



2018 FINRA Annual Conference

May 21 – 23, 2018 | Washington, DC

Common Examination Findings and Effective Compliance Practices for Institutional Firms

Monday, May 21

1:45 p.m. – 2:45 p.m.

Join FINRA staff as they discuss the most common deficiencies noted during FINRA cycle examinations of institutional firms. Industry practitioners discuss taking corrective action and updating compliance procedures and practices based on lessons learned from common examination findings pertaining to fixed income and equity sales, and trading business lines.

Moderator: William St. Louis
Vice President and District Director, Sales Practice
FINRA New York and Long Island District Offices

Panelists: Mark Catana
Managing Director and Head of Markets Compliance
JPMorgan Chase & Co.

Eric Field
Director of Capital Markets Compliance
Robert W. Baird & Co. Inc.

Jeffrey Herrmann
Examination Manager, Sales Practice
FINRA New York District Office

Gil Mogavero
Managing Director and Chief Compliance Officer
JMP Securities LLC

Common Examination Findings and Effective Compliance Practices for Institutional Firms

Panelist Bios:

Moderator:

William St. Louis is District Director of FINRA's New York and Long Island offices and manages the sales practice examination and surveillance staff in those offices. Prior to assuming this role in June 2014, he was the Regional Enforcement Chief Counsel for FINRA's North Region where he managed Enforcement staff in FINRA's New Jersey, Boston, and Philadelphia offices. He joined the company in 1998 and spent several years in a variety of Enforcement roles in New York including service as a Deputy Regional Chief Counsel. Mr. St. Louis earned a B.A. from Baruch College and a law degree from New York University School of Law. Prior to law school he worked in the Compliance Department of a regional broker-dealer.

Panelists:

Mark Catana is Managing Director and the Head of Markets Compliance at J.P. Morgan, where he has worked since 2004. He is responsible for managing the Compliance advisory program for the Fixed Income, Currencies & Commodities, Equities, Debt and Equity Capital Markets, and Futures and Options businesses in the firm's Corporate and Investment Bank. Previously, he was Regional Counsel with FINRA (then NASD) Enforcement in New York, and before that Vice President and Associate General Counsel in the Nomura Securities International, Inc. Legal Department. He began his career in private practice as an associate with Schulte Roth & Zabel LLP and with Drinker Biddle & Reath (then Shanley & Fisher, PC). Mr. Catana has an A.B. from Columbia University and a J.D. from the University Of Virginia School Of Law.

Eric Field has been with Robert W. Baird & Co. Inc. since 2010, first as Director of Equity Capital Markets Compliance, then as Director of Capital Markets Compliance in 2011, which includes responsibility for all equities and fixed income compliance. He is currently Baird's Municipal Advisor CCO. From 2003-2010, Mr. Field worked at a mid-size broker dealer near Washington, DC and was responsible for a variety of compliance areas including equities, fixed income, options, public communications, and registrations. Prior to that he worked from 2000-2003 as a TMMS examiner with then NASD, where he conducted examinations of member firms trading desks. Mr. Field has his Masters of Science Degree in Finance from Johns Hopkins University and his B.S. in Finance from West Virginia University. He currently serves on FINRA Series 57 exam writing committee.

Jeffrey Herrmann has been with FINRA for 12 years. He began his career in 1996, obtaining his series 7 and 63 registrations while conducting Broker Dealer sales to U.S. Retail and European Institutional Clients. Three year later, he joined the Market-Making Desk of Knight Capital Group where he obtained his series 55 registration. At Knight, Mr. Herrmann conducted Institutional Sales and Trading, specializing in semiconductor trading, merger arbitrage and technical analysis of cash and futures markets. Prior to joining FINRA, Mr. Herrmann also worked as an Operational Risk Specialist in the Global Asset Management business of a top-tier Broker-Dealer and traded his own capital as a registered Proprietary Equity Trader. Currently, Mr. Herrmann is a Manager of FINRA's Large Firms Cycle Examination Team. Additionally, he works with FINRA's Regulatory Specialist Program as a member of the Trading and Market Risk and Controls Subject Matter Expert Group and hosts the program's national conference calls on Algorithmic, Direct Market Access, High Frequency and Proprietary Trading Controls.

