMARY: COMPENSATION AND OVERSIGHT

In order to identify and manage compensation-related conflicts effectively, firms should take an integrated approach to designing and implementing their compensation, supervision and surveillance programs. The more significant a conflict a compensation structure may create, the more important it is for supervisory and surveillance programs to provide robust oversight. Supervisory and surveillance programs should enable firms to identify potential unsuitable activity arising from conflicts of interest across registered representatives and branch offices.

Effective practices include the following:

- **Compensation thresholds**: Firms avoid creating thresholds in their compensation structures that enable a registered representative to increase her compensation disproportionately through an incremental increase in sales.

- **Monitoring activity of representatives approaching compensation thresholds**: Firms’ supervisory programs include specialized measures to assess whether a registered representative’s recommendations may be influenced by thresholds in a firm’s compensation structure. Some firms perform specialized surveillance as registered representatives approach thresholds that:
  - move the registered representative to a higher payout percentage in a firm’s compensation grid;
  - qualify a representative to receive a back-end bonus; or
  - qualify a representative to participate in a recognition club, such as a President’s Club.

- **Neutral grid**: Firms minimize incentives in their compensation structure for registered representatives to favor one type of product (e.g., equities, mutual funds, variable annuities) over another.

continued
- **Fee-capping:** Firms reduce incentives for a registered representative to favor one mutual fund or variable annuity fund over another by capping the Gross Dealer Concession that will be credited to a representative’s production.

- **Compensation for proprietary or preferred provider products:** For comparable products, firms refrain from providing higher compensation, or providing other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements.

- **Customer liquidity events and suitability monitoring:** Firms monitor the suitability of registered representatives’ recommendations around key liquidity events in an investor’s lifecycle where the impact of those recommendations may be particularly significant, for example, at the point where an investor rolls over his pension or 401(k).

- **Compensation penalties:** Firms adjust compensation for employees who do not properly manage conflicts of interest. Using red flag processes and clawbacks can support this objective.

### Compensation Grids

At most firms with which FINRA met, compensation grids are a principal determinant of a registered representative’s compensation. As such, they are critical in understanding the incentives, and possible conflicts of interest, that a registered representative may face. The structure and operation of grids varies significantly among firms; as a consequence, a representative generating a set amount of gross revenue may receive different compensation depending on the firm with which the registered representative is associated. Some structures are fairly straightforward, while others are more complex.

### Structure and Mechanics

Typically, two factors drive a registered representative’s grid-based compensation: the revenue that the registered representative generates, and the payout percentage the registered representative receives on that revenue. In some cases, firms use a grid structure where the type of product sold affects a registered representative’s payout percentage. (Table 1, below, illustrates both types of grid; the former is frequently referred to as a “neutral grid.”)

**Table 1: Illustrative product neutral and non-neutral grid comparison**

<table>
<thead>
<tr>
<th>Gross Commission/ Sales Charge (figures in 000s)</th>
<th>Product Neutral Grid</th>
<th>Non-Neutral Grid</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Payout %</td>
<td>Payout %: Equities, bonds, ETFs</td>
</tr>
<tr>
<td>$200-300</td>
<td>28%</td>
<td>28%</td>
</tr>
<tr>
<td>$300-400</td>
<td>35%</td>
<td>35%</td>
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<tr>
<td>$400-500</td>
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<td>36%</td>
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<tr>
<td>$500-650</td>
<td>38%</td>
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</tr>
<tr>
<td>$650-800</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>$800-1,000</td>
<td>42%</td>
<td>42%</td>
</tr>
<tr>
<td>$1,000-1,500</td>
<td>44%</td>
<td>45%</td>
</tr>
<tr>
<td>$1,500-2,500</td>
<td>45%</td>
<td>45%</td>
</tr>
<tr>
<td>$2,500 +</td>
<td>48%</td>
<td>45%</td>
</tr>
</tbody>
</table>

(The figures in this table are for illustrative purpose only and do not reflect any particular firm’s grid structure.)
The payout percentage a registered representative receives typically increases as the broker’s production rises. A $1 million producer will typically earn a higher percentage of gross revenue than a $500,000 producer with the same firm. FINRA observed a variety of payout ranges, from 28 – 47 percent at one firm to 25 – 43 percent at another and 22 – 48 percent at a third. These figures are representative for only some firms, others’ payout rates may be higher. Firms with an independent contractor model may pay out a substantially higher percentage to registered representatives, but these firms also charge those representatives more for expenses associated with their business. In addition, one of the firms with which we met takes a notably different approach to its grid: This firm pays a flat 50 percent after the first $10,000 of monthly production.

The revenue tranches, or steps, within a grid are typically smaller at the low end of the grid and increase at the higher end. At some firms, an increase of $25,000 – $50,000 will move a representative from the lowest payout level to the next lowest. At the higher end, these tranches are larger and range into the millions, for example, from $1 – $2.5 million.

Firms described two basic approaches to handling payout percentages. Under one approach, the grid differentiates payout by product type—for example, equities, bonds, mutual funds and variable annuities. Under the other approach, commonly referred to as a “neutral grid,” the grid provides a flat payout percentage in a given gross production band, regardless of product type sold. Table 1, above, provides an illustrative comparison of payout structures under a neutral and non-neutral grid.

Under both neutral and non-neutral grids, firms may calculate payout percentages in different ways. Firms may apply grid payout percentages on a prospective or retroactive basis. The time period over which production is calculated to determine the applicable payout percentage may vary as well. Frequently firms that apply the payout percentage prospectively calculate a broker’s gross revenue on a trailing 12-month basis (T12). The firm applies the T12 production to its grid to determine the payout rate that applies to the broker’s subsequent month’s production (or longer periods depending on the firm’s approach). A broker’s payout rate for April 2013 would be determined by looking at total revenue generated from April 1, 2012, through March 31, 2013. If this total was $700,000, the grid for one firm establishes a 41 percent payout rate (40 percent in the product neutral portion of the example in Table 1). The broker’s monthly grid compensation is determined on this rolling basis.

Some firms apply a broker’s payout percentage on a retroactive basis. In these cases, many firms calculate gross revenue based on calendar year production, typically starting on January 1. Firms may start the registered representative off with $0 in revenue. The representative is paid at the lowest grid level until she reaches the next revenue tranche on the grid. Retroactive adjustments for revenue earned since January 1 may happen repeatedly through the year if a representative continues to move to revenue levels with higher payout percentages.

Other Approaches

Several firms with which FINRA met do not use a grid structure based on production. Some of these firms base payout percentages on a registered representative’s years of service. Others use a non-grid-based formula to calculate registered representatives’ compensation based on metrics such as employees’ service and sales performance.
Compensation and Oversight Structures

An effective practice FINRA observed at firms is the establishment of compensation governance structures that include a mandate to identify and manage the conflicts that compensation structures may create. When firms identify such conflicts, firms adjust the compensation system to eliminate or reduce the conflict as well as establish oversight mechanisms appropriate to the scale of the conflict that may remain.

In the context of compensation grids, paying a registered representative a higher percentage of gross revenue may legitimately reward effective and hard workers and encourage higher productivity. A conflict is created, however, if a representative’s desire to move to a higher payout level influences the number or type of recommendations he makes to customers. This conflict may be heightened when there is a relatively large increase in the percentage payout between revenue tranches; when there is a high probability that a few, incremental sales will move a registered representative to a new payout level; or where increased payout percentages are applied retroactively once a threshold is satisfied.

Neutral Grids

An effective practice FINRA observed was firms using “product neutral” compensation grids to reduce incentives for registered representatives to prefer one type of product over another. In identifying this as an effective practice, FINRA also notes that while the use of neutral grids eliminates the payout percentage as a factor that may influence registered representatives’ product recommendations, the commission credit still significantly affects that individual’s compensation. For example, on a given $10,000 purchase, a registered representative may receive more commission credit for a variable annuity sale than a mutual fund sale and more credit for a mutual fund sale than an equity transaction. Thus, a $10,000 customer purchase may result in different amounts credited to a representative’s gross revenues, even though the percentage payout from the amount of the credit is the same.

In these cases, the broker’s compensation is not product neutral. Therefore, the neutral grid should not be represented to customers as eliminating potential product biases in registered representatives’ recommendations. Firms should structure their oversight programs to address and mitigate those biases that differences in compensation may create.

Commission-based vs. Fee-based Accounts

Conflicts also may arise in recommending the type of account that a customer should open with a firm. A firm that is dually registered as a broker-dealer and an investment adviser should consider whether a commission-based or fee-based account is more appropriate for a customer. Many variables, including a customer’s desire for ongoing advice and portfolio management, may affect the decision. Depending on the circumstances, fee-based accounts may be preferable for customers with a fair amount of trading activity or the desire for active account monitoring and ongoing advice. Commission-based accounts may be more cost-effective or appropriate for customers with low trading activity.

Firms should examine their procedures to ensure that they are reasonably designed to monitor inappropriate behavior. A clear conflict would exist if a registered representative who is also registered as an investment adviser or advisory representative recommends that a customer purchase a mutual fund that is subject to a front-end sales load and, shortly thereafter, recommends that the customer move those mutual fund shares into an investment advisory account that is subject to an asset-based advisory fee. This behavior is an example of an inappropriate means by which a representative seeks to increase his compensation at the expense of his customer.29
Compensation for Proprietary or Preferred Provider Products

An effective practice is that for comparable products, firms not provide higher compensation, or provide other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements. The firms with which FINRA met each stated that their registered representatives are not compensated more highly for the sale of comparable proprietary or preferred provider products.

Fee-capping

In the context of mutual fund and variable annuity sales, an effective practice FINRA observed is firms’ use of “fee-capping” to reduce incentives for a registered representative to favor one product family over another for comparable products. In a fee-capping arrangement, a firm caps the GDC that can be credited to a registered representative’s grid. Any GDC in excess of the cap accrues to the firm. For example, a firm may cap at 4 percent the GDC for emerging market equity funds. This would eliminate incentives for a registered representative to favor a mutual fund that paid a higher GDC than the 4 percent. It would not, however, eliminate the potential incentive for the registered representative to recommend a fund with a 4 percent as opposed to a 2.5 percent GDC.

Supervision, Surveillance and Conflicts Management

Firms’ supervisory and surveillance processes to monitor registered representatives’ sales activities are key tools in a firm’s overall conflicts management framework. In this section of the report, we focus on supervision in four areas. The first three relate to thresholds in firms’ incentive structures: 1) step-up points in compensation grids, 2) milestones for admission to recognition clubs and 3) thresholds for back-end bonuses or other incentive compensation. These incentives may create a conflict of interest if a registered representative conducts, for example, excessive trading or recommends unsuitable or improper transactions in order to achieve a higher level of financial or other compensation. The fourth area relates to events in an investor’s lifecycle—e.g., a substantial liquidity event such as a pension rollover—that may significantly affect a registered representative’s compensation as well as the investor’s financial situation.

Supervision of Sales Activity Near Compensation Thresholds

Linking supervision and surveillance of registered representatives’ recommendations to thresholds in a firm’s compensation grid structure is one effective practice. This can enable firms to detect recommendations, or potential churning activities that may be motivated by a desire to move up in the grid structure and, thereby, receive a higher payout percentage. Unlike the two situations discussed below, FINRA is concerned that some firms’ supervision and surveillance functions have limited ability to assess a representative’s recommendations and representations in the context of grid compensation thresholds, despite the heightened conflicts that may exist as registered representatives approach those thresholds.

A second effective practice is to monitor registered representatives who are close to achieving the production level required for entry into recognition programs. In at least one firm with which FINRA met, this type of surveillance program is used to review the suitability of transactions that place registered representatives over the threshold to gain recognition in a firm’s “President’s Club” or similar recognition circle.
A third effective practice is to monitor registered representatives’ recommendations and trading activity as they approach milestones for “back-end” recruitment bonus payments. Firms generally make these payments if the recruited registered representative achieves a certain level of production by an anniversary date of hiring. Several firms monitor the compensation trends of each registered representative who is within three months of a back-end bonus milestone date. Compliance analysts monitor production spikes or spikes in product sales for each of the three months before the award date or the expiration of the bonus milestone. Another firm reviews changes in the type of products the representatives sell and suitability assessments of the recommendations they make to customers.

Supervision of Sales Activity at Investor Lifecycle Milestone Events

An effective practice is for firms to monitor the suitability of registered representatives’ recommendations around key liquidity events in an investor’s life, for example, at the point when an investor rolls over her pension or 401(k). These events may heighten conflicts of interest because of the large sums of money that may be involved. When an individual changes jobs or retires, she must decide what to do with her 401(k) account—leave it in place, roll it over to a new employer’s plan or roll it into an individual retirement account (IRA). Firms have a strong incentive to gather assets, and as a recent Government Accountability Office report noted, “(r)ollovers have become the largest source of contributions to IRAs.”30 It is not always clear, however, that rolling over a 401(k) to an IRA—as opposed to keeping money within the plan or rolling it over to a new employer’s plan—is the best option for an investor. The recommendations a representative makes at these points in time may have profound implications for the investor and deserve thorough scrutiny and review.

Other Effective Supervisory Practices

In addition to the effective practices described above that are tied to specific compensation thresholds or events, FINRA also observed more general effective supervisory practices among firms. One firm developed a surveillance program to determine whether certain products or services for which a registered representative receives more compensation were being sold improperly. The surveillance program identifies spikes in an individual’s production in these offerings from quarter to quarter. If the program flags a significant increase in production, the compliance department will review whether a particular product has caused the spike in revenue and then conduct a suitability analysis of the relevant recommended transactions. Another firm recently implemented a similar tool to assess revenue increases or shifts on a daily, weekly or monthly basis that leads to a deeper evaluation of a registered representative who is subject to production targets.

Compensation for Supervisory and Branch Management Staff

Financial incentives to registered representatives in firms’ retail and private wealth businesses are one source of conflicts of interest; the financial incentives to their managers and supervisors are another. Financial incentives for these personnel could encourage them to, among other things, push registered representatives to achieve branch or broader business unit financial performance targets without proper regard for suitability, hire poorly qualified registered representatives to meet hiring targets or perform oversight tasks in a manner favoring productivity standards over quality of oversight.
Most firms’ compensation structures for supervisory staff, branch office managers and their superiors are comprised of a base salary and discretionary bonus. The discretionary bonus may include elements that create potential conflicts of interest. Firms noted that they typically consider a variety of quantitative and qualitative factors in determining compensation for supervisors and managers. Examples of quantitative metrics include branch revenue and growth, profitability, net new assets and lending growth. Examples of the qualitative factors include an individual’s development of staff and the quality of a manager’s interaction with control functions.

Considering negative control issues—such as factoring in customer complaints or fines—in deciding bonuses for branch managers and their superiors is an effective practice. FINRA observed firms that could reduce or eliminate a branch manager’s bonus if that individual did not perform his supervisory responsibilities effectively. In some cases, negative control concerns may also affect the compensation of the individual registered representative involved.

With respect to supervisory staff, in some cases firms noted that their personnel are not part of the business reporting line and are paid on a salary plus discretionary bonus basis, and that the bonus has no direct ties to the individuals or branches they supervise. In these instances, the firm typically awards a bonus on the basis of an individual’s scope of responsibility, professional competency metrics and overall firm financial performance.

Deterrents to Poor Conflicts Management

Firms can mitigate the conflicts their financial incentives create through disincentives or deterrents in their compensation and performance evaluation systems. FINRA believes firms should consider imposing appropriate compensation adjustments on employees who do not properly manage conflicts of interest or otherwise engage in conduct detrimental to customers or the firm. Firms identified two effective tools they use in this regard: red flag programs and clawbacks. FINRA believes that a firm should consider employing both tools across its business, including retail and private wealth management (and to the extent permissible by state labor laws).

Red Flags

Firms use the compensation and performance evaluation processes to promote good conduct by their employees, including the appropriate handling of conflicts of interest. An effective practice for firms is to develop metrics for both good and bad behavior (red flags), assess employee performance against those metrics, and base compensation decisions on that performance. FINRA’s focus here is on measures of behavior related to conflicts of interest, but clearly, firms may include a variety of metrics to incent favorable conduct more generally.

The firms with which FINRA met use processes with varying degrees of formality and structure to gather qualitative and quantitative data—or red flags—about employee behavior and apply that to their compensation and performance assessment programs. On one end of this spectrum are firms that collect relatively little data, do not implement performance assessments, and whose registered representatives’ compensation structure is mostly or entirely commission-driven with little or no non-formulaic variable compensation, i.e., bonus. On the other end of the spectrum are firms that have highly formalized data collection, data review and performance assessment processes and whose employees receive a significant portion of variable compensation as a percentage of total compensation.
Firms with more formalized programs collect a broad range of information from multiple departments, including legal, compliance, human resources, risk management, sales supervision, operations and accounting. The types of information they accumulate includes registration and training lapses, trade input errors, suitability concerns, the frequency and severity of customer complaints, inappropriate or hostile behavior and other misconduct, excessive velocity, investment concentrations, mutual fund or annuity switching, audit or examination finding and credit limit violations. (Many of these measures do not relate directly to conflicts of interest concerns.) Depending on the firm, the human resources, compliance or risk management department may aggregate this information and then use it in performance evaluations as well as promotion and compensation decisions.

Most firms evaluate these red flags in a committee process—which may include a combination of staff from firm and sales management, human resources, compliance, legal or risk departments—and when warranted recommend further action. This action may take several forms. With respect to compensation, the firm may reduce a registered representative’s future grid payout rate and limit awards for referrals (or other items) for a period of time, e.g., the next three to six months. It may also require the registered representative to share in the cost of the representative’s trade input errors or customer settlements. The firm may also cap performance levels in an employee’s performance appraisal or limit an employee’s opportunities for promotion. Some firms also restrict access to employee achievement recognition programs, such as “President’s Clubs.” In some cases, firms noted that state labor laws may limit their ability to impose financial penalties on registered representatives.

One firm implements a particularly formalized red flags system, but it does not, as yet, cover customer-facing private wealth employees. The firm developed a series of indicators—or red flags—for behaviors that it would like to reduce. These include red flags for generic activities, such as overdue mandatory training and gifts and entertainment breaches—as well as for business specific activities, such as improper deal-logging and restricted list trading violations. This firm recently introduced red flags for supervisors. The more red flags a supervisor’s subordinates have, the more red flags the supervisor may have. The firm reported that the introduction of this supervisory, or tone from the top, flag was followed by a noticeable drop in total red flags. The firm risk-weights the breaches based on severity or frequency. Ultimately, these red flags feed into the compensation process and the firm has established policies to reduce variable compensation by prescribed ranges based on an individual’s red flags “score.” This reduction is communicated to the employee as part of the annual compensation discussion. The red flags score is also used as part of discussions around employees’ performance evaluation and promotions.

The firm identified several key lessons learned from implementing its red flags program. First, firm management should communicate clearly and consistently with employees about the program and its purpose. Second, the red flags themselves should be clearly aligned with an individual’s behavior. Third, the red flags should be objective rather than subjective.
Clawbacks

In broad terms, clawbacks are viewed as a tool to address conflicts of interest that might arise between an employee’s or management’s short-term interests and the long-term interests of the firm and its stakeholders. “Clawback” generally refers to a contractual clause that allows a firm to revoke some or all of an employee’s deferred compensation, in some cases including vested compensation.

Some firms apply clawback provisions only to a subset of a firm’s employees, such as senior executives, while others apply them more broadly. To date, most firms have exercised clawbacks only rarely, mostly in connection with terminations for cause. FINRA believes that clawback programs are an effective conflicts management practice and firms should consider employing them throughout their businesses to all employees that receive deferred compensation. Moreover, where implemented, FINRA believes that clawbacks should not be reserved only for instances that result in termination for cause.

Scope and Content of Policies

Most firms surveyed employ a structure that includes a deferred variable compensation component coupled with the ability to claw back or forfeit that compensation under defined circumstances, as discussed further below. Some firms limit such compensation to executives or senior management, but other firms apply it to all of their registered representatives and investment bankers as part of a bonus or incentive plan. The deferred compensation most commonly takes the form of restricted cash or equity (or a combination) and typically has a vesting period of between three and five years, although at least one firm has some vesting periods of up to eight years. In addition, some firms require minimum holding periods for stock, even if the equity has vested. Firms use these deferred compensation arrangements to better align employee interests with the long-term interests of the firm and to manage risk to the firm and, in some cases, to the market and financial system. In light of these purposes, firms tend to prohibit employee hedging activity related to equity subject to vesting or holding periods.

Firms’ compensation recoupment policies differ in scope, detail and processes, but have several common elements. The clawback and forfeiture policies usually apply only to unvested portions of deferred compensation. Firms indicated that they use other mechanisms to recoup or make adjustment for paid or vested compensation. Some firms reduce current year incentive compensation to redress circumstances or conduct that led to improper payment of unrestricted cash or equity payments in prior years. Two firms indicated they adjust the incentive compensation payout percentage for representatives that have, for example, excessive customer complaints, regulatory or ethical lapses, or significant trading errors.

Broadly speaking, there are three categories of clawbacks or forfeitures: performance-based, risk-based and behavior-based. Most of the surveyed firms include some combination of the three, with different points of emphasis. The clawback and forfeiture policies generally attach where the original compensation award is based on inaccurate financial or performance metrics or where there is a nexus between an employee’s conduct and certain events with material impact on a firm’s financial condition or reputation.
Performance-based

Performance-based clawbacks can be tied to the performance of the overall firm or business unit or the employee (and are not necessarily related to conflicts of interest). One common clawback trigger is a material restatement of financial results, as a consequence of error, not fraud. This may affect employee compensation in two ways. First, a firm may look to clawback compensation from an employee who materially contributes to the cause for a restatement. Second, firms may clawback or adjust for compensation that was tied to firm or division profitability and mistakenly awarded based on the inaccurate financial statements.

A related clawback allows for recovery of an award where a more specific performance measure is later determined to have been inaccurate. In this regard, one firm’s policies provide for recovery of incentive compensation paid to an employee on the basis of materially inaccurate performance metrics, irrespective of whether the inaccuracy leads to a restatement and even if the inaccuracy is not attributable to the employee.

Other firms have policies that permit clawbacks based on performance shortfalls, rather than inaccurate measurements. One firm can claw back awards based on negative business performance according to specific pre-defined performance standards, while another requires clawbacks for an annual loss at the firm, division or business unit. A firm with a similar policy will cancel all deferred compensation set to vest in a year where a group or division fails to generate positive net income before income taxes. One firm’s policies provide for flexibility to claw back awards for general poor performance of a team, business area or profit center unrelated to specific performance measures. Yet another firm can claw back an award if it was based on a deal or transaction that has a significant adverse effect on the firm. One firm may defer awards if the firm, line of business or product fails to remain profitable over the vesting period.

Risk-based

Many firms provide for clawbacks where an employee takes imprudent risk or violates risk policies. Most firms do not require that an actual loss result from that conduct to initiate a clawback review. One firm broadly applies its clawback policy to inappropriate consideration of risk that causes or has the potential to cause “material adverse impact on the firm, the employee’s business unit or the broader financial system.” Another firm similarly applies its policy to improper or gross negligence in identifying, raising or assessing risks or concerns with risks material to the firm. Other firms more narrowly tailor their risk-based clawback policy to apply only to material violations of firm risk limits or risk management policies.

Behavior-based

The broadest category of clawbacks and forfeitures involves employee misconduct. Most firms can recoup some or all of unvested deferred compensation in the event an employee engages in conduct that results in or could result in financial or reputational harm to the firm or violates securities laws, regulations or firm policies. Firms describe the offending conduct in a variety of ways—for example, “serious misconduct or ethical behavior” or “conduct detrimental to the firm”—yet most policies give the firm broad discretion to cancel some or all deferred compensation when an employee engages in bad acts or consequential conduct. While some firms require gross misconduct by the employee, other firms’ policies provide that negligent conduct can trigger forfeiture if the specified harm or violation ensues. Most firms automatically cancel any unvested compensation in the event of termination for cause. Some firms make such termination a condition precedent to forfeiting that compensation, but some firms can also cancel unvested compensation for misconduct or a policy breach even if the sanctions fall short of termination.
A few firms’ policies provide for claw back of vested deferred compensation. One firm can seek repayment of the value of awards already vested, but unpaid, if an employee was, or could have been, terminated for cause or engages in conduct that results in financial or reputational harm. Another firm can recoup vested compensation in the case of gross misconduct.

**Review Processes**

Firms employ different review processes to assess whether to impose a clawback or forfeiture. Many of the surveyed firms rely on the independent control functions—risk management, legal and compliance, human resources—to identify potential clawback situations or to conduct or provide input into a review to determine whether recoupment is appropriate. At some firms, a compensation committee makes clawback determinations and internal audit reviews the decision. One firm provides specific criteria to the review committee to consider in making its determination, such as the role and responsibility of the employee, the degree of involvement and the extent to which the individual raised concerns.

**CONCLUSION**

Conflicts of interest are present in many contexts in the financial services industry. There is no “one-size-fits-all” framework through which firms can manage conflicts. Firms need to assess what approach is most effective given their particular circumstances. As noted earlier, the conflicts management framework for a small firm almost certainly will be markedly different than that for a large firm; but some of the basic conflicts may be the same. All firms engaged in the distribution of securities should, for example, consider whether the incentives that stem from their compensation structures and product offering interfere with their suitability requirements. Do these structures create incentives for registered representatives to engage in unsuitable or excessive trading? If those incentives exist, how do firms structure their supervisory and other mechanisms to mitigate those incentives?

FINRA provides its observations in this report to stimulate firms’ thinking and to offer examples of how some firms address conflicts. FINRA’s expectation is that firms will use this information to, first, support a thoughtful analysis of the conflicts they face in their business and, second, implement an appropriate conflict management framework to identify, manage, or mitigate, or improve the mitigation of, those conflicts where necessary. As firms evaluate the measures appropriate for their circumstances, their reference points should include requirements in current statute and regulation, but also look beyond to encompass a broader ethical view that considers the impact of firm actions on customers. This will help firms avoid finding themselves out of step with evolving ethical norms and expectations.

The securities industry as a whole has played a tremendously valuable role in the development of the U.S. markets and economy. While they will continue to do so, the securities industry must strengthen the investing public’s trust and confidence. Addressing conflicts of interest more effectively is one important step in that direction.

Looking forward, FINRA will continue to focus on conflicts issues through its regulatory programs and will evaluate the effectiveness of firms’ conflicts management efforts. If firms make inadequate progress generally, FINRA will evaluate whether conflicts-focused rulemaking is necessary to enhance investor protection.
APPENDIX I—CONFLICTS REGULATION IN THE UNITED STATES AND SELECTED INTERNATIONAL JURISDICTIONS

United States

At the most general level, the Securities Exchange Act of 1934 (the Act) broadly prohibits misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities. Section 15(c) of the Act prohibits a broker from effecting any transaction in or inducing or attempting to induce the purchase or sale of any security by means of any manipulative, deceptive, or other fraudulent device or contrivance. FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) states that a firm “in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.” In addition, FINRA Rule 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices) provides that no firm “shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.”

In addition to these broad obligations, FINRA and the SEC have implemented measures which mandate disclosures and outright prohibitions on certain activities.

Table 2: Examples of conflicts-related disclosure requirements and regulatory prohibitions

<table>
<thead>
<tr>
<th>Mandated Disclosures</th>
<th>Prohibitions</th>
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<tr>
<td><strong>Firm’s Interest in the Security Recommended</strong>—Exchange Act Rules 15c1-5 and 15c1-6</td>
<td><strong>Restrictions on the Purchase and Sale of IPOs</strong>—FINRA Rule 5130 generally prohibits firms and their associated persons from purchasing a new issue for any account in which the firm or an associated person has an interest, except in accordance with the rule’s conditions.</td>
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<tr>
<td>generally require written disclosure to a customer if a broker-dealer has any control, affiliation, or interest in a security it is offering or in the issuer of the security.</td>
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<tr>
<td><strong>Disclosure and Consent When Trading on a Net Basis With Customers</strong>—FINRA Rule 2124</td>
<td><strong>Prohibition on Certain Market Activities</strong>—SEC Regulation M generally prohibits underwriters, broker-dealers, issuers and other persons participating in a distribution from bidding for or purchasing the offered security during a certain restricted period, or inducing another person to do so. Regulation M also regulates various market activities in connection with an offering and requires that firms notify FINRA or the market where certain bids are to be posted. FINRA Rule 5190 sets forth Regulation M notification requirements for firms.</td>
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<tr>
<td>requires transaction-by-transaction disclosure and written consent for net trades involving non-institutional customers. Net trades with institutional customers are subject to different consent requirements. For these purposes, a net trade is a principal transaction in which, for example, a market maker, after having received an order to buy a security, purchases the security from another broker-dealer or customer and then sells it to the customer at a different price.</td>
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<tr>
<td><strong>Disclosure of Control Relationship with Issuer</strong>—If a firm controls, is controlled by, or under common control with an issuer of a security, FINRA Rule 2262 requires disclosure to the customer prior to commencing a transaction in the security.</td>
<td><strong>Trading Ahead of Research Reports</strong>—FINRA Rule 5280 prohibits firms from using non-public advance knowledge of a research report to change its inventory position in a security or derivative of the security.</td>
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continued
## Mandated Disclosures and Prohibitions

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<th>Mandated Disclosures</th>
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<tr>
<td>Disclosure of Participation or Interest in Primary or Secondary Offering—FINRA Rule 2269 generally requires written disclosure to customers for trades in any security in which the firm is participating in the distribution or is otherwise financially interested.</td>
<td>Research Analysts and Research Reports—Among other things, NASD Rule 2711 and Incorporated NYSE Rule 472 restricts the activities of and the relationships between a firm’s research analysts and its investment bankers and personal trading by research analysts in the stocks that they cover.</td>
</tr>
<tr>
<td>Disclosure of Financial Condition upon Customer Request—FINRA Rule 2261 requires disclosure of the information in its most recent balance sheet.</td>
<td>Influencing or Rewarding Employees of Others—FINRA Rule 3220 prohibits firms from giving anything worth more than $100 annually to employees of other firms where the payment is made because of the employer’s business.</td>
</tr>
<tr>
<td>Public Offerings of Securities with Conflicts of Interest—FINRA Rule 5121 prohibits participation in an offering unless certain conditions are met, including prominent prospectus disclosure of the conflict.</td>
<td>Brokerage Rewarding Fund Sales—NASD Rule 2830(k) prohibits a firm from favoring the sale of a fund because of brokerage business that has been or may be directed to the firm.</td>
</tr>
<tr>
<td>Borrowing From or Lending to Customers—FINRA Rule 3240 prohibits these arrangements unless strict conditions are met.</td>
<td>Trading Ahead of Customers—FINRA Rule 5320 generally prohibits firms from trading ahead of a customer order for the firm’s own account.</td>
</tr>
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</table>

### International Organization of Securities Commissions

Concern about conflicts of interest is not confined to the United States. The International Organization of Securities Commissions (IOSCO)—a body of securities and commodity regulators from around the world—has developed policy recommendations and best practices related to conflicts of interest specific to various parts of the securities industry.32

### Australia, Canada and the European Union

Regulators in Australia, Canada and the European Union have adopted measures that require financial services firms, not just broker-dealers, to address conflicts of interest holistically.

#### Best Interest of the Client Standard

Australia, Canada and the European Union have all implemented a “best interests of the client” standard with respect to how firms address conflicts of interest. In Europe, under the Markets in Financial Instruments Directive (MiFID) the “best interests of the client” standard governs all aspects of the investment firm-client relationship, including conflicts of interest. In Australia, the “best interest of the client” standard applies to the provision of personal advice by financial licensees to retail clients and the “best interests” standard for investment dealers in Canada applies specifically to the management of conflicts of interest.
Conflicts of Interest Policies and Procedures
All three jurisdictions require that firms put in place policies and procedures to manage all material conflicts of interest. Among other things, these policies and procedures must clearly identify all material potential conflicts of interest and specify how an investment firm intends to address each potential conflict (e.g., by controlling, avoiding or disclosing these conflicts). Once the conflicts of interest policies, procedures and controls have been implemented, investment firms must put in place supervision and monitoring systems to ensure that they are properly implemented, maintained and updated. All three jurisdictions agree that the management of conflicts of interest cannot be achieved solely through disclosure, and that investment firms should seek first to avoid or control conflicts before relying on disclosure to resolve the conflict.

Disclosure of Conflicts of Interest
All three jurisdictions agree that when firms cannot avoid or control a conflict, they must disclose it. Canada requires that unless a firm avoids and controls a conflict in a way that “effectively ensures with reasonable confidence that the risk of loss to the customer has been eliminated,” the firm must disclose it to the customer. Once a firm determines that it must disclose a conflict, all three jurisdictions agree that the firm must disclose the conflict in a manner that provides sufficient information and time for the customer to take this information into account before making an investment decision.

Compensation-related Conflicts of Interest
Regulators in Europe and Australia have further determined that some conflicts of interest stemming from compensation practices cannot be disclosed away and have prohibited certain types of compensation, such as third party commissions or inducements to investment firms from product issuers and manufacturers. Starting January 1, 2013, the United Kingdom banned commissions from product manufacturers to investment firms that provide advice to retail customers and, in April 2013, banned payments from product manufacturers to platforms. The Financial Conduct Authority (FCA) believes that the potential for the commission to bias an advisor or platform towards products for which they receive a commission is such that disclosure of this commission to the client is not sufficient.

In Europe more generally, there is a proposal to amend MiFID that would prohibit investment firms that hold themselves out as independent from receiving fees, commissions or monetary benefit from any third party in relation to the advice or product recommended. The Australian government goes even further in its recent ban on “conflicted remuneration,” which is any monetary or non-monetary benefit given to a financial licensee that might influence or distort advice provided to retail clients.

To address compensation-related biases by sales representatives and their supervisors, the FCA and the European Securities and Markets Authority (ESMA) have both introduced further guidance on how to manage these conflicts to comply with MiFID and Australia has banned performance benefits that may bias advice. These regulators found that in spite of requirements for firms to effectively manage conflicts of interest, remuneration policies and practices were leading advisors to neglect the clients’ best interests, and to focus instead on selling products that generate the highest fees. Of particular concern were financial and non-financial benefits based on sales volume and financial incentives to sell proprietary products.
APPENDIX II—TEXT OF FINRA LETTER TO FIRMS ANNOUNCING CONFLICTS REVIEW

July 2012

Re: Conflicts of Interest

FINRA is reviewing how firms identify and manage conflicts of interest. As part of this review, we would like to meet with executive business and compliance staff of your firm to discuss the firm’s approach to conflict identification and mitigation. At the meeting, we would like your firm to present on, among other conflicts related topics, the most significant conflicts your firm is currently managing and the processes in place to identify and assess whether business practices put your firm’s—or your employee’s—interests ahead of those of your customers.

This inquiry is not an indication that FINRA has determined that your firm has violated any rules or regulations. FINRA’s goal in speaking with firms about their conflict identification and review process is to better understand industry practices and determine whether firms are taking reasonable steps to properly identify and manage conflicts that could affect their clients or the marketplace. Knowing what firms do to address conflicts and the challenges they face will help FINRA develop potential guidance for the industry and determine other steps FINRA could consider taking in this area.

In preparation for the referenced meeting, we request that your firm submit the following information to FINRA by September 14, 2012:

1. Summary of the most significant conflicts the firm is currently managing.
2. Names of departments and persons responsible for conducting conflicts reviews.
3. Summary of the types of reports or other documents prepared at the conclusion of a conflicts review.
4. Names of departments and persons who receive any final report or other documentation summarizing a conflicts review.
5. Available dates and times in the fourth quarter of 2012 that executive management of your firm can meet with FINRA staff for approximately three hours to discuss the firm’s approach to conflicts of interest.
APPENDIX III—SUMMARY OF CONFLICTS IDENTIFIED BY FIRMS

As part of its targeted examination letter (see Appendix II), FINRA asked recipient firms to summarize the most significant conflicts they face in their business. This appendix summarizes firms’ responses. There was considerable overlap in many cases between these activities. Most firms organized the conflicts they identified broadly around general and business line conflicts, and FINRA largely follows that approach here. FINRA notes that in some cases, and depending on the facts and circumstances, some of the conflicts described below may rise to the level of rule violations.

General Conflicts
Firms identified a number of conflicts that cut across firm activities or that were not related to specific business lines. These conflicts include:
- outside business interests: employees may engage in outside business activities which could create conflicts of interest with the firm or with a client;
- gifts and entertainment: offering or receiving a gift or entertainment could create a conflict of interest;
- political contributions: providing political contributions could create the perception that the company is seeking a quid pro quo;
- charitable donations: firm or employees charitable donations could create the perception that the company or employee is seeking a quid pro quo; and
- confidentiality: confidential information may be used inappropriately to benefit the firm, an employee, or a client.

Supervision and Compliance Conflicts
Some firms identified potential conflicts between a firm’s supervision and compliance departments’ oversight roles and responsibilities and a firm’s or individual’s revenue generation objectives:
- producing managers may spend more time on revenue generating activities than performing needed supervision; and
- supervisory and/or compliance staff could be subject to pressure from sales management to protect revenue generating financial advisors.

Research-related Conflicts
A number of firms identified various forms of research-related conflicts of interest. These conflicts include:
- timeliness of dissemination: research may be disseminated to clients at different times thereby potentially favoring one client over another, this could include internal clients, e.g., sales and trading;
- pressure from investment bankers: research may be subject to pressure from investment bankers to issue reports, or change existing ratings, to help win or sustain investment banking business;
- pressure from issuers: issuers could pressure research to issue favorable reports in return for investment banking or other business;
- preferential access to research: a firm may provide preferential access to desk strategists’ market commentary and trading ideas; and
- pressure from sales and trading: research may be biased to support the firm’s sales and trading activities.
Banking and Capital Markets

Firms identified a number of conflicts that could arise in the investment banking and capital markets area, and these relate primarily to the multiple roles a firm may play in a single transaction. There are a number of scenarios in which this could occur, including:

- advising one bidder for a company while financing another;
- advising on both sides of the same deal;
- advising a seller while financing a buyer;
- financing multiple bidders; and
- advising on the buy or sell side where the firm has an interest in one or more involved parties.

Retail/Private Wealth

Firms identified potential conflicts related to their retail and private wealth business. At their foundation, though, these relate mostly to the pursuit of revenue by the firm or its registered representatives at a client’s expense:

- firms offering, or preferencing, particular products or product providers because of their revenue or profit potential for the firm, such as through revenue sharing;
- registered representatives offering, or preferencing, particular products or services because of their income potential for the registered representative;
- registered representatives recommending transactions in order to generate revenue without due regard to suitability;
- firms offering sales incentive programs to employees; and
- firms or employees preferencing proprietary products.
ENDNOTES

1. See, e.g., the Securities Act of 1933, the Securities Exchange Act of 1934, the Glass-Steagall Banking Act of 1933, the Investment Company Act of 1940 and the Investment Advisor Act of 1940.

2. As the SEC noted in a 2005 release, “[b]roker-dealers are subject to extensive oversight by the Commission and one or more self-regulatory organizations under the Exchange Act. The Exchange Act, Commission rules, and SRO rules provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder.” See Securities Exchange Act Rel. No. 50980 (January 14, 2005).

3. FINRA rules also impose high ethical obligations on broker-dealers. See, e.g., FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and FINRA Rule 2111 (Suitability).

4. See Appendix II for a copy of FINRA’s letter informing firms of the review and requesting that they provide certain information to FINRA.

5. See Appendix III for a summary of conflicts firms identified in their responses to FINRA.

6. All recommendations are, of course, subject to FINRA Rule 2111 (Suitability). This rule requires firms to, among other things, conduct both reasonable basis and customer-specific determinations before recommending a transaction or investment strategy involving a security. A reasonable basis suitability determination is necessary to ensure that a transaction or investment strategy is suitable for at least some investors. The customer-specific suitability determination must be performed on an investor-by-investor basis.

7. FINRA believes that the increasing “retailization” of complex products requires increased review of these products by the firms. The inherent conflicts in these products—e.g., use of proprietary indices, certain call or extension features or use of affiliated calculation agents—and their typical complexity raise serious issues for a firm preparing to sell them to retail investors. Given these concerns, some firms impose heightened criteria for eligible customers before a complex product could be recommended. In the retail context, FINRA remains concerned that reliance on disclosure may be an inadequate antidote to conflicts, unless the firm is confident that the customer can effectively evaluate these disclosures and make sound judgments about their potential impact on an investment recommendation.

8. “Compensation grid” refers to the compensation schedule many firms use to pay brokers. Typically, the more commission revenue the registered representative generates, the larger the percentage of that revenue the representative may keep. Compensation grids are discussed in greater detail in the compensation section.

9. The federal securities laws and FINRA rules require broker-dealers to have comprehensive supervisory structures. Under Section 15(b) of the Securities Exchange Act, a firm and its supervisory personnel may be held liable for failing to supervise an individual who engages in bad behavior unless (i) the firm has established supervisory procedures and a system for applying the procedures, and (ii) individuals reasonably discharged their supervisory responsibilities. FINRA also requires comprehensive supervision. NASD Rule 3010 requires each firm, among other things, to establish, maintain and enforce a written supervisory system; designate supervisory personnel; and conduct an annual internal inspection. NASD Rule 3012 details the requirements for a firm’s supervisory control system.


11. In addition to the anti-fraud provisions discussed here, these also include rules under the Securities Exchange Act, e.g., Rule 10b-10. This rule generally requires a broker-dealer to provide confirmation statements for transactions, which must note, among other information, the firm’s compensation and whether it is acting as agent or principal. Rules 15c1-5 and 15c1-6 require a broker-dealer to disclose in writing to the customer if it has any control, affiliation, or interest in a security it is offering or in the issuer of the security.

12. As noted by the SEC staff, when a broker-dealer merely processes a customer’s order, but does not recommend securities or solicit the customer, the broker-dealer’s obligations are generally limited to information related to the consummation of the transaction. See January 2011 SEC Staff Study on Investment Advisers and Broker-Dealers, at 55 (SEC Staff Study).

