



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.

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December 2-3, 2015 | New Orleans, LA

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 \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

Red Flags

- 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

FINRA Branch Examinations

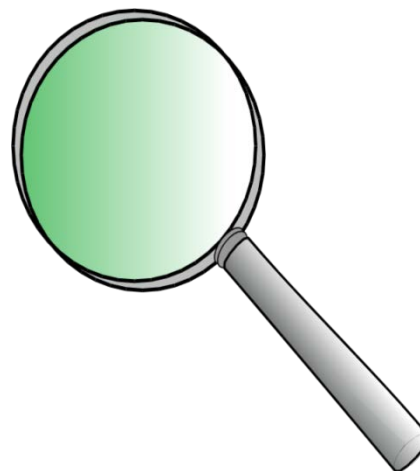
■ Common Review Methods

- 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



Regulatory Notice

15-05

Background Checks

SEC Approves Consolidated FINRA Rule Regarding Background Checks on Registration Applicants

Effective Date of FINRA Rule 3110(e): July 1, 2015

Effective Date of FINRA Rule 3110.15: April 24, 2014, to December 1, 2015

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.atabaki@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.ditrapani@finra.org.

March 2015

Notice Type

- Consolidated Rulebook
- New Rule

Suggested Routing

- Compliance
- Human Resources
- Legal
- Operations
- Registration
- Risk
- Senior Management
- Training

Key Topics

- Background Checks
- Bankruptcies
- BrokerCheck®
- Central Registration Depository
- Criminal Records
- Forms U4 and U5
- Judgments
- Liens
- Public Records

Referenced Rules & Notices

- FINRA Rules 3110(e) and 3110.15
- Information Notices 3/12/08 and 8/17/12
- MSRB Rule G-7
- NASD Rules 3010(e) and 3010(f)
- Notice to Members 05-39
- NYSE Rule 345.11
- NYSE Rule Interpretations 345.11/01 and /02
- Regulatory Notice 07-55
- SEA Rule 17f-2
- SEA Sections 3(a)(39), 15(b)(4) and 15(b)(11)



Financial Industry Regulatory Authority

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 disqualification⁶ 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.⁷

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.⁸ 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 U5,⁹ including any amendments, within 60 days of the filing date of the applicant's Form U4.¹⁰ If the firm is unable to review the Form U5, it has to demonstrate that it has made reasonable efforts to do so.¹¹ 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.¹² 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.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 search¹⁴ 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;¹⁵ (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),¹⁶ 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.¹⁷ 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

1. See Securities Exchange Act Release No. 73966 (December 30, 2014), 80 FR 546 (January 6, 2015) (Order Approving File No. SR-FINRA-2014-038).
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.
6. See Sections 3(a)(39) and 15(b)(4) of the Securities Exchange Act of 1934 (SEA).
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).

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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.

[(e)](f) 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.

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Regulatory Notice

14-10

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.¹ The new Rules 3110, 3120, 3150 and 3170 replace NASD Rules 3010, 3012 and 3110(i) and other corresponding NYSE rule provisions.² 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.³ 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.⁴

March 2014

Notice Type

- ▶ Consolidated Rulebook

Suggested Routing

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

Key Topics

- ▶ Communications
- ▶ Holding Customer Mail
- ▶ Supervision
- ▶ Supervisory Controls
- ▶ Taping Rule
- ▶ Transaction Review

Referenced Rules & Notices

- ▶ FINRA Rules 3110, 3120, 3150 and 3170
- ▶ NASD IM-1000-4
- ▶ NASD IM-3010-1
- ▶ NASD Rules 3010, 3012 and 3110
- ▶ NYSE Rules 342, Rule 342.21, 343, 351, 354, 401 and 401A
- ▶ NYSE Rule Interpretation 351(e)/01
- ▶ NTMs 99-45, 04-71, 05-44 and 99-92
- ▶ Regulatory Notices 07-53, 07-59, 08-24 and 10-57



Financial Industry Regulatory Authority

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.⁵

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

- ▶ the nature of activities at each location, including size and number of associated persons, scope of business activities, nature and complexity of products and services offered, volume of business done, the disciplinary history of persons assigned to such locations and any other indicators of irregularities or misconduct.