Gil Mogavero is Managing Director and Chief Compliance Officer of JMP Securities. In addition to the Compliance program at JMP, he oversees the broker-dealer operations. Prior to joining JMP in 2000, Mr. Mogavero was Chief Financial Officer and Chief Administrative Officer at Mitchum, Jones & Templeton, a San Francisco-based brokerage firm, with oversight of compliance and operations. He previously spent a year at Robertson Stephens as vice president of operations. From 1987 through 1996, Mr. Mogavero served as head of compliance and operations at Volpe, Welty & Company, where he established the firm's brokerage operations, compliance program and communications infrastructure. Earlier in his career, which began in 1973, Mr. Mogavero held compliance and operations positions at Donaldson, Lufkin & Jenrette and Oppenheimer & Co., among other financial institutions. He served on the Boards of San Francisco-based Industry Associations (Securities Operations Association, Association of Western Securities Managers) and various NASD/FINRA Committees. Currently, he serves on the FINRA

Small Firm Advisory Committee and the Schwab Compliance Technologies Advisory Board (formerly Compliance 11).



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Topics

- **Employee Activities**
- **Compliance Technology**
- **Centralized Supervision**
- **Managing Conflicts Inherent to Institutional Businesses**
- **Compliance Concerns**

Employee Activities

■ Employee Brokerage Accounts

- failure to acquire account transaction data
- failure to conduct adequate pre/post transaction surveillance

■ Rogue and Manipulative Trading Activity

- failure to maintain systems reasonably designed to detect patterns of unusual employee activities, including trading, electronic communications, etc.

Compliance Technology

■ Common Weaknesses

- reliance on multiple incompatible legacy systems
- dependence on unreliable manual processes
- reliance on incomplete or inaccurate data

■ Compelling Emerging Technology

- deployment of artificial intelligence to monitor activities

Centralized Supervision

■ Supervisors and Surveillance Analysts

- inadequate qualifications, training, resources, and gravitas

■ Processing Surveillance Alerts

- alerts not reviewed, or not reviewed in a timely manner
- inadequate controls to detect and escalate aged unresolved alerts
- no rationale, or inadequate rationale for disposing of alerts
- inadequate documentation of escalations
- inadequate testing of the accuracy and reasonableness of employee dispositions and escalations

Managing Conflicts Inherent to Institutional Businesses

■ Global Framework

- **identification of conflicts arising from:**
 - investment banking/research
 - sales trading
- **escalation and clearing of conflicts**
 - automated vs. manual tracking process
- **management of conflicts**
 - implementing information barrier program
 - pre and post transaction surveillance of firm, employee and customer accounts

Compliance Concerns

- What are the greatest compliance challenges that you are currently facing?
- How are you preparing for those challenges?

2018 Annual Regulatory and Examination Priorities Letter

January 2018

Topics

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Introduction

The 2018 Regulatory and Examination Priorities Letter identifies topics that FINRA will focus on in the coming year, and these include some new topics as well as others that remain ongoing areas of focus. FINRA's [2017 Examination Findings Report](#) presents observations on both concerns and effective practices relevant to some of these areas, and FINRA encourages broker-dealers to use that report and this letter as resources to enhance their compliance, supervisory and risk management programs, and to prepare for their FINRA examination.

Fraud

Fraud is always a major area of focus for FINRA. Fraudulent activities such as insider trading, microcap pump-and-dump schemes, issuer fraud and Ponzi-type schemes harm investors and damage the integrity of the market. In the past year, FINRA has made hundreds of referrals to the U.S. Securities and Exchange Commission (SEC) for potential insider trading and other fraudulent activities involving individuals or entities outside FINRA's jurisdiction, and we will continue to pursue our investigations in these areas aggressively.

In addition, FINRA will focus on microcap fraud schemes, including schemes that target senior investors. FINRA investigations have identified senior investors who have been victimized by unregistered individuals using high-pressure sales tactics as part of a pump-and-dump scheme. Last year's Regulatory and Examination Priorities Letter described controls firms can use to protect elderly investors, and, with the addition of FINRA's new Rule 2165 and amendments to FINRA Rule 4512 (discussed later in this document), firms have even more tools to protect senior investors from these types of schemes. In addition, FINRA reminds firms of their obligation to file a Suspicious Activity Report (SAR) for illicit activity involving the exploitation of senior investors.¹

Firms should be attentive to their brokers' activity in microcap stocks, particularly when brokers show a new or sudden interest in buying microcap stocks for their own accounts or those of their customers. FINRA will investigate brokers who use their own or their customers' accounts to coordinate trading in microcap stocks with known or unknown counterparties. Firms should also evaluate internal policies and training regarding permissible communications and interactions with microcap stock promoters to assist in preventing brokers from participating in any fraudulent scheme.