13. Id.

14. Id.


16. FINRA has stated on a number of occasions that firms must take care to present a fair and balanced picture of the risks, costs and benefits of investing in a product. In promoting the advantages of a product, firms must balance their promotional materials with disclosures concerning the attendant risks. Simply providing a prospectus does not cure unfair or unbalanced sales or promotional materials, whether prepared by the firm or the issuer. See, for example, Regulatory Notice 09-31, FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds, June 2009; Regulatory Notice 08-81, FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment, December 2008; Notice to Members 04-30, NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds, April 2004; and Notice to Members 03-71, Non-Conventional Investments: NASD Reminds Members of Obligations When Selling Non-Conventional Investments, November 2003.

17. See earlier guidance on this issue, for example, Regulatory Notice 07-55, Personnel Background Investigations: FINRA Reminds Member Firms of Their Obligations Regarding Background Investigations of Prospective Personnel, November, 2007; Notice to Members 97-19, NASD Regulation And New York Stock Exchange Memorandum Discusses Sweep Report And Provides Guidance On Heightened Supervision Recommendations, April 1997; and, with respect to supervisory visits to office with personnel who have disciplinary records, Notice to Members, 98-38, NASD Reminds Members Of Supervisory And Inspection Obligations, May 1998. Notice to Members 99-45, NASD Provides Guidance On Supervisory Responsibilities, June, 1999.
18. Firms need to determine whether a prospective employee is a statutorily “disqualified” person. The term disqualification is defined in Article III, Section 3 of the FINRA By-Laws, and among other things, renders FINRA member firms and their associated persons ineligible for membership, continued membership, association or continued association with FINRA.

19. See NASD Rule 3010(e).

20. See NASD Rule 3010(e) for greater specificity on the obligations of FINRA member firms and their hiring practices.

21. See NASD Rule 3010(b).

22. FINRA recognizes that in many firms a number of committees may review new business initiatives and that some of these may include conflict concerns as part of their remit. Here, FINRA focuses on the dedicated new business initiative review since firms identified this as the primary gateway for identifying and managing conflicts of interest in a new product launch.

23. In Notice to Members 05-26, New Products: NASD Recommends Best Practices for Reviewing New Products, April 2005, FINRA identifies a number of good practices that include, but also go beyond, conflicts of interest. In the current report, FINRA focuses on how firms address conflicts of interest in their new product review.


25. Large firms typically have a variety of committees outside the new business initiative committee where issues, including those related to conflicts, may arise. FINRA’s focus in this section is on the new business initiative committee.

26. Revenue-sharing payments can take many different forms. For example, a fund company may pay a firm additional amounts at year end based on the amount a firm’s customers currently hold in the offeror’s funds, or based on the firm’s total sales of the offeror’s funds in the previous year. They can also take the form of other cash payments, such as an offeror helping to pay the costs of a firm’s annual sales meeting. See, e.g., Securities Act Release No. 8358 (Jan. 24, 2004), 69 FR 6438 (Feb. 10, 2004), at 6441 n.17.

27. There are a number of FINRA rules which address compensation, including: NASD Rule 2440 (Fair Price and Commissions), IM-2440-1 (Mark-Up Policy), IM–2440-2 (Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities), FINRA Rule 5110 (Underwriting Compensation), FINRA Rule 5250 (Payments for Market-Making), NASD Rule 2830 (Investment Company Securities), FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company) and 5110 (Corporate Financing Rule—Underwriting Terms and Arrangements), and NASD Rule 2830 (Non-Cash Compensation).

28. The Commission has stated that undisclosed markups of more than 10 percent on an equity security are fraudulent, and that a markup of less than 10 percent may be fraudulent depending on the circumstances. Acceptable markups on debt securities are significantly lower.

29. See Timothy Edward Daly, FINRA Letter of Acceptance Waiver and Consent (April 27, 2012) for an example of inappropriate behavior with regard to commission-based vs. fee-based accounts.


31. Not all firms implement performance appraisals of their registered representatives. In addition, legal restrictions may limit firms’ ability to reduce the non-discretionary salary portions of individuals’ compensation.


33. Investment Industry Regulatory Organization of Canada, IIROC Rule 42.4 Guidance.
South Region Compliance Seminar
New Orleans, LA | December 2 – 3, 2015

Issues Affecting Registered and Associated Persons
Wednesday, December 2
12:45 p.m. – 1:45 p.m.

Panelists discuss registered persons’ obligations and effective practices they should implement when completing their day-to-day responsibilities. Topics include suitability, reporting outside business activities, protecting customer data, and more.

Moderator: Debra Jastredowski
Regional Cause Associate Director
FINRA South Region

Panelists: Beth Burns
Senior Vice President and Director of Compliance
Synovus Securities, Inc.

Stacy L. Hagar
Principal Examiner
FINRA Dallas District Office

Samuel Kuehn
Vice President and Chief Compliance Officer
Legend Equities Corporation
Issues Affecting Registered and Associated Persons Panelist Bios:

Moderator:

Debra Jastredowski is the Regional Cause Associate Director for FINRA’s South Region. Ms. Jastredowski began her career with NASD in 1996 as an examiner in the Cleveland District Office conducting sales practice and financial and operational examinations, as well as investigations regarding terminations for cause and customer complaints. Ms. Jastredowski was promoted to Examination Manager in July 2006, to Associate Director of the Atlanta Office in March 2011, as assumed her current role in June 2015. Ms. Jastredowski is currently responsible for the supervision of examination managers and examiners that conduct cause examinations in the four district offices that make up the South Region. Previously, she worked as an investment representative for a FINRA member firm, a compliance analyst for a bank broker dealer, and as a supervisor in the operations area of a bank broker dealer. Ms. Jastredowski is an associate member of the Association of Certified Fraud Examiners. Ms. Jastredowski earned a Bachelor of Science in Management from Purdue University and an MBA from Kent State University.

Panelists:

Beth Burns is Senior Vice President and Director of Compliance for Synovus Securities, Inc. (SSI), Synovus Trust Company, and GLOBALT Investments (collectively, Financial Management Services, FMS). As Director of Compliance, she is responsible for developing, directing, and monitoring the overall compliance and risk programs for the brokerage, investment advisory, trust and insurance functions. Her responsibilities include understanding and addressing all applicable laws and regulations, as well as acting as liaison with regulatory agencies and other internal control groups on compliance-related issues. Ms. Burns joined Synovus in 1983 and has more than 30 years of experience in the brokerage and investment advisory industry. Prior to her current role, Ms. Burns served as Synovus Securities’ Chief Compliance Officer. Other positions held during her tenure at Synovus Securities include Controller and Operations Manager. Ms. Burns is a director of Synovus Securities, Inc., a member of the Synovus Financial Regulatory and Risk Committee, and is also a member of the National Society of Compliance Professionals. Registrations include Series 4, 7, 24, 27, 63 and 65. She holds a bachelor of business administration from Columbus State University.

Stacy L. Hagar is a Principal Examiner with FINRA’s Dallas District Office, where she has been since 1988 after graduating from Tulsa University in Tulsa, Oklahoma with a bachelor’s degree in finance. Her responsibilities with FINRA have included all of the regulatory program categories, with an emphasis on cause investigations. She has participated in numerous special initiative examinations and sweep programs, involving a broad scope of sales practice issues. Ms. Hagar is a Certified Regulatory and Compliance Professional (CRCP), having completed the FINRA Institute at Wharton program, and is a Certified Fraud Examiner.

Samuel A. Kuehn is Vice-President and Chief Compliance Officer of Legend Equities Corporation. He is responsible for his firm’s compliance and supervision programs. In addition to his role as Chief Compliance Officer, he is also AML Officer for his firm as well as the General Agent for the firm’s affiliated Insurance Agency. He joined Legend Equities Corporation in 2007 and previously worked in various compliance positions beginning in 1999. A member of the National Society of Compliance Professionals (NSCP) and the Financial Services Institute (FSI), he also currently sits on the Continuing Education Council’s Content Development Committee. He holds the following licenses and securities registrations: Michigan and Florida Insurance License, Series 7, 9, 10, 14, 24, and 63. He has earned the Certified Regulatory and Compliance Professional (CRCP™) designation and is a 2007 graduate of the FINRA Institute at Wharton. Mr. Kuehn graduated from Madonna University in Livonia, Michigan with a Bachelor of Science Degree.
Issues Affecting Registered and Associated Persons
Panelists

Moderator:
• Debra Jastredowski, Regional Cause Associate Director, FINRA Atlanta District Office

Panelists:
• Beth Burns, Senior Vice President and Director of Compliance, Synovus Securities, Inc.,
• Stacy Hagar, Principal Examiner, FINRA Dallas District Office
• Samuel Kuehn, Vice President and Chief Compliance Officer, Legend Equities Corporation
Issues Affecting Registered and Associated Persons

Agenda:

- Outside Business Activities/Private Securities Transactions
- Seniors/Suitability
- Form U4 Disclosures
- Use of Discretion
Question #1

- Does your firm allow its registered persons to participate in private securities transactions under any circumstances?
  - Yes
  - No
Question #2

- Does your firm address outside business activities and private securities transactions in an annual questionnaire?
  - Yes
  - No
Question #3

Does your firm have written supervisory procedures specifically addressing the needs of senior customers?

• Yes
• No
Question #4

Does your firm provide training to its representatives to know what to do in the event that a senior customer displays signs of confusion or dementia?

- Yes
- No
Does your firm address Form U4 disclosures in an annual questionnaire?

- Yes
- No
Question #6

Do you think this is a well-worded question to ask on your annual questionnaire: “Is your Form U4 current?”

- Yes
- No
Question #7

Does your firm conduct periodic background checks for its registered persons?

• Yes
• No
### Question #8

Do you think that 100% of your firm’s representatives understand that discretion is not permissible in any circumstance, unless authorization is given in writing by the customer?

- Yes
- No
Question #9

Do you think a representative is improperly using discretion in a case where he/she speaks to a customer about purchasing a stock on Monday, the customer agrees to the trade, and he executes it on Friday? No written discretionary agreement is on file.

- Yes
- No
Question #10

Do you think a representative is improperly using discretion where he/she has verbally obtained a blanket permission from a customer to place whatever trades the broker deems suitable for the customer – the customer is busy and frequently out of touch. No written discretionary agreement is on file.

• Yes
• No
Issues Affecting Registered and Associated Persons

Resources:

- **Private Securities Transactions:**
  - Notice to Members 94-44 and 96-33
  - Seniors/Suitability:
    > Protecting Senior Investors: Compliance, Supervisory and Other Practices Used by Financial Services Firms in Serving Senior Investors
  - Form U4 Disclosures:
    - Form U4 and U5 Interpretive Questions and Answers
Statistics show that baby boomers today control more than $13 trillion in household investable assets, or over 50% of total U.S. household investment assets. Projections also show that nearly one in every six Americans will be 65 or older by the year 2020. Given the increasing number of investors who will need advice and guidance, financial services firms are actively developing new products and seeking to provide financial advice and services to investors as they prepare for and reach retirement.

In light of these demographics, Staff at the Securities and Exchange Commission (“SEC”), the Financial Industry Regulatory Authority (“FINRA”) and the North American Securities Administrators Association (“NASAA”) view the protection of senior investors as a top priority. While securities regulators have long focused on the senior population and its particular vulnerability to fraud and abuse, beginning in 2006 securities regulators expanded collaborative efforts aimed at protecting seniors by providing educational programs targeted to senior investors, conducting focused examinations of financial services firms doing business with senior investors, and prosecuting numerous investment scams preying on senior investors. Securities regulators have also provided information and guidance to financial services firms regarding senior investors.

These efforts are part of our shared mission to protect senior investors.
As part of this ongoing effort, in February 2008, the SEC Staff, NASAA and FINRA undertook a new initiative to identify and publish examples of practices that financial services firms have developed with respect to their interactions with senior investors. To that end, we invited securities professionals, financial services firms, and industry groups to voluntarily share their practices with us. A cross-section of firms and financial services industry groups and others chose to participate in this effort, including broker-dealer and investment advisory firms, larger firms and smaller firms, and firms with a variety of organizational structures. We gratefully acknowledge their contributions and their commitment to work with us on this initiative.

This Report summarizes practices used by financial services firms and securities professionals in serving senior investors in the following areas:

- Getting started: how firms are thinking of ways to remodel their supervisory and compliance structures to meet the changing needs of senior investors;
- Communicating effectively with senior investors;
- Training and educating firm employees on senior-specific issues (such as how to identify signs of diminished capacity and elder abuse);
- Establishing an internal process for escalating issues and taking next steps;
- Encouraging investors of all ages to prepare for the future;
- Advertising and marketing to senior investors;
- Obtaining information at account opening;
- Ensuring the appropriateness of investments; and
- Conducting senior-focused supervision, surveillance and compliance reviews.

By sharing this information, we hope to provide practical examples to firms that are seeking to strengthen their infrastructure to assist them in working with senior investors in an ethical, respectful and informed manner. This Report does not create or modify existing regulatory obligations with respect to senior investors. It also does not catalog the full range of compliance practices applicable to senior investors. Rather, this Report focuses on specific, concrete steps that firms are taking to identify and respond to issues that are common in working with senior investors. By sharing this information, we also hope that financial services firms will continue to identify and implement additional practices to help ensure that the financial services industry continues to consider the particular needs of senior investors.

I. The Challenges

Any discussion about seniors raises the obvious question of who, exactly, is a “senior investor.” Because investors of any age do not necessarily share the same characteristics, investment objectives, risk tolerances, or financial profiles, any definition of the term “senior investor”

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would be either under-inclusive or over-inclusive. Thus, we do not define “senior investor” by reference to a specific age, but rather use the term to include investors who have retired or are nearing retirement.

An investor’s age and life stage are critical components of an investor’s profile and firms cannot meet their regulatory obligations without considering these factors. Nonetheless, issues such as diminished mental capacity may be more prevalent among older investors and older investors may also be more frequent targets for financial abuse.

It is also important to note that not all firms are alike, and therefore practices that may make sense for one firm may not make sense for another. Our meetings with firms have demonstrated however, that there are certain issues and challenges that many firms commonly encounter in working with senior investors. Some of those issues relate to meeting regulatory obligations, such as assessing the appropriateness of an investment for investors at different stages of life, or marketing retirement products to investors who are at or near retirement age. Other challenges, such as recognizing the signs of diminished capacity or financial abuse, are not unique to the financial services industry. We have included in this Report examples of various steps that firms are taking to address these challenges because firms indicated to us that these issues are becoming increasingly common, and are of concern to the financial services industry. Ultimately, investors will benefit when financial services firms consider and address these challenges in a proactive way.

The following scenario, along with others provided throughout this Report, illustrates some of the challenges that firms face when working with senior investors and demonstrates the importance of taking steps to implement a program to address these issues.

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**Mr. Investor** is a 76 year old widower. **Bob Securities Professional** has handled his investment portfolio for 25 years. His investment objective for the last 10 years has been to generate income. Recently, Mr. Investor told Bob Securities Professional that he wanted to generate higher returns from his account, and to change the beneficiaries on his IRA and Trust account from his children to his sister-in-law. Bob Securities Professional also began to notice that Mr. Investor didn’t always return his telephone calls, which was unusual, as they spoke regularly over their 25 year relationship.

**Bob Securities Professional** is concerned about altering the investment strategy to take on more risk and also about changing the beneficiary of Mr. Investor’s account under these conditions. **Bob Securities Professional** wonders what, if anything, he should do next.

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6 Generally, “life stage” refers to the key milestones in an investor’s life, such as marriage, buying a home, saving for children’s college education, preparing for retirement and retirement.
II. Practices Used by Financial Services Firms In Serving Seniors

During our meetings, many firms indicated that they have implemented and are implementing new processes and procedures aimed at addressing common issues associated with their interactions with senior investors. Some firms have indicated that they sought to consider a full range of issues, such as how to communicate effectively with senior investors; how to train and educate firm employees on senior-specific issues; how to establish an internal process for escalating issues and taking next steps when issues or questions are identified; how to encourage investors of all ages to prepare for the future; how to advertise and market to senior investors; obtaining information at account opening; how to ensure the appropriateness of investments; and how to conduct supervision, surveillance and compliance reviews focused on senior-specific issues.

A. Getting Started: How firms are thinking of ways to remodel their supervisory and compliance structures to meet the changing needs of senior investors

Some firms told us that they have sought to develop a consistent process for addressing senior-related issues throughout the firm. To accomplish this goal, some firms created internal working groups, task forces, or committees, while others have designated one or more individuals within compliance, legal or management to focus on senior-related issues. The role of these groups or designated individuals varies greatly among firms, and examples of their responsibilities, some of which already are required, include:

- Conducting an inventory of the firm’s operations and identifying areas of the firm that need to emphasize investors’ life stage issues.
- Reviewing the adequacy of existing policies and procedures within different areas of the firm that need to incorporate investors’ life stage issues.
- Reviewing products for appropriateness for senior investors.
- Establishing age-based restrictions on certain products or product features.
- Reviewing the use of proposed senior designations.
- Reviewing and approving marketing materials aimed at senior investors.
- Developing firm-wide escalation procedures to assist securities professionals in raising concerns about potential diminished capacity or elder financial abuse situations.
- Making in-depth training opportunities available for the firm, including training by experts on issues related to aging.
- Consolidating all senior investor-related information into one website for easy access for securities professionals.
- Reviewing, and modifying when necessary, criteria used for risk-based supervisory and compliance reviews.

- Providing input in connection with the firm’s annual risk assessment regarding risks related to senior investors.

For many firms, this type of group or task force was viewed as helpful in streamlining processes across business units, acting as a central resource for issues related to seniors, and serving as a contact for employees as they come across situations they need help to resolve. In establishing and operating such groups, some firms:

- Include individuals from various areas of the firm and with different operational experience on the committee or taskforce, including but not limited to staff from portfolio management, sales, marketing, legal, compliance, and/or internal audit.

- Meet on a regular basis to discuss issues surrounding senior-specific policies and procedures.

For some firms, based on their size or other factors, establishing committees or working groups may not make sense. For these firms, designating a specific individual or a department to identify and develop protocols for working through senior-related issues or to serve as a central point of contact for questions about senior issues may be an alternative to establishing a committee or working group.

B. Communicating Effectively With Senior Investors

Financial services firms explained that they have adopted practices that they believe improve their communication with senior investors. These include:

- Increasing the frequency of contact with senior investors to remain informed about changes in investors’ financial needs, employment status, health, and other life events.

- Encouraging securities professionals to talk to investors about having an emergency or alternate contact on file with the firm, such as a trusted family member or other trusted individual.

- Educating investors about the benefits of having a power of attorney and when appropriate, encouraging investors who are in good health to share details of their financial affairs with trusted family members, estate lawyers and/or other professionals to help ensure that if the investor’s health deteriorates, their financial affairs will be properly handled.

- Documenting conversations with investors in case they have problems with lack of recall or to help resolve any misunderstanding.

- Sending follow-up letters to investors after conversations to document and reiterate what was discussed.
Avoiding financial jargon, using plain language, and having larger font versions of marketing materials available.

Providing brochures that explain to investors how to identify, locate, organize and store important documents so that they are easily accessible in case of an emergency.

Many firms produce brochures, newsletters and magazines aimed at educating senior investors. Some firms include educational materials in their monthly or quarterly mailings to investors. These materials are targeted to both a particular age group and life stage, and examples include:

- Marketing pieces (i.e., booklets, magazines, and single page flyers) to assist investors in understanding specific products, meeting financial goals and investment strategies for pre-retirement and retirement.
- Publications that are education-oriented and cover topics such as analyzing social security and retirement benefits, identifying healthcare and estate planning resources.
- Educational materials created by third parties and educational resources from public websites targeted to senior investors.

We note that many of these materials may be primarily designed to market retirement-oriented services and products to senior investors. Firms must make sure that these materials, like all materials provided to investors, are not misleading and comply with relevant regulatory requirements.

C. Training Firm Employees On Senior-Specific Issues

In the subsequent months, Bob Securities Professional spoke with Mr. Investor at least twice a month. Mr. Investor seemed disoriented and did not recall transactions that he had previously authorized. Bob Securities Professional noted these observations in his file. Bob Securities Professional asked Mr. Investor whether he had all of his financial information in one place. Mr. Investor was not sure where his financial information was located. Bob Securities Professional encouraged Mr. Investor to invite his Daughter to their meetings.

Many firms have taken a proactive approach in training their securities professionals to help ensure that when they are faced with similar difficult and sensitive situations, they have the proper tools to address the issues raised. Firms utilize a variety of training methods to help ensure that the training is effective, including the following:

- Using hypothetical examples to illustrate the potential issues that securities professionals may encounter.
Creating web-based modules focused on diminished capacity, suitability, communicating with senior investors, advertising, the use of professional designations and elder financial abuse.

Distributing periodic newsletters or emails that contain articles or reminders about current policies and procedures related to senior investors.

Collaborating with gerontologists and other aging experts to help securities professionals understand and meet the needs of senior investors.

Creating educational materials on multi-generational and wealth transfer issues and the transition from planning for retirement to managing financial needs during retirement.

Using small, interactive groups of securities professionals as forums to discuss senior issues in depth.

Regardless of the mechanism used, many firms appear to be developing training for their employees on senior-specific issues. Two areas that firms mentioned in particular are how to identify signs of diminished capacity and elder financial abuse. Each area is discussed below.

- **Training on How to Identify Diminished Capacity**

Some firms told us that a critical aspect of their educational programs for employees is focused on identifying signs of diminished mental capacity in an investor. The ability to observe changes in investors’ behavior places securities professionals in a unique and challenging position. Firms shared their concerns about steps they are taking when an investor shows signs of diminished capacity, about their responsibilities in these instances, and about their potential liability in instances where the securities professional does not address the issue.

We note that securities professionals cannot take advantage of investors in a manner that would violate an adviser’s fiduciary duty to the investor or a securities broker’s responsibility to follow just and equitable principles of trade. Firms have an obligation to supervise employees to prevent this behavior. In circumstances where the investor appears to lack capacity to understand an investment or to provide informed consent, firms may want to consider implementing procedures for securities professionals to follow, such as seeking advice from supervisors about contacting a trusted family member or the person designated in the investor’s power of attorney.

Many firms have included segments in their educational programs to help securities professionals identify signs -- or “red flags” -- that may indicate that an investor may have diminished capacity or a reduced ability to handle financial decisions. Examples of signs include, but are not limited to, the following:

- The investor appears unable to process simple concepts.

- The investor appears to have memory loss.
- The investor appears to have difficulty speaking or communicating.
- The investor appears unable to appreciate the consequences of decisions.
- The investor makes decisions that are inconsistent with his or her current long-term goals or commitments.
- The investor’s behavior is erratic.
- The investor refuses to follow appropriate investment advice; this may be of particular concern when the advice is consistent with previously-stated investment objectives.
- The investor appears to be concerned or confused about missing funds in his or her account, where reviews indicate there were no unauthorized money movements or no money movements at all.
- The investor is not aware of, or does not understand, recently completed financial transactions.
- The investor appears to be disoriented with surroundings or social setting.
- The investor appears uncharacteristically unkempt or forgetful.

**Training on How to Identify Elder Financial Abuse**

Elder abuse comes in a variety of forms. It can be physical or emotional and can be in the form of neglect, abandonment, or through financial exploitation. Elder financial abuse is generally referred to as the misuse of a person’s money or belongings by a family member or a person in a position of trust.

Similar to detecting diminished capacity, firms indicated that securities professionals are on the front lines of seeing indications of possible financial abuse and, as a result, have included segments in their educational programs to help securities professionals identify signs -- or “red flags” -- that may indicate that an investor may be subject to elder abuse. Examples of these signs include:

- The investor gives a power of attorney to someone that, to the investor’s securities professional, appears inappropriate.
- Indications that the investor does not have control over or access to his/her money.
- The investor’s mailing address has been changed to an unfamiliar and unexplained address.
- Inability of the securities professional to speak directly to the investor, despite attempts to do so.

- The investor appears to be suddenly isolated from friends and family.

- There is a sudden, unexplained or unusual change in the investor’s transaction patterns.

- There are unexplained disbursements made in an investor’s account that are outside of the norm.

- The sudden appearance of a new individual involved in the investor’s financial affairs.

**D. Establishing an Internal Process for Escalating Issues and Taking Next Steps**

Many firms told us that the key to responding to signs of diminished capacity or financial abuse is to establish internal procedures that permit the securities professional to obtain advice from others within the firm on possible next steps to take. The following are examples of escalation procedures or next steps identified by some firms:

- Requiring a securities professional to document suspected diminished capacity or elder financial abuse, and escalate the issue immediately.

- Clearly designating the individual or groups to whom the securities professional is to escalate the matter, *e.g.*, a branch manager, a designated member of the legal or compliance department or a specially-created senior task force within the firm.

- Training employees to escalate early - at the first sign.

- Embedding escalation procedures in employee training and continuing education courses.

Firms also told us that they had created and adopted policies with respect to the next steps to take after an issue was identified and escalated. These policies include:

- Prohibiting the securities professional from making securities recommendations to the investor or investments in the account until the concern no longer exists.

- Communicating with the investor’s designated emergency contact or the person provided with power of attorney for the investor.

- Conducting a review of the investor’s account and identifying any transactions or patterns that could indicate a problem (*i.e.*, financial abuse by a securities professional or other individual).

- Maintaining frequent contact with the investor to assess any new developments.
Having a manager or designated individual communicate with the investor along with the securities professional who has direct responsibility for the investor’s account.

Notifying the legal and compliance departments of further conversations with the investor, and involving them as appropriate.

Consulting appropriate state statutes to determine next steps, which may include alerting appropriate authorities, including a government protective services organization, if elder abuse is suspected.

Documenting any contact with the legal department in the investor’s file.

Firms indicated that having effective escalation procedures and a process for considering and taking further steps to be critical in helping to ensure that they address issues of possible diminished capacity or financial abuse.

E. Encouraging Investors of All Ages to Prepare for the Future

Financial services firms also told us that they are considering steps that help them and their investors prepare for the future. Investors of any age can take steps to plan for the event of mental or physical incapacity.

As stated above, some firms are asking investors to provide them with emergency or alternate contacts for use in the event that the firm is unable to contact the investor or if the firm suspects diminished capacity or elder abuse. Some firms specify the permitted purposes for contacting this alternate person and receive permission to keep this information in the investor’s files.

Another approach is for the securities professional to ask the investor whether he/she has provided a power of attorney granting authority over the investor’s account to a trusted friend or family member under certain circumstances. These arrangements may more formally facilitate the management of an investor’s account should certain circumstances occur. Practices in this area include:

- Encouraging securities professionals to have conversations about the benefits of executing powers of attorney with all investors as a matter of routine during the account opening process.

- Encouraging securities professionals to have a conversation with the investor prior to opening an account as to whether anyone else should be consulted with regard to the account.

Firms were mindful that powers of attorney can be abused and have developed practices to address risks associated with abuse of a power of attorney. Practices identified in this area include:

- Having a process for identifying accounts of investors where a power of attorney is added or changed, followed by a change in activity compared with the
investor’s stated financial objective and profile. For example, firms looked for
evidence of unusual checks written out of the account within a given timeframe,
and a concentration of checks to a single, third-party payee.

- Requiring that copies of all confirmations and account statements be sent to both
  the account holder and the power of attorney.
- Having a process to check the signature of the investor against other signed
documents received in order to determine authenticity.

Whether by encouraging investors to provide alternate contact information or to execute a power
of attorney, firms stated that encouraging all investors to be prepared for the future was an
increasingly important issue.

F. Advertising and Marketing to Seniors

Mr. Investor met with Bob Securities Professional to discuss his portfolio. At the
meeting, Mr. Investor showed Bob Securities Professional an advertisement that
he had received from another securities professional. The advertisement
indicated that Mr. Investor would receive a 50% return on his investment. The
bottom of the advertisement included the designation “Senior Specialist.” The
title confused Mr. Investor.

Many firms indicated that they have adopted one or more practices that were outlined in the
public report issued in September 2007 by the SEC’s Staff, NASAA and FINRA titled,
“Protecting Seniors: Report of Examinations of Securities Firms Providing “Free Lunch” Sales
Seminars.”7 In that report, in Appendix B, “Effective Compliance and Supervisory Practices,”
we noted examples of compliance and supervisory practices that appeared to be effective in
helping to ensure adequate supervisory oversight and compliance with the securities laws. While
that Report did not create or modify existing regulatory obligations to senior investors, we
provided those practices in that Report in order to assist financial services firms in reviewing
their practices in this area. While the complete list is not reiterated here, some of the practices
that many firms have adopted include:

- Banning securities professionals from using marketing materials to target
  particular age groups, such as referring to an event as a “senior seminar” or a
  “senior meeting.”
- Providing an online brochure with detailed instructions accessible to all
  employees describing the approval process required for seminars, investor
  appreciation events, continuing education seminars, outside speaking events,
  booths/exhibits, and business building/networking events.

7 Joint Report of the SEC’s Staff, NASAA, and FINRA September 2007 available at
Providing a library of pre-approved materials that were reviewed and approved by supervisory and compliance personnel.

Using a web-based training module for securities professionals to use as reference when they are creating materials for senior-oriented events.

Performing a minimum number of unannounced compliance visits to seminars on a yearly basis.

Instituting a “mystery shopper” program where a compliance professional attends seminars unannounced to verify that securities professionals are conducting seminars in accordance with firm policies and procedures.

Firms told us that these are among the mechanisms that they are using to heighten their review and approval processes for the use of marketing and sales materials and sales seminars by their employees with respect to seniors.

- The Use of Senior Designations

Regulators have identified the use of senior designations in advertising and marketing materials as a possible risk to investors because a designation may be used to imply expertise or credentials, which may be inaccurate or misleading. Many states are limiting the use of designations.

As a result of increased scrutiny by regulators, many firms have heightened their review and approval processes for the use of senior designations by their employees, and they monitor and limit their use. Some examples of these policies include:

- Reviewing the training materials used by entities or organizations that confer a designation to ensure that predatory sales techniques are not included as part of the training.

- Verifying the appropriate use of designations during field office inspections by reviewing securities professionals’ business cards.

- Maintaining a list of approved designations.

- Maintaining a list of prohibited designations.

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8 Some professionals use titles that imply they are experts at helping seniors with financial issues; these titles are known as Senior Designations. See “Senior” Specialists and Advisors: What You Should Know About Professional Designations” at [http://www.sec.gov/investor/pubs/senior-profdes.htm](http://www.sec.gov/investor/pubs/senior-profdes.htm).


10 For example, Massachusetts, Nebraska, New Hampshire, Virginia and Washington have restricted the use of senior designations.
Banning the use of any designation that includes the word “Senior” to help ensure that investors are not confused.

Permitting the use of designations only if accredited by a national accreditation organization.

Firms told us that they are using these mechanisms to heighten their review and approval processes for the use of senior designations by their employees, and to monitor and limit their use.

G. Obtaining Information at Account Opening

Mr. Investor’s Daughter opened an account with Betty Securities Professional over the phone. Daughter informed Betty Securities Professional that she was nearing retirement and wanted to preserve her nest egg. Betty Securities Professional asked Daughter to provide financial information and then filled in the remainder of the new account form herself. Under investment objectives, Betty Securities Professional put “speculative.” Betty Securities Professional purchased speculative stocks in Daughter’s account.

Pursuant to a variety of securities laws, and rules, financial services firms are required to obtain sufficient information about an investor to ensure that recommendations are appropriate for the investor, and that the investor’s account is managed consistent with the investor’s investment objectives. This information includes the investor’s age, financial and tax status, and investment objectives.11

We noted that some firms use the account opening process to ask questions that may broaden the conversation with investors. For example, some firms are:

- Documenting the response to lifestyle questions such as, “When do you plan to retire?” “How much money do you need to retire in the fashion you want?” “Do you have any other issues or expenses that we should contemplate as you retire?” “Do you have children or grandchildren who are dependent on you financially?” and “Do you have a will and a financial power of attorney?”

- Requiring in-person meetings with the investor to fill out the new account form. This helps to ensure that all investor information on the new account form is accurate and up-to-date.

- Encouraging the investor to bring a trusted family member or trusted individual to meetings.

- Requiring frequent updates of new account information, such as on an annual basis.

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11 Under, for example, NASD Rule 2310.
Firms told us that these steps better help them to obtain information about investors at account opening to aid in determining whether particular investments are appropriate.

**H. Ensuring the Appropriateness of Investments**

Mr. Investor also maintains an account with Betty Securities Professional. Recently, Betty Securities Professional suggested that Mr. Investor re-evaluate his portfolio and shift his investments from income-orientated securities to growth stocks. She also suggested that Mr. Investor add more speculative investments, in order to generate higher returns. Mr. Investor had difficulty understanding the complex structure of some of the recommendations. Currently Mr. Investor’s portfolio is diversified and holds bonds and other income-producing products.

Investors who are the same age can have very different investment profiles, and what is appropriate for one investor may not be appropriate for another investor. However, an investor’s age and life stage are important factors in assessing the appropriateness of recommendations for that investor. Some firms are using age in their risk-based supervisory reviews of investors’ accounts, as well as other information, to identify accounts or transactions for heightened review. These reviews may include the following:

- Assigning investment objectives to each product that the firm sells in order to aid securities professionals in assessing the appropriateness of the product for a particular investor, and to facilitate comparisons between the objective of the product and the investor’s stated investment objective by supervisors and compliance personnel.

- Conducting periodic supervisory interviews with securities professionals to discuss the portfolios of their senior investors.

- Conducting periodic calls with senior investors to confirm whether there have been changes that would impact the investor’s account information, such as financial changes or changes to their investment objectives.

- Confirming with the investor directly whether particular transactions were solicited or unsolicited.

- Using financial planning tools that help investors plan for retirement, and anticipate expenses, lifestyle changes, and goals during retirement. The tools provide guidance to securities professionals regarding investment choices that may help the investor reach their stated objectives.

- Using a filtering program based on age and investment objectives to assist securities professionals in selecting appropriate annuity products for investors.

- Requiring special supervisory review of all new account forms reporting investment objectives more aggressive than “income” for investors over a certain age.
➢ Conducting specialized reviews of new accounts that are opened as guardianship or conservatorship relationships for verification of proper documentation.

Some firms have also implemented product-specific practices or limitations in order to reduce the likelihood that a product will be recommended to an investor for whom it is inappropriate. Some firms have included age-restrictions in their product-specific practices, including:

➢ Limiting or prohibiting purchases of certain investment products, such as certain structured products, based on an investor’s life stage and risk profile.

➢ Prohibiting purchases of certain variable life insurance products by investors who are above a certain age.

➢ Imposing an age maximum on certain annuity riders that have actuarially little or no benefit to persons above that age.

➢ Requiring completion of additional or “targeted” suitability documentation before a transaction is processed.

Other firms have implemented heightened reviews of all variable annuity purchases. For senior investors, deferred annuities may pose special appropriateness concerns depending on the investor’s liquidity needs and investment time horizon. To help address these issues, some firms are:

➢ Creating a central review and approval process for all variable annuity transactions with special focus on purchases with additional riders. These firms have a process, independent of the securities professional, which compares the attributes of the product to the needs of the investor.

➢ Training a dedicated team of annuity application reviewers to be aware of the special nuances of these products.

➢ Requiring a heightened review of annuity applications for investors over a certain age in a low tax bracket or with low liquid net worth.

➢ Requiring securities professionals to fill out an annuity worksheet with the investor’s age, net worth, assets, and other factors. This information is used by the firm to assign a risk score to determine whether a more enhanced review is required.

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12 Broker-dealer firms have specific responsibilities with respect to transactions in deferred variable annuities (NASD Rule 2821).
Requiring the investor to select an investment time horizon for a variable annuity purchase. This helps supervisors review the variable annuity subaccount allocations for consistency with the designated investment time horizon.

Requiring securities professionals to complete an individual attestation that they made certain representations and disclosures to the investor in connection with the annuity transaction, including the accuracy of the investor’s profile, time horizon and the reason for purchase.

Implementing a hard block that prohibits variable annuity products to be sold to investors above a certain age based on the time horizon required for the instrument to accrue any benefit to the investor, and/or the length of the surrender period in light of the age group’s typical investment time horizon and liquidity needs.

As described above, firms are using a variety of techniques to help ensure the appropriateness of investments for seniors.

### III. Conducting Senior-Focused Supervision, Surveillance and Compliance Reviews

Mr. Investor, Jr. is 49 years old and plans to retire next year. Mr. Investor’s investment objective is conservative and he holds bonds and blue chip stocks in his portfolio. Last month, a highly speculative investment was purchased in his account. The Branch Manager/Chief Compliance Officer noted this apparent discrepancy during his review of transactions and inquired further.

While firms conduct supervisory and surveillance review of the activity in investors’ accounts regardless of the age of the investor, some firms told us that they use age or other parameters in their exception reports and other supervisory review activities in order to pay special attention to seniors’ accounts. These firms attempt to capture transactions and practices that may particularly impact seniors. Some examples of these practices include:

- Maintaining trade blotters that contain account information (such as age, net worth, investment objective) alongside the transactions for ease in supervisory review.

- Restricting high-risk trading for investors over a certain age unless pre-approved.

- Using exception reports to isolate activities and accounts for additional review, such as IRA distributions above the minimum required distribution, 1035 exchange transactions or investors over a certain age that list “speculative” as an investment objective.

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13 “1035 exchanges” are so named because IRS Code Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of one annuity contract for another annuity contract.
Requiring that all 1035 exchanges and 72T distribution requests be approved by a direct supervisor and a central review unit to verify that the exchange is suitable.¹⁴

Blocking a transaction if the surrender charge is greater than a pre-determined amount.

Some firms use exception reports to identify and monitor portfolio allocations, commissions, and other issues in accounts. The thresholds used in some of these exception reports are designed to identify risks that are common to senior investors, however, the individual thresholds used differ among firms. Some practices include:

- Identifying accounts of investors over a certain age that generated a commission-to-asset ratio above a certain percentage over a preceding period.
- Identifying accounts of investors over a certain age that generated commissions in speculative or complex investments.
- Identifying accounts of investors over a certain age that have “conservative” or “income” stated as their investment objective, and also have a margin loan balance above a certain threshold, and/or have options trading losses above a certain threshold over the preceding several months.
- Identifying accounts of investors over a certain age that have concentration and margin debit balances above a certain threshold.
- Identifying accounts of investors who are over a certain age, or of any age, in which a change in trading activity has occurred and a power of attorney has recently been added or amended.
- Identifying investors over a certain age with IRA rollover accounts to review activity relative to age, financial information, investment objectives, and risk tolerance.

In addition to performing supervision, surveillance and compliance reviews of investors’ accounts, firms also generate targeted reports concerning the activities of their securities professionals to help spot potentially inappropriate or abusive activity relating to senior investors. For example, firms use surveillance reports that identify securities professionals that:

- Sell a threshold number of annuities to investors over a certain age during a specified period.
- Sell a threshold number of annuities with the same rider.

¹⁴ “72T distributions” are so named because IRS Regulation 72t permits early withdrawal from a retirement account without the usual tax penalty (IRS Code Section 72(t)(2)(A)(iv)).
- Have a senior investor base that is above a certain threshold percentage of the total investor base.

- Generate commissions above a threshold amount during a particular period from investors over a certain age.

- Have a certain percentage of their rolling 12-month fees generated by investors over a certain age.

Firms stated that these types of supervisory, surveillance and compliance reviews were helpful to identify potentially inappropriate or abusive transactions or practices with respect to senior investors. As critical as identifying the questionable transaction or activity is effective investigation and follow-up to ensure that the investor is receiving appropriate financial service from the securities professional and the firm.

IV. Conclusion

Given the increasing number of Americans who will need advice and guidance as they near and reach retirement age, the issues described in this Report could not be more important for financial services firms that provide services to senior investors. And, as noted at the outset of this Report, we view the protection of senior investors as a top priority.

This Report describes a myriad of practices used by financial services firms when working with senior investors. Many firms are implementing new processes and procedures aimed at addressing common issues associated with their interactions with senior investors, including with respect to: communicating effectively with senior investors; training and educating firm employees on senior-specific issues (such as how to identify signs of diminished capacity and elder abuse); establishing an internal process for escalating issues and taking next steps when issues or questions are identified; encouraging investors of all ages to prepare for the future; advertising and marketing to senior investors; obtaining information at account opening; ensuring the appropriateness of investments; and conducting supervision, surveillance and compliance reviews focused on senior-specific issues.

By sharing this information, the SEC Staff, NASAA and FINRA hope that it will be helpful to financial services firms that are seeking to ensure that they serve senior investors in an ethical, respectful and informed manner. We also hope that by publishing this Report, financial services firms will be encouraged to identify additional practices that will help them to better serve senior investors.
RESOURCES

Below is a list of supplemental informational materials related to the topics discussed in this Report that may be helpful. We have included this list for your convenience.


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Form U4 and U5 Interpretive Questions and Answers

Below is a list of Frequently Asked Questions (FAQ) regarding a registered person’s reporting obligations with respect to Forms U4 or U5. These FAQ are organized by the question number as found on the Forms U4 and U5.

FORM U4

• Questions 14A and 14B

  Q1: Is a registered person required to report military charges?

  A: Yes. If a registered person is charged with, pleads guilty or no contest to, or is convicted of a felony or certain enumerated misdemeanors in a military court, such event must be reported. (02/13/98)

  Q2: If a registered person is convicted of a crime and later pardoned, must the conviction continue to be reported? What if a conviction is set aside?

  A: A person convicted of a crime and subsequently pardoned must continue to report the conviction. A pardon releases an individual from the punishment for a crime, but does not remove the conviction. If the conviction is set aside, a copy of the court's order should be sent to FINRA's Registration and Disclosure Department (RAD). In many cases, the purpose of an order to set aside a conviction is to restore the individual to the position he would have been in if the conviction had never been entered; in such case, the conviction is not reportable. In other cases, an order may restore some or all civil rights, but not order the expungement of, or otherwise remove, the conviction. Each order setting aside a conviction will be reviewed by RAD staff to determine if the conviction must be reported.