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.⁶ 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.⁷ 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.¹⁰ 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.¹¹

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.¹² 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.¹³ 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.¹⁹ 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).²⁰

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.²¹ 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.²² 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).²³ 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.²⁴

(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.²⁵ 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.²⁶

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.²⁷ 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.²⁸ 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.²⁹

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").³⁰ 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.³¹

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.³² 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,⁴² adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA),⁴³ 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).⁴⁴

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.⁴⁵ 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.⁴⁶ 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.⁴⁷

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.⁴⁸ 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.⁴⁹

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.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.

(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.⁵¹

(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 *Regulatory Notice* (or similar communication).

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."⁵²

Endnotes

1. See Securities Exchange Act Release No. 71179 (December 23, 2013), 78 FR 79542 (December 30, 2013) (Order Approving Proposed Rule Change as Modified by Amendment No. 1); File No. SR-FINRA-2013-025; see also [Regulatory Notice 08-24](#) (May 2008) (Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls).
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 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 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.

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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).
12. See [Regulatory Notice 07-59](#) (December 2007) (FINRA Provides Guidance Regarding the Review and Supervision of Electronic Communications).

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.*
15. *See* [Regulatory Notice 07-53](#) (November 2007) (Deferred Variable Annuities) (discussing use of automated supervisory systems).
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. 63260 (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).

22. FINRA Rule 3110(b)(6)(C)(ii)a.
23. FINRA Rule 3110(b)(6)(C)(ii)a.1 and .2.
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).
43. See Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.
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).
50. FINRA Rule 3110(d)(3)(A).
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).

Branch Office Inspections

FINRA and the SEC Issue Joint Guidance on Effective Policies and Procedures for Broker-Dealer Branch Inspections

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.

November 2011

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





National Examination Risk Alert

By the Office of Compliance Inspections and Examinations

in cooperation with the Financial Industry Regulatory Authority ¹

Information for Managers and Chief Compliance Officers

In this Alert:

Topic: Broker-dealer branch inspections

Objectives: Encourage firms to create effective policies and procedures for their branch inspections.

Key Takeaways:

A broker-dealer's branch inspection program is a key part of its supervisory system.

Exam staff have found a number of deficiencies in branch inspections conducted by firms.

This Risk Alert presents a joint report by OCIE staff and FINRA staff, highlighting a number of practices that examiners have observed that are found in effective branch office supervisory systems.

**Volume I, Issue 2
30, 2011**

November

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.

¹ 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.² 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.³ Those cases suggest that regular branch office inspections over reasonably short intervals, including unannounced inspections, are the cornerstone of a well designed branch office

² Staff Legal Bulletin No. 17, Remote Office Supervision (March 19, 2004) (“SLB 17”).

³ 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.⁴ The Commission has sanctioned firms that have not conducted unannounced examinations of their branch offices.⁵ 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.⁶ 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.⁷

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."⁸ 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.⁹ A broker-dealer's procedures should instruct the supervisor on the requirements needed to be in compliance with the regulations.¹⁰ The

⁴ See, e.g., *Consolidated Investment Services, Inc.*, Rel. No. 34-36687 (Jan. 5, 1996); *Signal Securities, Inc.*, Rel. No. 34-43350 (Sep. 26, 2000); *Quest Capital Strategies, Inc.*, Rel. No. 34-44935 (Oct. 15, 2001).

⁵ See, e.g., *Quest Capital Strategies, Inc.*, Rel. No. 34-44935 (Oct. 15, 2001) and *NYLIFE Securities Inc.*, Rel. No. 34-40459 (September 23, 1998) (settled matter).

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.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”)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.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.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.¹⁵

¹¹ *Id.*

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.

¹³ NASD Rule 3010(c)(1)(B).

¹⁴ 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:

- Safeguarding of customer funds and securities;
- Maintaining books and records;
- Supervision of customer accounts serviced by branch office managers;
- Transmittal of funds between customers and RRs and between customers and third parties;
- Validation of customer address changes; and
- Validation of changes in customer account information.

¹⁵ 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.

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.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.

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.

Regulatory Notice

10-19

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.

April 2010

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Operations
- Registered Representatives
- Senior Management
- Systems
- Training

Key Topics

- Account Statements
- Communications with the Public
- Correspondence
- Internal Controls
- Supervision
- Supervisory Controls Systems

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.¹ 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,⁹ 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.¹⁰

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 SIPC¹²; 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.
- 6 NASD Rule 2210(d)(1)(A). See also *Regulatory Notice 08-27* (May 2008) (Misleading Communications About Expertise).
- 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.

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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.