High-risk Firms and Brokers

Building on our work in 2017, a top priority for FINRA will continue to be identifying high-risk firms and individual brokers and mitigating the potential risks that they can pose to investors.² FINRA will focus on firms' hiring and supervisory practices for high-risk brokers, including, for example, firms' remote supervision arrangements; supervision of point-of-sale activities, including individual broker accountability when using joint rep codes; and branch inspection programs. FINRA reminds firms of their existing obligation to adopt and implement tailored heightened supervisory procedures under FINRA Rule 3110 (Supervision) for high-risk individuals.

FINRA will also continue to focus on the risks that these firms and brokers pose to investors, including unsophisticated or senior investors. For example, we will focus on recommendations for speculative or complex products by high-risk brokers to investors who may not have the necessary sophistication, experience or investment objectives. We will also review situations where registered representatives have control of investors' finances as power-of-attorney or trustee on customer accounts, or have future rights to customer assets as a named beneficiary on customer accounts. We will also evaluate rollovers of qualified plans into non-qualified accounts for senior investors.

In addition, FINRA will continue to focus on registered representatives who conduct approved private securities transactions by raising funds from investors they serve away from their firm. FINRA will assess firms' ability to monitor the proper use of proceeds from these offerings and whether registered representatives make adequate disclosures about their interest in, control of, or association with the issuer.

FINRA will also continue to review firms' controls regarding the outside business activities of registered persons, including to identify instances of settling away where registered representatives borrow money from their customers or make payments to customers from their outside business bank accounts.³

Operational and Financial Risks

Business Continuity Planning

Recent events such as Hurricanes Harvey and Maria underscore the need for firms to maintain written Business Continuity Plans (BCPs) that address continued access to critical systems, including in situations where firms may not have physical access to locations, potentially for an extended period. FINRA Rule 4370 requires firms to maintain plans that are reasonably designed to enable them to meet their existing obligations to customers in an emergency or business disruption. FINRA will review firms' BCPs with a focus on their implementation of the plan. For example, we will review how and under what circumstances firms activate their BCPs, how they classify systems as mission-critical or secondary, how they accomplish data backup and recovery, and where applicable, how firms coordinate with their affiliates and vendors during a business continuity situation. We will also review firms' plans for restoring systems, procedures and records once they are prepared to return to normal business, as well as how they make those decisions.

Customer Protection and Verification of Assets and Liabilities

The protection of customer assets and the accuracy of firms' financial data are perennial priorities in FINRA's examinations. FINRA will examine the accuracy of firms' net capital and reserve computations under Securities Exchange Act (SEA) Rules 15c3-1 and 15c3-3. In our examination of firms' records, we will review their processes for verifying customer assets and proprietary assets and liabilities in those financial records. We may also contact appropriate entities, such as custodial banks, to assess the validity of reported positions.

In our examination of firms' compliance with SEA Rule 15c3-3, we will evaluate whether firms have implemented adequate controls and supervision to protect customer assets and assess their compliance with the specific requirements of the rule (*e.g.*, whether they properly perform their possession or control calculations). In addition, FINRA will review whether firms maintain sufficient documentation to demonstrate that securities are held free of liens and encumbrances, especially for securities held at foreign custodians. FINRA will review whether firms' foreign depositories, clearing agencies and custodial banks are good control locations, including whether firms have filed applications with the SEC for such foreign custodial arrangements. We may also look at the underlying arrangements with foreign custodians to determine if they permit cross-liens or use temporary holding accounts. Where customer securities may be held in, or move through, temporary holding accounts, we will consider whether these accounts are good control locations and whether firms have instituted reasonable procedures to monitor them for customer securities.

Technology Governance

FINRA will review firms' information and technology change management policies and procedures. Some firms have experienced significant customer service and regulatory problems as a result of operational breakdowns caused by the implementation of new systems as well as enhancements and modifications to existing proprietary or vendor systems. These breakdowns can arise from coding issues, system capacity limitations or other flaws, and may have a significant adverse impact on order entry or execution, data integrity or customer protection. It is critical that firms maintain strong controls over changes to their information technology to prevent inaccurate, incomplete, untested or unauthorized changes to their production environments. These can result in system defects or outages, data inaccuracies or unintended consequences that can negatively affect customers, the firm or the market.

Cybersecurity

Cybersecurity threats remain a significant risk and will continue to be a priority. FINRA will evaluate the effectiveness of firms' cybersecurity programs to protect sensitive information, including personally identifiable information, from both external and internal threats. FINRA will review firms' preparedness, technical defenses and resiliency measures, among other things. Firms should review the Examination Findings Report for additional information about FINRA's observations regarding concerns and effective practices related to cybersecurity. FINRA also reminds firms that they must have policies and procedures in place to assess whether to file a SAR when they identify a cybersecurity event.