  Even if the conviction is not reportable, the charge may still be reportable. Registered persons have an obligation to determine whether a criminal event is required to be reported through one or more questions under Item 14A or 14B. (Originally posted 02/13/98; revised 04/29/98; revised 09/01/99; revised 05/18/09)

  Q3: If a registered person is arrested but not charged with a crime, is the arrest required to be reported?

  A: No. An arrest without a charge is not required to be reported. (02/13/98)

  Q4: Is a misdemeanor charge or conviction of failure to file income tax or a guilty or no contest plea to such offense required to be reported?

  A: No. (Originally posted 02/13/98; amended 08/05/98)
Q5: Is an offense that results in an individual being placed in a pre-trial diversion or intervention program required to be reported?

A: Each case must be reviewed individually to determine if formal charges were filed. If so, the matter must be reported. The registered person should submit the official court documents and a copy of the relevant statute to demonstrate that no formal charges were filed or charges otherwise are not required to be reported. (02/13/98)

Q6: Are misdemeanor gambling charges or convictions required to be reported?

A: No. (02/13/98)

Q7: Are summary courts-martial reportable?

A: No. (04/29/98)

Q8: Is a dishonorable discharge reportable?

A: A dishonorable discharge itself is not a reportable event. However, the underlying charge and conviction may be reportable under Question 14A or 14B; if so, the dishonorable discharge should be included in item 4 (Disposition Disclosure Detail) of the Criminal Disclosure Reporting Page (DRP). (Originally posted 04/29/98; revised 09/01/99, revised 08/05/05)

• Question 14D

Q1: If a regulatory agency enters an order against a registered person in connection with an investment-related activity, and later vacates the order, may the registered person answer “No” to Question 14D(1)(d)?

A: Generally, no. The question asks whether a regulatory agency has ever entered an order. The vacated order represents the final disposition of the action; it does not relieve the registered person from the obligation to disclose the original findings. However, if the regulatory agency vacates the order and explicitly signals its intent that the vacating order should have retroactive effect by using terminology such as the Latin phrases “nunc pro tunc” (“now for then”) or “ab initio” (“from the beginning”), the regulatory action is not reportable, and a registered person may answer “No” to Question 14D(1)(d). If the vacated order was originally reported to CRD, the registered person may amend the corresponding DRP to indicate the regulatory agency vacated the order nunc pro tunc or ab initio, and therefore, it is no longer reportable. (Originally posted 02/13/98; revised 09/01/99; revised 08/05/05)

• Question 14E

Q1: Is a FINRA Acceptance, Waiver, and Consent ("AWC") reportable?

A: Yes, an AWC is reportable if it contains any of the findings set forth in this Question. (04/29/98)

Q2: Is a rule violation that results in a fine of $2,500 or less always a Minor Rule Violation, and therefore not reportable?
A: No, the determination is not made solely based on the amount of the fine. Minor Rule Violations are defined in the Explanation of Terms on the Forms. A violation must be designated as a Minor Rule Violation as part of a plan submitted to and approved by the SEC. Under FINRA Rule 9216 (formerly Article II, Section 10 of the Code of Procedure), a violation is considered a minor rule violation only if the violation is the subject of a minor rule violation plan letter submitted by a member or associated person that is accepted by FINRA in accordance with Rule 9216. The list of the rules covered by FINRA's plan is set forth in FINRA Rule 9217. FINRA's plan became effective on October 1, 1993, and has no retroactive application. (05/26/98)

- **Question 14G**

Q1: When does a registered person have to report that he is the subject of a FINRA investigation?

A: The Forms define the term "investigation." An investigation is defined to include a FINRA investigation after the Wells notice has been given or after an associated person has been advised by the staff that it intends to recommend formal disciplinary action. An investigation does not include subpoenas, preliminary or routine regulatory inquiries or requests for information, deficiency letters, "blue sheet" requests or other trading questionnaires, or examinations. (02/13/98)

Q2: If FINRA files a complaint against a registered person, but the complaint is dismissed and not appealed, what should the registered person report?

A: When the registered person receives written notice that he is the subject of a FINRA investigation, the registered person should answer "Yes" to Question 14G(2). When the complaint is dismissed, the answer can be amended to "No." (Originally posted 02/13/98; revised 09/01/99)

- **Question 14I Generally**

Q1: What constitutes a sales practice violation?

A: The term "sales practice violation" is defined in the instructions to the Forms and includes any conduct directed at or involving a customer which would constitute a violation of any rules for which a person could be disciplined by any self-regulatory organization; any provision of the Securities Exchange Act of 1934; or any state statute prohibiting fraudulent conduct in connection with the offer, sale or purchase of a security or in connection with the rendering of investment advice. (02/13/98)

Q2: Who is included in the term "consumer"?

A: The term includes a current, former, or prospective customer or a person who can act for such person by law or contract, including an executor, conservator, or a person holding a power of attorney. An example of a person who is not a "consumer" is a customer's relative who does not hold a power of attorney. (08/05/98)

Q3(A): If a registered person is the subject of a written customer complaint that was reported under Question 14I(3) which settles for less than $10,000 prior to 5/18/09 or for less than $15,000 on or after 5/18/09, must he report the settlement under Question 14I(2)?

A: No. The registered person can answer "No" to Question 14I(2); however, the registered person has an obligation to update the DRP to disclose the disposition of the customer complaint. The "Yes"
response to Question 14I(3) remains applicable for two years from the date the complaint was received by the firm. (Originally posted 02/13/98; revised 09/01/99; revised 05/18/09)

Q3(B): If a registered person is the subject of an investment-related, consumer-initiated arbitration claim or civil litigation that was reported under 14I(5) and settles for less than $15,000, must he report the settlement under Question 14I(4)?

A: No. The registered person can answer "No" to Question 14I(4); however, the registered person has an obligation to update the DRP to disclose the disposition of the customer complaint. The "Yes" response to Question 14I(5) remains applicable for two years from the date the complaint was received by the firm. (Originally posted 05/18/09)

Q4: If a customer files a written complaint with a broker-dealer that must be reported under Question 14I(3) and later files an arbitration regarding the same allegations, does the registered person have to answer "Yes" to both Questions 14I(3) and 14I(1)? What if a customer files a written complaint with the member and then subsequently files an arbitration claim that raises completely separate allegations, e.g., the written complaint alleges a sales practice violation with respect to a mutual fund transaction, while the subsequent arbitration alleges a different sales practice violation with respect to a bond transaction?

A: When the written customer complaint is filed with the broker-dealer, the registered person must answer "Yes" to Question 14I(3). When the arbitration is filed over the same allegations, the registered person should amend his U4 by changing the answer to Question 14I(3) to "No" and answering either Question 14I(1) "Yes" (if he is a named party to the arbitration), or Question 14I(5) "Yes" (if he is the subject of, but not a named party to, the arbitration).

If the subsequent claim raises different allegations, the registered person must answer "Yes" to both Questions 14I(3) and 14I(1) (if named as a party in the arbitration) or "Yes" to Questions 14I(3) and 14I(5) (if not named as a party in the arbitration), and disclose details of the new claim on a separate DRP. Therefore, the original written customer complaint and the subsequent arbitration would be treated separately for reporting purposes. (Originally posted 02/13/98; revised 09/01/99; revised 05/18/09)

Q5: A customer files a written complaint against registered persons A and B, and the complaint is reported against both under Question 14I(3). Subsequently, the customer files an arbitration against registered person A, but not registered person B, regarding the same allegations contained in the complaint. Registered person A amends his U4 to change 14I(3) to "No" and 14I(1) to "Yes" and amends his DRP with details on the pending arbitration. Although registered person B is not required to answer "Yes" to Question 14I(1) because he was not named in the arbitration, is registered person B obligated to update his DRP for the 14I(3) "Yes" answer to reflect that the customer has filed an arbitration against Broker A?

A: It depends. Registered Person B is obligated to update his DRP for Question 14I(3) to reflect the disposition of the customer complaint only as it pertains to him. Although registered person B was not a respondent in the arbitration, he may still be the subject of the arbitration (i.e., a customer party may have alleged that he committed sales practice violations). If this is the case, registered person B must answer "Yes" to Question 14I(5), change the answer to Question 14I(3) to “No” and update Questions 7-11 on the DRP, as appropriate. If registered person B is not a respondent in, or the subject of, the arbitration, he does not need to update his DRP until the disposition of the customer complaint as it pertains to him. The "Yes" response to Question 14I(3) or 14I(5) will remain applicable for two years.
from the date the complaint was received by the firm. (Originally posted 08/05/98; revised 09/01/99; revised 05/18/09)

**Q6:** If a customer complaint, arbitration or litigation is settled for a total of $10,000 or more before 5/18/09, or $15,000 or more on or after 5/18/09, but the registered person’s contribution is less than the threshold amount, should the registered person answer “Yes” to Question 14I(1)(c) or (d), 14I(2) or 14I(4)(a)?

**A:** Yes. These questions refer to the total amount of the settlement, not the registered person’s contribution. The fact that the registered person contributes less than the threshold amount does not change his obligation to report. (Originally posted 02/13/98; revised 09/01/99; revised 05/18/09)

**Q7:** How should a customer complaint settled through mediation for $10,000 or more before 5/18/09, or $15,000 or more on or after 5/18/09 be reported?

**A:** If the customer complaint was settled via mediation before the customer filed an arbitration case, the settlement should be reported under Question 14I(2). If the customer complaint was settled through mediation after the customer filed an arbitration and the registered person was a named party, he should report that the arbitration was settled under Question 14I(1). If the registered person was not a named party but was the subject of the arbitration, he should report the settlement via mediation under Question 14I(4)(A). In any case, the terms of the settlement should be reported on a Customer Complaint DRP. (Originally posted 04/29/98; revised 09/01/99; revised 05/18/09)

**Q8:** What if the terms of a settlement agreement are confidential? Does the registered person have to report his contribution to the settlement if the total settlement is $10,000 or more before 5/18/09 or $15,000 or more on or after 5/18/09?

**A:** Yes. The registered person and firm must report the entire settlement, including the individual’s contribution amount. The terms of a settlement agreement cannot be confidential for purposes of CRD reporting and FINRA BrokerCheck®. By filing a Form U4, a registered person agrees to provide true and complete answers to the Questions. A registered person cannot nullify that obligation by a separate settlement agreement with a customer. Thus, a settlement agreement between a registered person and/or firm and customer could only require that parties other than registered persons or firms, e.g., the customer or his attorneys, not divulge the terms of the settlement.

Note that it is also a violation of just and equitable principles of trade (FINRA Rule 2010) to include any provision in a settlement agreement that purports to prevent a customer or his attorney from talking to or otherwise cooperating with a regulator. See Notice to Members 95-87 (October 1995) and Notice to Members 04-44 (June 2004). (Originally posted 04/29/98; revised 05/18/09)

**Q9:** If an arbitration is no longer required to be reported under Question 14I(1) because it has been withdrawn or dismissed, is there any requirement to report it under Question 14I(3)?

**A:** No. For reporting purposes, the arbitration does not revert to a customer complaint when the arbitration is withdrawn or dismissed. If the arbitration was preceded by a written customer complaint regarding the same allegations, then the registered person should have: (1) answered "Yes" to Question 14I(3) at the time the written customer complaint was received by the broker-dealer; (2) filed an amendment answering "No" to Questions 14I(3) and "Yes" to Question 14I(1) when the arbitration was filed naming him as a party; and (3) filed a further amendment when the arbitration is withdrawn or
dismissed changing the answer to Question 14I(1) to "No." If the arbitration was not preceded by a written customer complaint regarding the same allegations, then the registered person continues to answer "No" to Question 14I(3). (Originally posted 08/05/98; revised 09/01/99; revised 05/18/09)

**Q10:** For purposes of reporting a customer complaint, arbitration or litigation that settles for $10,000 or more before 5/18/09 (under Questions 14I(1)(c) or 14I(2)(a)), or for $15,000 or more on or after 5/18/09 (under Questions 14I(1)(d), 14I(2)(b), or 14(4)(a)), should the attorney fees be included in the threshold total?

**A:** No. The attorney fees are not included in the settlement amount for purposes of reporting a customer complaint, arbitration or litigation that settles for at least the threshold amount. (Originally posted 08/05/05; revised 05/18/09)

**Q11:** If a registered person is not named as a respondent in an arbitration, but the statement of claim alleges that such person engaged in a sales practice violation, must the matter be reported?

**A:** Yes. The registered person should report the arbitration under Question 14I(5). (Originally posted 05/18/09)

- **Question 14I(1)**

**Q1:** What if a customer files an arbitration claim in which the registered person is a named party, alleging sales practice violations against several respondents and the claim is withdrawn or dismissed as to a particular respondent prior to any settlement or award? Is that respondent obligated to report any subsequent settlement or award?

**A:** In general, when a claim is dismissed or withdrawn against a respondent prior to a settlement or award, he may change his answer to Question 14I(1) from "Yes" to "No." The dismissal or withdrawal is the final disposition as to him and he is not required to report the disposition with respect to the remaining respondents. (See, however, Question 2 regarding withdrawal of a claim as part of a settlement.)

However, if a withdrawn or dismissed respondent contributes directly or indirectly to the settlement of the claim (e.g., his firm withholds compensation as repayment for the firm's settlement costs), then that respondent must continue to answer Question 14I(1) "Yes" and amend the relevant DRP with details as to the settlement and his contribution. (Originally posted 02/13/98; amended 08/05/98; revised 09/01/99; revised 05/18/09)

**Q2:** What if a customer withdraws an arbitration claim against a named particular respondent as part of a settlement of $10,000 or more before 5/18/09, or $15,000 or more on or after 5/18/09?

**A:** The registered person should answer "Yes" to Question 14I(1)(c) or (d), as appropriate. The registered person should report in items 14-16 of the DRP that the claim was settled and in item 24 that the claim against him was withdrawn as part of the settlement and that no contribution was made to the settlement. (Originally posted 02/13/98; revised 09/01/99; revised 05/18/09)

**Q3:** If a registered person has reported an arbitration under Question 14I(1), and the arbitration is settled by other respondents for at least the threshold amount, but the registered person is not a direct or indirect party to the settlement and does not pay any part of it, should the registered person answer
"Yes" to Question 14I(1)? What if the registered person is a party to the settlement, but still does not pay any part of the settlement?

A: If an arbitration is settled as to some respondents but not others, then the respondents who do not settle must continue to report that the arbitration is pending under Question 14I(1)(a) until there is some other disposition, e.g., withdrawal or dismissal of the claim or a separate settlement. If the registered person is a party to the settlement he must report the settlement under Question 14I(1)(c) or (d), as appropriate, even if he contributed nothing to the settlement, continues to arbitrate additional claims, or reaches an additional separate settlement. The registered person can state in item 24 of the DRP that he contributed nothing to the settlement. (Originally posted 02/13/98; revised 09/01/99; revised 05/18/09)

Q4: If an arbitration claim names several registered persons as respondents, and the statement of claim contains allegations of sales practice violations, but does not specifically allege that each respondent was involved in a violation, which respondents should answer "Yes" to Question 14I(1)(a)? For example, if the statement of claim alleges that a broker engaged in churning and that his office manager should have been overseeing the broker's activities, and the persons named as respondents are the broker and his branch manager, as well as the compliance director and the president of the broker/dealer, who should report?

A: The broker and his branch manager should answer "Yes" to Question 14I(1)(a), but the compliance director and the president may answer "No." A registered person must report an arbitration under Question 14I(1)(a) if he is named as a respondent and the statement of claim alleges that he was involved in one or more sales practice violations. Because the statement of claim alleges no sales practice violation by the compliance director or the president, they are not required to report the arbitration, even though they are named as respondents.

The terms "involved" and "sales practice violations" are defined to clarify reporting obligations. The term "involved" includes both doing an act and failing reasonably to supervise another in doing an act. The term "sales practice violations" includes any conduct directed at or involving a customer that would constitute a violation of an SRO rule for which a person could be disciplined; any provision of the Securities and Exchange Act of 1934; or any state statute prohibiting fraudulent conduct in connection with the offer, sale or purchase of a security or in connection with the rendering of investment advice, and thus includes churning. Thus, the broker and the branch manager must report the arbitration.

It is not necessary that a statement of claim use precise legal terminology. The fact that the claim does not use the legal term "failing reasonably to supervise" does not alleviate the branch manager's obligation to report. The allegation that the manager should have been overseeing a broker's activities is sufficient to trigger reporting. Firms and registered persons should review each claim on a case-by-case basis and make a good faith determination as to whether reporting is required. (Originally posted 02/13/98; revised 09/01/99)

Q5: What if (1) an arbitration is dismissed by an arbitration panel or withdrawn by the claimant prior to settlement and the respondent pays no part of the settlement; (2) the panel decides in favor of the respondent; or (3) the arbitration is settled for less than the threshold amount?

A: The registered person should file an amended Form U4 to (1) change the answer to Question 14I(1) from "Yes" to "No," and (2) update the DRP with disposition details that support the change in the answer. (Originally posted 02/13/98; amended 05/26/98; amended 08/05/98; revised 09/01/99)
Q6: Is an arbitration reportable under Question 14I(1)(b) if the arbitration panel denies all claims against a registered person but requires him to pay a portion of the forum fees?

A: No. Payment of forum fees is not payment of an arbitration award. (Originally posted 04/29/98; revised 09/01/99)

Q7: Is an arbitration proceeding that is stayed or enjoined by a court considered pending for purposes of this Question?

A: Yes. If a party to an arbitration seeks to have the proceeding stayed or enjoined, then the proceeding will be treated as pending for purposes of this question until a court enters a permanent stay or injunction and all appeals are exhausted. At that time, the arbitration is closed and no longer considered pending for the purpose of the Question. An arbitration will be treated as pending if it is subject to a temporary stay or preliminary injunction. (Originally posted 05/26/98; revised 05/18/09)

• Question 14I(2)

Q1: Is a registered person required to report an oral complaint? What if a customer makes an oral complaint that is resolved through a written settlement agreement for $10,000 or more before 5/18/09, or $15,000 or more on or after 5/18/09 that acknowledges that the customer alleged a sales practice violation, and there is no other writing that evidences the complaint?

A: An oral complaint by itself is not reportable under Question 14I(3). An oral complaint that alleges a sales practice violation that is settled for $10,000 or more before 5/18/09, or $15,000 or more on or after 5/18/09 is reportable under Question 14I(2). (Originally posted 02/13/98; revised 04/29/98; revised 09/01/99; revised 05/18/09)

• Questions 14I(3) and 14I(5)

Q1(A): If a registered person reports a customer complaint under Question 14I(3) that, after 24 months, has neither settled for $10,000 or more before 5/18/09 or for $15,000 or more on or after 5/18/09, nor evolved into an arbitration or civil litigation in which the registered person is a named party, should the registered person file an amended Form U4 changing the answer to Question 14I(3) to “No”?

A: Yes. The registered person should file an amended Form U4 to change the answer to Question 14I(3) to "No" and update the DRP with disposition details once the pending customer complaint is resolved. (Originally posted 02/13/98; revised 09/01/99; revised 05/18/09)

Q1(B): If a registered person reports an arbitration or civil litigation under Question 14I(5) that, after 24 months, has not settled for $15,000, should the registered person file an amended Form U4 changing Question 14I(5) to a "No" response?

A: Yes. The registered person should file an amended Form U4 to change the answer to Question 14I(5) to "No" and update the DRP with the disposition details. (Originally posted 05/18/09)

Q2: If a written customer complaint (reportable under Question 14I(3)) alleges a sales practice violation and forgery, should the registered person submit two DRPs?
A: No, the registered person should answer “Yes” to both Questions 14I(3)(a) and 14I(3)(b) and submit one DRP with details for both alleged violations. (Originally posted 04/29/98; revised 09/01/99, revised 05/18/09)

Q3: Are there any differences for reporting securities, commodities, banking, insurance and real estate complaints under Questions 14I(3)(a) and (b) or 14I(5)(a) and (b)?

A: Yes. The definitions of the terms "investment-related," "sales practice violations," and "self-regulatory organization" should be carefully reviewed because they result in different reporting obligations under 14I(3)(a) and (b) and 14I(5)(a) and (b).

A written customer complaint that includes an allegation of a sales practice violation (as well as the other threshold requirements) must be reported under Question 14I(3)(a). Likewise, the subject of an arbitration/litigation that includes an allegation of a sales practice violation (as well as the other threshold requirements) must be reported under Question 14I(5)(a). A sales practice violation is defined to include any conduct directed at or involving a customer which would constitute a violation of any rules for which a person could be disciplined by any self-regulatory organization; any provision of the Securities Exchange Act of 1934; or any state statute prohibiting fraudulent conduct in connection with the offer, sale, or purchase of a security or in connection with the rendering of investment advice. A self-regulatory organization is defined to include any national securities or commodities exchange, any national securities association (e.g., FINRA), or any registered clearing agency. Thus, a sales practice violation includes a violation of the rules of FINRA, any national securities or commodities exchange (e.g., the New York Stock Exchange, the Chicago Board of Trade), and any registered clearing agency (e.g., the National Securities Clearing Corporation); a violation of the Exchange Act; and a violation of any state statute prohibiting fraudulent conduct in connection with the offer, sale, or purchase of a security or in connection with the rendering of investment advice. A sales practice violation does not include violations of banking, insurance, or real estate laws or rules. Thus, complaints concerning a security, variable contract that is subject to regulation under the federal securities laws, or commodity exchange product are reportable under Questions 14I(3)(a) or 14I(5)(a), but complaints solely concerning other products are not reportable under Questions 14I(3)(a) or 14I(5)(a).

However, Questions 14I(3)(b) and 14I(5)(b) are not limited by the term "sales practice violations." Thus, a written customer complaint that relates to securities, commodities, banking, insurance, or real estate and alleges forgery, theft, or misappropriation or conversion of funds or securities is reportable under 14I(3)(b). Similarly, a registered person who is the subject of an investment-related, consumer-initiated arbitration claim or civil litigation relating to securities, commodities, banking, insurance, or real estate that alleges that the registered person was involved in forgery, theft, misappropriation or conversion of funds or securities is reportable under 14I(5)(b). (Originally posted 04/29/98; revised 09/01/99; revised 05/18/09)

Q4: What is included in the term "misappropriation or conversion of funds or securities"?

A: Misappropriation refers to any intentional or reckless use of customer funds or securities. This includes, but is not limited to, placing money from a customer into an account under a representative’s control, diverting funds or securities from one customer’s account to another customer’s account, and stealing customer funds or securities. The term does not include complaints about delays in transfers of funds or accounts.
A firm should immediately investigate any allegation of misappropriation or conversion of customer funds or securities and immediately report any conclusion that such an act has occurred to appropriate regulatory and law enforcement authorities.

Criminal charges or convictions of wrongful taking of property are separately reportable under Questions 14A or 14B. (Originally posted 05/26/98; revised 09/01/99)

Q5: If a firm solicits information from a customer about an account, and the customer submits a written document that meets the reporting criteria of Question 14I(3), is such a document a "consumer-initiated" complaint?

A: Yes. A customer is a "consumer." (See Question 14I Generally, Q2) A firm may solicit information about a problem with an account for a variety of reasons, and may ask for information by a variety of means, including a telephone call, letter, questionnaire, or survey. The customer determines whether to respond to the request, and if so, whether to do so in writing or in a form requested by the firm (e.g., questionnaire or survey). Once the customer decides to submit a written document, the document is consumer-initiated and should be reviewed to determine if it meets the remaining criteria of Question 14I(3). If so, it constitutes a complaint that must be reported. (Originally posted 08/05/98; revised 09/01/99)

Q6: If a customer sends a written complaint that meets the criteria of Question 14I(3) to a regulator, and the regulator sends a copy to the registered person or his firm, is the complaint "consumer-initiated"?

A: Yes. A complaint is initiated by the customer even if the customer determines to send it to a regulator rather than to a firm.

FINRA and most jurisdictions will forward any written customer complaint they receive to the registered person and his current employer. If the complaint concerns conduct at a previous employer, FINRA also will send a copy of the written complaint to the previous employer. Each firm has an independent obligation to determine if any complaint it receives is reportable on the Forms -- the current employer and the representative must determine if the complaint is reportable under Question 14I(3) on the Form U4, and the former employer must determine whether the complaint is reportable under Question 7E3 on Form U5. Under FINRA By-Laws, if the complaint is required to be reported on the Forms, reporting must occur within 30 days of receipt by the respective firms. (Originally posted 08/05/98; revised 04/05/02)

Q7: A customer sends a written complaint to a firm regarding a registered person and such person's Form U4 is amended to answer "Yes" to Question 14I(3). The customer subsequently sends a letter to the firm withdrawing the complaint. Can the Form U4 be amended to change the answer to Question 14I(3) to "No"? What if the withdrawal letter is received before the original complaint letter is reported on the Form U4?

A: No. The original complaint should be reported on Form U4, regardless of whether the customer withdraws the complaint even if the withdrawal is received within 30 days of receipt of the original complaint and prior to disclosure to CRD. The complaint should be reported as withdrawn in item 9 of the DRP. (Originally posted 08/05/98; revised 09/01/99; revised 05/18/09)

Q8: Is an arbitration proceeding that is stayed or enjoined by a court considered pending for purposes of Question 14I(5)?
A: Yes. If a party to an arbitration seeks to have the proceeding stayed or enjoined, then the proceeding will be treated as pending for purposes of Question 14I(5) until a court enters a permanent stay or injunction and all appeals are exhausted. At that time, the arbitration is closed and no longer considered pending for the purpose of the Question. An arbitration will be treated as pending if it is subject to a temporary stay or preliminary injunction. (Originally posted 05/26/98; revised 05/18/09)

• Question 14K

Q1: What is a “Compromise with Creditors” for purposes of responding to Question 14K on Form U4?

A: A compromise with one or more creditors\(^1\) generally involves an agreement between a borrower and a creditor in which a creditor agrees to accept less than the full amount owed in full satisfaction of an outstanding debt. A creditor can be a natural person or an entity, but is often a financial institution that extends credit and typically charges interest on a loan. In general, for purposes of Form U4 Question 14K, any agreement between a borrower and a creditor that changes only the terms of the repayment and does not result in a decrease in the full amount owed does not constitute a compromise with a creditor. (Originally posted 03/23/12)

Q2: Is a real estate short sale reportable under Question 14K on Form U4?

A: The answer depends on the terms of the short sale transaction. A short sale is reportable as a “compromise with creditors” if the lender/creditor forgives all or part of the borrower’s outstanding amount owed. Firms should make a good faith determination based on the facts and circumstances of the short sale to determine whether the lender/creditor has released the short seller/homeowner from some or all of the full amount owed. Generally, in a short sale, a lender/creditor “compromises” by agreeing to permit the sale of the real estate although it will receive from the borrower an amount less than the full amount owed. The nature of the short sale agreement and relevant state laws may enable a lender or third party to seek a judgment for the unpaid amount owed after the auction or sale of the real estate. Consequently, in such cases, the short sale may not have been a compromise, and is therefore not reportable as a “compromise with creditors.” Any resulting judgment (to the extent it has not been satisfied) relating to the unpaid amount owed, however, would be reportable under Question 14M on Form U4. (Originally posted 03/23/12)

• Question 14M

Q1: If a registered person receives notice of a judgment/lien on a date that is different than the date it was filed, which date should the registered person report?

A: The registered person should report both dates. The date that the judgment/lien was filed should be reported in Question 4 (Date Filed) on the Judgment/Lien DRP and the date that the registered person received notice or learned of the judgment/lien should be reported in Question 8 (Comment section) on the DRP. CRD will use the date that the registered person received notice of the judgment/lien to determine whether a late disclosure fee should be assessed and, if so, the amount of the fee. If the date the judgment/lien was filed is the same date that the registered person received notice of the judgment/lien, the registered person should report that date only in Question 4 on the DRP. (Originally posted 08/13/12)

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\(^1\) To the extent that *Dep’t of Enforcement v. Cody*, Complaint No. 200500318901, 2009 FINRA Discip. LEXIS 17 (January 29, 2009); National Adjudicatory Council Decision (May 10, 2010) (*appealed on other grounds*); Exchange Act Rel. No. 64565 (May 27, 2011) (*appealed on other grounds*) could be read to state that a compromise with more than one creditor is necessary to trigger reporting under Question 14K, the staff disagrees. FINRA staff’s view is that a compromise with a single creditor is sufficient to trigger the reporting requirement.
Q2: Do I need to report that I have been ordered to pay child support as a result of a divorce proceeding or settlement in response to Question 14M on Form U4?

A: No. In general, you do not need to report that you are obligated to pay child support ordered by a court (or magistrate) as part of a divorce proceeding or divorce settlement in response to Question 14M provided you are current in paying such child support obligations. Only unsatisfied judgments or liens are reportable in response to Question 14M. Accordingly, if you are current in meeting your child support obligations, you do not need to report the existence of those obligations in response to Question 14M. However, depending on the law applicable to your court order, you may have a reporting obligation if you are in default of making child support payments (even without the issuance by a court of a judgment for non-payment). You are responsible for determining if there is an unsatisfied judgment or lien resulting from your failure to meet your child support obligations. (Originally posted 01/02/13)

Q3: If a registered person satisfies a judgment or lien within 30 days of receiving notice or learning that it was unsatisfied (not paid within the period provided by a court, statute, or applicable contract or agreement), does the registered person need to amend their Form U4 to report the judgment or lien?

A: Yes. A registered person’s obligation to amend their Form U4 arises on the date the registered person receives notice or learns that they have an unsatisfied judgment or lien; therefore, the registered person must report the judgment or lien no later than 30 days from that date. The reporting obligation exists even if the registered person satisfies the judgment or lien in the interim period prior to the 30-day deadline for filing the Form U4 amendment. (Originally posted 03/05/15)

Q4: How should a registered person amend their Form U4 to report a satisfied judgment or lien that was not reported when it was unsatisfied?

A: To report a satisfied judgment or lien in such situations, a registered person should create a new Judgment/Lien DRP and provide the necessary information about the matter. No change should be made to the response to Question 14M; a new Judgment/Lien DRP can be created even if the response to Question 14M is “No.” (Originally posted 03/05/15)

FORM U5

- Questions 7C and 7D

Q1: Questions 7C and 7D on the Form U5 request information about criminal or regulatory actions involving a former associated person that were initiated after that person has left the firm, but that were initiated based on events that occurred while the individual was employed by or associated with the firm. Does this mean that a firm is required to monitor all former associated persons to ensure that it has adequately responded to these questions? What if actions are initiated in connection with events that occurred while the person was employed by or associated with the firm, but the firm is never informed of the initiation of these actions?

A: Firms are required to answer "Yes" to these questions only if they have actual notice of an action that is required to be reported on a form. In this context, actual notice means express notice -- that is, a communication by the responsible agency/authority regarding the initiation of a criminal or regulatory action directly to a representative of the firm who is aware of the Form U5 reporting requirement or
should be aware of such requirement because such person has official responsibility for receiving such notice. Generally speaking, firms would receive actual notice of the initiation of a criminal or regulatory action against a terminated person only if that action is based on events that occurred in connection with the former associated person’s employment. (Originally posted 09/01/99; revised 04/05/02)

• **Question 7E**

**Q1:** Does a firm’s reporting obligation on Form U5 cease after a certain period of time?

**A:** No. Article V, Section 3 of the FINRA By-Laws requires an amendment to any information on Form U5 that is inaccurate or incomplete. This obligation does not lapse. If a firm receives actual notice of an event that involves a former associated person, and that is reportable on Form U5, the firm must amend the person’s Form U5. (Originally posted 08/05/05)

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**General Questions**

**Q1:** Is documentation required to support changing a "Yes" answer to a "No" answer?

**A:** Although documents are not generally required to be filed, you may be required to provide them to a jurisdiction or SRO. See General Instructions on the Forms. (Originally posted 05/26/98; revised 09/01/99)

**Q2:** If I am registered or seeking registration with multiple broker-dealer and/or investment adviser firms, in which section of Form U4 should I list the firms corresponding with those registrations (or requests)?

**A:** You should report in Section 12 (Employment History) the broker-dealers and investment adviser firms with which you are currently registered or seeking registration, or with which you have been employed in the last ten years. This includes unaffiliated and affiliated firms reported in Sections 3 and 6 of Form U4, respectively. You should not report any of these firms in Section 13 (Other Business). Section 13 elicits current employment or business activities that are separate from (i.e., “outside”) the activities you perform in your capacity as a registered person with the broker-dealer(s) and/or investment adviser(s) that you report in Section 12. (Originally posted 01/26/12)

**Reminders**

1. The Guidance provided in this document applies only to the question or questions noted. (04/29/98)

2. When a firm files an amendment to Question 11 of the Form BD, the firm should determine whether corresponding Form U4 filings should be made for individuals listed as control persons on Schedule A of the Form BD. Refer to the Form BD instructions to determine who should be listed as a control person. RAD may send deficiency notices to firms that fail to do so and continued failure to do so could result in disciplinary action. (Originally posted 04/29/98; revised 09/01/99; revised 05/18/09)
Executive Summary
On May 15, 1994, the NASD® issued Special Notice to Members 94-44, which clarified the applicability of Article III, Section 40 of the NASD Rules of Fair Practice to investment advisory activities of registered representatives (RRs) who also are investment advisers (RR/IAs). In particular, the Notice addressed the supervision of securities transactions conducted by RR/IAs away from the NASD members with which they are associated. Since the issuance of Notice to Members 94-44, the NASD has responded to questions concerning the types of records that may be used and recordkeeping systems that may be established by an NASD member to ensure that investment advisory transactions subject to Article III, Section 40 are properly recorded and the RR/IA adequately supervised. The NASD also has responded to other general compliance and interpretive questions relating to Article III, Section 40. To further facilitate member firm compliance with Article III, Section 40, this Notice discusses recordkeeping approaches and presents the answers to some of the most frequently asked questions regarding Section 40 since the release of Notice to Members 94-44.

Questions regarding this Notice may be directed to Daniel M. Sibears, Director, Regulation, at (202) 728-6911; or Mary Revell, Senior Attorney, Regulation, at (202) 728-8203.

Background
As reviewed in Notice to Members 94-44, Article III, Section 40 requires that any person associated with an NASD member who participates in a private securities transaction must, before participating in the transaction, provide written notice to the member with which he or she is associated. The written notice must describe the transaction, the associated person’s role, and disclose whether the associated person will or may receive selling compensation. Thereafter, the NASD member must advise the individual in writing whether it approves or disapproves the associated person’s participation in a private securities transaction. If the member approves the transaction, the transaction must be recorded on the member’s books and records, and the member must supervise the associated person’s participation as if the transaction were executed on behalf of the member.

Most notably, Notice to Members 94-44 clarifies the analysis that members must follow to determine whether the activity of an RR/IA falls within the parameters of Section 40. Fundamental to this analysis is whether the RR/IA participates in the execution of a securities transaction such that his or her actions go beyond a mere recommendation, thereby triggering the recordkeeping and supervision requirements of Section 40.

Where the RR/IA does not participate in the execution of securities transactions, Notice to Members 94-44 reminds members and their RR/IAs that while Section 40 may not apply, the activity, nonetheless, may be subject to the notification provisions of Article III, Section 43. That section requires an RR to provide written notice to the NASD member with which he or she is associated of any proposed employment or outside business activity pursuant to which he or she will receive compensation from others. The form and content of an Article III, Section 43 notice is to be determined by the NASD member.

Article III, Section 40 Books And Records Relating To Investment Advisory Transactions
Where a member has approved an RR/IA’s participation in private securities transactions for which he or she
will or may receive selling compensation, the member must develop and maintain a recordkeeping system that, among other things, captures the transactions executed by the RR/IA in its books and records and facilitates supervision over that activity. Recordkeeping systems that simply record all transactions will not result in adequate supervision under Article III, Section 27 of the Rules of Fair Practice. Rather, the records created and recordkeeping system used, together with relevant supervisory procedures, must enable the member to properly supervise the RR/IA by aiding the member’s understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA’s authority, and the suitability of the transactions.

Since the transactions subject to Section 40 by definition occur at and through another member or directly with a product sponsor, the NASD member licensing the RR/IA is not required to record the activity in the same manner it records transactions executed on behalf of its own firm (i.e., on its purchase and sales blotter). Rather, members may develop and use alternative approaches that meet their specific needs and business practices, such as special blotters, separate Section 40 recordation forms and files, and unit systems, for capturing the RR/IA activity that occurs through other firms. In this regard, Section 40 recordkeeping systems may involve many of the following books and records:

- dated notifications from the RR/IA detailing the services to be performed by the RR/IA and the identity of each RR/IA customer serviced at another firm in a private securities transaction;
- dated responses from the NASD member to the RR/IA acknowledging and approving or disapproving the RR/IA’s intended activities;
- a list of RRs who also are IAs;
- a list of RR/IAS approved to engage in private securities transactions;
- a list of RR/IA customers, including those that are customers of both the member firm and the RR/IA, with a cross reference to the RR/IA;
- copies of customer account opening cards to determine, among other things, suitability;
- copies of discretionary account agreements;
- duplicate confirmation statements;
- duplicate customer account statements;
- a correspondence file for RR/IA customers;
- investment advisory agreements between the RR/IA and each advisory client;
- advertising materials and sales literature used by the RR/IA to promote investment advisory services wherein the RR/IA holds himself or herself out as a broker/dealer, complemented by a process that shows whether proper filings have been made at the NASD and whether the RR/IA is using any electronic means, such as the Internet, to advertise services or correspond with customers;
- exception reports, where feasible, based on various occurrences or patterns of specified activity, such as frequency of trading, high compensation arrangements, large numbers of trade corrections, and cancelled trades; and
- supervisory procedures fully responsive to Article III, Section 27 requirements and designed to address Section 40 compliance. The procedures may include such items as the identity of persons responsible for Section 40 compliance, the recordkeeping system to be used and followed, and memoranda or compliance manuals that notify RR/IA of the member’s procedural requirements for Section 40 compliance.

Neither the federal securities laws nor the NASD Rules of Fair Practice mandate the supervisory system or structure that a member must use. Rather, each member can develop and implement its own supervisory system that is reasonably designed to detect and prevent violations. In this regard, no single document or combination of the referenced documents is specifically required or necessarily adequate to comply with Section 40 requirements. Rather, each member that determines to permit its associated persons to transact securities business through another broker/dealer must decide which tailored combination of records is necessary to develop an adequate supervisory system that addresses the allowable activities of RR/IA. For example, obtaining duplicate confirmation statements directly from the RR/IA alone would permit a member to fulfill recordation requirements for the trades represented by confirmations received, but would not necessarily permit a member to reasonably ensure that it is capturing all trades. However, an arrangement under which the member obtains duplicate confirmation statements directly from the firm (or firms) that executes transactions for the RR/IA should be sufficient to ensure that the member captures all trades.

Member firms have tremendous flexibility to develop and implement recordkeeping and supervisory systems that meet the unique nature and scope of their own operations, and the permitted activities and services provided by their dually registered persons. In all circumstances, however, recordkeeping and supervision
must be adequate to ensure that full and complete transaction information is captured, and be reasonably designed to detect and/or prevent misconduct that could violate the federal securities laws and NASD Rules.

**Answers To Frequently Asked Questions Concerning The Application Of Article III, Section 40 To Investment Advisory Activities**

**Question #1:** Does Article III, Section 40 require prior approval of each transaction executed by an RR/IA away from his or her NASD member firm if the compensation received by the RR/IA is not transaction based?

**Answer:** An RR/IA may be involved in numerous transactions on a daily basis for which he or she receives asset-based or performance-based fees. Requiring prior notice of each trade executed under these conditions may hinder investors from properly receiving the investment advisory services provided by RR/IAS. Accordingly, the Board of Governors, acting on the recommendation of a special Ad Hoc Committee, has interpreted Article III, Section 40 to require prior notice of the investment advisory services that will be provided by the RR/IA for an asset-based or a performance-based fee, rather than prior notice of each trade executed by an RR/IA for a particular customer. This interpretation is intended to vigorously apply the investor protection concepts of Article III, Section 40 to investment advisory activities in a practical manner.

A member must receive prior written notice from an RR/IA requesting approval to conduct investment advisory services for an asset-based or performance-based fee on behalf of each of his or her advisory clients. This notice must include details such as:

- a declaration that the individual is involved in investment advisory activities;
- the identity of each customer to whom the notice would apply;
- the types of securities activities that may be executed away from the firm;
- a detailed description of the role of the RR/IA in the investment advisory activities and services to be conducted on behalf of each identified customer;
- information regarding the RR/IA’s discretionary trading authority, if any;
- compensation arrangements;
- the identity of broker/dealers through which trades away will be executed; and
- customer financial information.

Only after written approval from the NASD member may the RR/IA engage in the disclosed activities. If there is a change in the RR/IA’s proposed role or activities for any customer from what the member initially approved, the RR/IA must provide the member with a subsequent written notice that details the changes and requests the member’s further approval to conduct advisory activities on behalf of the customer. The employer member must thereafter record subsequent transactions on its books and records and supervise activity in the affected accounts as if it were its own.

**Members are reminded, however, that if the RR/IA receives transaction-based compensation, the member’s prior approval of each trade is required.**

**Question #2:** Does Article III, Section 40 apply to persons employed by or associated with registered investment advisory firms if such persons are not registered in an individual capacity with the Securities and Exchange Commission (SEC) or various states?

**Answer:** Yes. Article III, Section 40 of the Rules of Fair Practice applies to all of an associated person’s private securities transactions, regardless of whether or not such associated persons are also registered with other regulatory authorities such as the SEC or the states. The reference to registered investment advisers in Notice to Members 94-44 does not limit the applicability of Article III, Section 40 to only those persons individually registered as such with other regulatory entities. In addition, if the advisory service is not registered with any regulatory agency, a member should ensure that such registration is not required.

**Question #3:** Is it appropriate for a limited principal (i.e., a Series 26 Investment Company Principal) to supervise Article III, Section 40 transactions in products such as equity securities that are not covered by that registration category?

**Answer:** Limited principals may not supervise Article III, Section 40 transactions in products not covered by their registration category. Therefore, if a firm only has principals registered in a limited capacity, associated persons engaging in Article III, Section 40 transactions may do so only in products covered by the licenses of the firm’s principals.

**Question #4:** Is it appropriate for a limited representative (i.e., a Series 6 Investment Company Representative) to execute Article III, Section 40 transactions in products such as equity securities that are not covered by that registration category?

**Answer:** A limited RR who is otherwise in compliance with applicable
federal and state registration requirements, such as the SEC’s investment adviser registration requirements, may not execute transactions in securities not covered by his or her NASD registration. Registration with the NASD as a representative subject an individual to all NASD rules, regulations, and requirements, including qualification requirements. Those rules preclude a limited representative from acting as a representative in any area not covered by his or her registration category. A limited representative who wishes to execute transactions in securities not covered by his or her registration category is required to pass an appropriate qualification exam.

**Question #5:** If an RR/IA is registered with more than one NASD member, must all members approve, supervise, and record the Article III, Section 40 transactions?

**Answer:** All members with whom a person is registered are responsible for the registered representative’s involvement in Section 40 transactions. Members may develop a detailed, formal allocation arrangement whereby at least one member agrees and is able to provide the supervision and recordkeeping required by Article III, Section 40. However, the other members would be required to take the reasonable steps necessary to ensure that Section 40’s recordkeeping and supervisory requirements are being carried out since members cannot delegate, by contract or otherwise, their ultimate responsibility for compliance with regulatory requirements.

**Question #6:** What is a member’s responsibility with regard to supervising Section 40 securities transactions where an advisory client of an RR/IA refuses to provide information to the member, citing the confidentiality of client information provisions of an investment advisory agreement?

**Answer:** Article III, Section 40, which was adopted in 1985, and its predecessor Interpretation of the Board of Governors have always stipulated that a member that allows an associated person to participate in a Section 40 transaction is responsible for supervising that transaction as if it were its own. If a member determines that in order to meet its supervisory obligations under Section 40, it must have certain information from the customer and if the customer refuses to provide the information, the member should deny the associated person’s request who would then be precluded from participating in the Section 40 activity.

**Question #7:** Are there circumstances under which income received as salary payments may be deemed selling compensation as defined by Article III, Section 40?

**Answer:** As explained in Notice to Members 94-44, selling compensation is broadly defined to include any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security. If salary payments are direct or indirect compensation for an RR/IA’s participation in the execution of securities transactions away from his or her member firm, the salary payments would be deemed “selling compensation,” and the activities would be subject to Article III, Section 40.

**Question #8:** Where investment seminars are conducted by RR/IAs away from their employing NASD member and seminar participants are charged a fee for attendance, would any income derived from the seminar for this investment advisory activity be governed by Article III, Section 40 or Section 43 of the Rules of Fair Practice?

**Answer:** If an investment seminar itself does not result in the execution of securities transactions, Article III, Section 43 would govern the investment advisory activity. In determining whether Article III, Section 40 applies, the NASD has focused primarily upon the RR/IA’s participation in the execution of securities transactions and whether the participation goes beyond a mere recommendation. If after an investment seminar, however, participants decide to engage in securities transactions with the participation of the RR/IA, that subsequent activity and any compensation received in connection therewith would be subject to Section 40.

**Question #9:** Must a member review performance reports produced by RR/IAs to properly discharge its supervisory responsibilities under Article III, Section 40?

**Answer:** It has come to the NASD’s attention that some RR/IAs use information supplied by the broker/dealer through which they conduct private securities transactions or by the investment advisory service corporations with which they are associated to create performance reports for their advisory clients. These reports may be individualized performance reports that provide customized information for a specific client or standardized performance reports that provide general information to multiple clients. With regard to this practice, members and RR/IAs are cautioned that in creating or recreating performance reports, a risk is taken that calculations for securities transactions may be inaccurate, incomplete, or misleading, thus resulting in material misrepresentations being made or material facts being omitted. NASD member supervisory responsibilities should include a determination as to whether to permit associated persons to develop performance reports for securities transactions. If this activity is permitted, the member firm must review the performance reports.
Standardized reports sent to multiple clients are considered sales literature and must be reviewed by a registered principal at the member firm before distribution by the RR/IA to clients. If the RR/IA uses the same standardized format for different clients, principal approval before use is required only on the performance report prototype. This review must ensure that the reports are accurate, not misleading, or otherwise in violation of NASD or SEC Rules. In particular, members should review the standards set forth in Article III, Section 35 of the NASD Rules governing member communications with the public, as well as applicable SEC regulations.

Individualized performance reports are considered correspondence. As such, review by the member firm before RR/IA distribution to clients is not required. However, the firm must have appropriate procedures in place, as required by Article III, Section 27 of the NASD Rules of Fair Practice, for review and retention of individualized performance reports and other correspondence.

**Question #10:** Must NASD members that employ RR/IAS provide training to this segment of their associated persons under the Firm Element of the Continuing Education requirements?

**Answer:** The Firm Element of the Continuing Education requirements (see Schedule C of the NASD By-Laws) is designed to be flexible and to permit firms to develop tailored educational programs based on their business practices and needs. In this regard, each member that permits its associated persons to conduct securities transactions through another firm should assess the need to provide specific Firm Element training with regard to Section 40 requirements. Where the assessment establishes a need for educational initiatives for all or some portion of the covered persons conducting business away from the member, the firm’s written training plan should include defined and scheduled Section 40 training for specified individuals.

Although this Notice and previously issued Notices to Members 91-32 and 94-44 clarify the application of Article III, Section 40 to investment advisory activities, Section 40 has been in effect since November 12, 1985 (see Notice to Members 85-84). Accordingly, members and their RR/IAS are expected to be in compliance with Article III, Section 40.
Executive Summary

The Board of Governors, acting on the recommendation of a special Ad Hoc Committee, is clarifying the applicability of Article III, Section 40 of the NASD Rules of Fair Practice to the investment advisory activities of registered representatives. This Notice describes those investment advisory activities that constitute private securities transactions within the scope of Article III, Section 40.

Summary Of Article III, Section 40

Article III, Section 40 provides that any person associated with a member who participates in a private securities transaction must, prior to participating in the transaction, provide written notice to the member with which he or she is associated. The required notice must describe the transaction, the associated person's role, and state whether the associated person has received or may receive selling compensation. The member must respond to the notice in writing indicating whether it approves or disapproves the proposed transaction. Where the registered person has received or may receive selling compensation, the member approving the transaction must record the transaction in its books and records and must supervise the registered person's participation in the transaction as if it was the member's own under Article III, Section 27 of the Rules of Fair Practice.

Section 40 defines "private securities transaction" as any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the U.S. Securities and Exchange Commission (SEC).

"Selling compensation" is defined as any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

Notice to Members 85-84, which announced the approval of Article III, Section 40, broadly defined the scope of selling compensation and deliberately meant to include the receipt of any item of value received or to be received, directly or indirectly, from the execution of any such securities transaction. The Notice also discussed that Article III, Section 40 was specifically designed to apply to situations where the registered person was acting as a salesperson or in some other capacity.

Background Of The Application Of Section 40 To RR/RIAs

The National Business Conduct Committee (NBCC), at its May 1991 meeting, considered the issue of the applicability of Article III, Section 40 of the Rules of Fair Practice to certain activities of individuals who are registered both as representatives of an NASD member firm and with the SEC as a Registered Investment Adviser ("dually registered person" or "RR/RIA"), and who conduct their investment advisory activities "away from" their NASD member employer. The issue was considered by the NBCC as a result of a number of requests for interpretations relating to programs under which registered representatives directed securities transactions for their investment advisory clients to a broker/dealer other than the firm with which they are registered.
The NBCC concluded that Article III, Section 40, consistent with the policy announced when the section was adopted, applied in such a manner as to cover certain activities of individuals who are registered both as a representative of an NASD member and with the SEC as an investment adviser. The NBCC stated that Section 40 should apply to all investment advisory activities conducted by these dually registered persons that result in the purchase or sale of securities by the associated person's advisory clients, with the exception of their activities on behalf of the member. The NBCC also determined that the receipt of compensation as a result of investment advisory activities constituted the receipt of selling compensation as defined in Section 40.

The NBCC then issued Notice to Members 91-32, explaining its position and soliciting comments on other advisory compensation arrangements, including "wrap" fees, that had not been before the Committee. In response to Notice to Members 91-32, the NASD received over 150 comment letters. Few of the letters addressed the NBCC's request for information on other compensation arrangements but rather sought to clarify the NBCC's view on the application of Section 40 to various factual scenarios involving the activities of dually registered persons. After reviewing the comments, the NBCC and the Board appointed an Ad Hoc Committee of the Board to examine this entire area. This special committee met numerous times to review the comment letters, the history and intent of Section 40, and to receive input from various segments of the securities industry, including those most affected by the NBCC's position.

Following extensive discussions and deliberations, the Ad Hoc Committee formulated a clarification which the Board considered and adopted. The following discussion explains the Board's clarification of its position on the scope of transactions that would be deemed to be "for compensation" under Article III, Section 40 with respect to registered representatives/registered investment advisers.

Clarification

In clarifying its previous position in Notice to Members 91-32, the Board focused primarily upon the RR/RIA's participation in the execution of the transaction—meaning participation that goes beyond a mere recommendation. Article III, Section 40, therefore, applies to any transaction in which the dually registered person participated in the execution of the trade.

An example of a RR/RIA clearly participating in the execution of trades is where he or she enters an order on behalf of the customer for particular securities transactions either with a brokerage firm other than the member they are registered with, directly with a mutual fund, or with any other entity, including another adviser, and receives any compensation for the overall advisory services. As a result, the "for compensation" provisions of Article III, Section 40 would apply, thereby requiring the RR/RIA adviser to provide notice to his or her firm and requiring that firm, if it approved the activities, to record the transactions and supervise the conduct of the RR/RIA. The Board has determined to exclude from Section 40 coverage arrangements under which the account is "handed off" to unaffiliated third-party advisers that make all investment decisions. This, and most other advisory activities, would fall under and be subject to the requirements of Article III, Section 43 of the Rules of Fair Practice.

Activities that would fall under either Sections 40 or 43 of the Rules of Fair Practice can be generally categorized as follows:

1. Transactions executed on behalf of the customer in which the RR/RIA participated in the execution would be subject to the full "for compensation" provisions of Section 40, thereby requiring the member to record and supervise the transactions. This would be the case whether the RR/RIA received transactionally related, commission-type compensation, asset-based management fees, wrap fees, hourly, yearly, or per-plan fees, as long as fees paid include execution services by the RR/RIA. Also included are situations where the dually registered person has an arrangement with a third-party money manager to handle the customer's account and the RR/RIA makes individual investment decisions for the client, based on recommendations or alternatives provided by the third-party manager.

2. Only transactions executed on the customer's behalf without any form of compensation would be subject to the "non-compensation" provisions of Section 40. It is unlikely that activity of this sort would exist to any substantial degree outside of a familial type relationship.

3. All other investment advisory activities that do not include the RR/RIA's participation in the execution would be subject to the notification provisions of Article III, Section 43. These activities would include securities transactions executed by customers independently through another broker/dealer or directly with a fund or other entity based on specific recommendations of the dually registered person, timing services where the service makes the investment decision, the utilization of unaffiliated third-party advisers where the RR/RIA does not participate in investment decisions for the client, financial plan creation and other such activities.

Analysis Of Various Scenarios Under The Clarification

The following are issues raised in correspondence from members and the results under this interpretation.

1. A service offered by many discount brokerage firms includes the firm providing "back office" services for the dually registered person which include collection of the asset-based advisory fee. Here, the RR/RIA has opened an account on behalf of a customer and has discretionary authority to execute transactions on the customer's behalf. Under these facts, the "for compensation" of Section 40 would apply.
2. Some RR/RIAs engage in activities limited to the writing of financial plans for a fee which do not include specific securities purchase recommendations or executions. Under this approach, such activities would be governed by Section 43.

3. Some asset management firms offer "wrap fee" programs to registered investment advisers. The "wrap fee" includes a fee for management, accounting, and reporting. This fee is shared with the investment adviser who is also a registered representative. Portfolio transactions are handled through a broker/dealer firm at substantial discounts and are not known to or handled by the RR/RIA. Investment advisers receive a part of the asset management fee only and receive no part of any transaction fee. The adviser is registered with the SEC and any states as necessary. This activity would be subject to Section 43 rather than Section 40 of the Rules of Fair Practice.

4. There are firms offering market timing services where the firm, operating as an independent investment adviser, directs the switches within a family of mutual funds, either load or no-load. There are no transaction charges and the investment adviser, also a registered representative, is not involved in handling switches among funds. The dually registered person does receive some part/percentage of the market timing fee. If the customer or timing firm effects the switches with no involvement by the RR/RIA, this fact pattern would be considered as falling under Section 43.

5. Investment advisers who are also registered representatives often charge an advisory fee to "time" a group of load or no-load mutual funds for clients. This process could also be described as asset allocation or a monitoring service. The exchange of funds is handled directly by the investment adviser with the fund group. This pattern differs from number 4 in that the adviser effects the transactions. These are "for compensation" transactions pursuant to Section 40.

6. There are several firms which provide asset allocation models, software, computer hardware, and direct lineup and execute the transactions as necessary. Each adviser can produce statements for clients based on downloaded information. The RR/RIA receives a portion of the asset-based fee for his or her monitoring of the account. The firm to which the account is referred actually handles all implementation, and the dually registered person has no part in the actual transactions. These third-party arrangements are covered by Section 43.

7. Institutional advisers offer services to individual investment advisers which include permitting the adviser to implement, via computer, purchases and sales in institutional funds. Assets are held at banks and the RR/RIA produces statements and confirms for a client. The RR/RIA also handles the allocation of assets and places transactions. The client can pay one combined fee or two separate fees. One is paid to the mutual fund (internal fee) and the second is paid separately to the dually registered person for handling the account. To the degree that the RR/RIA participates in the execution of the transactions, this would produce a "for compensation" Section 40 result.

8. Investment advisers may advise clients on assets held and transacted at another broker/dealer without being involved in implementation or execution. The RR/RIA may receive copies of statements and charges an advisory fee which is for investment advice and monitoring not related to any transactions in the account. This scenario does not involve either the recommendation or execution of transactions. Since the service is solely advice and monitoring "not related to any transactions in the account," the activities would fall under Section 43.

9. Varying situation number 8, such that the adviser calls the representative of the other broker/dealer to implement or execute transactions but receives no fee or commission for the handling thereof, results in "for compensation" transactions under Section 40.

Members and RR/RIAs are expected to be in compliance with the Board's Interpretation as clarified in this Notice. Those firms and RR/RIAs who have not been operating in accordance with the provisions of Notice to Members 91-32 must immediately conform their activities in order to ensure compliance with the concepts and requirements that have been clarified in this Notice. NASD district examiners will be closely reviewing for compliance with this Interpretation during the course of their field examinations, and violations will be reviewed by DBCCs for consideration of disciplinary action. This clarification should enhance members' abilities to design internal policies and procedures to protect customers who deal with dually registered persons and to prevent potential violations of NASD rules and regulations, particularly Article III, Section 40 of the Rules of Fair Practice. directed to Daniel Sibears, Director, Any questions or inquiries concerning the applicability of Article in, Section 40 to the activities of RR/RIAs may be directed to Craig Landauer, Associate General Counsel at (202) 728-8291. Questions relating to members' general compliance and recordkeeping responsibilities under Article III, Section 40 may be Regulatory Policy at (202) 7286911. ©2014 FINRA. All rights reserved.
South Region Compliance Seminar  
New Orleans, LA | December 2 – 3, 2015

FINRA Qualification Exam Program Restructure and Web Delivery of CE  
Wednesday, December 2  
12:45 p.m. – 1:45 p.m.

This session presents information around the proposal to restructure FINRA’s representative qualification examinations and the transition to Web delivery of the Regulatory Element Continuing Education (CE) program. Participants learn about the October 2015 implementation and the timeline for the remainder of the transition, and understand the important points of FINRA’s proposed restructuring of the representative level qualification examination program.

**Moderator:**  
Scott Maestri  
Associate District Director  
FINRA Dallas District Office

**Panelists:**  
John Kalohn  
Vice President  
FINRA Registration and Disclosure/Testing and Continuing Education

Joseph McDonald  
Senior Director  
FINRA Testing and Continuing Education

Krishna Podury  
Director  
FINRA Registration and Disclosure/Testing and Continuing Education
FINRA Qualification Exam Program Restructure and Web Delivery of CE Panelist Bios:

Moderator:

Scott H. Maestri is the Associate District Director in FINRA’s Dallas Office. He began his career with NASD in 1999 as an examiner in the New Orleans District Office. Mr. Maestri was promoted to management in September of 2003 and became responsible for a team of examiners who monitored member firms through cycle and cause investigations, as well as the Membership Application Process and Financial Surveillance. Mr. Maestri was promoted to the Associate District Director position in May of 2010, where his primary responsibility is the review and approval of the district office’s major program areas. During the course of his career, Mr. Maestri has been selected for Advanced Management training and successfully obtained the Certified Regulatory and Compliance Professional designation (CRCP) both issued through The Wharton School at the University of Pennsylvania. In addition, he received a bachelor’s of business administration in finance from The Else School of Management at Millsaps College.

Panelists:

John Kalohn is Vice President, FINRA, Registration and Disclosure/Testing and Continuing Education. He leads FINRA’s efforts in the development, maintenance and delivery of the securities industry qualification examinations and continuing education programs. He has over 20 years of experience in educational measurement and assessments, and extensive experience developing, implementing and managing assessment programs for professional licensure and university admissions. Mr. Kalohn’s prior experiences include service with one of the nation’s largest providers of educational and workplace measurement and research services. He holds a bachelor’s degree from State University of New York, a master’s degree from Wake Forest University and a doctorate from the University of Wisconsin, Madison.

Joe McDonald is Senior Director in FINRA’s Testing and Continuing Education Department, where he manages the FINRA qualification examination and examination waivers programs. Previously, he was a director in FINRA’s Market Regulation Department. Mr. McDonald has been with FINRA for 17 years. Before joining FINRA, he worked as counsel in the Office of Compliance and Inspections and the Division of Market Regulation at the Securities and Exchange Commission, and as a clerk for an administrative law judge at the Commodity Futures Trading Commission. Mr. McDonald received a bachelor’s degree in psychology from the State University of New York at Stony Brook and a law degree from the American University’s Washington College of Law.

Krishna Podury is Director, FINRA, Registration and Disclosure/Testing and Continuing Education. He manages the day-to-day operational aspects of the testing and continuing education programs. He has over 10 years of experience with FINRA as a subject matter expert for the FINRA systems that manage the development of content and administer qualification examination and CE sessions. Mr. Podury’s prior experience includes architecting and designing enterprise class software systems. He holds a bachelor’s and master’s degree from Osmania University of Hyderabad, India and a master’s degree from the University of Mississippi.
FINRA Qualification Exam Program Restructure and Web Delivery of CE
Panelists

Moderator:

- Scott Maestri, Associate District Director, FINRA Dallas District Office

Panelists:

- John Kalohn, Vice President, FINRA Registration and Disclosure/Testing and Continuing Education
- Joseph McDonald, Senior Director, FINRA Testing and Continuing Education
- Krishna Podury, Director, FINRA Registration and Disclosure/Testing and Continuing Education
Future Directions for Qualification Examinations and Continuing Education
Evolution of CE and Qualification Exams

- **Regulatory Element Continuing Education Program**
  - Started in 1995 – S101 only
  - Introduction of the S106 and S201 Programs
  - Redesign of the Regulatory Element Program 2007 – 2010
  - Launch of S901 for Operations Professionals
  - Introduction of Web Delivery – 2015

- **Qualification Exams**
  - Long history – starting in 1956 with the Series 1
  - Exams have been added as the industry has grown and new products have been created.
Future

- Restructuring of Qualification Exams
- Continuing Education
  - Introduction of CE Online – October 2015 and January 2016
  - Projected Evolution of CE
    - Availability via tablet, smartphone
    - Develop content on a more timely basis
CE Online – Preparations for Online Delivery

- Conducted industry outreach to seek feedback
  - Industry Focus Groups
  - Firm Survey

- Pilot test conducted Summer of 2014
  - 2,073 participants responded overwhelmingly positive to Web delivery of CE

- Post-pilot analysis
  - Follow up survey to firms
  - Outreach to firms that indicated opposition to online delivery
  - Reviewed results with CE Council and CE content committees
CE Online – Launch

- Implemented updates based on lessons learned from outreach and pilot
- Participant accesses CE program via a link either on FINRA.org or cecouncil.com
- FINRA CE Online System checks to verify participant is using a supported browser
  - Supported Browsers:
    - Internet Explorer: Versions 9 and higher
    - Firefox: Versions 20 and higher
    - Chrome: Versions 27 and higher
    - Safari: Versions 5 and higher (MAC only- no tablet support at this time)
- Updated Captcha Software
CE Online – Firm Notifications

- Automatic CRD messaging to firms regarding the 120-day window status continues
  - CE Contacts continue to receive standard CRD CE alerts at 90/30/10 day intervals and notice if an individual goes CE Inactive
- CRD will allow firms to track participants’ sessions

<table>
<thead>
<tr>
<th>Individual CE Information</th>
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<tbody>
<tr>
<td><strong>Current CE Status</strong></td>
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<tr>
<td><strong>CE Base Date</strong></td>
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<th>CE Appointments</th>
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<td><strong>Session</strong></td>
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<th>Current CE Requirements</th>
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<td><strong>Requirement Type</strong></td>
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<td>Anniversary</td>
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<tr>
<th>Next Requirement</th>
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<tr>
<td><strong>Window Dates</strong></td>
</tr>
<tr>
<td>09/08/2018 - 01/05/2019</td>
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</tbody>
</table>
CE Online – Advantages

- Increased productivity - elimination of travel to test centers
- No onerous test center security measures
- Ability to access CE Online anytime/anywhere
  - No session time restriction of 3.5 hours
  - Participant can satisfy requirement anytime within 120 day window
- Bookmarking allows participants to complete at their own pace and return to last location in session
- No requirements for firms to proctor sessions
  - Flexibility as to amount of involvement/oversight
  - WSPs may define where/when/how participants take CE Online sessions
CE Online – Sessions

- Participant clicks on link located on FINRA.org or CECouncil.com to begin session
  - Logs in using first name / last name / CRD #
  - Responds to Captcha
- Acknowledges Data Privacy Policy
- Agrees to Code of Conduct
- System randomly requests participant to enter either first 5 or last 4 numbers of SSN and date of birth
  - This information is matched against CRD and discarded
  - SSN and DOB are NOT stored in the FINRA CE Online System
  - 30-minute lockout period if participant enters information incorrectly 3x
- Participants must enter their firm email address to receive a copy of their CE completion certificate
CE Online – Open Sessions

- Returning to session
  - Participant logs back in using a shortened login process, if within 3 hour window and from the same computer
  - Session timeout after 30 minutes of inactivity

- Participants will repeat modules until they show proficiency
  - Only repeat module(s) when they don’t show proficiency

- Open session expires when CE enrollment window closes

- CE Online session fee of $55 is charged at time of completion

- CE Inactive Status
  - Any open session closes at end of 120 days
  - Entire session will need to be taken again
CE Online – Transitioning from Test Centers

Phase 1  (October 1, 2015)
  • Participants access CE Online for S201/S106/S901 Programs
  • S101 continues to be administered at test centers

Phase 2  (January 4, 2016)
  • Participants can access CE Online for S101
    ▪ Personalized S101 content rolls out
    ▪ S501 retires as a program and is merged into S101 Trading Module
    ▪ Complete In-Firm Delivery transitions

Phase 3  (June 2016)
  • 100% of CE sessions completed via CE Online
CE Online – Rule Changes

- Rule Filing Approved by SEC
  - Changes to Rule 1250
    - Removed language related to In-Firm Delivery sites
    - Eliminated Proctor registration
    - Fee for CE Online reduced to $55
    - Regulatory Notice
CE Online – Roadmap

Q4 2015
- S106, S201, S901 Programs Go Live

Q1 2016
- S101 - Personalization Goes Live
  - *S501 Program Merged into S101 Program

Q2 2016
- 100% Web Delivery

Q3 2016

Q4 2016

Q1 2017

Q2 2017

Planning next generation of CE
Exam Restructuring
Today’s Representative-Level Exams

Series 7
- Series 99
- Series 22
- Series 82
- Series 72
- Series 87
- Series 62
- Series 86
- Series 87
- Series 62
- Series 99

Series 79
- Series 55
- Series 37
- Series 42
- Series 56
- Series 17
- Series 11

Series 6
- Series 38
- Series 17
- Series 38
- Series 11
- Series 56
- Series 42
Qualification Exam Restructuring

- Respond to industry and regulatory changes
- Reduce the redundancy of content across exams
- Streamline the exam process
- Minimize impact and change to the registration rules
- Ensure registered reps have a solid breadth of understanding of the industry
Revised Exam Structure

Essentials Exam

- Series 6
- Series 7
- Series 99
- Series 22
- Series 82
- Series 57
- Series 79
- Series 86/87
Securities Industry Essentials Exam Content

- Securities Industry Essentials Exam content would include knowledge all securities industry registrants should understand, including but not limited to:
  - Structure and functioning of the securities industry
  - Regulatory agencies and their functions
  - Basic economics
  - Product knowledge (stocks, bonds, mutual funds)
  - Regulated and prohibited practices
  - Professional conduct

- Content would be largely stable and subject to little change over time (i.e., the characteristics of products are constant)
Essentials Exam Eligibility

- FINRA would introduce two new features for the Essentials Exam:
  - A person would not need to be associated with a member firm to take the Essentials Exam
  - A passing score on the Essentials Exam would be valid for four years from the date the person passes the exam

- Passing the Essentials Exam alone would not qualify a person to hold a registered position
Example: Current vs. Future (Conceptual Illustration)
Path to Registered Representative Registration

Current:
Series 7 Exam
250 Questions

Future/Proposed:
Essentials
Exam
100 Questions

Revised
Series 7
125 Questions
Other Features of the Proposal

- Series 11 Exam (Order Processing Assistant) – FINRA considering the impact of retiring exam and registration category
- Series 17/37/38 Exams – FINRA analyzing whether UK and Canadian certifications have a high enough overlap of content with the Essentials Exam to exempt certificate holders
- FINRA would retire the Series 42 (Options Representative), Series 62 (Corporate Securities Representative), and Series 72 (Government Securities Representative) exams
Effect on Current Registrants

- Current representative-level registrants would maintain registration without additional testing.
- Most current registrants would be considered to have passed the Essentials Exam and it would be valid for 4 years upon leaving the industry.
  - If the registrant returns within 2 years, she would regain registration without the need to take the Essentials or top-off exam.
  - If the registrant returns between 2 and 4 years later, she would not need to take the Essentials Exam, only the top-off exam for the registration position.
  - If the registrant returns more than 4 years later, she would need to take both the Essentials and the top-off exam.
Industry Opportunities

- New exam structure will give firms an opportunity to employ new business models for onboarding staff
- Targeted training for Essentials and top off exams will allow reps to gain a more thorough understanding of products and associated rules
- Allowing non-registered staff (e.g., administrative, back office) to take Essentials Exam will help them gain a better understanding of the securities industry
- With current rep population aging, new exam structure will create a larger pool of potential new reps
Published May 27, 2015, with a 60 day comment period

FINRA received 20 comment letters – almost all commenters support the proposal

Commenters believe proposal will make exam program less burdensome, less costly and more efficient

Commenters support 4 year validity period for Essentials exam – some suggest a 5 or 6 year period of validity

Commenters support retiring exams which have lost utility
Many commenters believe allowing non-firm associated persons to take the Essentials will encourage younger people to come into the securities industry.

A few commenters expressed concern that persons who pass only the Essentials may hold themselves out to public as qualified to do business.

Content on Essentials exam should be tailored to test concepts at an appropriate level.
Next Steps

- Present proposal to FINRA Board for approval to file with SEC
- Make registration rule, fee and qualification exam filings with the SEC in early to mid 2016
- Implement Essentials and top off exams in the first half of 2017
- FINRA is looking at principal level qualification examination program to identify an opportunity for restructuring
Questions
South Region Compliance Seminar
New Orleans, LA | December 2 – 3, 2015

Regulatory Inspections, Examinations, Reviews and Compliance Practices
Wednesday, December 2
2:00 p.m. – 3:00 p.m.

FINRA staff discuss common deficiencies noted during FINRA cycle examinations, and identify controls, procedures and leading compliance practices that member firms are incorporating into their respective supervisory systems to address these deficiencies.

Moderator: Daniel J. Stefek
Associate Vice President and District Director
FINRA Atlanta District Office

Panelists: Casey Harper
Examination Manager
FINRA Dallas District Office

Emilio R. Mahia
Examination Manager
FINRA New Orleans District Office

Elizabeth Mauro
Examination Manager
FINRA Boca Raton District Office
Regulatory Inspections, Examinations, Reviews and Compliance Practices Panelist Bios:

Moderator:

**Daniel J. Stefek**, Associate Vice President, is District Director of FINRA’s Atlanta District Office. The Atlanta office is responsible for the examination and regulation of the FINRA member firms located in Georgia, North Carolina and South Carolina (approximately 180 main offices and 10,500 branches). Mr. Stefek has extensive regulatory experience, starting his career in NASD’s Los Angeles District Office in 1983. While in Los Angeles, he worked in a variety of positions for NASD (FINRA’s predecessor), first conducting financial and sales practice examinations, then managing the district’s examination programs as Exam Manager and then as Associate Director. Mr. Stefek moved to Georgia in 2004, where he became Director of the Atlanta Office. He received his business degree in finance from the University of Southern California.

Panelists:

**Casey Harper** has been an Examination Manager in FINRA’s Dallas District Office since 2010. In this role, Mr. Harper leads a team of Examiners in the planning and execution of risk-based cycle examinations involving many different types of broker dealers. He also managed the on-going surveillance of approximately 100 broker dealers during his first two years as an Examination Manager. Mr. Harper started his career with FINRA in 2005 as an Examiner conducting cycle and cause examinations and worked on numerous high profile examinations involving allegations of fraud. Mr. Harper holds a B.B.A. in Finance from Texas A&M University-College Station.

**Emilio R. Mahia** is an examination manager in the FINRA New Orleans District Office. Mr. Mahia joined NASD/FINRA in 1999 as an examiner. Prior to his current position, Mr. Mahia served as an examiner for 14 years. Mr. Mahia has participated in numerous high profile cycle, cause and special initiative examinations, involving a broad scope of sales practice issues. Mr. Mahia received a bachelor’s degree in economics from the University of Southern Mississippi. Mr. Mahia is designated as a Certified Regulatory and Compliance Professional (CRCP™) through the FINRA Institute at Wharton.

**Elizabeth Mauro** is an Examination Manager in the Florida District office and is responsible for managing a team of examiners that conduct Sales Practice cycle examinations. Prior to becoming an Examination Manager, she served as a Staff Examiner and as a Regulatory Coordinator assigned to the District’s member firms as their primary point of contact at FINRA, and responsible for monitoring their overall regulatory compliance through ongoing financial and sales practice surveillance. Ms. Mauro’s knowledge of the securities industry has evolved from approximately 19 years of regulatory experience, including serving as an Examiner and Finance Coordinator with the New York Stock Exchange specializing in the Financial and back-office Operations of a broker-dealer, and compliance with the Net Capital and Customer Protection rules. She has also served as a Securities Compliance Examiner with U.S. Securities and Exchange Commission in their Miami Regional office. Ms. Mauro received her Bachelor in Business Administration degree with a major in Finance and Banking from Hofstra University.
South Region Compliance Seminar
December 2-3, 2015 | New Orleans, LA

Regulatory Inspections, Examinations, Reviews and Compliance Practices
### Panelists

**Moderator:**
- Daniel J. Stefek, Associate Vice President and District Director, FINRA Atlanta District Office

**Panelists:**
- Casey Harper, Examination Manager, FINRA Dallas District Office
- Emilio R. Mahia, Examination Manager, FINRA New Orleans District Office
- Elizabeth Mauro, Examination Manager, FINRA Boca Raton District Office
Overview of Cycle Examination Process

- Examination begins on announcement date
- Onsite visit will typically occur 60 days after announcement date
- Prior to onsite visit, the exam team is conducting risk reviews and interviews of firm personnel
- This is contingent upon timely and accurate production via Firm Gateway
Overview of Cycle Examination Process

- Exit meeting will typically occur on the last day of the field work.
- Examination report will typically be issued within 60 days of the exit interview.
- Examination is complete after the firm has responded to the examination report and final disposition letter has been issued, typically within 30 days after examination report date.
- This is contingent upon timely and adequate responses.
Preparing for a FINRA Exam

- Conduct a risk assessment of your business activities, products, sales force, compliance and supervisory structure
- Identify gaps in your controls or supervision
- Encourage staff to escalate gaps they identify
- Encourage Preventive Compliance
- Maintain ongoing dialogue with your FINRA Regulatory Coordinator
- Monitor regulatory actions and consider whether your firm has potential exposure
Preparing for a FINRA Exam

- Resources
- FINRA’s Annual Priorities Letters – Correlate to your firm’s business
- FINRA On-Demand Video Webinars
- Your Regulatory Coordinator
Common Deficiencies: Transaction Supervision

Failure to review for or evidence reviews of high risk activity
- Suspicious activity
- Variable Annuity exchanges, share classes and riders
- Open and closed-end mutual fund switching
- Active accounts (e.g. high volume trading, turnover, commissions)
- Higher risk alternative products (e.g. illiquid products, inverse and/or leveraged products, speculative products)
Common Deficiencies: Supervision of Transactions

- FINRA Rules 3110(b)(2) and 3110.05
- Principal review of all securities transactions:
  - Retains requirement that a principal review all transactions; but allows firms to use a risk-based approach.
  - A reasonably designed risk-based review system will provide the firm with sufficient information to enable the firm to focus on the areas that pose the greatest risks of violation.
  - Principal must review parameters and is responsible for any deficiency in the system’s criteria.
Common Deficiencies: Supervision of Transactions

- **Direct Business**
  - Transaction blotters
  - Commission reconciliation
  - Suitability considerations (e.g., source of funds)
  - Patterns of red flag transactions (e.g., switches, exchanges, withdrawals)

- **Cleared Business**
  - Use of exception reports
  - Reliance on clearing firms (e.g. AML, wires)
Common Deficiencies: Supervision of Transactions

- **Resources**
  - *Regulatory Notice 12-03* – Complex Products
  - *Regulatory Notice 14-10* – Consolidated Supervision Rules
  - *Regulatory Notice 07-53* – Deferred Variable Annuities
Common Deficiencies: Issues Involving Registered Representatives – Books and Records

- **FINRA By-Laws, Article V, Sections 2 & 3:**
  - Late complaint disclosures (RN 13-08)
  - Undisclosed OBAs/PSTs
  - Undisclosed Disclosures (e.g., criminal and bankruptcy records, civil litigations, judgments and liens)
  - Effective July 1, 2015 – FINRA Rule 3110(e) – Background Checks on Registration Applicants
Common Deficiencies: Issues Involving Registered Representatives – Books and Records

**Effective Practices**

- Use of outside vendors for background checks of new hires
- Conduct independent internet searches (e.g., GOOGLE, Secretary of State Websites)
- Employ the use of FREQUENT attestations
- Conduct independent reviews on an ONGOING basis (e.g., annually, branch office inspections) not just at the time of hire
- Indications of financial pressure (e.g., requests for commission advances, loans)
- Educate RRs of consequences for disclosure failures
Common Deficiencies: Issues Involving Registered Representatives – Conflicts of Interests

- Potential Fiduciary Relationships
  - Power of Attorney
  - Beneficiary
  - Trustee
  - Executor
Common Deficiencies: Issues Involving Registered Representatives – Conflicts of Interests

- Common Fact Patterns
  - RR befriends elderly customer with no close relatives
  - RR runs errands for customer, involves customer with own family, keeps other away from customer
  - RR is named as beneficiary in will
  - RR does not tell firm until after inheritance
  - Firm and RR become involved in dispute with relatives
  - Disciplinary action by FINRA based upon firm’s procedures
Common Deficiencies: Issues Involving Registered Representatives – Conflicts of Interests

**Effective Practices**

- Require annual disclosure of acting as power-of-attorney, trustee, executor
- Require annual disclosure of being named as beneficiary, successor beneficiary, successor trustee, executor
- Require annual disclosure of immediate family being named or acting in these roles
- If there is approval of any of these roles, require transfer of account to a different representative
- Educate RRs that receipt of funds as a trustee or executor is an outside business activity
Use of Discretion w/o Written Authorization (NASD Rule 2510).

Most Commonly Associated With:
- Actively traded accounts
- Variable Annuity subaccount reallocations

Preventive Measures:
- Use of in-house and/or clearing firm exception/surveillance reports
- Use of outside vendor activity reports
- Customer contact by an independent party as is deemed necessary (by letter and/or phone)
Detecting and Preventing Fraudulent Investment Schemes
Wednesday, December 2
2:00 p.m. – 3:00 p.m.

This session focuses on noteworthy fraud cases. FINRA staff highlight emerging trends in securities fraud, provide tips to identify potential red flags, and discuss who to contact if you suspect a fraudulent scheme.

Speaker: Cameron Funkhouser
Executive Vice President
FINRA Office of Fraud Detection and Market Intelligence
Cameron Funkhouser is Executive Vice President of FINRA’s Office of Fraud Detection and Market Intelligence. He has been with FINRA, formerly known as NASD, since 1984, serving in various roles of increasing responsibility with a focus on the surveillance of securities traded on The Nasdaq Stock Market, New York Stock Exchange, American Stock Exchange and the over-the-counter markets. Mr. Funkhouser has extensive experience conducting securities fraud investigations and is regularly called upon by civil and criminal law enforcement authorities to provide training, technical assistance, investigative/litigation strategy consulting and expert testimony. Currently, he is responsible for overseeing the Office of Fraud Detection and Market Intelligence, which includes the Insider Trading and Fraud Surveillance units responsible for monitoring the trading activity of more than 10,000 publicly traded securities, FINRA's Complaint Center and FINRA's Whistleblower program. Mr. Funkhouser and his staff have been responsible for uncovering numerous cases of Internet fraud, insider trading, market manipulation, Ponzi schemes and other white collar misconduct, which have been successfully investigated and prosecuted by FINRA, the Securities and Exchange Commission and other law enforcement agencies across the country and internationally. He graduated from Georgetown University with a bachelor’s degree in business and George Mason University with a law degree. Mr. Funkhouser is a member of the Virginia State Bar.
Detecting and Preventing Fraudulent Investment Schemes
Panelists

Speaker:

• Cameron Funkhouser, Executive Vice President, FINRA Office of Fraud Detection and Market Intelligence
Variable Annuities Procedures Practices and Findings
Wednesday, December 2
2:00 p.m. – 3:00 p.m.

This session covers suitability and supervision considerations for variable annuities. Industry panelists discuss monitoring, use of exception reports and effective practices for training registered representatives on variable annuities. FINRA staff highlight areas of focus for examiners and recent examination deficiencies related to the sale of variable annuities.

**Moderator:**
Neivon Morantez  
Principal Examiner  
FINRA New Orleans District Office

**Panelists:**
Mitchell Atkins  
Founder and Principal  
FirstMark Regulatory Solutions, Inc.

Penelope Blackwell  
Deputy Regional Chief Counsel  
FINRA Enforcement

Ronald King  
Chief Compliance Officer  
Capital Investment Brokerage, Inc.

Julie Preuitt  
Assistant Regional Director, Fort Worth Regional Office  
U.S. Securities and Exchange Commission
Variable Annuities Procedures Practices and Findings Panelist Bios:

Moderator:

Neivon Morantez is a Principal Examiner located in the FINRA New Orleans District Office. He joined NASD / FINRA in 1998. During his 17 years with the New Orleans Office, Mr. Morantez has participated in many high profile cycle, cause and special initiative examinations, a number of which involved variable annuities. Mr. Morantez received a bachelor’s degree in finance from Auburn University.

Panelists:

Mitchell Atkins is Founder and Principal of FirstMark Regulatory Solutions, Inc., based in Fort Lauderdale, Florida. His focus is complex problem solving for FINRA broker-dealers and registered investment advisers. His recent compliance focuses include cybersecurity compliance, FINRA membership applications, non-traded REIT and variable annuity compliance, and anti-money laundering. Mr. Atkins has 20 years of experience in various roles at FINRA (previously NASD), most recently as Senior Vice President and Regional Director, with overall responsibility for four districts comprising FINRA’s South Region (home to 850 brokerage firms). He oversaw the region’s routine inspection program, sales practice special investigations, financial surveillance and membership application programs. Mr. Atkins oversaw the development of innovative initiatives such as the National Anti-Money Laundering Investigative Unit in 2012. Mr. Atkins oversaw the successful startup of the Florida District Office of FINRA in 2005. Mr. Atkins frequently addresses financial services industry groups. He is a Certified Regulatory and Compliance Professional through the FINRA Institute at Wharton. He is a graduate of Louisiana State University and a member of the Florida Securities Dealer's Association and the SIFMA Compliance and Legal Society.

Penelope Blackwell is Deputy Regional Chief Counsel for FINRA Enforcement in Dallas, Texas. Prior to joining FINRA in 2014, Ms. Blackwell was a Shareholder in the law firm of Greenberg Traurig LLP. In private practice, Ms. Blackwell represented clients in all aspects of security litigation and regulatory proceedings. Ms. Blackwell graduated Order of the Coif from Louisiana State University Paul M. Herbert Law Center, and clerked for the Honorable Henry A. Politz, United States Court of Appeal for the Firth Judicial Circuit.

Ron King is Chief Compliance Officer with the Capital Investment Companies. He has been with the firm since 2007 and in the financial securities industry since 1994. Ron is a graduate of The Southeastern Trust School of Campbell University and a 2006 graduate of the National Association of Insurance and Financial Advisors Leadership in Life Institute. Prior to joining Capital he served as an Investigator with the North Carolina Secretary of State Securities Division. He is married with one child and enjoys fly fishing, classic cars and photography.