Anti-Money Laundering

FINRA will assess the adequacy of firms' anti-money laundering (AML) programs. FINRA continues to identify concerns related to, for example, the adequacy of (1) firms' policies and procedures to detect and report suspicious transactions; (2) resources for AML monitoring; and (3) independent testing required under FINRA Rule 3310(c). Firms should review the Examination Findings Report to understand FINRA's areas of concern and observations on effective practices related to AML. In addition to those concerns, firms should be attentive to the potential use of their foreign affiliates to conduct high-risk transactions through accounts at member firms, including in microcap and dual-currency securities. FINRA has observed situations where firms do not monitor, or may monitor less closely, accounts opened for an affiliate. Firms should also confirm that their AML surveillance programs cover accounts used in connection with securities-backed lines of credit (SBLOCs) and aggregate activity across accounts when they use multiple accounts to receive and disburse funds in connection with an SBLOC.

Liquidity Risk

FINRA will continue to focus on firms' liquidity planning, compare strengths and weaknesses across firms' liquidity plans and share effective practices. FINRA will evaluate whether a firm's liquidity planning is appropriate for the firm's business and customers, and whether it includes scenarios that are consistent with its collateral resources and client activity. In addition, FINRA will focus on the adequacy of firms' material stress testing assumptions, including how firms identify unencumbered assets and encumbered cash in their liquidity stress tests. A stress test that clearly identifies the largest liquidity sources and uses can enhance a firm's liquidity planning. FINRA urges firms to review [Regulatory Notice 15-33](#) for effective practices that may be useful in developing liquidity management plans.

Short Sales

FINRA will examine firms' policies and procedures for establishing and monitoring the rates charged to customers for short sales. FINRA has observed some instances where, for example, securities are borrowed into a conduit account and then loaned to a house account at a significantly higher rate, which then may be marked up further. FINRA will review whether firms calculate such rates in a manner consistent with their procedures.

Sales Practice Risks

Suitability

As the number and complexity of products available to investors continue to increase, FINRA will continue to assess the adequacy of firms' controls to meet their suitability obligations. This includes reviewing how firms identify products that are subject to new product vetting, the vetting process itself, and the supervisory systems and controls firms put in place to ensure personnel are appropriately educated and trained on the sale and supervision of the product and that recommendations are suitable.⁴ As part of the vetting process, firms should identify the risks associated with a product and include those risks in their product training so that registered representatives can appropriately evaluate them prior to recommending the product to a customer. FINRA will pay particular attention to suitability determinations in those situations where registered representatives recommend complex products to unsophisticated, vulnerable investors.

FINRA will review firms' handling of products where FINRA has observed firms experiencing problems implementing effective controls, such as firms' handling of Unit Investment Trusts (UITs) and multi-share class products as addressed in the Examination Findings Report, or products that are higher risk or complex. Moreover, FINRA will review for recommendations that result in undue concentration in securities positions, including recommendations resulting in concentrated positions in interest-rate-sensitive instruments or recommendations that result in short-term trading of products typically intended to be held on a long-term basis.

Employer-sponsored retirement plans play a critical role in many individuals' retirement planning and for this reason will be an important area of focus for FINRA. In this regard, FINRA will focus on the suitability of firms' and registered representatives' recommendations made to plan participants, including Individual Retirement Account rollover recommendations involving securities transactions.⁵ FINRA will also review the supervisory mechanisms firms establish for these recommendations.

In addition, FINRA will review situations in which registered representatives recommend a switch from a brokerage account to an investment adviser account where that switch clearly disadvantages the customer, such as where the registered representative recommended that the customer purchase a securities product subject to a front-end sales charge in a brokerage account and then shortly thereafter recommended that account be transferred to a fee-based account.

Initial Coin Offerings and Cryptocurrencies

Digital assets (such as cryptocurrencies) and initial coin offerings (ICOs) have received significant media, public and regulatory attention in the past year.⁶ FINRA will closely monitor developments in this area, including the role firms and registered representatives may play in effecting transactions in such assets and ICOs. Where such assets are securities or where an ICO involves the offer and sale of securities, FINRA may review the mechanisms—for example, supervisory, compliance and operational infrastructure—firms have put in place to ensure compliance with relevant federal securities laws and regulations and FINRA rules.