Julie Preuitt is an Assistant Regional Director in the Commissions Fort Worth Regional Office. She joined the Commission in 1992 as an examiner. Prior to her current position, Ms. Preuitt served as a Branch Chief for five years. Her current responsibilities include overseeing broker-dealer, transfer agent, and municipal advisor examinations for a three state area; Texas, Oklahoma and Arkansas. Ms. Preuitt graduated cum laude with a BA from the University of Maryland University College in Okinawa, Japan.
Variable Annuities Procedures Practices and Findings
Panelists

Moderator:
- Neivon Morantez, Principal Examiner, FINRA New Orleans District Office

Panelists:
- Mitchell Atkins, Founder and Principal, FirstMark Regulatory Solutions, Inc.
- Penny Blackwell, Deputy Regional Chief Counsel, FINRA Enforcement
- Ronald King, Chief Compliance Officer, Capital Investment Brokerage, Inc.
- Julie Preuitt, Assistant Regional Director, U.S Securities and Exchange Commission
FINRA Exam Findings

FINRA

• 2015 Exam Findings
  – Supervisory Deficiencies
    ▪ Multiclass Variable Annuities
      > Supervisory Deficiencies/WSPs
      > Disclosures
      > Exception Reports
      > Training
    ▪ Exchange Transactions
      > Compliance with rule 2330 (d)
      > Manual Systems vs Automated Monitoring
FINRA Exam Findings

FINRA

• 2015 Exam Findings – continued
  – Suitability Concerns
    ▪ Rider Compatibility
      > Share Class
      > Time Horizon

• Formal Actions vs. Informal Actions
  – What Factors Are Considered?
  – When Are Suitability Charges Considered?
SEC – Exam Findings

- SEC
  - VA Focus Areas for Policy Divisions
  - Typical Enforcement/Examination Findings
  - Rollover Issues
Creating Effective Compliance Programs
Covering Variable Annuity Share Classes

FINRA South Region Compliance Seminar
New Orleans, Louisiana
December 2015

http://firstmarksolutions.com
Creating Effective Variable Annuity Share Class Compliance Programs.

### Assessing / Vetting / Implementing

| Stage 1: Evaluate Current State - Due Diligence / Procedures / Products
| Stage 2: Conduct Gap Analysis - Existing Guidance vs. Current Processes
| Stage 3: Discuss Potential Changes with Key Stakeholders - Gather Input on Sound Processes
| Stage 4: Prepare and Implement Updated Processes and Procedures

#### Stage 1: Current State
- Review current written supervisory procedures to determine if VA share classes are discussed / discussion is adequate.
- Review existing key documents and forms
- Review product due diligence process for vetting products and variations on products
- Review sample of transactions

#### Stage 2: Gap Analysis
- Gather information on existing guidance and FINRA/SEC cases
- Gather information from VA companies
- Review media articles
- Peer discussions
- Compare existing processes, procedures, and forms to information gathered

#### Stage 3: Gather Input
- Discuss processes with due diligence principal / identification of variations
- Forms changes - new accounts principal(s)
- Product vendors - rider limitations –rider criteria
- Recommended WSP changes with CCO / other constituents
- Advertising principal / email

#### Stage 4: Implementation
- Present draft WSP amendments for approval
- Revise Forms and Disclosures
- Conduct training for appropriate personnel
- Conduct follow-up testing and verification that new procedures are being effectively implemented

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**Objective:** To ensure that new and existing products are sold in a compliant manner by approaching from several business and compliance angles.

- **Written Procedures and Supervision (FINRA Rule 3110)**
  
  “Reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA Rules.”

- **Due diligence** process and resulting actions
- **Input of various departments** (e.g., compliance, operations, sales and marketing)
- **Suitability of recommendations** – circumstances under which various share classes and riders are and are not appropriate (time horizon, liquidity needs, reason for selecting share class and riders) – _NASD Notice 99-35 “+”_
- **Complaint handling** – patterns of complaints in share classes or riders
- **Documentation** maintained about rationales – these are complex products
  - Representative notes – critically important to document rationale for purchase
  - Product comparison in exchange transactions w/ rationales for exchange and fee disclosure
  - Design forms to include rationales and disclosures as appropriate
Key Aspects of Compliance, Cont.

- **Written Procedures and Supervision (Continued)**
  
  - Evidence of suitability review of recommendations (product level, sub-account level, share class level, riders)
  
  - Red flags (e.g., rep only sells one share class, long term riders w/ short term shares, clients with no need for income, long term horizons, etc.) – automated surveillance reports helpful
  
  - Continuing Education Training Plan / Needs Analysis
  
  - Communication guidelines regarding riders and share classes
  
  - Conflicts mitigation – whether compensation structure creates conflicts and how the firm mitigates
  
  - Testing – a system to periodically test and verify whether the procedures and controls in this area are adequate – FINRA Rule 3120
  
  - Branch audits might include a review of share class suitability as appropriate
  
  - Use of forms and disclosures with client purchases
  
  - Records and Blotters or other methods of identifying and reviewing share class recommendations
  
  - Hiring – review of representative’s activity in on-boarding process / follow-up
Key Aspects of Compliance, Cont.

- **New Product Due Diligence (NASD Notice to Members 05-26)**
  - **Product Variations** - New share classes and riders (or changes to existing)

- **Training**
  - **Representatives and Supervisors**
  - **New product features**: share classes, fees related to each class, suitability profile for each share class, variance in surrender period and charges
  - **Optional features**: riders, including charges and features
  - **Examples** of client profiles for which specific share classes may and may not be suitable

- **Forms and Disclosures**
  - **New account form** / VA purchase form prompts for share class and rider selection, along with rationale
  - **Client share class and rider disclosure** (often client signs – may be part of new account form)
  - **Clear disclosure of fees** (including M&E and surrender charges) associated with the share class
  - **User friendly** – blocks certain riders with incompatible share classes, or requires special disclosure to client

- **Communications with the Public**
  - **Retail Communications** – Ensure that principals reviewing communications are trained in features of VA products being sold, including share classes and riders; review for proper characterization in communications
  - **Electronic communications** – consider updating flagging keywords to include triggers related to riders and share classes. Ensure those reviewing electronic communications are trained in share class issues
Capital Investment Group

- CIG’s Process and Procedures
South Region Compliance Seminar
New Orleans, LA | December 2 – 3, 2015

Branch Office Supervision Protecting Your Practice
Wednesday, December 2
3:15 p.m. – 4:15 p.m.

FINRA panelists review common branch exam findings. Panelists further discuss effective practices in implementing an effective branch office supervision program from both a firm and regulatory perspective. Topics include red flags associated with branch office inspections and common findings.

Moderator: Brian Hartman
Associate Director
FINRA New Orleans District Office

Panelists: Christopher Barton
Executive Director and Complex Manager
Morgan Stanley

Denise Morrison
Compliance Executive and Wealth Management Senior Vice President
Regions Securities LLC

Scott Pays
Principal Examiner
FINRA New Orleans District Office
Branch Office Supervision Protecting Your Practice Panelist Bios:

Moderator:

Brian Hartmann is an Associate Director in FINRA’s New Orleans District Office. He joined FINRA (formerly NASD) in 1987 as an Examiner. Prior to his current position, Mr. Hartmann served as a Supervisor of Examiners for eleven years. His current responsibilities include overseeing all of the District Office’s regulatory programs. Mr. Hartmann is a Certified Public Accountant (inactive), and is designated as a Certified Regulatory and Compliance Professional (CRCP) through the FINRA Institute at Wharton. He received his bachelor’s degree in accounting from Louisiana State University.

Panelists:

Chris Barton is currently an Executive Director and Complex Manager for Morgan Stanley in Dallas, TX. The complex, called ‘Dallas East’, is comprised of 7 offices, 144 Financial Advisors, 210 total staff, $16 Billion in client assets and $130 Million in revenue. The Dallas East complex is responsible for the Wealth Management in North Texas from Dallas to Shreveport, Louisiana. 2015 marks his 20th year with Morgan Stanley and its predecessor firm, Smith Barney. He has had management roles with the firm over that time in Dallas, Philadelphia, Boston, New York and New Jersey. He was hired into Smith Barney in 1995 as a Financial Advisor before entering into management in 1998. He began his career in 1993 in a support role of a large team at an independent firm in New Jersey. Mr. Barton graduated from Syracuse University with a B.S. degree in Biology and Physiology.

Denise Morrison is Compliance Executive, Wealth Management Compliance Senior Vice President and rejoined Regions in 2013. Mrs. Morrison has been engaged in financial services compliance for over 17 years and brings extensive regulatory and compliance experience to Regions. Prior to assuming the role of Wealth Management Compliance Executive with Regions, Mrs. Morrison served as the Chief Compliance Officer of Securities America. While in this role, she was an active member of the Executive Leadership team and led compliance for both the broker-dealer and investment adviser. She previously served as the Managing Director of Regulatory Affairs at Morgan Keegan with extensive responsibilities, including Equity Capital Markets, Advisory Compliance, International Compliance, Advertising & Marketing, Privacy and Anti-Money Laundering. In this role, Mrs. Morrison also served as the Chief Compliance Officer of the dually registered investment adviser. She came to Morgan Keegan from AmSouth Investment Services, Inc., where she served as the Executive Representative. Prior to AmSouth, Mrs. Morrison was the Chief Compliance Officer of NBC Securities, Inc. where she reported to both the President and parent company’s Board of Directors. Mrs. Morrison serves as the Wealth Management Compliance Executive, managing the Wealth Management Compliance Program. In her role, Mrs. Morrison is responsible for the development and ongoing management of the compliance and regulatory risk management for multiple business areas. The Wealth Management Compliance Program includes Regions Insurance Group, Regions Investment Services, Asset Management, Private Wealth Management, Institutional Services, Wealth Management Operations, Treasury Management, Capital Markets, and Regions Securities, along with a number of enterprise regulations. Mrs. Morrison graduated from Samford University with a Bachelor’s degree in business management, with a concentration in finance. Mrs. Morrison maintains a number of securities registrations, including Series 7, 24, 53, 63, and 65 licenses, IB and OS registrations. In addition, she is a member of the Securities Industry and Financial Markets Association, the National Society of Compliance Professionals, and the Securities and Insurance Licensing Association.

Scott Pays is a Principal Examiner located in the New Orleans District Office and has been employed with FINRA since 1999. As an Examiner, he has conducted numerous cycle, cause, and branch examinations of member firms. Mr. Pays obtained the Certified Fraud Examiner designation in 2013.
Branch Office Supervision: Protecting Your Practice
Panelists

Moderator:
• Brian Hartmann, Associate Director, FINRA New Orleans District Office

Panelists:
• Chris Barton, Executive Director and Complex Manager, Morgan Stanley
• Denise Morrison, Compliance Executive and Wealth Management Senior Vice President, Regions Securities, LLC
• Scott Pays, Principal Examiner, FINRA New Orleans District Office
Definition of Supervisor

- Supervisor \textbackslash Su\`per*vis"or\, n. 1. One who supervises; an overseer; an inspector.

- In a securities firm, a Supervisor is any individual who is responsible for compliance with the written procedures in any area of the firm’s business. This is who the individual regulators will look to when problems arise with compliance.
Expectations of a Supervisor

- Enforce firm procedures
- Conduct onsite visits
- Conduct thorough and effective reviews of transactions and activity
- Monitor handling of customer funds and securities
- Conduct email and social networking reviews
- Question suspicious activity and transactions
- Ensure safeguards are being adhered to
- Exercise prudence
Definition of Compliance Officer

- A Chief Compliance Officer (CCO) is a corporate official in charge of overseeing and managing compliance issues within an organization, ensuring, for example, that a company is complying with regulatory requirements, and that the company and its employees are complying with internal policies and procedures.

- A Compliance Officer may or may not be a Supervisor.
## Expectations of a Compliance Officer

- Act as an Advisor, not a Supervisor
- Create an adequate supervisory system and enforce implementation
- Monitor (Surveillance Function)
- Test and Examine
- Develop Training Program for Compliance Staff
- Communication of New Rules to the Appropriate Parties
- Take / Recommend Internal Disciplinary Action when needed
- Be Involved in Continuing Education
- Resolve Customer Complaints
- Communicate with Regulators
- Make Required Filings
- Conduct Internal Investigations
A Red Flag can be defined as ANY KNOWLEDGE which triggers a duty by the Supervisor to inquire further.
Red Flags

REMEMBER: the very best supervisory procedures and the most diligent supervision will not always prevent and detect EVERY rule violation. The test will be whether the broker-dealer had reasonable procedures in place that were followed and whether this was documented.
FINRA Branch Examinations

- Common Areas of Review
  - FINRA Annual Priorities
  - Branch Office Supervision
  - Customer Suitability
  - Branch Office Operations
  - Outside Business Activities
  - Consolidated Account Reports
  - Cybersecurity
Common Review Methods

- Customer Files
- Correspondence Files
- Emails
- Handling of Customer Funds
- Internet Searches
- Public Records
- Annual Questionnaires
Common Findings

- Undisclosed Matters
  - OBAs
  - Complaints
  - Criminal History
  - Financial History
  - Websites
  - Unapproved Correspondence
  - Conflicts of Interests
Questions
Executive Summary

The SEC approved FINRA’s proposed rule change to adopt NASD Rule 3010(e) (Qualifications Investigated) relating to background checks on registration applicants as FINRA Rule 3110(e) (Responsibility of Member to Investigate Applicants for Registration)\(^1\) in the consolidated FINRA rulebook.\(^2\) FINRA Rule 3110(e) is based in part on substantially similar provisions in NASD Rule 3010(e) and Incorporated NYSE Rule 345.11 (Investigation and Records),\(^3\) and includes new provisions relating to the verification of information in the Form U4 (Uniform Application for Securities Industry Registration or Transfer). The SEC also approved FINRA Rule 3110.15 (Temporary Program to Address Underreported Form U4 Information), which establishes a temporary program that will issue a refund to members of Late Disclosure Fees assessed for the late filing of responses to Form U4 Question 14M, subject to specified conditions.\(^4\) FINRA Rule 3110(e) becomes effective on July 1, 2015. FINRA Rule 3110.15 became retroactively effective on April 24, 2014, and it will automatically sunset on December 1, 2015.\(^5\)

The amended rule text is attached as Appendix A.

Questions regarding this Notice should be directed to Afshin Atabaki, Associate General Counsel, Office of General Counsel, at (202) 728-8071 or afshin.atanaki@finra.org.

Technical questions regarding the temporary refund program under FINRA Rule 3110.15 should be directed to Mario DiTrapani, Vice President, CRD/Public Disclosure, at (240) 386-4796 or mario.ditrpani@finra.org.
Background & Discussion

Background Checks
A critical part of the registration process in the securities industry is the background investigation of applicants for registration and the timely and accurate reporting of information to the Central Registration Depository (CRD®) system via the Form U4. For instance, FINRA reviews the information disclosed on the Form U4 to determine whether an applicant is subject to a statutory disqualification or whether the applicant may present a regulatory risk for the firm and customers. Further, firms use the information reported to the CRD system to determine whether an applicant is subject to a statutory disqualification or a candidate for special supervision. Firms also use the information reported to the CRD system to check the backgrounds of applicants they are considering sponsoring for registration. In addition, the information that FINRA releases to the public through BrokerCheck, which helps investors make informed choices about the individuals and firms with which they conduct business, is derived from the CRD system.

FINRA Rule 3110(e), which is based on NASD Rule 3010(e) and NYSE Rule 345.11, sets forth a member’s obligation to conduct a background check on applicants it intends to sponsor for registration.

Investigation Process
FINRA Rule 3110(e) requires that each member firm ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before the firm applies to register that applicant with FINRA and before making a representation to that effect on the application for registration. This is a principle-based requirement, and it is substantially similar to the requirement under NASD Rule 3010(e). Firms are required to complete the investigation process prior to filing the Form U4. Further, FINRA does not place any limits on the scope of such a background investigation—a firm must obtain all the necessary information to make an evaluation. Firms should consider all available information gathered in the pre-registration process for this purpose, including, but not limited to, Form U4 and Form U5 (Uniform Termination Notice for Securities Industry Registration) responses, authorized searches of the CRD system, fingerprint results obtained under SEA Rule 17f-2 and communications with previous employers. Firms also may wish to consider private background checks, credit reports and reference letters for this purpose. However, firms must ensure that such background investigations are conducted in accordance with all applicable laws, rules and regulations, including federal and state requirements, and that all necessary approvals, consents and authorizations have been obtained.
Consistent with the requirement under NASD Rule 3010(e), if an applicant previously has been registered, FINRA Rule 3110(e) requires that a firm review a copy of the applicant’s most recent Form U5, including any amendments, within 60 days of the filing date of the applicant’s Form U4. If the firm is unable to review the Form U5, it has to demonstrate that it has made reasonable efforts to do so. FINRA Rule 3110(e) clarifies that a firm is required to review a copy of an applicant’s most recent Form U5 if the applicant previously has been registered with FINRA or another self-regulatory organization.

**Verification Process**

FINRA Rule 3110(e) requires that a firm adopt written procedures reasonably designed to verify the accuracy and completeness of the information contained in an applicant’s Form U4 by no later than 30 calendar days after an initial or a transfer Form U4 is filed with FINRA. While this is a new requirement, it is based on an underlying requirement in the Form U4 that the person signing the form on behalf of the firm certify that he or she has taken appropriate steps to verify the accuracy and completeness of the information contained in and with that form. FINRA Rule 3110(e) expressly requires that a firm’s written procedures specify the firm’s process for verifying the information in the Form U4 and that the firm complete that verification process by no later than 30 calendar days after the Form U4 is filed.

FINRA understands that the verification process could vary firm by firm. For instance, one firm may verify an applicant’s identity and name by checking a valid state-issued driver’s license, whereas another firm may do so by reviewing a valid government-issued passport. Further, the verification process for some of the information in the Form U4 is embedded in the form itself. For instance, the Form U4 provides that the person signing the form on behalf of the firm certify that the firm has communicated with the applicant’s previous employers for the past three years and has documentation on file with the names of the persons contacted and the date of contact. Moreover, FINRA does not expect firms to verify all of the information in the Form U4 where such verification is not feasible or practical. However, in such cases, a firm should document that the information could not be verified and the reasons (including the steps taken to verify the information).

Firms must complete the verification process by no later than 30 calendar days after filing the Form U4 with FINRA, with the understanding that if they become aware of any discrepancies as a result of the verification process conducted after the filing of the Form U4, they will be required to file an amended Form U4. FINRA Rule 3110(e) does not require firms to conduct the verification process only during the 30-day window after the Form U4 has been filed or base the verification on information that is obtained only during the 30-day window after the form has been filed. Rather, the 30-day window is intended to accommodate firms that may find it difficult to conduct the verification process before filing an applicant’s Form U4, such as where an applicant is hired immediately to fill a needed role at the firm. For most applicants, FINRA expects that firms will conduct the
investigation and verification process concurrently using some of the same information and prior to filing the Form U4. Moreover, FINRA encourages firms to complete the verification process prior to filing the Form U4. In this regard, as is the case today with respect to amended Form U4 filings, a firm will be subject to a Late Disclosure Fee if the disclosure event should have been reported on the initial or transfer Form U4, regardless of whether the firm completes the verification process within the 30-day window pursuant to FINRA Rule 3110(e).

Under FINRA By-Laws, a firm is obligated to file an amended Form U4 no later than 30 calendar days after learning of the facts or circumstances giving rise to the amendment.\textsuperscript{13} Therefore, if a firm completes its verification process during the 30-day window pursuant to FINRA Rule 3110(e) and learns of facts or circumstances that require the filing of an amended Form U4, the firm will continue to have 30 calendar days from the date it learns of such facts or circumstances to file an amended Form U4, provided that the firm will be subject to any applicable Late Disclosure Fees.

FINRA also recognizes that there will on occasion be circumstances beyond a firm’s control that prevent completion of the verification process within the 30-day window after the Form U4 is filed with FINRA. For example, a firm may not be able to comply with the 30-day window where the firm is relying on fingerprint results for verifying criminal information, and the FBI determines the fingerprints to be “illegible” and requires resubmission of the fingerprints. In such circumstances, the firm’s procedures should provide that the verification must be completed as soon as practical, and the firm should document the basis for the delay.

In addition, FINRA Rule 3110(e) requires that a firm’s verification process must, at a minimum, provide for a national search\textsuperscript{14} of reasonably available public records conducted by the firm or a third-party service provider to verify the accuracy and completeness of the information contained in an applicant’s Form U4. Similar to the overall verification process, the requirement to conduct a public records search must be satisfied by no later than 30 calendar days after an initial or a transfer Form U4 is filed with FINRA. The public records search is a new requirement, and it is a mandatory component of the overall verification process described above. Public records include, but are not limited to general information, such as name and address of individuals, criminal records, bankruptcy records, civil litigations and judgments, liens, and business records. However, FINRA Rule 3110(e) requires a national search only of reasonably available public records. The scope of what is considered reasonably available public records may change over time, but FINRA understands that currently such records include criminal records, bankruptcy records, judgments and liens. This is a minimum or base requirement. A firm may find it necessary to conduct a more in-depth search of public records depending on the applicant’s job function, responsibilities or position at the firm.
A firm could comply with the requirement to conduct a national search of reasonably available public records in several ways. For example, a firm may satisfy the requirement by: (1) reviewing a credit report from a major national credit reporting agency that contains public record information (such as bankruptcies, judgments and liens) and the applicant’s fingerprint results; (2) searching a reputable national public records database, such as LexisNexis, a division of Reed Elsevier, Inc., and reviewing the applicant’s fingerprint results; or (3) reviewing a consolidated report from a specialized provider, such as Business Information Group, Inc. (BIG), that includes criminal and financial public records.

Moreover, as explained above, the scope of the requirement is limited to reasonably available public records, which currently include criminal records, bankruptcies, judgments and liens. FINRA notes that the public records search requirement does not require firms to obtain a credit report, which contains both public and non-public records. FINRA included a credit report in the list above as an example of a type of document that includes reasonably available public records. FINRA further reiterates that, as is the case with the investigative process, firms must ensure that such public records searches are conducted in accordance with all applicable laws, rules and regulations, including federal and state requirements, and that all necessary approvals, consents and authorizations have been obtained.

The verification requirement, including the public records search, applies to an initial Form U4 or a transfer Form U4. The term “initial Form U4” refers to the Form U4 filing required when an individual is registering with a FINRA member for the first time, including in the context of concurrent or subsequent dual registration, or is registering with a FINRA member after more than two years have passed since the individual was last registered with a FINRA member. The term “transfer Form U4” refers to a Form U4 filing required when a registered person terminates his or her registration with one FINRA member and registers with another FINRA member without having to requalify by examination (i.e., within two years of having been registered with another FINRA member). This would include a Form U4 filed for an individual who terminates his or her registration with a FINRA member and registers with another member within 30 calendar days.

The verification requirement applies to an applicant that is concurrently registering with multiple firms, including affiliated firms. However, where an applicant is concurrently registering with multiple affiliated firms, the affiliated firms may rely on a single verification conducted by any one of the affiliates. In addition, where an applicant who is registered with a firm subsequently registers with an affiliate of that firm, the affiliated firm will be required to verify any new information disclosed on the Form U4 and conduct the minimum public records search for criminal records, bankruptcy records, judgments and liens. However, the affiliated firm will not be required to verify any historical Form U4 information, such as residential and employment history, that was verified by the original firm during the initial registration.

The verification requirement does not apply to the mass transfer process because that process does not involve the filing of a Form U4, which is the basis for the verification requirement under FINRA Rule 3110(e).
Temporary Refund Program

As announced on April 24, 2014, to verify against public records whether material financial information has been timely and accurately reported to the CRD system via the Form U4, FINRA is performing a one-time search of specific financial public records, including bankruptcies, judgments and liens, on all registered persons.18 FINRA expects to complete this process on or before August 2015.

FINRA has established a temporary refund program to address concerns regarding the assessment of the Late Disclosure Fee in circumstances where an unsatisfied judgment or lien has been satisfied, and at the time it was unsatisfied was of a relatively low amount (under $5,000) and was reportable prior to the August 13, 2012, introduction of the procedures regarding the application of the Late Disclosure Fee to the reporting of judgments and liens on the Form U4.19 The refund program also addresses circumstances where the failure to report related to a mistaken belief that satisfying a judgment or lien shortly after learning it was unsatisfied (within 30 calendar days of when it became unsatisfied) obviated the need to report the matter.20

Specifically, as stated in FINRA Rule 3110.15, FINRA will issue a refund to firms of Late Disclosure Fees assessed for the late filing of responses to Form U4 Question 14M (unsatisfied judgments or liens) if the Form U4 amendment is filed between April 24, 2014, and December 1, 2015, and one of the following conditions is met:

1. the judgment or lien has been satisfied, and at the time it was unsatisfied, it was under $5,000, and the date the judgment or lien was filed with a court (as reported on Form U4 Judgment/Lien DRP, Question 4A) was on or before August 13, 2012; or
2. the unsatisfied judgment or lien was satisfied within 30 days after the individual learned of the judgment or lien (as reported on Form U4 Judgment/Lien DRP, Question 4.B.).

The refund program has a retroactive effective date of April 24, 2014, and it will automatically sunset on December 1, 2015. Thus, firms will not be able to obtain a refund pursuant to the parameters established under the program after December 1, 2015. While the program is in effect, FINRA will initially assess firms a Late Disclosure Fee and subsequently refund the fee in the firm’s FINRA Flex-Funding Account if the firm can establish, or if FINRA otherwise determines, that the conditions of the program have been satisfied.
Endnotes


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 members, 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 members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see Information Notice 3/12/08 (Rulebook Consolidation Process).

3. See also Incorporated NYSE Rule Interpretations 345.11/01 and /02. For convenience, this Notice refers to Incorporated NYSE Rules as NYSE Rules.

4. See supra note 1.

5. The refund program under FINRA Rule 3110.15 originally was scheduled to expire on July 31, 2015. However, based on FINRA’s experience with the program, FINRA extended the expiration date of the program until December 1, 2015 to give firms adequate time to conduct their reviews and identify and report information to FINRA. See File No. SR-FINRA-2015-005, which was filed with the SEC for immediate effectiveness on March 3, 2015.


7. Firms must comply with MSRB Rule G-7 (Information Concerning Associated Persons) regarding those applicants engaged solely in municipal securities activities.

8. See Regulatory Notice 07-55 (FINRA Reminds Member Firms of Their Obligations Regarding Background Investigations of Prospective Personnel) (November 2007).

9. FINRA is eliminating NASD Rule 3010(f) (Applicant’s Responsibility), which requires an applicant to provide a copy of his or her Form U5 upon a firm’s request, because firms have electronic access to an applicant’s Form U5 through the CRD system.

10. If the applicant has been recently employed by a Futures Commission Merchant or an Introducing Broker that is notice-registered with the SEC pursuant to SEA Section 15(b)(11), the registering firm also is required to review a copy of the individual’s most recent CFTC Form 8-T.

11. FINRA expects firms to use this provision in very limited circumstances, such as where the previous firm fails to file a Form U5 or goes out of business before filing a Form U5.

12. The Form U4 also provides that the person signing the form on behalf of the firm certify that the firm has communicated with the applicant’s previous employers for the past three years and has documentation on file with the names of the persons contacted and the date of contact. In addition, firms have an obligation to comply with SEA Rule 17f-2. Pursuant to SEA Rule 17f-2, specific persons employed in the securities industry are required to be fingerprinted for purposes of a criminal background check. Firms are responsible for obtaining those fingerprints and required identifying information. Firms then submit the fingerprints together with the required identifying information to FINRA. FINRA, in turn, submits these fingerprints to the FBI. FINRA also makes the fingerprint results available to the employing member and regulators, consistent with applicable federal laws and FBI and FINRA requirements. See Notice to Members 05-39 (May 2005).
13. See FINRA By-Laws, Article V, Section 2(c).

14. The requirement is limited to a national search. However, firms may find it necessary to conduct a search of public records in a foreign jurisdiction as part of their verification process and, where appropriate, should consider such a search consistent with applicable foreign laws, rules and regulations.

15. Firms may rely on the SEA Rule 17f-2 fingerprint results to comply with the requirement to conduct a public records search of criminal records.

16. For example, FINRA has contracted with BIG to provide competitive pricing to member firms that are conducting background investigations of applicants, currently at a cost of $10 to $13 per applicant (depending on volume). In general, FINRA does not endorse any particular third-party service, and a firm’s use of BIG’s services or the services of any other specific provider would not be deemed to be a safe harbor by FINRA. BIG is a provider in the Compliance Resource Provider Program. Additional information regarding that program is available at: http://www.finra.org/industry/p118766.

17. If an individual has been registered with another FINRA member firm within 30 calendar days prior to filing a Form U4, the individual is required to complete the Form U4 with the exception of Section 9 (Identifying Information/Name Change), Section 10 (Other Names), Section 11 (Residential History), Section 12 (Employment History) and Section 13 (Other Business).

18. See FINRA Board Approves Amendment to Supervision Rule Requiring Firms to Conduct Background Checks on Registration Applicants, FINRA News Release, April 24, 2014.

19. See Information Notice 8/17/12 (Late Disclosure Fee Related to Reporting of Judgment/Lien Events).

20. FINRA believes that there may be a misconception regarding the obligation to report unsatisfied judgments and liens under Question 14M on the Form U4. The obligation to amend a Form U4 arises on the date a registered person receives notice or learns that he or she is subject to an unsatisfied judgment or lien, and an amended Form U4 should be filed no later than 30 calendar days from that date, regardless of whether the registered person satisfies the judgment or lien in the interim period prior to the 30-day deadline for filing a Form U4 amendment.

Additional guidance regarding the reporting of judgments and liens is available on the Form U4 and U5 Interpretive Questions and Answers page under Question 14M.
Appendix A

Amended Rule Text
New language is underlined; deletions are in brackets.

* * * * *

3000. SUPERVISION AND RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS

3100. SUPERVISORY RESPONSIBILITIES

3110. Supervision

(a) Supervisory System

Each member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules. Final responsibility for proper supervision shall rest with the member. A member’s supervisory system shall provide, at a minimum, for the following:

(1) through (2) No Change.

(3) The registration and designation as a branch office or an office of supervisory jurisdiction (OSJ) of each location, including the main office, that meets the definitions contained in paragraph [(e)](f) of this Rule.

(4) through (7) No Change.

(b) through (d) No Change.

(e) Responsibility of Member to Investigate Applicants for Registration

Each member shall ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before the member applies to register that applicant with FINRA and before making a representation to that effect on the application for registration.

If the applicant previously has been registered with FINRA or another self-regulatory organization, the member shall review a copy of the applicant’s most recent Form U5, including any amendments thereto, within 60 days of the filing date of an application for registration, or demonstrate to FINRA that it has made reasonable efforts to do so. In conducting its review of the Form U5, the member shall take such action as may be deemed appropriate.
The member shall also review an applicant’s employment experience to determine if the applicant has been recently employed by a Futures Commission Merchant or an Introducing Broker that is notice-registered with the SEC pursuant to Section 15(b)(11) of the Exchange Act. In such a case, the member shall also review a copy of the applicant’s most recent CFTC Form 8-T, including any amendments thereto, within 60 days of the filing date of an application for registration, or demonstrate to FINRA that it has made reasonable efforts to do so. In conducting its review of a Form 8-T, the member shall take such action as may be deemed appropriate.

In addition, each member shall establish and implement written procedures reasonably designed to verify the accuracy and completeness of the information contained in an applicant’s initial or transfer Form U4 no later than 30 calendar days after the form is filed with FINRA. Such procedures shall, at a minimum, provide for a search of reasonably available public records to be conducted by the member, or a third-party service provider, to verify the accuracy and completeness of the information contained in the applicant’s initial or transfer Form U4.

### Definitions

1. No Change.
2. (A) through (B) No Change.

   (C) The term “business day” as used in paragraph [(e)](f)(2)(A) of this Rule shall not include any partial business day provided that the associated person spends at least four hours on such business day at his or her designated branch office during the hours that such office is normally open for business.

### Supplementary Material: --------------

**.01 Registration of Main Office.** A member’s main office location is required to be registered and designated as a branch office or OSJ if it meets the definitions of a “branch office” or “office of supervisory jurisdiction” as set forth in Rule 3110[(e)](f). In general, the nature of activities conducted at a main office will satisfy the requirements of such terms.

**.02 Designation of Additional OSJs.** In addition to the locations that meet the definition of OSJ in Rule 3110[(e)](f), each member shall also register and designate other offices as OSJs as is necessary to supervise its associated persons in accordance with the standards set forth in Rule 3110. In making a determination as to whether to designate a location as an OSJ, the member should consider the following factors:

   (a) through (e) No Change.

**.03 through .14 No Change.**
.15 Temporary Program to Address Underreported Form U4 Information. FINRA is establishing a temporary program that will issue a refund to members of Late Disclosure Fees assessed for the late filing of responses to Form U4 Question 14M (unsatisfied judgments or liens) if the Form U4 amendment is filed between April 24, 2014 and December 1, 2015 and one of the following conditions is met: (1) the judgment or lien has been satisfied, and at the time it was unsatisfied, it was under $5,000 and the date the judgment or lien was filed with a court (as reported on Form U4 Judgment/Lien DRP, Question 4.A.) was on or before August 13, 2012; or (2) the unsatisfied judgment or lien was satisfied within 30 days after the individual learned of the judgment or lien (as reported on Form U4 Judgment/Lien DRP, Question 4.B.). This program has a retroactive effective date of April 24, 2014, and it will automatically sunset on December 1, 2015. Members will not be able to use the program after December 1, 2015.

* No Change.
Regulatory Notice

Consolidated Supervision Rules

SEC Approves New Supervision Rules

Effective Date: December 1, 2014

Executive Summary

The SEC approved FINRA’s new consolidated rules governing supervision. The new Rules 3110, 3120, 3150 and 3170 replace NASD Rules 3010, 3012 and 3110(i) and other corresponding NYSE rule provisions. The new rules become effective on December 1, 2014.

The text of the new rules is available at www.finra.org/notices/14-10.

Questions concerning this Notice should be directed to:

- Brant Brown, Associate General Counsel, Office of General Counsel (OGC), at (202) 728-6927; or
- Kosha Dalal, Associate Vice President and Associate General Counsel, OGC, at (202) 728-6903.

Background & Discussion

The SEC recently approved new FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) to replace NASD Rules 3010 (Supervision), 3012 (Supervisory Control System) and corresponding provisions of the NYSE Rules and Interpretations. In addition, new FINRA Rules 3150 (Holding of Customer Mail) and 3170 (Tape Recording of Registered Persons by Certain Firms) replace NASD Rules 3110(i) and 3010(b)(2) (often referred to as the “Taping Rule”), respectively. The new rules, discussed in detail below, become effective on December 1, 2014.

I. FINRA 3110 (Supervision)

A. Supervisory System

FINRA Rule 3110(a) (Supervisory System), based on NASD Rule 3010(a), requires a firm to have a supervisory system for the activities of its associated persons that is reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules, and sets forth the minimum requirements discussed below for a firm’s supervisory system.
1. Establishing and Maintaining Written Procedures and Designating Principals Responsible for Supervision

FINRA Rule 3110(a)(1) requires a firm’s supervisory system to provide for the establishment and maintenance of written supervisory procedures. In addition, FINRA Rule 3110(a)(2) requires a firm to designate an appropriately registered principal(s) with authority to carry out the supervisory responsibilities for each type of business in which the firm engages for which registration as a broker-dealer is required.

2. Designating Offices of Supervisory Jurisdiction

FINRA Rule 3110(a)(3) requires a firm to register and designate as a branch office or an office of supervisory jurisdiction (OSJ) each location, including the main office, that meets the branch office and OSJ definitions in FINRA Rule 3110(e). In addition, FINRA Rules 3110(a)(3) and 3110.01 (Registration of Main Office) require all branch offices and OSJs to be registered. FINRA Rule 3110.02 (Designation of Additional OSJs) adopts, with no substantive changes, the provisions in NASD Rule 3010(a)(3) setting forth factors a firm should consider in designating additional locations as OSJs.

3. Designating OSJ/Non-OSJ Branch Principals

FINRA Rule 3110(a)(4) requires a firm to designate one or more appropriately registered principals in each OSJ (defined in FINRA Rule 3110.03 as the “on-site principal”) and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the firm.

FINRA Rule 3110.03 (Supervision of Multiple OSJs by a Single Principal) clarifies the requirement in FINRA Rule 3110(a)(4) for a firm to designate one or more appropriately registered principals in each OSJ with the authority to carry out the supervisory responsibilities assigned to that office. The designated on-site principal for each OSJ must have a physical presence, on a regular and routine basis, at each OSJ for which the principal has supervisory responsibilities. The rule establishes a general presumption that a principal will not be designated and assigned to be the on-site principal pursuant to Rule 3110(a)(4) to supervise more than one OSJ. If a firm determines it is necessary to designate and assign a principal to be the on-site principal supervising two or more OSJs, then the firm must consider, among other things, the following factors:

- whether the on-site principal is qualified by virtue of experience and training to supervise the activities and associated persons in each location;
- whether the on-site principal has the capacity and time to supervise the activities and associated persons in each location;
- whether the on-site principal is a producing registered representative;
- whether the OSJ locations are in sufficiently close proximity to ensure that the on-site principal is physically present at each location on a regular and routine basis; and
FINRA Rule 3110.03 further requires the firm to establish, maintain and enforce written supervisory procedures regarding the supervision of all OSJs. In all cases where a firm designates and assigns one on-site principal to supervise more than one OSJ, the firm must document in its written supervisory and inspection procedures the factors used to determine why the firm considers the supervisory structure to be reasonable. In addition, the rule provides that the determination by the firm will be subject to scrutiny by FINRA.

4. Supervision of One-Person OSJs

One-person OSJs are subject to the requirement set forth in FINRA Rule 3110(a)(5) that all registered persons must be assigned to an appropriately registered representative(s) or principal(s) who is responsible for supervising that person’s activities, as well as FINRA Rule 3110(b)(6), which requires procedures prohibiting supervisory personnel from, among other things, supervising their own activities. FINRA reminds firms to conduct focused reviews of one-person OSJ locations, especially in light of possible conflicts of interest that may arise. For its part, FINRA will continue to monitor one-person OSJs to determine whether a firm adequately supervises such locations including, but not limited to, supervision addressing possible conflicts of interest or sales practice violations.

5. Assigning Supervisors for Registered Representatives and Determining Qualifications of Supervisory Personnel

FINRA Rule 3110(a)(5) requires that each registered person be assigned to an appropriately registered representative(s) or principal(s) who is responsible for supervising that person’s activities. FINRA Rule 3110(a)(6) requires a firm to use reasonable efforts to determine that all supervisory personnel have the necessary experience or training to be qualified to carry out their assigned responsibilities.

6. Annual Compliance Meeting

FINRA Rule 3110(a)(7) requires each registered representative and registered principal to participate, at least once each year, in an interview or meeting at which compliance matters relevant to the particular representative or principal are discussed. These meetings need not be in person. However, a firm that chooses to conduct compliance meetings using other methods (e.g., on-demand webcast or course, video conference, interactive classroom setting, telephone or other electronic means) must ensure, at a minimum, that each registered person attends the entire meeting. For example, the firm might use on-demand annual compliance webcast requiring each registered person to use a unique user ID and password to gain access and use a technology platform to track the time spent on the webcast, provide click-as-you-go confirmation and have an attestation of completion at the end of a webcast. The firm also must ensure that registered persons are able to ask
questions regarding the presentation and receive answers in a timely fashion. For example, a firm could host an on-demand annual compliance webcast that allows registered persons to ask questions via an email to a presenter or a centralized address or via a telephone hotline and receive timely responses directly or view such responses on the firm’s intranet site.

B. Written Procedures

FINRA Rule 3110(b) (Written Procedures), based on NASD Rule 3010(b), requires a firm to establish, maintain and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules.8

1. Transaction Review and Use of Risk-Based Review

FINRA Rule 3110(b)(2) (Review of Member’s Investment Banking and Securities Business), based on NASD Rule 3010(d)(1), requires a firm to have supervisory procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the firm’s investment banking or securities business. However, FINRA Rule 3110.05 (Risk-based Review of Member’s Investment Banking and Securities Business) permits a firm to use a risk-based system to review its transactions. The term “risk-based” describes the type of methodology a firm may use to identify and prioritize for review those areas that pose the greatest risk of potential securities laws and self-regulatory organization (SRO) rule violations. In this regard, a firm is not required to conduct detailed reviews of each transaction if the firm is using a reasonably designed risk-based review system that provides the firm with sufficient information to enable the firm to focus on the areas that pose the greatest numbers and risks of violation.

If a firm’s procedures for the review of its transactions by a registered principal include the use of technology-based review systems with parameters designed to assess which transactions merit further review, a principal must review the parameters and document the review in writing. As is always the case with the exercise of supervision under FINRA rules, a principal using an automated supervisory system, aid or tool for the discharge of supervisory duties remains responsible for the discharge of supervisory responsibilities in compliance with FINRA Rule 3110(b)(2). Also, a principal relying on a risk-based review system is responsible for any deficiency in the system’s criteria that would result in the system not being reasonably designed.9

A firm that does not engage in any transactions relating to its investment banking or securities business (e.g., firm conducting only a mutual fund underwriting business that effects no transactions) does not have any review obligations pursuant to FINRA Rule 3110(b)(2). Moreover, the firm may comply with FINRA Rule 3110(b)(2) by acknowledging in its supervisory procedures that it does not engage in any such transactions and that it must have supervisory policies and procedures in place before doing so.
2. Correspondence and Internal Communications Review

FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) generally incorporates the substance of NASD Rule 3010(d)(2) (Review of Correspondence) and requires a firm to have supervisory procedures, which are appropriate for the firm’s business, size, structure and customers, to review incoming and outgoing written (including electronic) correspondence and internal communications relating to its investment banking or securities business. In particular, the supervisory procedures must require the firm’s review of (1) incoming and outgoing written (including electronic) correspondence to properly identify and handle in accordance with firm procedures, customer complaints, instructions, funds and securities and communications that are of a subject matter that require review under FINRA rules and federal securities laws; and (2) internal communications to properly identify communications that are of a subject matter that require review under FINRA rules and federal securities laws.

The rule also requires that reviews of correspondence and internal communications be conducted by a registered principal and be evidenced in writing, either electronically or on paper.

(i) Risk-based Review

FINRA Rule 3110.06 (Risk-based Review of Correspondence and Internal Communications) reflects existing guidance regarding a firm’s ability to use risk-based principles to review its correspondence and internal communications. Specifically, a firm, by employing risk-based principles, must decide the extent to which additional policies and procedures for the review of incoming and outgoing written (including electronic) correspondence that fall outside of the subject matters listed in FINRA Rule 3110(b)(4) are necessary for its business and structure. If a firm’s procedures do not require that all correspondence be reviewed before use or distribution, the procedures must provide for:

- the education and training of associated persons regarding the firm’s procedures governing correspondence;
- the documentation of such education and training; and
- surveillance and follow-up to ensure that such procedures are implemented and followed.

In addition, with respect to internal communications, FINRA Rule 3110.06 requires a firm, by employing risk-based principles, to decide the extent to which additional policies and procedures for the review of these internal communications that are not of a subject matter that require review under FINRA rules and federal securities laws are necessary for its business and structure. Consistent with the guidance, FINRA Rules 3110(b)(4) and 3110.06 do not require that a firm review every internal communication. For instance, if a firm does not engage in any activities that are of a subject matter that require review, a firm would not be required to review its internal communications for references to those activities, provided that its supervisory procedures acknowledged that factor as part of the firm’s determination that its procedures were reasonably designed to achieve compliance with applicable federal securities laws and FINRA rules.
(ii) *Evidence of Review*

FINRA Rule 3110.07 (Evidence of Review of Correspondence and Internal Communications) codifies existing guidance that a firm must identify what communication was reviewed, the identity of the reviewer, the date of review and the firm’s actions taken as a result of any significant regulatory issues identified during the review. Merely opening a communication is not sufficient review.¹⁴

FINRA Rule 3110.07 permits the use of lexicon-based screening tools or systems; however, as noted in [Regulatory Notice 07-59](#), firms using automated tools or systems in the course of their supervisory review of electronic communications must have an understanding of the limitations of those tools or systems and should consider what, if any, further supervisory review is necessary in light of those limitations. Furthermore, the use of electronic surveillance tools to review communications represents a direct exercise of supervision by the supervisor (including any use of such tools by the supervisor’s delegate to review communications). The supervisor remains responsible for the discharge of supervisory responsibilities in compliance with the rule and also is responsible for any deficiency in the system’s criteria that would result in the system not being reasonably designed.¹⁵

With respect to communications reviewed by electronic surveillance tools that are not selected for further review, a firm may demonstrate compliance with FINRA Rule 3110.07 if the electronic surveillance system has a means of electronically recording evidence that those communications have been reviewed by that system. With respect to communications that do not generate alerts, a firm may use an electronic surveillance or reviewing tool that only captures the specified information fields to the extent necessary to comply with applicable FINRA and SEC rules.¹⁶

(iii) *Delegation of Review*

FINRA Rule 3110.08 (Delegation of Correspondence and Internal Communication Review Functions) codifies guidance that a supervisor or principal may delegate review functions to an unregistered person; however, the provision also codifies the principle noted above, that the supervisor or principal remains ultimately responsible for the performance of all necessary supervisory reviews.¹⁷

(iv) *Retention of Communications*

FINRA Rule 3110.09 (Retention of Correspondence and Internal Communications) requires a firm to retain its internal communications and correspondence of associated persons relating to the firm’s investment banking or securities business for the period of time and accessibility specified in SEA Rule 17a-4(b).¹⁸ The names of the persons who prepared outgoing correspondence and who reviewed the correspondence must be ascertainable from the retained records, and the retained records must be readily available to FINRA upon request.
3. Review of Customer Complaints

FINRA Rule 3110(b)(5) (Review of Customer Complaints) requires a firm to have supervisory procedures to capture, acknowledge and respond to all written (including electronic) customer complaints. The rule does not include oral complaints because they are difficult to capture and assess and may raise competing views as to the substance of the complaint being alleged. However, FINRA encourages firms to provide customers with a form or other format that will allow customers to communicate their complaints in writing. FINRA also reminds firms that the failure to address any customer complaint, written or oral, may be a violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).

4. Supervision of Supervisory Personnel

FINRA Rule 3110(b)(6) (Documentation and Supervision of Supervisory Personnel) eliminates NASD Rule 3012’s provisions specifying the supervision of a producing manager’s customer account activity and heightened supervision when any producing manager’s revenues rise above a specific threshold. Instead, a firm must have procedures to prohibit its supervisory personnel from (1) supervising their own activities; and (2) reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising. FINRA Rule 3110(b)(6) addresses potential abuses in connection with the supervision of all supervisory personnel, rather than addressing only the supervision of a subset of supervisory personnel and their customer account activity. FINRA believes that addressing the supervision of all supervisory personnel, rather than just producing managers, is better designed to prevent supervisory situations from occurring that would not lead to effective supervision.

   (i) Limited Exception

FINRA Rule 3110(b)(6) provides an exception for a firm that determines, with respect to any of its supervisory personnel, that compliance with either of the prohibitions outlined above is not possible because of the firm’s size or a supervisory personnel’s position within the firm. A firm relying on the exception must document the factors the firm used to reach its determination and how the supervisory arrangement with respect to such supervisory personnel otherwise complies with FINRA Rule 3110(a). FINRA Rule 3110.10 (Supervision of Supervisory Personnel) reflects FINRA’s expectation that this exception will be used primarily by a sole proprietor in a single-person firm or where a supervisor holds a very senior executive position within the firm. However, FINRA Rule 3110.10’s list of situations is non-exclusive, and a firm may still rely on the exception in other instances where it cannot comply because of its size or the supervisory personnel’s position within the firm, provided the firm complies with FINRA Rule 3110(b)(6)’s documentation requirements. A firm is not required to notify FINRA of its reliance on the exception.
(ii) Conflicts of Interest

FINRA Rule 3110(b)(6) also requires a firm to have procedures reasonably designed to prevent the standards of supervision required pursuant to FINRA Rule 3110(a) from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, such as the supervised person’s position, the amount of revenue such person generates for the firm or any compensation that the supervisor may derive from the associated person being supervised. This provision does not impose a strict liability obligation to eliminate all conflicts of interest, but rather requires that the supervisory procedures be reasonably designed despite the firm’s conflicts of interest.

5. Maintenance of Written Supervisory Procedures

FINRA Rule 3110(b)(7) (Maintenance of Written Supervisory Procedures), based on NASD Rule 3010(b)(4), requires a firm to retain and keep current a copy of the firm’s written supervisory procedures at each OSJ and at each location where supervisory activities are conducted on the firm’s behalf. A firm also must amend its written supervisory procedures to reflect changes in applicable securities laws or regulations and FINRA rules, and as changes occur in its supervisory system. Each firm must promptly communicate its written supervisory procedures and amendments to all associated persons to whom such written supervisory procedures and amendments are relevant based on their activities and responsibilities.

FINRA Rule 3110.11 (Use of Electronic Media to Communicate Written Supervisory Procedures) permits a firm to satisfy its obligation to communicate its written supervisory procedures (and any amendments) using electronic media, provided that the firm complies with specific conditions, including that the written supervisory procedures have been promptly communicated to, and are readily accessible by, all associated persons to whom such supervisory procedures apply based on their activities and responsibilities.

FINRA Rules 3110(b)(7) and 3110.11 reflect FINRA’s continued belief that it is important for all associated persons to have knowledge of the supervisory procedures relevant to their activities. However, the rule provisions do not prohibit a firm from providing only its supervisory personnel with the written supervisory procedures’ parameters detailing how a firm monitors or reviews its associated persons’ activities to detect and prevent potential violative conduct (e.g., parameters detailing how a firm reviews an associated person’s correspondence or trading).
C. Inspection Requirements

1. Mandatory Inspection Cycles

FINRA Rule 3110(c)(1), based on NASD Rule 3010(c)(1), requires a firm to review, at least annually, the businesses in which it engages. The review must be reasonably designed to assist the firm in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA rules. FINRA Rule 3110(c)(1) also retains NASD Rule 3010(c)(1)’s requirement that a firm review the activities of each office, including the periodic examination of customer accounts to detect and prevent irregularities or abuses. Each firm must retain a written record of the date upon which each review and inspection is conducted. The rule requires a firm to inspect OSJs and supervisory branch offices at least annually (on a calendar-year basis), non-supervisory branch offices at least every three years and non-branch locations on a regular periodic schedule.

There is a general presumption that a non-branch location will be inspected at least every three years, even in the absence of any indicator of irregularities or misconduct (i.e., “red flags”). If a firm establishes a periodic inspection schedule longer than three years, the firm must document in its written supervisory and inspection procedures the factors used in determining that a longer periodic inspection cycle is appropriate. A firm also must retain a written record of each review and inspection, reduce a location’s inspection to a written report and keep each inspection report on file either for a minimum of three years or, if the location’s inspection schedule is longer than three years, until the next inspection report has been written.

As FINRA has previously recognized, a general practice exists where a firm may inspect non-supervisory branch offices on a more frequent cycle than every three years but target only specified areas of the offices’ activities during a particular examination. Consistent with NASD Rule 3010(c)(1), FINRA Rule 3110(c)(1) requires that a firm engaging in this practice must inspect all of the required areas listed in FINRA Rule 3110(c)(2) within the three-year cycle, regardless of the number of times within that cycle a non-supervisory branch office is inspected. Also a firm must set forth in its written supervisory and inspection procedures the manner in which it will inspect those areas within the three-year cycle.

2. Inspection Report Content Requirements

FINRA Rule 3110(c)(2) relocates NASD Rule 3012’s requirements regarding the review and monitoring of specified activities, such as transmittals of funds and securities and customer changes of address and investment objectives. Specifically, a firm must test and verify a location’s supervisory policies and procedures for:

- safeguarding of customer funds and securities;
- maintaining books and records;
- supervision of supervisory personnel;
transmittals of funds or securities from customers to third party accounts; from customer accounts to outside entities; from customer accounts to locations other than a customer’s primary residence; and between customers and registered representatives, including the hand-delivery of checks; and
changes of customer account information, including address and investment objectives changes, and validation of such changes.33

A firm’s policies and procedures for transmittals of funds or securities must include a means or method of customer confirmation, notification or follow-up that can be documented. However, a firm may use reasonable risk-based criteria to determine the authenticity of the transmittal instructions.34

In addition, a firm’s policies and procedures for changes of customer account information must include a means or method of customer confirmation, notification or follow-up that can be documented and that complies with SEA Rules 17a-3(a)(17)(i)(B)(2) and 17a-3(a)(17)(i)(B)(3).35

With respect to the transmittal of funds or securities from customers to third party accounts, FINRA Rule 3110(c)(2) does not include NASD Rule 3012’s parenthetical text (“i.e., a transmittal that would result in a change in beneficial ownership”) to clarify that all transmittals to an account where a customer on the original account is not a named account holder are subject to the rule. The rule’s follow-up procedures provide an important investor protection function by verifying that the customer was aware of the transfer.

Similarly, with respect to changes of customer account information, a firm must have procedures to monitor all changes of customer account information and not only address and investment objective changes.36 Examples of other changes to customer account information would include, without limitation, changes to a customer’s name, marital status, telephone, email or other contact information. A firm may delegate reviews of such changes to an appropriately qualified person who is not a principal, unless another FINRA or SEC rule would require principal review (e.g., FINRA Rule 4515 (Approval and Documentation of Changes in Account Name or Designation) prohibiting an account name or designation change unless authorized by a qualified and registered principal designated by the firm).

If a location being inspected does not engage in all of the activities listed above, the firm must identify those activities and document that supervisory policies and procedures must be in place at that location. Firms have the flexibility to provide this information in either their written supervisory procedures or a location’s written inspection report.37
3. Associated Persons Conducting Inspections
FINRA Rule 3110(c)(3) replaces NASD Rule 3010(c)(3)’s provision prohibiting branch office managers and supervisors and the persons they directly or indirectly supervise from conducting office inspections. FINRA Rule 3110(c)(3) generally prohibits an associated person from conducting a location’s inspection if the person either is assigned to that location or is directly or indirectly supervised by, or otherwise reports to, someone assigned to that location.38 This restriction does not prohibit firms from using compliance personnel assigned to a firm’s separate compliance department and supervised solely by the compliance department to conduct a location’s inspections. Such an arrangement helps to protect against the potential conflicts of interest the provision is designed to address.

4. Limited Exception
FINRA Rule 3110(c)(3) retains, with modifications, NASD Rule 3010(c)(3)’s exception for firms with limited size and resources from the general prohibitions regarding who can conduct a location’s inspection. Specifically, if a firm determines that it cannot comply with FINRA Rule 3110(c)(3)’s general prohibitions, the firm must document in the inspection report both the factors the firm used to make its determination and how the inspection otherwise complies with FINRA Rule 3110(c)(1).39 A firm will generally rely on the exception in instances where the firm has only one office or has a business model where small or single person offices report directly to an OSJ manager who is also considered the offices’ branch office manager (e.g., independent contractor business model).40 However, a firm may still rely on the exception in other instances, provided the firm documents the factors used in making its determination that it needs to rely on the exception.
FINRA Rule 3110(c)(3) does not include NASD Rule 3010(c)(3)’s restriction that a firm relying on the exception must have a principal who has the requisite knowledge to conduct the inspection. Eliminating this restriction provides a firm with flexibility to assign the most appropriate person who has the requisite knowledge, regardless of registration status, to conduct a location’s inspection, taking into consideration the requirement under FINRA Rule 3110(c)(1) that a firm’s review of its businesses be reasonably designed to assist the firm in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA rules.

5. Conflicts of Interest
FINRA Rule 3110(c)(3) eliminates NASD Rule 3010(c)(3)’s heightened office inspection requirements firms must implement if the person conducting the office inspection either reports to the branch office manager’s supervisor or works in an office supervised by the branch manager’s supervisor and the branch office manager generates 20 percent or more of the revenue of the business units supervised by the branch office manager’s supervisor. Instead, firms must have procedures reasonably designed to prevent the effectiveness of the inspections from being compromised due to the conflicts of interest that may be present with respect to the location being inspected, including but not limited to, economic, commercial or financial interests in the associated person and businesses being inspected.41
A firm is not required to eliminate all conflicts of interest with respect to a location’s inspections. As stated above, however, a firm’s review of its businesses must be reasonably designed to assist the firm in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA rules. To that end, firms should be diligent in identifying potential conflicts of interest and the manner in which they will be addressed to prevent a location’s inspection from being compromised.

F. Transaction Review and Reporting

Section 15(g) of the Exchange Act, adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), requires every registered broker or dealer to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the broker or dealer or any associated person of the broker or dealer. To help firms comply with ITSFEA, NYSE Rule 342.21 required firms to review trades in NYSE-listed securities and related financial instruments effected for the firm’s account or for the accounts of the firm’s employees and family members and to promptly conduct an internal investigation into any trade the firm identified that may have violated insider trading laws or rules. FINRA Rule 3110(d) extends the requirement beyond NYSE-listed securities and related financial instruments to cover all securities.

In particular, FINRA Rule 3110(d) requires a firm to include in its supervisory procedures a process for reviewing securities transactions that is reasonably designed to identify trades that may violate the provisions of the Exchange Act, its regulations or FINRA rules prohibiting insider trading and manipulative and deceptive devices that are effected for:

- accounts of the firm;
- accounts introduced or carried by the firm in which a person associated with the firm has a beneficial interest or the authority to make investment decisions;
- accounts of a person associated with the firm that are disclosed to the firm pursuant to NASD Rule 3050 or NYSE Rule 407, as applicable; and
- covered accounts (as defined below).

Firms may take a risk-based approach to monitoring transactions that take into account their specific business models, and firms are encouraged to tailor their policies and procedures to their specific business models. There is no implied obligation on firms as to how best to conduct the reviews. For instance, some firms may determine that only specific departments or employees pose a greater risk and examine trading in those accounts accordingly.
1. Covered Accounts

FINRA Rule 3110(d) defines the term “covered account” to include any account introduced or carried by the firm that is held by (1) the spouse of a person associated with the firm; (2) a child of the person associated with the firm or such person’s spouse, provided that the child resides in the same household as or is financially dependent upon the person associated with the firm; (3) any other related individual over whose account the person associated with the firm has control; or (4) any other individual over whose account the associated person of the firm has control and to whose financial support such person materially contributes. Once a firm has identified a potentially violative trade, the firm must conduct promptly an internal investigation into the trade to determine whether a violation of the relevant laws or rules has occurred.

2. Internal Investigation Reporting

Although all firms must include in their supervisory procedures a process for reviewing transactions that is reasonably designed to identify trades for insider trading, only firms engaging in investment banking services must file with FINRA written reports (signed by a senior officer) regarding their internal investigations. A firm engages in “investment banking services” if it, without limitation, acts as an underwriter; participates in a selling group in an offering for the issuer or otherwise acts in furtherance of a public offering of the issuer; acts as a financial adviser in a merger or acquisition; or provides venture capital or equity lines of credit or serves as placement agent for the issuer or otherwise acts in furtherance of a private offering of the issuer.

Although firms engaged in investment banking services may have special access to information that increases the risk of insider trading by individuals at the firm, FINRA understands that some types of “investment banking services” may present less risk of insider trading than others, and firms should take these risks into account when developing their policies and procedures. As part of implementing a firm’s risk-based approach to these requirements, a firm’s procedures should include establishing guidelines or criteria for taking reasonable follow-up steps to determine which trades are potentially violative trades and, therefore, merit further review via an internal investigation. FINRA does not expect that every trade highlighted in an exception or other report would require a firm to conduct an internal investigation; however, firms that use such reports should maintain additional written procedures that set forth guidelines or criteria for reasonable follow-up steps for determining which trades initially highlighted merit further review.

(i) Quarterly Reporting

FINRA Rule 3110(d) requires firms engaging in investment banking services to make written reports to FINRA within ten business days of the end of each calendar quarter describing each internal investigation initiated in the previous calendar quarter, including the firm’s identity, the commencement date of each internal investigation, the status of each open internal investigation, the resolution of any internal investigation reached
during the previous calendar quarter, and, with respect to each internal investigation, the identity of the security, trades, accounts, firm’s associated persons or family members of such associated person holding a covered account, under review, and a copy of the firm’s insider trading review policies and procedures.\textsuperscript{50} If a firm did not have an open internal investigation, or either initiate or complete an internal investigation during a particular calendar quarter, the firm is not required to submit a report for that quarter.

\textit{(ii) Reporting Insider Trading Violations}
In addition, if a firm determines after an internal investigation that a trade has violated provisions of the Exchange Act, its regulations or FINRA rules prohibiting insider trading and manipulative and deceptive devices, the firm must, within five business days of the internal investigation’s completion, file a written report with FINRA. The report must detail the completion of the investigation, including the results of the investigation, any internal disciplinary action taken, and any referral of the matter to FINRA, another SRO, the SEC or any other federal, state or international regulatory authority.\textsuperscript{51}

\textit{(iii) Filing Written Reports with FINRA}
Firms required to file a written report with FINRA under FINRA Rule 3110(d) must provide the report, either in hard copy or electronically, to their Regulatory Coordinator. FINRA is considering alternative methods for filing such reports and will announce any changes to the filing procedures in a future \textit{Regulatory Notice} (or similar communication).

\textbf{E. Branch Office and OSJ Definitions}
FINRA Rule 3110(e) retains NASD Rule 3010(g)’s definitions of “branch office” and “office of supervisory jurisdiction,” as well as the definition of “business day.”
II. FINRA Rule 3120 (Supervisory Control System)

A. Testing and Verifying a Firm’s Supervisory Procedures

FINRA Rule 3120(a), based on NASD Rule 3012(a)(1), requires each firm to designate and identify to FINRA one or more principals who must establish, maintain and enforce a system of supervisory control policies and procedures that (1) test and verify that the firm’s supervisory procedures are reasonably designed with respect to the firm’s and its associated persons’ activities to achieve compliance with applicable securities laws and regulations and FINRA rules, and (2) where necessary, create additional or amended supervisory procedures. The designated principals must also prepare and submit to the firm’s senior management a report at least annually summarizing the test results and any necessary amendments to those procedures.

B. Additional Content Requirements—FINRA Rule 3120(b)

FINRA Rule 3120(b) requires a firm that reported $200 million or more in gross revenue (total revenue less, if applicable, commodities revenue) on its FOCUS report in the prior calendar year to include, to the extent applicable to the firm’s business, a:

- tabulation of the reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year; and
- a discussion of the preceding year’s compliance efforts, including procedures and educational programs, in each of the following areas:
  - trading and market activities;
  - investment banking activities;
  - antifraud and sales practices;
  - finance and operations;
  - supervision; and
  - anti-money laundering.

The additional content requirements, which are drawn from NYSE Rule 342.30 (Annual Report and Certification), provide valuable information for FINRA’s regulatory program and will be valuable compliance information for a firm’s senior management. In addition, some content requirements relate to regulatory obligations, such as supervision and anti-money laundering, that apply to all firms, regardless of their business activities. However, because all the content requirements are not relevant to every firm, FINRA Rule 3120 provides that a firm’s report must include the additional content only to the extent applicable to the firm’s business.
III. FINRA Rule 3150 (Holding of Customer Mail)

FINRA Rule 3150, which replaces NASD Rule 3110(i) (Holding of Customer Mail), eliminates the strict time limits in NASD Rule 3110(i) and generally allows a firm to hold a customer’s mail for a specific time period in accordance with the customer’s written instructions if the firm meets several conditions. Specifically, a firm may hold mail for a customer who will not be receiving mail at his or her usual address, provided that the firm:

- receives written instructions from the customer that include the time period during which the firm is requested to hold the customer’s mail. If the time period included in the customer’s instructions is longer than three consecutive months (including any aggregation of time periods from prior requests), the customer’s instructions must include an acceptable reason for the request (e.g., safety or security concerns). Convenience is not an acceptable reason for holding mail longer than three months;

- informs the customer in writing of any alternate methods, such as email or access through the firm’s website, that the customer may use to receive or monitor account activity and information and obtains the customer’s confirmation of the receipt of such information; and

- verifies at reasonable intervals that the customer’s instructions still apply.

In addition, the firm must be able to communicate, as necessary, with the customer in a timely manner during the time the firm is holding the customer’s mail to provide important account information (e.g., privacy notices, the SIPC information disclosures required by FINRA Rule 2266 (SIPC Information)). A firm holding a customer’s mail also must take actions reasonably designed to ensure that the customer’s mail is not tampered with, held without the customer’s consent, or used by a firm’s associated persons in any manner that would violate FINRA rules or the federal securities laws.

IV. FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms)

FINRA Rule 3170 reconstitutes NASD Rule 3010(b)(2) (Tape Recording of Conversations) without any substantive changes and includes a definition clarifying that the term “tape recording” includes without limitation, any electronic or digital recording that meets the rule’s requirements. Specifically, the rule requires a firm to establish, enforce and maintain special written procedures supervising the telemarketing activities of all of its registered persons, including the tape recording of conversations, if the firm has hired more than a specified percentage of registered persons from firms that meet FINRA Rule 3170’s definition of “disciplined firm.” To assist firms in complying with FINRA Rule 3170, FINRA provides a “Disciplined Firms List” identifying those firms that meet the definition of “disciplined firm.”
Endnotes


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 members, the Incorporated NYSE Rules apply only to those member firms of FINRA that are also members of the NYSE. 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 03/12/03 (Rulebook Consolidation Process).

3. Effective December 1, 2014, the following NYSE Rules and Interpretations will be deleted from the Transitional Rulebook: (1) NYSE Rule 342 (Offices-Approval, Supervision and Control) and NYSE Rule Interpretations 342(a)(b)/01 through 342(a)(b)/03, 342(b)/01 through 342(b)/02, 342(c)/02, 342(e)/01, 342.10/01, 342.13/01, 342.15/01 through 342.15/05, 342.16/01 through 342.16/03; (2) NYSE Rules 343 (Offices-Sole Tenancy, and Hours), 343.10 and NYSE Rule Interpretation 343(a)/01; (3) NYSE Rule 351(e) (Reporting Requirements) and NYSE Rule Interpretation 351(e)/01 (Reports of Investigation); (4) Incorporated NYSE Rule 354 (Reports to Control Persons); and (5) NYSE Rule 401 (Business Conduct), and (6) NYSE Rule 401A (Customer Complaints).

4. This standard, which requires that a firm’s supervisory system be reasonably designed to achieve compliance with applicable federal securities laws and regulations and FINRA rules recognizes that a supervisory system cannot guarantee firm-wide compliance with all applicable laws and regulation and FINRA rules. See Notice to Members 99-45 (June 1999) (noting that NASD Rule 3010’s “reasonably designed” standard “recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations” but that the “reasonably designed” standard requires that the system “be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member’s business”).

5. FINRA Rule 3110.02 specifies that, in addition to the locations that meet the definition of OSJ in Rule 3110(e), each firm must also register and designate other offices as OSIs as is necessary to supervise its associated persons in accordance with the standards set forth in Rule 3110. In making a determination as to whether to designate a location as an OSJ, the firm should consider the following factors:

(a) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;

(b) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;

(c) whether the location is geographically distant from another OSJ of the firm;

(d) whether the firm’s registered persons are geographically dispersed; and

(e) whether the securities activities at such location are diverse or complex.
6. See SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004) (reminding broker-dealers that small, remote offices require vigilant supervision and specifically noting that “[n]o individual can supervise themselves”); NASD Regulatory & Compliance Alert, Volume 11, Number 2 (June 1997) (cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves); see also In re Stuart K. Patrick, 51 S.E.C. 419, 422 (May 17, 1993) (“[s]upervision, by its very nature, cannot be performed by the employee himself”) (SEC order sustaining application of the New York Stock Exchange’s supervisory rule – also cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves).

7. See FINRA Rule 3110.04 (Annual Compliance Meeting) (codifying existing guidance that a firm is not required to conduct in-person meetings with each registered person or groups of registered persons to comply with the annual compliance meetings required by FINRA Rule 3110(a)(7)); see also Notices to Members 99-45 (June 1999) and 05-44 (June 2005); see also Letter from Afshin Atabaki, FINRA, to Evan Charkes, Citigroup Global Markets, Inc., dated November 30, 2006 (firms may use on-demand webcast technology to satisfy the annual compliance meeting requirement, subject to specified safeguards and conditions); letter from Afshin Atabaki, FINRA, to S. Kendrick Dunn, Pacific Select Distributors, Inc., dated February 5, 2013 (firms may use on-demand course without voice narration to satisfy annual compliance meeting requirement, subject to specified safeguards and conditions).

8. See FINRA Rule 3110(b)(1) (General Requirements).

9. See also Regulatory Notice 07-53 (November 2007) (Deferred Variable Annuities) (discussing use of automated supervisory systems).

10. FINRA Rule 3110(b)(4) and FINRA Rules 3110.06-.08 refer to “correspondence,” consistent with FINRA Rule 2210’s (Communications with the Public) definition and use of the term “correspondence.”

11. Communications that are of a subject matter that require review under FINRA rules and the federal securities laws include (without limitation):

• Communications between non-research and research departments concerning a research report’s contents (NASD Rule 2711(b)(3) and NYSE Rule 472(b)(3));

• Certain communications with the public that require a principal’s pre-approval (FINRA Rule 2210);

• The identification and reporting to FINRA of customer complaints (FINRA Rule 4530) (as further detailed herein, FINRA Rule 3110(b)(5) also affirmatively requires firms to capture, acknowledge and respond to all written (including electronic) customer complaints); and

• The identification and prior written approval of changes in account name(s) (including related accounts) or designation(s) (including error accounts) regarding customer orders (FINRA Rule 4515).

13. See id. at 3, 9 ("with the exception of the enumerated areas requiring review by a supervisor, members may decide, employing risk-based principles, the extent to which review of any internal communications is necessary in accordance with the supervision of their business"); see also id. at 3 (specifically noting that the guidance neither created new supervisory requirements nor required the review of every communication).

14. See id.


16. See FINRA Rule 3110.09 (Retention of Correspondence and Internal Communications) and SEA Rule 17a-4(b)(4) (requiring, among other things, that a broker-dealer’s retained communications records include any approvals of communications sent).

17. See Regulatory Notice 07-59 (December 2007).

18. The rule purposefully aligns the record retention period for communications with the SEC’s record retention period for the same types of communications to achieve consistent regulation in this area.

19. Although NYSE Rule 401A previously required firms to acknowledge and respond to specified customer complaints (both oral and written), to harmonize the NASD and NYSE rules in the interim period before completion of the Consolidated FINRA Rulebook, FINRA amended Incorporated NYSE Rule 351(d) (Reporting Requirements) to limit the definition of “customer complaint” to include only written complaints, thereby making the definition substantially similar to that in NASD Rule 3070(c) (Reporting Requirements). See Securities Exchange Act Release No. 58533 (September 12, 2008), 73 FR 54652 (September 22, 2008) (Order Approving File No. SR-FINRA-2008-036). FINRA adopted FINRA Rule 4530 to replace NASD Rule 3070 and comparable provisions in NYSE Rule 351. See Securities Exchange Act Release No. 61260 (November 5, 2010), 75 FR 69508 (November 12, 2010) (Notice of Filing of Amendments No. 1 and 2 and Order Granting Accelerated Approval of File No. SR-FINRA-2010-034). FINRA Rule 4530 became effective on July 1, 2011. See Regulatory Notice 11-06 (February 2011).

20. In addition, FINRA’s investor education literature advises customers to communicate any complaints to their broker-dealer in writing, especially if customers have lost money or there were any unauthorized trades made in the customers’ accounts. See FINRA’s pamphlet Investor Complaint Program: What to Do When Problems Arise; see also NASD Rule 2340(a) (Customer Account Statements) (requiring a customer account statement to, among other things, advise the customer that any oral communications should be re-confirmed in writing to further protect the customer’s rights, including rights under the Securities Investor Protection Act (SIPA)).

21. FINRA Rule 3110(b)(6)(C)(i) and (ii). FINRA Rule 3110(b)(6) also requires that a firm’s supervisory procedures include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable laws and regulations, and FINRA rules, as well as a record of the names of its designated supervisory personnel and the dates for which such designation is or was effective. FINRA Rule 3110(b)(6)(A) and (B).


24. NASD Rule 3012 requires a firm relying on a similar exception to notify FINRA through an electronic process (or any other process prescribed by FINRA) within 30 days of the date on which the firm first relies on the exception, and annually thereafter. Firms provide this notification through the FINRA Contact System (FCS). Effective December 1, 2014, firms will no longer be required to provide this information, and FINRA intends to disable FCS's notification feature.

25. FINRA Rule 3110(b)(6)(D).

26. Specifically, FINRA Rule 3110.11 provides that a firm may use electronic media to communicate its written supervisory procedures (and amendments) provided that (1) the written supervisory procedures have been promptly communicated to, and are readily accessible by, all associated persons to whom such supervisory procedures apply based on their activities and responsibilities through, for example, the firm’s intranet system; (2) all amendments to the written supervisory procedures are promptly posted to the firm’s electronic media; (3) associated persons are notified that amendments relevant to their activities and responsibilities have been made to the written supervisory procedures; (4) the firm has reasonable procedures to monitor and maintain the security of the material posted to ensure that it cannot be altered by unauthorized persons; and (5) the firm retains current and prior versions of its written supervisory procedures in compliance with SEA Rule 17a-4(e)(7)’s applicable record retention requirements.

27. See also Notice to Members 99-45 (June 1999) (distinguishing between a firm’s compliance procedures and written supervisory procedures and specifying that “[i]t is crucial that all persons associated with a member be informed of any changes in the supervisory system and applicable written procedures. [NASD Rule 3010(b)(3)], therefore, requires members to inform all associated persons of such changes.”).

28. For purposes of FINRA Rule 3110(c)(1), the term “annually” means on a calendar-year basis.

29. See FINRA Rule 3110(c)(1)(A)–(C). In addition, FINRA Rule 3110.12 (Standards for Reasonable Review) retains the content of NASD IM-3010-1 (Standards for Reasonable Review) setting forth the standards for the reasonable review of offices.

30. FINRA Rule 3110.13 (General Presumption of Three-Year Limit for Periodic Inspection Schedules).

31. FINRA Rule 3110(c)(2).

32. See Notice to Members 04-71 (October 2004).

33. FINRA Rule 3110(c)(2)(A).

34. FINRA Rule 3110(c)(2)(B). See Regulatory Notice 09-64 (November 2009) (Verification of Instructions to Transmit or Withdraw Assets from Customer Accounts) (guidance on firms’ policies and procedures to verify transmittal instructions).

35. FINRA Rule 3110(c)(2)(C).

36. This requirement is consistent with NASD Rule 3010(c)’s requirement that a firm have supervisory policies and procedures for validating changes in customer account information. See NASD Rule 3010(c)(2)(F).
37. FINRA Rule 3110(c)(2)(D).
38. FINRA Rule 3110(c)(3)(B).
39. FINRA Rule 3110(c)(3)(C).
40. See FINRA Rule 3110.14 (Exception to Persons Prohibited from Conducting Inspections).
41. FINRA Rule 3110(c)(3)(A).
42. 15 U.S.C. 78o(g).
44. FINRA Rule 3110(d)(1)(A)-(D).
45. FINRA Rule 3110(d)(1)’s “reasonably designed” standard acknowledges that firms with different business models may adopt different procedures and practices.
46. FINRA Rule 3110(d)(4)(A).
47. FINRA Rule 3110(d)(2).
48. FINRA Rule 3110(d)(3).
49. FINRA Rule 3110(d)(4)(B).
51. FINRA Rule 3110(d)(3)(B).
52. FINRA previously provided the list to assist firm’s supervisory obligations under NASD Rule 3010(b)(2).
Executive Summary
FINRA and the Securities and Exchange Commission’s Office of Compliance Inspections and Examinations are issuing the attached National Exam Risk Alert to provide broker-dealer firms with information on developing effective policies and procedures for branch office inspections. The Alert reminds firms of supervisory requirements under FINRA’s supervision rule and notes common deficiencies and strong compliance practices.

Questions concerning this Notice should be directed to:

- Michael Rufino, Chief Operating Officer, Member Regulation Sales Practice, at (212) 858-4487; or
- George Walz, Vice President, Office of Risk, at (202) 728-8211.

Notice Type
- Guidance

Suggested Routing
- Compliance
- Internal Audit
- Risk
- Senior Management

Key Topics
- Branch Office Inspections
- Risk Management
- Supervision

Referenced Rules & Notices
- NASD Rule 3010
- NTM 98-96
- NTM 99-45
Information for Managers and Chief Compliance Officers

Volume I, Issue 2
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Broker-Dealer Branch Inspections

The branch inspection process is a critical component of a comprehensive risk management program and can help protect investors and the interests of the firm. OCIE and FINRA examination staff have observed that firms that execute this process well typically:

- tailor the focus of branch exams to the business conducted in that branch and assess the risks specific to that business;
- schedule the frequency and intensity of exams based on underlying risk, rather than on an arbitrary cycle, but examine branch offices at least annually;
- engage in a significant percentage of unannounced exams, selected through a combination of risk based analysis and random selection;
- deploy sufficiently senior branch office examiners who understand the business and have the gravitas to challenge assumptions; and
- design procedures to avoid conflicts of interest by examiners that may serve to undermine complete and effective inspection.

The Securities and Exchange Commission (“SEC”), as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the staff of the Office of Compliance Inspections and Examinations (“OCIE”) in coordination with other SEC staff, including in the Division of Trading and Markets, and do not necessarily reflect the views of the Commission or the other staff members of the SEC. This document was prepared by OCIE staff in consultation with the staff of the Financial Industry Regulatory Authority (“FINRA”) and is not legal advice.
Conversely, firms with significant deficiencies in the integrity of their overall branch inspection process, typically:

- utilize generic examination procedures for all branch offices, regardless of business mix and underlying risk;
- try to leverage novice or unseasoned branch office examiners who do not have significant depth of experience or understanding of the business to challenge assumptions;
- perform the inspection in a “check the box” fashion without questioning critically the integrity of underlying control environments and their effect on risk exposure;
- devote minimal time to each exam and little, if any, resources to reviewing the effectiveness of the branch office exam program;
- fail to follow the firm’s own policies and procedures by not inspecting branch offices as required, announcing exams that were supposed to be unannounced, or failing to generate a written inspection report that included the testing and verification of the firm’s policies and procedures, including supervisory policies and procedures;
- fail to have adequate policies and procedures, particularly in firms that use an independent contractor model and that allow registered personnel to also conduct business away from the firm; and
- lack heightened supervision of individuals with disciplinary histories or individuals previously associated with a firm with a disciplinary history.

A well-designed branch inspection program is both: (1) a necessary element (but not the only element) of a firm’s compliance and reasonable supervision of its branch offices and branch office personnel under Section 15(b)(4)(E) of the Securities Exchange Act as well as FINRA rules; and (2) an integral component of the firm’s risk management program. The branch inspection provides the firm with the opportunity to validate its surveillance results from branch offices and to gather on-site intelligence that supplements the ongoing management and surveillance of the branch from a business and risk management standpoint.

**Risk-Based Inspections**

An effective risk assessment process will help drive the frequency, intensity and focus of branch office inspections; it should also serve as an important consideration in the decision to conduct the exam on an announced or unannounced basis. Therefore, branch offices should be continuously monitored with respect to changes in the overall business, products, people and practices. Branch inspections should be conducted by persons that have sufficient knowledge and experience to evaluate the activities of the branch, and should be overseen by senior personnel such as the CCO or other knowledgeable principal. Further, procedures should be designed to avoid conflicts of interest that may serve to undermine complete and effective inspections because of the economic, commercial or financial interests that an examiner holds in the associated person or branch being inspected.

Branch office inspections provide an opportunity for oversight that should enhance the firm’s routine surveillance and supervisory activities. For instance, branch office inspections may allow a firm to better identify the nature and extent of outside business activities of registered branch office personnel. Outside business activities conducted by registered persons may carry added risk because these activities may be perceived by customers as part of the member’s business. Confirming that the scope of outside business activities of registered branch office personnel
conform to those activities authorized by the firm is an important component of the branch office inspection, and addresses a risk that may be more difficult to monitor. For much the same reasons, unannounced inspections (which do not provide an opportunity to hide, alter or destroy documentation or other information reflecting such activities) are a critical element of any well designed branch office inspection program and should constitute a significant percentage of all exams conducted.

This ongoing risk analysis should be a key element of the firm’s exam planning process and lead to more frequent examinations of offices posing higher levels of risk than dictated by the firm’s non-risk based cycle, and lead firms to engage in more unannounced exams of such offices. Some areas of high risk to consider are: sales of structured products; sales of complex products, including variable annuities; sales of private or otherwise unregistered offerings of any type; or offices that associate with individuals with a disciplinary history or that previously worked at a firm with a disciplinary history. NASD IM-3010-1 also lists additional factors to consider in making this determination.

Pursuant to NASD Rule 3010(c)(2), each branch office inspection must include a written report that includes, at a minimum, testing and verification of the firm’s policies and procedures in specified areas. As discussed further below, it is a good practice for this report to note any deficiencies and areas of improvement, as well as outline agreed-upon actions, including timelines, to correct the identified deficiencies.

**Oversight of Branch Office Inspections**

A broker-dealer’s internal branch inspection program is a necessary part of its supervisory system and a strong indicator of a firm’s culture of compliance. To test the quality of broker-dealers’ required inspections of branch offices, SEC and FINRA examiners may seek to review and verify items related to an effective branch examination program, particularly matters such as supervisory procedures regarding customer accounts and sales of retail products. For example, examiners may review the following:

- policies and procedures, including supervisory procedures as they pertain to the supervision of customer accounts, including those serviced by income producing managers;
- policies and procedures relating to the handling of money and securities physically received at the branch;
- validation of changes in customer addresses and other account information in accounts serviced by the branch;
- procedures related to transmittals of funds between customers and third parties, and between customers and registered representatives (“RRs”);
- firm testing of policies and procedures related to specific retail products, including:
  - sales of structured products;
  - private and other unregistered offerings;
  - municipal securities;
  - mutual funds; and
  - variable annuity sales and exchanges;
- firm testing in retail sales practice areas, including:
• verification of customer account information;
• supervision of customer accounts;
• written supervisory procedures ("WSPs");
• new account review, suitability of investments;
• unauthorized trading;
• churning;
• allocations of new issues;
• licensing; and
• training;

• advertising and other communications with the public or with customers (such as email and other written correspondence) and compliance with approval procedures;
• evidence of unreported outside or other unauthorized business activities by review of: customer files, written materials on the premises and at any satellite locations, branch office accounting records, appointment books and calendars, phone records, bank records;
• procedures for handling of customer complaints;
• risk-based reviews of bank accounts of the branch and affiliated entities, third-party wire transfers, and branch signature guarantee log; and
• procedures to uncover use of unauthorized computers or other electronic devices and/or social media.

Requirements and Guidance Pertaining to Broker-Dealer Branch Inspections

The responsibility of broker-dealers to supervise their associated persons is a critical component of the federal regulatory scheme. Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act authorize the Commission to impose sanctions on a firm or any person that fails to reasonably supervise someone that is subject to the supervision of such firm or person who violates the federal securities laws. In order to defend such a charge, a broker-dealer could show that it has established procedures that would reasonably be expected to prevent and detect a violation by such other person, and has a system for applying such procedures that has been effectively implemented. Such a system must be designed in such a way that it could reasonably be expected to prevent and detect, insofar as practicable, securities law violations.

The staff of the SEC’s Division of Trading and Markets (formerly known as the Division of Market Regulation) has noted that an effective branch office inspection program is a vital component of a supervisory system reasonably designed to oversee activities at remote branch offices. A number of Commission decisions in the area, both settled and litigated, set forth principles that can guide firms in constructing an effective branch office inspection program. Those cases suggest that regular branch office inspections over reasonably short intervals, including unannounced inspections, are the cornerstone of a well designed branch office

\[\text{Staff Legal Bulletin No. 17, Remote Office Supervision (March 19, 2004) ("SLB 17").}\]

\[\text{See, e.g., Consolidated Investment Services, Inc., Rel. No. 34-36687 (Jan. 5, 1996) (where the Commission notes that: "We also agree with the law judge that surprise inspections of [the branch office] would have been a prudent course of action;") Signal Securities, Inc., Rel. No. 34-43350 (Sep. 26, 2000) (citing Consolidated Investment Services); and Quest Capital Strategies, Rel. No. 34-44935 (Oct. 15, 2001) (where the Commission stated that: "A surprise inspection is a compliance tool that is necessarily available to every securities firm in carrying out its supervisory responsibilities."); Royal Alliance Associates, Inc., Rel. No. 34-38174 (Jan. 15, 1997) (settled matter); see also SLB 17.}\]
inspection program. The Commission has sanctioned firms that have not conducted unannounced examinations of their branch offices. Where a firm only conducts pre-announced examinations, that could create opportunities for branch office personnel to alter or destroy documents, or commit other securities law violations, resulting in major fines for the firm. As a result, OCIE and FINRA staff believe that a well-constructed branch office inspection program should include unannounced inspections, based on a combination of random selection, risk-based selection and for cause exams.

Beyond the timing and nature of the inspections, OCIE and FINRA staff also believe that past guidance suggests that a well-constructed branch office supervisory program should include: procedures for heightened supervision of remote branch offices that have associated persons with disciplinary histories; independent verification of the nature and extent of outside business activities; senior management’s involvement in assuring that adequate procedures are in place and that sufficient resources are devoted to implementing those procedures; periodic reassessment of supervisory responsibilities; adequate delineation of supervisory responsibilities; periodic reassessment of supervisory responsibilities; thorough investigation and documentation of customer complaints; and a system of follow up and review of those and other red flags.

FINRA rules and rule interpretations provide additional requirements and guidance in the area. NASD Rule 3010(b) requires every member broker-dealer to establish, maintain and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of RRs, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable FINRA rules.

Notice to Members 99-45 instructs broker-dealers to adopt and implement a supervisory system that is “tailored specifically to the member’s business and must address the activities of all its registered representatives and associated persons.” Procedures that merely recite the applicable rules or fail to describe the steps the firm will take to determine compliance with applicable securities laws and regulations are not reasonable. A broker-dealer’s procedures should instruct the supervisor on the requirements needed to be in compliance with the regulations.

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6 See, e.g., Fidelity Brokerage Services, LLC, Rel. No. 34-50138 (Aug. 3, 2004) (pre-announced inspections resulted in, among other things, employees altering and destroying documents; sanctions included a $1,000,000 fine payable to the SEC, plus a $1,000,000 fine payable to the NYSE) (settled matter).
7 See, e.g., Prospera Financial Services, Admin. Pro. File No. 3-10306, Rel. No. 34-43352 (September 26, 2000) (settled matter) for a discussion of the above elements of a branch office supervisory program; see also SLB 17 for further discussion of these and other elements of an effective branch office supervisory system. See also NASD IM-3010-1 (Standards for Reasonable Review).
8 NASD Notice to Members 99-45 (June 1999) at 294.
9 Id. at 295. See also NASD Notice to Members 98-96 (Dec. 1998).
10 NASD Notice to Members 99-45 (June 1999) at 293-94 (giving examples of situations in which “written supervisory procedures would instruct the supervisor” in how to document compliance).
procedures should describe the activities the supervisor will conduct along with the frequency as to when the reviews will be conducted.\textsuperscript{11}

NASD Rule 3010(c)(1) requires each member to conduct a review, at least annually, of the businesses in which it engages. A broker-dealer must conduct on-site inspections of each of its office locations; Office of Supervisory Jurisdictions (“OSJs”)\textsuperscript{12} and non-OSJ branches that supervise non-branch locations at least annually, all non-supervising branch offices at least every three years; and non-branch offices periodically. For these other branch offices, firms should consider whether a cycle of less than three years would be more appropriate, using factors such as the nature and complexity of the branch’s securities business, the volume of business done, and the number of associated persons assigned to each branch.\textsuperscript{13} Pursuant to NASD Rule 3010(c)(1), broker-dealers must document the examination schedules for each non-supervisory branch and non-branch office in their WSPs, including a description of the factors used to determine the examination cycle for such locations. The rule also requires broker-dealers to record the dates each inspection was conducted.\textsuperscript{14}

Pursuant to NASD Rule 3010(c)(2) the reports reflecting these reviews and inspections must be kept on file by the broker-dealer for a minimum of three years. NASD Rule 3010(c)(3) generally prohibits a branch office manager or any other person within the office with supervisory duties (or any person supervised by such person) from conducting an inspection of the office.\textsuperscript{15}

\begin{flushleft}
\textsuperscript{11} Id.
\textsuperscript{12} An OSJ is defined under NASD Rule 3010(g) as any office of a member at which any one or more of the following functions take place: (a) order execution and/or market making; (b) structuring of public offerings or private placements; (c) maintaining custody of customers' funds and/or securities; (d) final acceptance (approval) of new accounts; (e) review and endorsement of customer orders; (f) final approval of advertising or sales literature, except for an office that solely conducts final approval of research reports; or, (g) responsibility for supervising the activities of associated persons at one or more other branch offices. NASD Rule 3010(c)(1)(B).
\textsuperscript{13} NASD Rule 3010(c), which governs “Internal Inspections,” requires that each broker-dealer review the activities of each of its offices including the periodic examination of customer accounts to detect and prevent irregularities or abuses. The rule also requires that the written inspection report include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in the following areas:

\begin{itemize}
  \item Safeguarding of customer funds and securities;
  \item Maintaining books and records;
  \item Supervision of customer accounts serviced by branch office managers;
  \item Transmittal of funds between customers and RRs and between customers and third parties;
  \item Validation of customer address changes; and
  \item Validation of changes in customer account information.
\end{itemize}

\textsuperscript{14} However, the rule provides an exception from this requirement for a firm so limited in size and resources that it cannot otherwise comply. Under NASD Rule 3010(c)(3) the basis for this exception must be documented in the report for each inspection conducted in reliance on the exception.
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**Review of Effective Practices**

As noted throughout this Risk Alert, SEC and FINRA examiners have identified some practices that are characteristic of many effective supervisory procedures and effective branch office supervisory systems.\(^\text{16}\) Such practices are consolidated here:

- Using risk analysis to identify whether individual non-supervising branches should be inspected more frequently than the FINRA-required minimum three-year cycle. Branches that meet certain risk criteria based on risk ratings are inspected more often. In addition, some firms conduct “re-audits” more frequently than required when routine inspections reveal a higher than normal number of deficiencies, repeat deficiencies or serious deficiencies. Typically, these re-audits and audits for cause are unannounced inspections.
- Using surveillance reports, employing current technology and techniques as appropriate, to help identify risk and develop a customized approach for the firm’s compliance program and branch office inspections that considers the type of business conducted at each branch.
- Employing comprehensive checklists that incorporate previous inspection findings and trends from internal reports such as audit reports.
- Conducting unannounced branch inspections. Firms elected to conduct unannounced examinations either randomly or based on certain risk factors. These “surprise” exams may yield a more realistic picture of a broker-dealer’s supervisory system, as it reduces the risk that individual RRs and principals might attempt to falsify, conceal or destroy records in anticipation for an internal inspection.
- Including in the written report of each branch inspection any noted deficiencies and areas of improvement. The report should also outline agreed upon actions, including timelines, to correct the identified deficiencies.
- Using examiners with sufficient experience to understand the business being conducted at the particular branch being examined and the gravitas to challenge assumptions.
- Designing procedures to avoid conflicts of interest by examiners that may serve to undermine complete and effective inspection.
- Involving qualified senior personnel in several branch office examinations per year.
- Incorporating findings on results of branch office inspections into appropriate management information or risk management systems; and using a compliance database that enables compliance personnel in various offices to have centralized access to comprehensive information about all of the firm’s RRs and their business activities. Such a system appears to be highly useful to the compliance personnel at the OSJ and elsewhere for quickly accessing information and for supervising independent contractor RRs dispersed across a broad geographic area.
- Providing branch office managers with the firm’s internal inspection findings and requiring them to take and document corrective action.

\(^\text{16}\) Firms are encouraged to consider the practices described herein in assessing their own procedures and implementing improvements that will best protect their clients. Firms are cautioned that these factors and suggestions are not exhaustive, and they constitute neither a safe harbor nor a “checklist” for SEC staff examiners. Other practices besides those highlighted here may be appropriate as alternatives or supplements to these practices. While some of the effective practices above are existing regulatory requirements, the adequacy of a supervisory program can be determined only with reference to the profile of the specific firm and the specific facts and circumstances.
• Tracking corrective action taken by each branch office manager in response to branch audit findings.
• Elevating the frequency and/or scope of branch inspections where registered personnel are allowed to conduct business activities other than as associated persons of a broker-dealer, for example away from the firm.

**Conclusion**

This alert reminds broker-dealers that their branch office inspections must be conducted with vigilance. It describes certain supervisory tools that, based on OCIE and FINRA staff examinations and Commission enforcement cases, are characteristic of good supervisory procedures for branch office inspections, including the use of unannounced onsite inspections. While this alert summarizes recognized precedent and standards, and provides OCIE and FINRA staff views with regard to means to enhance branch inspections, it does not provide an exhaustive list of steps to effectively discharge responsibilities. A well-designed branch office inspection program is a necessary element – but not the only element – of reasonable supervision of a firm’s branch offices and branch office personnel.

We recognize that each firm is different and that firms need flexibility to adopt procedures to suit their individual structures and business needs. Our suggestions as to compliance methods are not meant to be exclusive or exhaustive and do not constitute a safe harbor. Rather, this report may assist firms in crafting more effective policies and procedures for branch office inspections to prevent and detect misconduct. We urge firms to review their policies and procedures in this regard to determine if they are reasonably designed to prevent and detect violations of applicable law and rules.
Consolidated Reports

FINRA Reminds Firms of Responsibilities When Providing Customers With Consolidated Financial Account Reports

Executive Summary

The practice of providing customers with consolidated financial account reporting has become increasingly common in the financial services industry. In many cases, these reports offer a single document that combines information regarding most or all of the customer’s financial holdings, regardless of where those assets are held. Firms are reminded that these reports represent communications with the public by the firm; the dissemination of these reports must comply with all applicable FINRA rules as well as the federal securities laws.

As investor demand for this service has grown and as increasingly sophisticated software and data service providers have become available, firms have developed differing practices for generating these communications. If not rigorously supervised, this activity can raise a number of regulatory concerns, including the potential for communicating inaccurate, confusing or misleading information to customers, lapses in supervisory controls, and the use of these reports for fraudulent or unethical purposes.

This Notice reminds firms of their responsibilities to ensure that they comply with all applicable rules when engaging in this activity, and highlights a number of sound practices. Firms are strongly encouraged to review the overall adequacy and effectiveness of their current policies and procedures relating to their consolidated reporting. Any firm that cannot properly supervise the dissemination of consolidated reports by its registered representatives must prohibit the dissemination of those reports and take the necessary steps to ensure that its registered representatives comply with this prohibition.

Referenced Rules & Notices

- NASD Rule 2210
- NASD Rule 2340
- NASD Rule 3010
- NASD Rule 3012
- NYSE Rule 342
- NYSE Rule 409
- Regulatory Notice 08-27
- NTM 05-48
General questions about this Notice should be directed to:

- Steve Kasprzak, Associate Director & Principal Counsel, Sales Practice Policy, Member Regulation, at (646) 315-8603; or
- Bill Hayden, Director, Emerging Regulatory Issues, at (202) 728-8860.

For questions about communications with the public, contact Amy Sochard, Director, Programs & Investigations, Advertising Regulation, at (240) 386-4508.

Discussion and Background

Many firms, as a service to their customers, provide documents that consolidate information regarding a customer’s various financial holdings.² For the purpose of this Notice we will refer to this practice and document as “consolidated reporting” and “consolidated reports,” respectively. These consolidated reports offer a broad view of customers’ investments, may include assets held away from the firm, and may provide not only account balances and valuations, but performance data as well. In many cases these consolidated reports are prepared at the request of the customer, who may also direct which of his or her accounts to include and provide access to data for non-held accounts. These communications may supplement, but do not replace, the customer account statement required pursuant to NASD Rule 2340 and NYSE Rule 409,² which is prepared and disseminated to the customer through a separate process. Consolidated reports may not be represented as a substitute for, and must be distinguished from, account statements that are required by rule.

Firms create consolidated reports through fully integrated, in-house data gathering and reporting systems, fully outsourced solutions from third-party vendors,³ “off-the-shelf” software applications or a combination of these methods. Firms also disseminate these consolidated reports through a variety of means, such as direct mailing to customers, providing access to secure servers via the Internet and hand delivery during face-to-face meetings. The consolidated reports themselves may contain a variety of information and may be produced as a highly customized document created by an individual representative, or as a standardized report created by a firm system. To the extent individual representatives create consolidated reports, firms are required to supervise this activity, and both the firm and the individual representatives are responsible for compliance with all applicable rules.

Consolidated reports are communications with the public. Therefore, they must be clear, accurate and not misleading.⁴ For assets held at the firm, this includes providing information, including valuations, that is consistent with the customer’s official account statement.⁵ For assets held away, this includes, among other things, taking reasonable steps to accurately reproduce information obtained regarding outside accounts and not to include information that is false or misleading.

Consolidated reports, particularly those published on firm letterhead, can create a
misconception that the firm produced or verified all of the data, including the valuation of assets held away. Therefore, these reports should be constructed and provided in such a manner that neither customers nor third parties with whom the customer interacts (e.g., banks, mortgage companies, other broker-dealers) are likely to be confused or misled as to the nature of the information presented, or mistake these documents for official account statements regarding the reported assets. The reports should clearly delineate between information regarding assets held on behalf of the customer, which are included on the firm’s books and records, and other external accounts or assets.

If a firm is unable to test or otherwise validate data for non-held assets, including valuation information, the firm should clearly and prominently disclose that the information provided for those assets is unverified. In addition, to the extent a consolidated report contains information regarding financial products that are outside a registered representative’s area of proficiency, representatives must discuss and present these financial products in a manner that does not mislead customers as to the scope of the representative’s financial expertise.6

Consolidated reports are also subject to the regulatory requirements regarding supervision and internal controls, records retention, privacy and safeguarding of customer information.7 Effective firm controls would include procedures to vet and approve consolidated report templates for compliance with regulatory requirements before they are put into production. These reviews can help ensure that any new consolidated report-generating process complies with regulatory requirements and firm policies, and that it is integrated into the firm’s supervisory control program. Similar controls should be put in place for any programming that permits customization, as well as any subsequent changes to the approved templates or programming.

The risks associated with a firm’s failure to maintain adequate safeguards over the use and dissemination of customer account information are well established. Beyond the obvious concern regarding the use of account information for fraudulent activity, even well-intentioned but incautious consolidated reporting could result in customers being misled or confused. Given the reliance that customers may place on consolidated reports and the potential consequences if these communications contain mistakes or are misused by firm personnel, firms must review their consolidated reporting programs with particular care. The more complex a firm’s program for consolidated reporting, the more difficult it may be to conform that reporting to applicable rule requirements. Factors that contribute to program complexity include:

- the production within a firm of a large number of varying types of consolidated reports, especially consolidated reports that are highly customizable;
- reporting on a wide variety of asset classes, especially assets held outside the firm; and
- a decentralized consolidated reporting structure employing multiple reporting systems.8
If a firm provides this service to customers, it must ensure that the size and complexity of the consolidated reporting program does not exceed the firm’s ability to supervise the activity and to subject it to a rigorous system of internal controls. Any firm that cannot properly supervise the dissemination of consolidated reports by its registered representatives must prohibit the dissemination of those reports and take necessary steps to ensure that its registered representatives comply with this prohibition.

Sound Practices

FINRA encourages firms to consider the practices described below when reviewing their consolidated reporting programs. This Notice is not intended to be a comprehensive roadmap for compliance and supervision; rather, it outlines measures that may assist firms in complying with their various supervisory obligations. Firms should consider these practices in assessing their own procedures and in implementing improvements that will best protect their customers. Firms must adopt procedures and controls that are most effective given the firm’s size, structure and operations.

1. Ongoing audits and reviews

   Due to the potential risks related to consolidated reporting, some firms have incorporated a review of the consolidated reporting process as a standard element in their testing and oversight programs. These firms test for regulatory compliance, data accuracy and adherence to supervisory procedures in audits, branch office reviews and as an ongoing part of their program of internal inspections required by NASD Rule 3010. Some firms require branch offices that produce consolidated reports to obtain an annual third-party audit of the process.

2. Centralize reporting systems

   Maintaining multiple consolidated reporting systems can create a patchwork of processes and applications that may be difficult to adequately supervise. Some firms have chosen to centralize their consolidated reporting programs by requiring use of a single firm-wide system. Other firms that allow multiple report-producing systems, subject them to a centralized review and approval process. Participants in this review and approval process may include personnel from information technology, compliance and legal departments.
3. **Customer addresses**

Some of the stronger programs require that all consolidated reports be mailed centrally using the customer’s address of record, and have processes in place that reconcile address information used for account statements and consolidated reports. In the limited circumstances where different addresses are used to deliver customer account statements and consolidated reports, firms should maintain documentation explaining the discrepancy and indicating that the customer was provided notice or acknowledged the differing addresses.

4. **Assets held away**

Some firms verify, when possible, information pertaining to assets held away. Some of these firms have opted not to include assets in the consolidated report when the firm cannot verify their existence or cannot validate the valuations.

5. **Supporting documentation**

Some firms maintain supporting documentation for reported assets with the customer file, or otherwise have it available to be reviewed alongside the consolidated report. This documentation may include information regarding source of data and methods used to determine accuracy and asset valuation. The information may be useful in discussing the consolidated reports with customers, in validating the accuracy of consolidated report-generating systems and for internal control/audit testing purposes.

6. **Source documents**

It is sound practice to encourage customers to review and maintain the original source documents that are integrated into the consolidated report, such as the statements for individual accounts held away from the broker-dealer. Customers may be tempted to disregard these source documents because of the convenience of the consolidated report. However, source documents may contain notices, disclosures and other information important to the customer, and may also serve as a reference should questions arise regarding the accuracy of the information in the consolidated report.
7. **Report design**

The design and formatting of consolidated reports is important for ensuring information is clearly communicated. In addition to the requirements outlined above, firms are encouraged to include, when applicable, the following disclosures:11

- that the consolidated report is provided for informational purposes and as a courtesy to the customer, and may include assets that the firm does not hold on behalf of the customer and which are not included on the firm's books and records;
- the names of the entities providing the source data or holding the assets, their relationship with each other (e.g., parent, subsidiary or affiliated organization) and their respective functions (introducing/carrying brokerage firms, fund distributor, banking/insurance product providers, etc.);
- a statement clearly distinguishing between assets held or categories of assets held by each entity included in the consolidated report;
- the customer’s account number and contact information for customer service at each entity included in the consolidated report;
- identify that assets held away may not be covered by SIPC32; and
- if the consolidated report provides aggregate values for several different assets, an explanation of how the aggregated values of the different types of assets were arithmetically derived from separate asset totals.

8. **Disclosures and attestations**

To help ensure that a customer is apprised of the nature of the consolidated reporting process, and to ensure delivery of any disclosures or other pertinent information, firms may consider obtaining the customer’s signed acknowledgement that he or she has been provided with the relevant disclosures and understands the nature and limitations of the consolidated reporting process. These disclosures may, for example, be included with applicable communications regarding privacy protections. Firms should consider a means to refresh this notice on a periodic basis.
Endnotes

1. This reporting is most commonly issued by firms that maintain an affiliated investment adviser or by registered representatives who also provide investment advisory services to their customers.

2. The FINRA rulebook currently consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and the 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 3/12/08 (Rulebook Consolidation Process). For convenience, the Incorporated NYSE Rules are referred to as the NYSE Rules.

3. Vendors include Web-based application service providers (ASPs) that aggregate financial data and create reports to firm specifications that may be mailed to customers or, if the firm desires, can be accessed on a read-only basis from the ASP’s Web server. To the extent that firms rely on third-party vendors, firms are responsible for complying with applicable requirements regarding outsourcing, as discussed in Notice to Members 05-48. The Notice clarifies firm responsibilities when outsourcing “covered activities,” which the Notice identifies as activities or functions that, if performed directly by firms, would be required to be the subject of a supervisory system and written supervisory procedures pursuant to NASD Rule 3010.

4. Depending on the form, content and method of dissemination, these consolidated reports may be considered sales literature or correspondence. As such, they may be subject to various requirements outlined in NASD Rules 2210 and 2211 and associated guidance, such as the requirement for clear and prominent display of the firm’s name on communications and disclosures related to use of performance information.

5. Inaccuracies may include discrepancies associated with having consolidated reports and customer account statements produced through separate systems or by different entities. For example, firms have reported finding numerous instances in which the same in-house transaction was reflected differently in each document, thereby requiring a correction before publication or dissemination.


7. The better information security programs routinely test controls over access to systems and data related to the reporting process as part of the firm’s internal controls regime. Access controls must be rigorously supervised to avoid unauthorized use or manipulation of customer account data.

8. These multi-system situations often arise when a firm affiliates with or acquires a new group of representatives or branch offices that bring with them legacy systems. In some instances, a reporting system may be unique to a single branch office, even to the extent that a single branch may maintain a separate contractual relationship with a third-party vendor to provide these services.
Endnotes continued

9 Firms are required to have procedures to review, monitor and validate customer changes of address. These policies and procedures must include “a means or method of customer confirmation, notification, or follow-up that can be documented.” NASD Rule 3012(a)(2)(B) and NYSE Rule 401.

10 This is consistent with NYSE Rule 409(b) and FINRA’s proposed rule change to adopt NASD Rule 2340 (Customer Account Statements) as FINRA Rule 2231. Proposed Supplementary Material .01 (Transmission of Customer Account Statements to Other Persons or Entities) would expressly require a firm to obtain written instructions from the customer in order to send/deliver customer statements, confirmations or other communications to other persons or entities. See Securities Exchange Act Release No. 59921 (May 14, 2009), 74 FR 23912 (May 21, 2009).

11 These elements are drawn from existing guidance relating to multi-account reporting practices for customer account statements in NYSE Rule Interpretations 409(a)/04 (Assets Externally Held and Included on Statements Solely as a Service to Customers) and (a)/06 (Use of Summary Statements) and are consistent with FINRA’s proposed rule change to adopt NASD Rule 2340 (Customer Account Statements) as FINRA Rule 2231. The multi-account reporting guidance in proposed FINRA Rule 2231, Proposed Supplementary Material .04 (Assets Externally Held and Included on Statements Solely as a Service to Customers) and Proposed Supplementary Material .06 (Use of Summary Statements) are substantially unchanged from existing NYSE Rule Interpretations 409(a)/4 and 409(a)/6. See Securities Exchange Act Release No. 59921 (May 14, 2009), 74 FR 23912 (May 21, 2009).

12 Firms should consider including a disclosure clarifying that their firm’s SIPC coverage would only apply to those assets held at the firm, and to the extent some of the other reported entities may be SIPC members, customers should contact their financial representative or the other entity or refer to the other entity’s statement regarding SIPC membership.
The Who, What and Why of Enforcement Case Studies
Wednesday, December 2
3:15 p.m. – 4:15 p.m.

This session provides an overview of new developments and trends in enforcement, including enforcement priorities, as well as policy changes and clarifications, particularly regarding information requests. Panelists highlight noteworthy decisions and settlements that illustrate FINRA priorities, and provide guidance on regulatory and compliance practices. They also provide information and insights on navigating enforcement investigations and the disciplinary process.

**Moderator:** Jessica Hopper
Vice President of Regional Enforcement
FINRA Enforcement

**Panelists:**
David Klafter
Regional Chief Counsel
FINRA Enforcement

Jeffrey Pariser
Chief Litigation Counsel
FINRA Enforcement

Michael Manly
Senior Regional Counsel
FINRA Enforcement
The Who, What and Why of Enforcement Case Studies Panelist Bios:

Moderator:

Jessica Hopper is FINRA’s Vice President of Regional Enforcement, responsible for the Department of Enforcement’s attorneys and professionals in 15 District Offices throughout the country. She oversees the nationwide disciplinary proceedings that regional Enforcement brings against broker-dealers and registered representatives for violations of FINRA’s rules. She joined FINRA Enforcement in 2004 and served as a Director in FINRA’s Washington D.C. home office until 2011. Prior to joining FINRA, from 2000 to 2004 she was a member of the Legal & Compliance Department of Legg Mason Wood Walker, Inc.’s, where her responsibilities focused on retail sales compliance issues. Earlier in her career, she was an associate at a law firm and an editor in legal publishing.

Panelists:

David B. Klafter, Regional Chief Counsel, FINRA-South Region, has been employed by FINRA for approximately 16 years. Mr. Klafter supervises FINRA’s South Region Enforcement staff. Mr. Klafter has prosecuted numerous cases involving a broad array of misconduct including: fraud, sales practice violations, AML violations, forgery, falsification of records, conversion, registration violations, net capital violations and various supervision violations. For several years prior to joining FINRA, Mr. Klafter was in private practice in Manhattan primarily involved in securities litigation and arbitration. Mr. Klafter graduated from Syracuse University's School of Management with a B.S. and received his J.D. degree from New York Law School.

Jeff Pariser is Chief Litigation Counsel at FINRA. Mr. Pariser leads a team of experienced trial and appellate lawyers who handle many of FINRA's most important disciplinary proceedings. Mr. Pariser also consults on litigated matters throughout the Enforcement program, providing advice, reviewing and revising significant briefs, and assisting in hearing preparation. Mr. Pariser joined FINRA in 2010 as Senior Litigation Counsel. He became a Director in 2011 and Chief Litigation Counsel in 2013. Prior to joining FINRA, he was a litigation associate and then litigation partner at Hogan & Hartson LLP (now Hogan Lovells) between 1998 and 2010. Mr. Pariser was a member of Hogan’s Recruitment Committee and ran Hogan’s litigation training program between 2000 and 2003. Mr. Pariser was a litigation associate at Simpson Thacher & Bartlett in New York from 1994 to 1998, joining that firm following a clerkship with Justice Stewart Pollock of the New Jersey Supreme Court. During his time at Simpson Thacher, he taught as an adjunct writing instructor at Brooklyn Law School. Mr. Pariser has tried cases and argued appeals in federal and state courts and before arbitration and FINRA disciplinary panels. Mr. Pariser graduated magna cum laude from the New York University School of Law, where he was on the Law Review. He received his B.A. degree from the University of Virginia.

Mike Manly is a Senior Regional Counsel in FINRA's Department of Enforcement. He works in FINRA's Dallas District Office. His responsibilities include the initiation and prosecution of FINRA disciplinary matters, including participation as trial counsel in disciplinary proceedings. He also consults with Member Regulation personnel regarding ongoing examinations. Prior to joining FINRA, Mr. Manly was a partner at Neal, Gerber & Eisenberg LLP in Chicago, where he represented broker/dealers in customer disputes brought in federal and state courts, as well as various arbitration forums, including FINRA Dispute Resolution. Mr. Manly also was a general litigation associate at Jones Day, where he handled complex litigation involving antitrust, securities, and bankruptcy matters. Mr. Manly graduated from the University of Nebraska College of Law with high distinction and earned his undergraduate degree, with distinction, from the University of Nebraska-Lincoln.
The Who, What and Why of Enforcement Case Studies
Panelists

Moderator:

• Jessica Hopper, Vice President of Regional Enforcement, FINRA Enforcement

Panelists:

• David Klafter, Regional Chief Counsel, FINRA Enforcement
• Jeffrey Pariser, Chief Litigation Counsel, FINRA Enforcement
• Michael Manly, Senior Regional Counsel, FINRA Enforcement
2015 Enforcement Statistics
2015 Enforcement Statistics

- **2015 Formal Actions**: Approximately 1,000 formal actions (complaint, settled, or expedited actions) through Enforcement as of October 2015. Majority of actions are settled – less than 10% are complaints that go to hearing. Approximately 30 disciplinary hearings are held each year.

- **Settlements in 2015**: As of October 31, 2015, FINRA ordered over $108M paid back to customers as part of formal actions.

- **Litigation Trends in 2015**: Hearings involve increasingly complex issues.

- **Frequent formal action issues** include suitability, Private Securities/OBA nondisclosure, conversion, and Rule 8210 compliance.

- **Complex cases typically involve fraud, Section 5 violations, AML compliance, and supervision.**

- **Average length of hearings scheduled** has increased from 3.2 days in 2013 to 5.6 days in 2015. In 2015, several cases set hearings of 10 days or more that settled before hearing. As a result, the average hearing length of matters that actually go to hearing is less than in prior years.

- **Liability was found in 22 of 25 cases decided in 2015; sanctions include 10 all-capacity bars, two principal capacity bars, four member firm expulsions and two statutory disqualifications.**
FINRA Disciplinary Proceedings
FINRA Disciplinary Proceedings – Pre-Complaint

- Referral of findings to Enforcement by Member Regulation, Office of Fraud Detection and Market Intelligence, or other source.

- Wells Notice (reported on Individual’s CRD) – FINRA provides Firm or Individual with notification of contemplated charges and opportunity to present information as to why the action should not be brought.

- Settlement through Acceptance Waiver & Consent
  - Firm or Individual consents to entry of factual findings without admitting or denying those findings.
  - Individual sanctions may include bar, suspension in some or all capacities, fines, restitution, disgorgement, and requalification.
  - Firm sanctions may include censure, expulsion, suspension of some or all business activities, fines, restitution, disgorgement, and an undertaking.
FINRA Disciplinary Proceedings – Post-Complaint

- Complaint filed, allegations reported on CRD (FINRA Rule 9212)
- Hearing Officer assigned after Respondent files Answer
- Mediation is available to facilitate settlement. Mediation is conducted by a Hearing Officer other than the one assigned to the case
- Post-complaint settlements styled as Offer of Settlement, and includes consent to entry of complaint allegations as findings (FINRA Rule 9270)
- Discovery governed by FINRA Rules 9251, 9252 and 9253
- Pre-hearing exchange (witnesses, exhibits, pre-hearing briefs and motions) governed by FINRA Rule 9242
## FINRA Disciplinary Proceedings – Hearing and Appeal

- Extended Hearing Panel consists of Hearing Officer and two Panelists (current or former members of District Committees)
- Hearings are formal proceedings, include opening statements, presentation of evidence, and closing arguments
- Witnesses provide sworn testimony
- Hearing Officer determines admissibility of evidence
- Traditional rules of evidence not applied; hearsay is admissible in FINRA disciplinary proceedings
- Panel Members may question witnesses
- Written decisions are issued by the Panel after the Hearing. It typically takes several months for the Panel to issue a decision. In longer, complex cases, it can take almost a year.
- Decisions may be appealed by any party to the National Adjudicatory Council
Recent Decisions
Recent Extended Hearing Panel Decisions

- **John Thomas Financial, Inc., et al.** (Case No. 2012033467301) – Trading ahead of customer orders, 8210 violations, harassment and intimidation
- **John Carris Investments, LLC, et al.** (Case No. 2011028647101) – Fraud in connection with offering by parent company, suitability, stock price manipulation
- **TNP Securities, LLC et al.** (Case No. 2011025785602) – Fraud in offering documents, failure to supervise private placements
- **Fox Financial Management Corp. et al.** (2012030724101) – Failure to supervise representative’s private securities transactions
- **Kimberly Springsteen-Abbott** (Case No. 2011025675501): Misuse of investor funds
- **Brian M. White** (Case No. 2012033128703) – Undisclosed private securities transactions and outside business activities, false testimony
Recent Extended Hearing Panel Decisions

- *Louis Ottimo* (Case No. 2009017440201) – Fraudulent omissions in offering documents, willful U4 nondisclosures
- *Kenneth Brownlee* (Case No. 2013036217601) – Suitability, undisclosed private securities transactions, false testimony
- *Wedbush Securities, Inc. et al.* (Case No. 2012034934301) – Inaccurate and incomplete blue sheets, related supervision
- *J. Michael Casas* (Case No. 2013036799501) – Misrepresentations and conversion
Enforcement Priorities in 2016
2016 Enforcement Priorities

1. Fraud/Misrepresentations
2. AML
3. Section 5/Microcap Compliance
4. Complex Products (Suitability and Supervision)
5. Supervision of Private Securities Transactions/Outside Business Activity
6. Individual Liability
7. Senior Investors
Questions?
Fixed Income: What’s on the Horizon?
Wednesday, December 2
3:15 p.m. – 4:15 p.m.

During this session, FINRA staff provide an update on fixed income issues. Panelists also discuss the regulatory framework for municipal advisors, and address the implementation process and potential compliance matters relating to the municipal advisor rules.

Moderator: Cynthia Friedlander
Director of Fixed Income Regulation
FINRA Member Regulation

Panelists: Rick Agster
Vice President and Director of Fixed Income Compliance
Raymond James & Associates, Inc.

Gail Marshall
Associate General Counsel – Enforcement Coordination
Municipal Securities Rulemaking Board (MSRB)

Christopher Melton
Executive Vice President – Legal and Compliance
Coastal Securities, Inc.
Fixed Income: What’s on the Horizon? Panelist Bios:

Moderator:

**Cynthia Friedlander** is the Director of Fixed Income Regulation within FINRA Member Regulation. Ms. Friedlander is responsible for directing FINRA’s policies and national programs related to fixed income securities, including related regulatory matters in FINRA District Offices. Specifically, she is responsible for the design, development and delivery of fixed income policy guidance to staff throughout FINRA, as well as to member firms, and is one of FINRA’s primary representatives in fixed income regulatory matters with the Municipal Securities Rulemaking Board (MSRB) and the Securities and Exchange Commission (SEC). Ms. Friedlander represents FINRA at government agency, SRO, and industry and advisory meetings, and is a staff liaison to FINRA’s Fixed Income Committee. She holds a bachelor’s degree from the University of Virginia and a master of business administration from George Mason University.

Panelists:

**Rick Agster** is the Director of Fixed Income Compliance at St. Petersburg, Florida-based Raymond James & Associates, Inc. (RJA), a member of a diversified financial services holding company with subsidiaries engaged primarily in investment and financial planning, in addition to investment banking and asset management. Through its three broker/dealer subsidiaries, Raymond James Financial (ticker:RJF) has approximately 6,500 financial advisors serving in excess of 2.7 million client accounts in more than 2,600 locations throughout the United States, Canada and overseas. In addition, RJA is a top 10 municipal underwriter. Mr. Agster's team's responsibilities include regulatory change management and oversight of supervision of all aspects of fixed income sales, trading, operations and investment banking and also working directly with exam teams from various regulatory authorities. In addition, Mr. Agster leads firm efforts in the areas of pay-to-play and municipal advisor rules. Mr. Agster is an active participant in industry compliance/legal groups in industry trade association that focus on fixed income issues, working with legislators, regulatory authorities and association members with respect to new rulemaking and industry best practices. Prior to joining Raymond James, Mr. Agster was a corporate securities transactional lawyer at the law firms of Foley & Lardner LLP, Bryant Miller & Olive, P.A. and Brown & Wood LLP and even interned one summer with The Bond Market Association. Mr. Agster is licensed to practice law in both New York and Florida. Mr. Agster earned his JD from the Northwestern University School of Law in Chicago, Illinois, his MBA from Rollins College in Winter Park, Florida, and his BA in Music from the University of Central Florida in Orlando, Florida.

**Gail Marshall** is Associate General Counsel – Enforcement Coordination for the Municipal Securities Rulemaking Board (MSRB). She manages the MSRB’s relationship with regulatory authorities and collaborate on rulemaking and regulatory policy functions and legal projects in connection with market price transparency, trade reporting and uniform practice rules. Prior to this role, Ms. Marshall was the Associate General Counsel at the MSRB where she provided legal expertise and support associated with the development of regulations governing municipal market professionals, including dealers and municipal advisors. Prior to joining the MSRB, Ms. Marshall served as of counsel at Bingham McCutchen LLP from 2000-2015 where she advised broker-dealers and investment advisers on compliance with federal and state securities laws and regulations and rules of self-regulatory organizations, such as the MSRB. Prior to 2000, she was an attorney with the Securities and Exchange Commission (SEC) where she served as special counsel to Commissioner Isaac C. Hunt, Jr. as well as special counsel in the Division of Trading and Markets and Division of Enforcement. Ms. Marshall received a bachelor’s degree in business management, from Westfield State University, a juris doctor from New England School of Law, and an masters of laws in Securities and Financial Regulation from Georgetown University Law Center.

**Christopher Melton** is currently Executive Vice President-Legal and Compliance at Coastal Securities, Inc. in Houston. He has served Coastal as Chief Compliance Officer since 2003, and has held his current title since 2006. His entire career in the securities industry has been spent at regional broker dealers focused on fixed income securities. His professional experience includes the areas of institutional sales, public finance and operations as well as compliance. Mr. Melton is past president of the Arkansas Corporate Counsel Association, a past chairman of the FINRA District 6 Committee and is immediate past Treasurer and serves ex-officio on the Board of Directors of the Bond Dealers of America. He is currently serving a one year term on the FINRA Small Firm Advisory Board (SFAB). His education includes a BSBA in Finance from the University of Arkansas and a
J.D. from the University of Arkansas at Little Rock. He holds a license to practice law in the State of Arkansas and FINRA Series 7, 63, 24, 27, 53 and 79 securities licenses.
Fixed Income: What’s on the Horizon?
Panelists

Moderator:

• Cynthia Friedlander, Director of Fixed Income Regulation, FINRA Member Regulation

Panelists:

• Rick Agster, Vice President and Director of Fixed Income Compliance, Raymond James & Associates, Inc.
• Gail Marshall, Associate General Counsel – Enforcement Coordination, Municipal Securities Rulemaking Board (MSRB)
• Christopher Melton, Executive Vice President – Legal and Compliance, Coastal Securities, Inc.
Fixed Income: What’s on the Horizon?
Wednesday, December 2
3:15 p.m. – 4:15 p.m.

Resources

MSRB Resources

- MSRB Notice 2015-16, “Request for Comment on Draft Rule Amendments to Require Confirmation Disclosure of Markups for Specified Principal Transactions with Retail Customers” (September 2015)
  www.msrb.org/~media/Files/Regulatory-Notices/RFCs/2015-16.ashx

- MSRB Notice 2015-14, “MSRB Revises Effective Date for MSRB Rule G-18, on Best Execution of Transactions in Municipal Securities, and Related Rule Amendments” (September 2015)
  www.msrb.org/~media/Files/Regulatory-Notices/Announcements/2015-14.ashx

- MSRB Notice 2015-12, “MSRB Revises Content Outlines for its Professional Qualification Examinations for Municipal Securities Dealers” (July 2015)
  www.msrb.org/~media/Files/Regulatory-Notices/Announcements/2015-12.ashx

- MSRB Notice 2015-09, “MSRB to Extend Due Date for First Submissions Under MSRB Rule G-45, Reporting of Information on Municipal Fund Securities” (June 2015)
  www.msrb.org/~media/Files/Regulatory-Notices/Announcements/2015-09.ashx

  www.msrb.org/~media/Files/Regulatory-Notices/Announcements/2015-07.ashx

- MSRB Notice 2015-06, “MSRB Files Content Outline for Municipal Advisor Representative Qualification Examination (Series 50)” (April 2015)
  www.msrb.org/~media/Files/Regulatory-Notices/Announcements/2015-06.ashx

- MSRB Notice 2015-04, “MSRB to Amend Rules to Create Professional Qualification Standards for Municipal Advisors” (March 2015)
  www.msrb.org/~media/Files/Regulatory-Notices/Announcements/2015-04.ashx
  
  www.msrb.org/~media/Files/Regulatory-Notices/Announcements/2014-07.ashx?n=1

FINRA Resources

• FINRA Regulatory Notice 15-41, Trade Reporting and Compliance Engine (TRACE), SEC Approves Amendments to Require Firms to Report Transactions in TRACE-Eligible Securities As Soon As Practicable (November 2015)
  

  

  

• FINRA Regulatory Notice 15-31, Debt Research, SEC Approves Rule to Address Conflicts of Interest Relating to the Publication and Distribution of Debt Research Reports (August 2015)
  

  

• FINRA Regulatory Notice 15-14, Trade Reporting and Compliance Engine (TRACE), SEC Approves Amendments to Require Firms to Identify Transactions with Non-Member Affiliates in TRACE Trade Reports (May 2015)
  

• SR-FINRA-2015-036, Proposed Rule Change to Amend FINRA Rule 4210 (Margin Requirements) to Establish Margin Requirements for the TBA Market
  
  www.finra.org/industry/rule-filings/sr-finra-2015-036

• SR-FINRA-2015-033, Proposed Rule Change to Amend FINRA Rule 0150 to Apply FINRA Rule 2121 and its Supplementary Material .01 and .02 to Transactions in Exempted Securities That Are Government Securities
  
  www.finra.org/industry/rule-filings/sr-finra-2015-033
South Region Compliance Seminar
New Orleans, LA | December 2 – 3, 2015

Ask FINRA Staff
Wednesday, December 2
4:30 p.m. – 5:30 p.m.

FINRA senior staff provides updates on regulatory key issues, enforcement and hot topics facing the industry. They address questions relating to the examination program, effective compliance practices, the implication of new and pending FINRA rules, and other important issues.

Moderator: Chip Jones
Senior Vice President
FINRA Member Relations and Education

Panelists:
J. Bradley Bennett
Executive Vice President
FINRA Enforcement

Cameron Funkhouser
Executive Vice President
FINRA Office of Fraud Detection and Market Intelligence

Jeffrey Pasquerella
Senior Vice President and Regional Director
FINRA South Region

Michael Rufino
Executive Vice President
FINRA Member Regulation, Sales Practice
Ask FINRA Staff Panelist Bios:

Moderator:

Chip Jones is the Senior Vice President of Member Relations and Education for FINRA. In leading the Member Relations and Education Department, Mr. Jones’ responsibilities include maintaining and enhancing open and effective dialog with FINRA member firms. Mr. Jones also oversees FINRA’s Member Education area, which includes FINRA conferences and other member firm educational offerings such as the FINRA Institute at Wharton for the Certified Regulatory and Compliance Professional™ (CRCP™) designation. In addition, Mr. Jones oversees the FINRA Compliance Resource Provider Program, where FINRA works with companies that offer compliance-related products and services to regulated firms at negotiated discounts. Prior to joining FINRA, Mr. Jones spent six years as Vice President of Regulatory and Industry Affairs at American Express Financial Advisors (AEFA). Previous to AEFA, he spent two years as Advocacy Administrator for the Association for Investment Management and Research (AIMR). Mr. Jones was employed by the Virginia Securities Division as a senior examiner/investigator for more than six years prior to joining AIMR. He received a master’s degree in business administration and a bachelor’s degree from Radford University in Radford, Virginia.

Panelists:

J. Bradley Bennett, Executive Vice President, is responsible for FINRA’s Department of Enforcement. In this capacity, Mr. Bennett directs investigating and bringing all formal disciplinary actions against firms and associated persons for violations of FINRA rules and federal securities laws. Mr. Bennett received his undergraduate degree from St. Lawrence University and his law degree from Georgetown University Law Center. He started his career at the SEC as a senior attorney in the Division of Enforcement, focusing on cases of all facets of securities law, including accounting, broker-dealer regulation, tender offers and insider trading.

Cameron Funkhouser is Executive Vice President of FINRA’s Office of Fraud Detection and Market Intelligence. He has been with FINRA, formerly known as NASD, since 1984, serving in various roles of increasing responsibility with a focus on the surveillance of securities traded on The Nasdaq Stock Market, New York Stock Exchange, American Stock Exchange and the over-the-counter markets. Mr. Funkhouser has extensive experience conducting securities fraud investigations and is regularly called upon by civil and criminal law enforcement authorities to provide training, technical assistance, investigative/litigation strategy consulting and expert testimony. Currently, he is responsible for overseeing the Office of Fraud Detection and Market Intelligence, which includes the Insider Trading and Fraud Surveillance units responsible for monitoring the trading activity of more than 10,000 publicly traded securities, FINRA’s Complaint Center and FINRA’s Whistleblower program. Mr. Funkhouser and his staff have been responsible for uncovering numerous cases of Internet fraud, insider trading, market manipulation, Ponzi schemes and other white collar misconduct, which have been successfully investigated and prosecuted by FINRA, the Securities and Exchange Commission and other law enforcement agencies across the country and internationally. He graduated from Georgetown University with a bachelor’s degree in business and George Mason University with a law degree. Mr. Funkhouser is a member of the Virginia State Bar.

Jeffrey M. Pasquerella is Regional Director and Senior Vice President overseeing FINRA’s South Region, which includes offices in Atlanta, Boca Raton, Dallas and New Orleans. Previous to serving as Regional Director, he was the District Director of FINRA’s District 10 Office located in New York. He has been employed by FINRA since August of 1999. Prior to joining FINRA, Mr. Pasquerella served as an assistant district attorney in the Westchester County District Attorney’s Office for three years. He is a 1993 graduate of Villanova University, Villanova, Pennsylvania, and a 1996 graduate of Pace University School of Law, White Plains, New York. Mr. Pasquerella is a member of the New York and Connecticut State Bars.

Michael Rufino is Executive Vice President and Head of Member Regulation—Sales Practice. In this capacity, he is responsible for overseeing FINRA’s Sales Practice program, which encompasses 15 District offices across the United States and the Membership Application Program. Mr. Rufino began his regulatory career in 1988 at the New York Stock Exchange. He has been with FINRA since its creation in 2007. Prior to serving in his current capacity, Mr. Rufino was the Chief Operating Officer in Member Regulation—Sales Practice. He has been involved in various industry initiatives throughout his career in regulation. In addition, Mr. Rufino is a representative on FINRA’s Compliance Advisory Committee. He has also served as a member of the Securities
Industry Continuing Education (CE) Council, assisted in the creation of Electronic Communications Guidance to the industry and served as a member of the Social Networking Task Force. In addition, he participated in the Financial Action Task Force’s (FATF) initiative to create guidance on the risk-based approach to the prevention of money laundering and terrorist financing as well as the FATF Typology on the Securities Industry. He previously served as FINRA’s representative on International Organization of Securities Commissions’ (IOSCO) Committee 3 on Intermediaries. Mr. Rufino graduated magna cum laude from Iona College with a degree in finance, and received his MBA with honors in management information systems from Iona.

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Ask FINRA Staff
Panelists

Moderator:
• Chip Jones, Senior Vice President, FINRA Member Relations and Education

Panelists:
• J. Bradley Bennett, Executive Vice President, FINRA Enforcement
• Cameron Funkhouser, Executive Vice President, FINRA Office of Fraud Detection and Market Intelligence
• Jeffrey Pasquerella, Senior Vice President and Regional Director, FINRA South Region
• Michael Rufino, Executive Vice President, FINRA Member Regulation, Sales Practice
South Region Compliance Seminar
New Orleans, LA | December 2 – 3, 2015

Senior Investors: Protecting and Understanding Their Needs
Thursday, December 3
8:30 a.m. – 9:30 a.m.

In response to the rapid and continued growth of the senior population in the United States, this session provides an important opportunity for participants to learn about and discuss special considerations and practices for seniors. Join FINRA staff and industry panelists as they discuss possible solutions to help protect our senior investors from exploitation and fraudulent practices.

Moderator:  
Yvette Panetta  
Deputy District Director  
FINRA Boca Raton District Office

Panelists:  
Susan Hechtlinger  
Chief Compliance Officer  
SunTrust Investment Services, Inc.

Gary Klein  
Chief Regulatory Officer  
Raymond James & Associates, Inc.

Robert Mascio  
Manager  
FINRA Boca Raton District Office
Senior Investors: Protecting and Understanding Their Needs Panelist Bios:

Moderator:

**Yvette Q. Panetta** is the Deputy Director in FINRA's Florida District Office located in Boca Raton, Florida where she is primarily responsible for the Member Regulation Examination Program and FINRA's Securities Helpline for Seniors. Ms. Panetta responsibilities include managing the Sales Practice Examination Program, the Cause Examination Program, and the Surveillance Program. She is also actively involved in several initiatives related to current industry topics. Prior to joining FINRA, Ms. Panetta served as an examination manager with the U.S. Securities and Exchange Commission’s Office of Compliance Inspections and Examinations located in New York. Ms. Panetta received her undergraduate and graduate degrees from Baruch College, The City University of New York where she graduated with honors. Ms. Panetta also holds the title of Certified Public Accountant from the American Institute of Certified Public Accountants.

Panelists:

**Susan Hechtlinger** is the Senior Vice President, Private Wealth Management Operational Risk and Compliance Officer for SunTrust Bank and the Chief Compliance Officer for SunTrust Investment Services, Inc. Ms. Hechtlinger has leadership responsibility for SunTrust Investment Services, Domestic Wealth Management, International Wealth Management, Sports and Entertainment, Investment Advisory Group, Institutional Investment Solution, GenSpring Family Office, and SunTrust Investment Services Inc. She is based in Atlanta. Ms. Hechtlinger joined SunTrust in 2008, as Chief Compliance Officer of STIS, and took on her current role in PWM in October 2012. Ms. Hechtlinger has more than 25 years of experience, including 14 years as a regulator working for FINRA in various roles, including Deputy Director for their New York office, and 10 years at Bank of America (and their predecessor NationsBank) in various compliance and risk positions and as CCO for their retail broker-dealer for eight years. She maintains her series 4, 7, 24, 27 and 66 FINRA registrations and holds Six Sigma Greenbelt Certification. Ms. Hechtlinger earned her bachelor's degree in finance from Northeastern University and master's degree in business administration from Rutgers University.

**Gary Klein** has more than 28 years of regulatory, compliance and litigation experience. Mr. Klein joined RJ in September 2014 as the firm’s Chief Regulatory Officer, where he oversees, among other responsibilities, the Dispute Resolution and Regulatory Affairs Groups for RJA and RJFS. Before joining RJ, he was General Counsel for NEXT Financial Group and its affiliated companies in Houston, Texas, Deputy General Counsel at LPL Financial in Boston MA, where he created LPL's Regulatory Group and directed its regulatory program. In addition, Mr. Klein has twice served as Branch Chief for the United States Securities and Exchange Commission in Miami, FL, first in the Enforcement Division, and later in the Office of Compliance Inspections and Examinations. Earlier in his career, Mr. Klein maintained his own private practice, served as Deputy General Counsel to a boutique Wall Street broker-dealer, worked in-house for Prudential Securities Incorporated as Vice President, Associate General Counsel, and began his legal career as an Assistant District Attorney in Bronx, New York.

**Rob Mascio** has been with FINRA for ten years and is currently the Manager for the FINRA Security Helpline for Seniors – HELPS™. Launched in April 2015, the FINRA Securities Helpline for Seniors™ is designed to provide senior investors with a supportive place to raise issues and get assistance from knowledgeable FINRA staff members relating to concerns they have with their brokerage accounts and investments. Before assuming the role of Manager for the Helpline, he was an Examination Manager with the Florida District Office. Prior to moving to the Florida District Office, Mr. Mascio worked in FINRA’s Market Regulation department where he focused on reviews and investigations of market irregularities and manipulations within the fixed income, equity, and derivatives markets. Mr. Mascio obtained his undergraduate degree from Salisbury University and his MBA from Florida State University.
Senior Investors: Protecting and Understanding Their Needs
Panelists

Moderator:
• Yvette Panetta, Deputy District Director, FINRA Boca Raton District Office

Panelists:
• Susan Hechtlinger, Chief Compliance Officer, SunTrust Investment Services, Inc.
• Gary Klein, Chief Regulatory Officer, Raymond James & Associates, Inc.
• Robert Mascio, Manager, FINRA Boca Raton District Office
Question #1

Do you have a grandparent alive?

- Yes
- No
Question #2

- Do you have a parent that is alive?
  - Yes
  - No
Question #3

Do you know where your grandparents/parents assets are held?

- Yes
- No
<table>
<thead>
<tr>
<th>Question #4</th>
</tr>
</thead>
</table>

- Do you know if your grandparents/parents have an established POA or if they have selected anyone to act on their behalf?
  - Yes
  - No
Question #5

Do you worry about your grandparents/parents but feel unable to pry into their finances?

• Yes
• No
Effective Steps to Combat Money Laundering
Thursday, December 3
9:45 a.m. – 10:45 a.m.

Join industry practitioners and FINRA staff as they discuss money laundering risks and vulnerabilities, including bank-like activity, direct market access from high-risk jurisdictions, micro-cap securities, and suspicious activity reporting obligations and expectations. FINRA staff will also discuss current trends in AML and the Office of Foreign Assets Control (OFAC) enforcement actions.

Moderator: Jason Foye
Examination Manager
FINRA AML Investigative Unit

Panelists: Edward Balsmann
Chief Compliance Officer
Tudor, Pickering, Holt & Co., LLC

Jeffrey Horowitz
Managing Director and Chief Compliance Officer
Pershing, LLC

Alistair Johnston
Surveillance Director
FINRA New Orleans District Office
Effective Steps to Combat Money Laundering Panelist Bios:

Moderator:

Jason Foye is an examination manager in FINRA's Anti-Money Laundering Investigations Unit (AMLIU). He manages a team of seven examiners located throughout the country, and has responsibility for managing AML-related examinations conducted by the AMLIU and consulting with other FINRA staff on AML issues. In addition to his exam-related responsibilities, Mr. Foye provides training to district staff on trends and best practices, including analytical techniques used by AMLIU staff during examinations. Mr. Foye has been with FINRA for seven years and worked as an examiner in both the Florida District and AMLIU. Jason is both a Certified Anti-Money Laundering Specialist (CAMS) and a Certified Fraud Examiner (CFE).

Panelists:

Ed Balsmann serves as the Chief Compliance Officer for the Tudor, Pickering, Holt & Co. family of companies, which include two institutional broker-dealers, a registered investment adviser and affiliated companies in the United Kingdom and Canada. Mr. Balsmann has over sixteen years of experience working for and with financial services firms, including institutional and retail broker/dealers, registered investment advisers, banks, private equity firms and private fund advisers. He joined Tudor, Pickering, Holt & Co. in August of 2010 and is currently a member of the FINRA District 6 Committee. Mr. Balsmann previously served as the general counsel and chief compliance officer at CSG Holdings, LLC in Memphis, Tennessee. Prior to that, he was an attorney with Baker, Donelson, Bearman, Caldwell & Berkowitz, PC in Memphis, Tennessee where he specialized in broker-dealer, investment adviser and investment company matters. From 2000 through 2004, he served as compliance attorney for the Equity Capital Markets division at Morgan Keegan in Memphis, Tennessee and eventually went on to serve as deputy general counsel of regulatory affairs at the firm. He holds a BSBA in finance from Southeast Missouri State University and a JD from the University of Mississippi, School of Law.

Jeff Horowitz is a Managing Director and Chief Compliance Officer for Pershing LLC a BNY Mellon company. Mr. Horowitz previously served as the Chief Anti-Money Laundering (AML) and OFAC Officer for Pershing, where he was responsible for the development and implementation of the firm’s global AML Program across the Pershing enterprise. Mr. Horowitz has represented Pershing as a securities industry representative to the U.S. Treasury Department’s Bank Secrecy Act Advisory Group (BSAAG) and was also a past co-chair of the Securities Industry and Financial Markets Association (SIFMA) Anti-Money Laundering Committee. He has also served as the BSAAG co-chair of the Securities and Futures Subcommittee. Mr. Horowitz is an active member of the International Council of Securities Association group on AML and the Foreign Account Tax Compliance Act (FATCA) and serves on the Florida International Bankers Association AML Compliance Conference Advisory Committee as well as the Association of Certified Anti-Money Laundering Specialists Annual AML & Financial Crime Conference Task Force. Mr. Horowitz currently represents Pershing on SIFMA’s Compliance and Regulatory Policy Committee. Prior to joining Pershing, Mr. Horowitz was a Director and Head of AML Compliance for Citigroup’s Corporate and Investment Banking Division in North America. His responsibilities included the Institutional Sales and Trading Departments of Citigroup Global Markets Inc., Investment Banking, Global Relationship Banking and Global Transaction Services. Prior to joining Citigroup, Mr. Horowitz held several senior compliance roles at Lehman Brothers, Goldman Sachs and Salomon Brothers Inc. He began his career at the Federal Deposit Insurance Corporation (FDIC) in the Division of Resolutions. Mr. Horowitz earned a Bachelor of Science degree in Economics from Trenton State College. He has also completed the Securities Industry Institute® program, sponsored by the Securities Industry and Financial Markets Association, at the Wharton School of the University of Pennsylvania.

Alistair E. Johnson, Surveillance Director in FINRA’s New Orleans District Office, manages Regulatory Coordinator staff responsible for the ongoing financial monitoring, sales practice surveillance and examination planning for member firms in the New Orleans District. Prior to becoming Surveillance Director, she was a Senior Regulatory Specialist in FINRA’s Regulatory Programs Group working on the development and support of FINRA’s National Examination Program. This included authoring and approving examination policies and procedures on a variety of topics. She also serves as an Anti-Money Laundering Regulatory Specialist and has been involved in most aspects of interpretation and enforcement of FINRA and federal AML rules. She has designed and conducted AML training for both FINRA staff and the financial services industry. She is also a frequent speaker on the topic of AML. Prior to joining Regulatory Programs in 2006, she was a Special
Investigator in the New Orleans District Office since 1999, conducting cycle, sweep and cause examinations. Ms. Johnson received her B.A. degree from Tulane University in New Orleans. She is also a designated Certified Regulatory and Compliance Professional™ (CRCP™) and Certified Anti-Money Laundering Specialist (CAMS).
Effective Steps to Combat Money Laundering
Panelists

Moderator:

• Jason Foye, Examination Manager, FINRA AML Investigative Unit

Panelists:

• Edward Balsmann, Chief Compliance Officer, Tudor, Pickering, Holt & Co., LLC

• Jeffrey Horowitz, Managing Director and Chief Compliance Officer, Pershing, LLC

• Alistair Johnston, Surveillance Director, FINRA New Orleans District Office
South Region Compliance Seminar
New Orleans, LA | December 2 – 3, 2015

Tips and Considerations for Supervising Independent Contractors
Thursday, December 3
9:45 a.m. – 10:45 a.m.

This panel of FINRA staff and industry members addresses common challenges in supervising independent contractors, including issues related to consolidated account reports and compensation arrangements. The session offers examples and suggestions for firms to use in their everyday supervision and compliance efforts. The panel also discusses existing rules and related guidance, and shares effective industry practices.

Moderator: Brooks Brown
Associate District Director
FINRA Atlanta District Office

Panelists:
Walter Butler
Vice President of Field Supervision
FSC Securities Corporation

Daniel Gibbons
Principal Examiner
FINRA New Orleans District Office

Ron Klimas
Senior Vice President, Director of Compliance
Securities Service Network, Inc.
Tips and Considerations for Supervising Independent Contractors Panelist Bios:

Moderator:

**Brooks Brown** joined FINRA’s New Orleans District Office in 2001, and then transferred to FINRA’s Atlanta District Office in 2006. Since April 2011, Mr. Brown has supervised five staff members who conduct routine examinations to review for compliance with FINRA and SEC rules. Prior to joining FINRA, Mr. Brown worked with Trustmark National Bank in Jackson, Mississippi, from 1999 to 2001 as an equity analyst in Trustmark’s Trust Department. He earned the Certified Regulatory and Compliance Professional designation from the Wharton School in 2013. Mr. Brown is a graduate of Millsaps College in Jackson, Mississippi, and he also earned an M.B.A from Millsaps College’s Else School of Management.

Panelists:

**Walter M. Butler** is the Vice President of Field Supervision for FSC Securities Corporation, where he is responsible for overseeing the supervisory functions of FSC. He has over 30 years of industry experience and previously served as Vice President and Product Manager of Commercial Paper Operations at First Trust of New York and BankAmerica National Trust Company. He also served as an Assistant Vice President and Operations Manager for the Reliance Trust Company. Reporting to Mr. Butler are FSCs Supervision Regional Vice Presidents, Regional Supervision Directors and Regional Supervision Managers, who serve as the First Line Supervisors of the OSJ Managers, who monitor the quality of supervision of the underlying producers. Mr. Butler currently holds FINRA Series 4, 7, 24, 53, and 66 licenses as well as Georgia, life, health, sickness and variable annuity insurance licenses.

**Daniel Gibbons** is a Principal Examiner located in the New Orleans District Office and has been employed with FINRA since 2000. As an Examiner, he has conducted numerous cycle, cause, and branch examinations of member firms. Mr. Gibbons is a FINRA Fixed Income Regulatory Specialist. He received his bachelor’s degree in business administration from Millsaps College.

**Ron Klimas** is Senior Vice President, Director of Compliance with Securities Service Network, Inc., a Knoxville, TN-based independent contractor broker-dealer with approximately 400 producing registered representatives. He has been the head of compliance at SSN since 1998. Mr. Klimas graduated from Widener University School of Law in 1992 and is a member of the Florida Bar Association. He initially started in the industry as a retail broker but quickly moved onto compliance. In the early part of his career, he worked as compliance examiner with INVEST Financial Corporation, and also served as in-house counsel for InterSecurities, Inc. and Western Reserve Life. Mr. Klimas’ registrations include Series 4, 7, 24, 63 and 65.
Tips and Considerations for Supervising Independent Contractor
Panelists

Moderator:
- Brooks Brown, Associate Director, FINRA Atlanta District Office

Panelists:
- Walter Butler, Vice President of Field Supervision, FSC Securities Corporation
- Daniel Gibbons, Principal Examiner, FINRA New Orleans District Office
- Ron Klimas, Senior Vice President and Director of Compliance, Securities Service Network, Inc.
Agenda

- Introduction
- Tips and Considerations for Supervising:
  - Consolidated Account Reporting
    - Risks and best practices
  - Outside Business Activities / Private Securities Transactions
    - Activities that pose unique challenges and risks
  - Cybersecurity
    - Risks and best practices
- Q&A
# Consolidated Account Reports ("CARs")

- Why are CARs relevant and important to IC firms?
- Effective supervisory practices:
  - Scope of activity permitted
  - Due diligence
  - Systems and processes
- Notable regulatory findings:
  - Fraud
  - Supervision
- Regulatory Notice 10-19
Why are OBAs and PSTs relevant and important to IC firms?

Activities that pose unique challenges to IC firms, and how to tailor supervision in order to identify risks and red flags:

- Non-affiliated individuals
- Attorney/client privilege or other restrictions

Notable regulatory findings:

- Branch inspections
- Conflicts of interest
Cybersecurity

- Why is cybersecurity relevant and important to IC firms?
- Effective supervisory practices:
  - Due diligence
  - Branch inspections
  - Training
- Notable regulatory findings:
  - Third party money movements
  - Data encryption
  - Supervisory controls
Questions and Answers

- Questions
Variable Annuities Procedures Practices and Findings
Thursday, December 3
9:45 a.m. – 10:45 a.m.

This session covers suitability and supervision considerations for variable annuities. Industry panelists discuss monitoring, use of exception reports and effective practices for training registered representatives on variable annuities. FINRA staff highlight areas of focus for examiners and recent examination deficiencies related to the sale of variable annuities.

**Moderator:**
Neivon Morantez  
Principal Examiner  
FINRA New Orleans District Office

**Panelists:**
Mitchell Atkins  
Founder and Principal  
FirstMark Regulatory Solutions, Inc.

Penelope Blackwell  
Deputy Regional Chief Counsel  
FINRA Enforcement

Ronald King  
Chief Compliance Officer  
Capital Investment Brokerage, Inc.

Julie Preuitt  
Assistant Regional Director, Fort Worth Regional Office  
U.S. Securities and Exchange Commission
Variable Annuities Procedures Practices and Findings Panelist Bios:

Moderator:

**Neivon Morantez** is a Principal Examiner located in the FINRA New Orleans District Office. He joined NASD / FINRA in 1998. During his 17 years with the New Orleans Office, Mr. Morantez has participated in many high profile cycle, cause and special initiative examinations, a number of which involved variable annuities. Mr. Morantez received a bachelor’s degree in finance from Auburn University.

Panelists:

**Mitchell Atkins** is Founder and Principal of FirstMark Regulatory Solutions, Inc., based in Fort Lauderdale, Florida. His focus is complex problem solving for FINRA broker-dealers and registered investment advisers. His recent compliance focuses include cybersecurity compliance, FINRA membership applications, non-traded REIT and variable annuity compliance, and anti-money laundering. Mr. Atkins has 20 years of experience in various roles at FINRA (previously NASD), most recently as Senior Vice President and Regional Director, with overall responsibility for four districts comprising FINRA’s South Region (home to 850 brokerage firms). He oversaw the region’s routine inspection program, sales practice special investigations, financial surveillance and membership application programs. Mr. Atkins oversaw the development of innovative initiatives such as the National Anti-Money Laundering Investigative Unit in 2012. Mr. Atkins oversaw the successful startup of the Florida District Office of FINRA in 2005. Mr. Atkins frequently addresses financial services industry groups. He is a Certified Regulatory and Compliance Professional through the FINRA Institute at Wharton. He is a graduate of Louisiana State University and a member of the Florida Securities Dealer’s Association and the SIFMA Compliance and Legal Society.

**Penelope Blackwell** is Deputy Regional Chief Counsel for FINRA Enforcement in Dallas, Texas. Prior to joining FINRA in 2014, Ms. Blackwell was a Shareholder in the law firm of Greenberg Traurig LLP. In private practice, Ms. Blackwell represented clients in all aspects of security litigation and regulatory proceedings. Ms. Blackwell graduated Order of the Coif from Louisiana State University Paul M. Herbert Law Center, and clerked for the Honorable Henry A. Politz, United States Court of Appeal for the Fifth Judicial Circuit.

**Ron King** is Chief Compliance Officer with the Capital Investment Companies. He has been with the firm since 2007 and in the financial securities industry since 1994. Ron is a graduate of The Southeastern Trust School of Campbell University and a 2006 graduate of the National Association of Insurance and Financial Advisors Leadership in Life Institute. Prior to joining Capital he served as an Investigator with the North Carolina Secretary of State Securities Division. He is married with one child and enjoys fly fishing, classic cars and photography.

**Julie Preuitt** is an Assistant Regional Director in the Commissions Fort Worth Regional Office. She joined the Commission in 1992 as an examiner. Prior to her current position, Ms. Preuitt served as a Branch Chief for five years. Her current responsibilities include overseeing broker-dealer, transfer agent, and municipal advisor examinations for a three state area; Texas, Oklahoma and Arkansas. Ms. Preuitt graduated cum laude with a BA from the University of Maryland University College in Okinawa, Japan.
Variable Annuities Procedures Practices and Findings
Panelists

Moderator:
• Neivon Morantez, Principal Examiner, FINRA New Orleans District Office

Panelists:
• Mitchell Atkins, Founder and Principal, FirstMark Regulatory Solutions, Inc.
• Penny Blackwell, Deputy Regional Chief Counsel, FINRA Enforcement
• Ronald King, Chief Compliance Officer, Capital Investment Brokerage, Inc.
• Julie Preuitt, Assistant Regional Director, U.S Securities and Exchange Commission
FINRA Exam Findings

FINRA

• 2015 Exam Findings
  – Supervisory Deficiencies
    ▪ Multiclass Variable Annuities
      > Supervisory Deficiencies/WSPs
      > Disclosures
      > Exception Reports
      > Training
    ▪ Exchange Transactions
      > Compliance with rule 2330 (d)
      > Manual Systems vs Automated Monitoring
FINRA Exam Findings

FINRA

• 2015 Exam Findings – continued
  – Suitability Concerns
    ▪ Rider Compatibility
      > Share Class
      > Time Horizon

• Formal Actions vs. Informal Actions
  – What Factors Are Considered?
  – When Are Suitability Charges Considered?
SEC – Exam Findings

- SEC
  - VA Focus Areas for Policy Divisions
  - Typical Enforcement/Examination Findings
  - Rollover Issues
Creating Effective Compliance Programs
Covering Variable Annuity Share Classes

FINRA South Region Compliance Seminar
New Orleans, Louisiana
December 2015
Creating Effective Variable Annuity Share Class Compliance Programs.

Assessing / Vetting / Implementing

Stage 1: Evaluate Current State - Due Diligence / Procedures / Products

Stage 2: Conduct Gap Analysis - Existing Guidance vs. Current Processes

Stage 3: Discuss Potential Changes with Key Stakeholders - Gather Input on Sound Processes

Stage 4: Prepare and Implement Updated Processes and Procedures

Stage 1

Current State

- Review current written supervisory procedures to determine if VA share classes are discussed / discussion is adequate.
- Review existing key documents and forms
- Review product due diligence process for vetting products and variations on products
- Review sample of transactions

Stage 2

Gap Analysis

- Gather information on existing guidance and FINRA/SEC cases
- Gather information from VA companies
- Review media articles
- Peer discussions
- Compare existing processes, procedures, and forms to information gathered

Stage 3

Gather Input

- Discuss processes with due diligence principal / identification of variations
- Forms changes - new accounts principal(s)
- Product vendors - rider limitations –rider criteria
- Recommended WSP changes with CCO / other constituents
- Advertising principal / email

Stage 4

Implementation

- Present draft WSP amendments for approval
- Revise Forms and Disclosures
- Conduct training for appropriate personnel
- Conduct follow-up testing and verification that new procedures are being effectively implemented
Key Aspects of Compliance – VA Share Classes

Objective: To ensure that new and existing products are sold in a compliant manner by approaching from several business and compliance angles.

- **Written Procedures and Supervision (FINRA Rule 3110)**
  
  “Reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA Rules.”

  - **Due diligence** process and resulting actions
  - **Input of various departments** (e.g., compliance, operations, sales and marketing)
  - **Suitability of recommendations** – circumstances under which various share classes and riders are and are not appropriate (time horizon, liquidity needs, reason for selecting share class and riders) – *NASD Notice 99-35 “+”*
  - **Complaint handling** – patterns of complaints in share classes or riders
  - **Documentation** maintained about rationales – these are complex products
    - Representative notes – critically important to document rationale for purchase
    - Product comparison in exchange transactions w/ rationales for exchange and fee disclosure
    - Design forms to include rationales and disclosures as appropriate
Key Aspects of Compliance, Cont.

• **Written Procedures and Supervision (Continued)**

  – **Evidence of suitability review** of recommendations (product level, sub-account level, share class level, riders)
  – **Red flags** (e.g., rep only sells one share class, long term riders w/ short term shares, clients with no need for income, long term horizons, etc.) – automated surveillance reports helpful
  – **Continuing Education** Training Plan / Needs Analysis
  – **Communication guidelines** regarding riders and share classes
  – **Conflicts mitigation** – whether compensation structure creates conflicts and how the firm mitigates
  – **Testing** – a system to periodically test and verify whether the procedures and controls in this area are adequate – FINRA Rule 3120
  – **Branch audits** might include a review of share class suitability as appropriate
  – **Use of forms and disclosures** with client purchases
  – **Records and Blotters** or other methods of identifying and reviewing share class recommendations
  – **Hiring** – review of representative’s activity in on-boarding process / follow-up
Key Aspects of Compliance, Cont.

- **New Product Due Diligence** *(NASD Notice to Members 05-26)*
  - **Product Variations** - New share classes and riders (or changes to existing)

- **Training**
  - **Representatives and Supervisors**
  - **New product features**: share classes, fees related to each class, suitability profile for each share class, variance in surrender period and charges
  - **Optional features**: riders, including charges and features
  - **Examples** of client profiles for which specific share classes may and may not be suitable

- **Forms and Disclosures**
  - **New account form** / VA purchase form prompts for share class and rider selection, along with rationale
  - **Client share class and rider disclosure** (often client signs – may be part of new account form)
  - **Clear disclosure of fees** (including M&E and surrender charges) associated with the share class
  - **User friendly** – blocks certain riders with incompatible share classes, or requires special disclosure to client

- **Communications with the Public**
  - **Retail Communications** – Ensure that principals reviewing communications are trained in features of VA products being sold, including share classes and riders; review for proper characterization in communications
  - **Electronic communications** – consider updating flagging keywords to include triggers related to riders and share classes. Ensure those reviewing electronic communications are trained in share class issues
Capital Investment Group

- CIG’s Process and Procedures
Cybersecurity: Understanding the Exposure
Thursday, December 3
11:00 a.m. – 12:00 p.m.

This session provides an overview of the latest cybersecurity threats firms’ face and provides preventative measures firms can take to protect their business. Industry panelists and FINRA staff share effective practices to develop a cyber-risk program and steps to take to address cyber weaknesses. Panelists discuss real-life examples of cyber breaches and lessons learned from them.

Moderator:  
David Kelley  
Surveillance Director  
FINRA Kansas City District Office

Panelists:  
Mark Grosvenor  
Chief Technology Officer  
NFP Securities, Inc.

Christopher Longobucco  
Regulatory Principal, Technology Control  
FINRA Chicago District Office

Thomas Shaw  
Vice President – Enterprise Financial Crimes Management  
USAA
Cybersecurity: Understanding the Exposure Panelist Bios:

Moderator:

Dave Kelley is the Surveillance Director based out of their Kansas City District office, and has been with FINRA for more than five years. Mr. Kelley also leads FINRA’s Regulatory Specialist team for Cyber Security, IT Controls and Privacy. Prior to joining FINRA, he worked for more than 19 years at American Century Investments in various positions, including Chief Privacy Officer, Director of IT Audit and Director of Electronic Commerce Controls. He led the development of website controls, including customer application security, ethical hacking programs and application controls. Mr. Kelley is a CPA and Certified Internal Auditor, and previously held the Series 7 and 24 licenses.

Panelists:

Mark Grosvenor joined NFP in January 2006 as Senior Vice President and advanced into his current role as Chief Technology Officer. Prior to joining NFP, he served as Vice President of Professional Services and Support at ResolutionEBS and Program Manager and Regional Delivery Lead at GTECH. Mr. Grosvenor holds a B.A. in Operations Management and Management Information Systems from Texas A&M University.

Chris Longobucco is presently Regulatory Principal, Technology Control from the FINRA Chicago District office where he is a member of a team of Technology professionals responsible for the continued development and implementation of the firm’s Cybersecurity exam program over member firms. Mr. Longobucco has over twenty years of experience working with global financial service companies on Wall Street as a strategic business leader with a broad range of skills in Technology Operations, Governance, Risk, and Finance. While working in the financial services sector, he provided the strategic direction in leading large Technology and Finance operations’ groups in delivering complex projects for global financial organizations; Investment Banking, Private Banking, Asset Management, Credit, Risk/Compliance, and Commodities. While in leading Technology positions he worked closely with the firm’s regulators domestically and abroad. Prior to joining FINRA, he was with Morgan Stanley, as their Chief Operating Officer and Business Manager for their global Technology Risk and Enterprise Data Security organizations. Mr. Longobucco was responsible for developing and implementing best practices relating to operational and technology risk controls enterprise wide. Also, he spent a considerable amount of time leading the New York Mercantile Exchange’s Technology operations group, and assisting the Exchange in going public in 2006, and instrumental in leading the development and implementation of three new exchanges, in Dubai, Dublin, and London. From 2009 to 2010, Mr. Longobucco worked with the company’s newly merged entity, the Chicago Mercantile Exchange and was an integral participant in leading the integration of the two entity’s systems operations and implementing an enterprise Technology governance program. Other financial firm experience was with Deutsche Bank and American Express where he lead enterprise wide re-organizations of the both the firm’s Technology and IT Finance groups. Mr. Longobucco began his career with Arthur Andersen. Mr. Longobucco holds an undergraduate degree in Accounting and a master degree in Finance from Southern Methodist University.

Tom Shaw, Vice President of Enterprise Financial Crimes Management for USAA, has overall responsibility for fraud prevention, detection, recovery and investigations. He is also the Identity Theft Officer for USAA. Mr. Shaw has over 25 years’ experience in the financial services industry with 16 years of this time at Bank of America. He currently serves as Chairman of the Board for the Association of Certified Fraud Examiner’s Financial Foundation. He is a member of the MasterCard US Fraud Advisory Council and a member of the Visa North America Risk Executive Council. Mr. Shaw is a Certified Fraud Examiner (CFE) and a Certified Anti-Money Laundering Specialist (CAMS). He earned his MBA from Our Lady of the Lake University and his BS in International Economics from Texas Tech University.
Cybersecurity: Understanding the Exposure
Panelists

Moderator:
• David Kelley, Surveillance Director, FINRA Kansas City District Office

Panelists:
• Mark Grosvenor, Chief Technology Officer, NFP Securities, Inc.
• Christopher Longobucco, Regulatory Principal, Technology Control, FINRA Chicago District Office
• Thomas Shaw, Vice President – Enterprise Financial Crimes Management, USAA
Outline

- FINRA’s Definition of Cybersecurity
- Governance
- Risk Assessment
- Access Control
- Vendor Management
- Incident Response Plan
- Training
- Branch Controls
- Technical Measures
- Information Sharing
What do we mean by “Cybersecurity”?

In broad terms we mean the protection of investor and firm information from compromise through the use – in whole or in part – of electronic media (e.g., computers, cell phones, IP-based telephony systems).

- “Compromise” refers to a loss of data confidentiality, integrity or availability
- Protection of customer information and PII (Personal Identifiable Information)
- Protection of firm confidential information
Governance

- Principle: Firms should establish Information Security governance frameworks that support informed decision-making and escalation at appropriate levels within the organization. This would include:
  - Active senior management and, as appropriate, board level oversight of cybersecurity
  - Articulated risk appetite that guides firm decision-making with respect to the acceptance, mitigation, avoidance or transfer of risks
  - Defined accountabilities, structures, policies and procedures to support decision-making based on risk appetite and industry effective practices
  - Use of appropriate metrics and thresholds
Risk Assessment

- Principle: Firms should conduct regular risk assessments to identify vulnerabilities and prioritize risk remediation activities.
  - **What is a risk assessment?**
    - As defined by the International Organization for Standardization (ISO), risk assessment is a systematic approach to estimating the magnitude of risks (risk analysis) and comparing risk to risk criteria (risk evaluation). It is an ongoing process, not a single point-in-time review.
  - **Scope of a risk assessment**
    - Critical asset inventory
    - Threat evaluation – both external and internal
    - Vulnerability assessment of assets
    - Risk evaluation and prioritization – governance
    - Technical Controls
    - Vendors and their Affiliates
Access Control

- Principle: Physical and logical – Access to assets and associated facilities is limited to authorized users, processes, or devices, and to authorized activities and transactions.
  - Access permissions are managed, incorporating the principles of least privilege and separation of duties
  - Identities and credentials are managed for authorized devices and users
  - Physical access to assets is managed and protected
  - Remote access is managed
  - Password rules are appropriate
Vendor Management

**Principle:** Firms should address cybersecurity risks that arise from vendor relationships.

- Vendor management should cover the lifecycle of the relationship, from initiation through termination, and should be risk-based, i.e., there is greater due diligence and oversight on vendors who have access to sensitive data or processes.
- Appropriate initial and ongoing due diligence
- Incorporation of appropriate contractual requirements
- Include vendors and vendor systems as part of the overall risk assessment process
- Cloud Computing applications – understanding segregation of data and controls around access
- Firms should conduct ongoing vendor re-assessments
Incident/Breach Response Planning

- Principle: Firms should develop plans to respond to cybersecurity incidents. Key elements include:
  - Event/Alert Management
  - Established policies and procedures – as well as roles and responsibilities – for escalating cybersecurity incidents
  - Media
  - Prepared communications plan for outreach to relevant stakeholders, e.g., customers, regulators, industry information-sharing bodies, law enforcement, and intelligence agencies, as appropriate
  - External Sources
  - Involvement in industry-wide exercises as appropriate to the role and scale of a firm’s business in the securities markets, e.g. BCP/DR
  - Testing of the Plan
Training

- Principle: Firms should provide cybersecurity training to their staff and provide additional training based on staff’s role.
  - Appropriate types of training are driven by:
    - Staffs’ functional responsibilities:
    - Training on fraudulent money transfer schemes for account reps
    - Training on secure coding practices for developers
    - Firm’s experience with cybersecurity incidents, such as loss incidents
    - Risk assessment
    - Awareness and intelligence about threats firm may face
    - In addition, firms should also consider providing resources to customers that will help them enhance their own cybersecurity practices
Firms with an Independent Contractor branch model may have more risk due to the nature of the branch technology infrastructure. Control Areas would include:

- The use of passwords
- Physical security of assets and data
- Encryption of computers
- Use and storage of email
- Transmission of data
- Incident reporting of lost or stolen data and hardware
- Patch and virus protection processes
- Firm branch exams
- RR training and certification
## Technical Measures

There are a number of technical measures firms take to enhance their cybersecurity controls.

<table>
<thead>
<tr>
<th>Anti-virus software</th>
<th>Anti-malware software</th>
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<tbody>
<tr>
<td>Application firewalls</td>
<td>Identity, access and privilege management</td>
</tr>
<tr>
<td>Data encryption</td>
<td>DDOS tools</td>
</tr>
<tr>
<td>Patch and software updates</td>
<td>Email content filtering</td>
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<tr>
<td>Web/URL filtering</td>
<td>Use of removable media</td>
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<tr>
<td>Penetration (PIN) testing</td>
<td>WiFi protection</td>
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<tr>
<td>BYOD</td>
<td>Online Access Management</td>
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</tbody>
</table>
Information Sharing

- Principle: Firms should monitor the cybersecurity landscape and use information about current and evolving threats to enhance their ability to protect customer and firm information.
  - Information sharing can help firms prevent incidents or respond to incidents more quickly and can help protect the industry as a whole
  - A firm’s infrastructure in this area should be scaled to the size of the firm and its degree of exposure to cybersecurity threats
  - Firms should participate in industry information-sharing bodies such as the FS-ISAC, NCFTA, 3rd Party Security Vendors and local law enforcement authorities
Supplemental Guidance

- FFIEC cybersecurity resources for banking organizations: [www.ffcic.gov/cybersecurity.htm](http://www.ffcic.gov/cybersecurity.htm) AND [www.ffcic.gov/cybersecurity.htm](http://www.ffcic.gov/cybersecurity.htm)
- [www.sec.gov/rules/final/34-42974.htm](http://www.sec.gov/rules/final/34-42974.htm)
- [www.sec.gov/rules/final/34-44992.htm](http://www.sec.gov/rules/final/34-44992.htm)
- [www.fsisc.com/](http://www.fsisc.com/)
- [www.ncfta.net/](http://www.ncfta.net/)
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Resources

FINRA Resources

- FINRA Report on Cybersecurity
  

SEC Resources

- Identity Theft Red Flags Rules (April 2013)
  

  
  [www.sec.gov/rules/final/34-44992.htm](http://www.sec.gov/rules/final/34-44992.htm)

- Privacy of Consumer Financial Information (Regulation S-P) (November 2000)
  

Federal Financial Institutions Examination Council (FFIEC) Cybersecurity Resources

- Cybersecurity Awareness
  
  [www.ffciec.gov/cybersecurity.htm](http://www.ffciec.gov/cybersecurity.htm)

NIST Resources

- Cybersecurity Framework
  
National Conference of State Legislatures Resources

- State Laws Related to Internet Privacy
  

- Security Breach Notification Laws
  

SIFMA Resources

- Cybersecurity Resource Center
  
  www.sifma.org/issues/operations-and-technology/cybersecurity/overview/

Information Systems Audit and Control Association

- COBIT 5 Framework
  

International Organization for Standardization

- ISO/IEC 27001 - Information Security Management
  
  www.iso.org/iso/home/standards/management-standards/iso27001.htm

Financial Services Information Sharing and Analysis Center

- FSISAC main webpage
  
  www.fsisac.com/

National Cyber-Forensics & Training Alliance

- Cracking Down on Cyber Crime
  
  www.ncfta.net/