Use of Margin

FINRA will assess firms' disclosure and supervisory practices related to margin loans. FINRA has observed situations where registered representatives solicited customers to engage in share purchases on margin, but customers were not aware of the risks associated with those transactions. Moreover, in some cases, registered representatives entered into margin transactions without written authority from the customer. FINRA will examine whether firms and registered representatives adequately disclose the risk of margin loans and whether firms maintain controls reasonably designed to prevent excessive margin trading.

Securities Backed Lines of Credit

The use of SBLOCs has increased significantly in the past years, and FINRA will review firms' compliance with sales practice and operational obligations that apply to SBLOCs. FINRA will assess the adequacy of disclosures firms provide customers regarding the potential risks associated with SBLOCs, including the potential impact of a market downturn, the potential tax implications if pledged securities are liquidated and the potential impact of an increase in interest rates.

Separately, where the SBLOC lender is an affiliate of the member firm or other third party, the firm must establish controls to earmark the collateral securing the SBLOC and ensure that the SBLOC collateral is not dually pledged for any other extension of credit (*e.g.*, a margin arrangement with the firm). In these cases, firms must also be alert to red flags indicating that proceeds of an SBLOC are possibly being used to purchase or carry margin stock and follow-up to ensure that they are not improperly arranging credit.

Market Integrity

Manipulation

Protecting the integrity of our markets must remain a top priority for firms, as it is for FINRA. To capture new threat scenarios and changes in market participants' behavior, we regularly evaluate our surveillance program, and enhance and expand it to address these changes, and firms should be aware that FINRA may review their programs in these areas. For example, we launched the Cross Market Auction Ramping surveillance pattern in August 2017. This pattern leverages machine learning techniques to identify aggressive and dominant trading surrounding the open or close. We also (1) revised our Cross Market Marking the Open and Close surveillance pattern to reduce false positives and more accurately identify potential instances of marking the open or close and (2) enhanced the Cross Market Layering surveillance pattern in July 2017 to detect collusion among multiple market participants engaged in layering. In addition, we are working on incorporating machine learning techniques to aid in further detection of manipulative layering activity.

Best Execution

Best execution is an important investor protection requirement and remains a FINRA priority. In addition to the concerns identified in the Examination Findings Report, FINRA is expanding our equity best execution surveillance program to assess the degree to which firms provide price improvement when routing customer orders for execution or when executing internalized customer orders. Once the new surveillance pattern is in production, we will review systematically both the frequency of price improvement, as well as the relative amount of price improvement obtained or provided when compared to other routing or execution venues.⁷

In addition, FINRA initiated an examination sweep in November 2017 that focuses on broker-dealers' best execution obligations when they receive order routing inducements, such as payment for order flow and maker-taker rebates, or when they internalize order flow. If a broker-dealer receives an order routing inducement, it must not let that inducement or its proprietary interests interfere with its duty of best execution. FINRA

will review how broker-dealers manage the conflict of interest that exists between their duty of best execution and their own financial interests, including whether the broker-dealers' procedures provide for a regular and rigorous evaluation of the execution quality they are likely to obtain from the market centers trading a security.

We will also expand our review of execution quality and fair pricing in fixed income securities. For example, we expect to implement surveillance patterns that focus on fair pricing and best execution in transactions in Treasury securities.

Regulation SHO

FINRA will increase our focus on evaluating firms' compliance with Rule 201 of Regulation SHO. That rule requires firms to develop policies and procedures to prevent the execution or display of a short sale order at a price that is equal to or less than the national best bid when a Short Sale Circuit Breaker (SSCB) is in effect for a National Market System (NMS) security.⁸ If a firm's Rule 201 policies and procedures include an automated, rules-based control to ensure compliance, FINRA expects the firm to develop a supervisory system to test that the control works properly and to conduct thorough supervisory reviews both before and regularly after it is operational.

If a firm chooses to rely on an exemption to Rule 201, it must ensure that its activity or short sale transactions qualify for the exemption. For example, FINRA has observed that firms engaging in exchange-traded fund arbitrage activity are availing themselves of the Domestic Arbitrage Exemption detailed in Rule 201(d)(3), although SEC written guidance states that (1) the exemption does not apply to such activity and (2) a "*bona fide* market making" exemption to Rule 201 does not exist. Finally, firms that choose to execute a short sale in reliance on an exemption to Rule 201 must mark the order and report the trade as short exempt.

Fixed Income Data Integrity

Data integrity remains a priority for FINRA's fixed income surveillance and trading examination programs. In anticipation of the launch of Treasury securities reporting to the Trade Reporting and Compliance Engine (TRACE) in July 2017, FINRA developed a suite of data integrity surveillance patterns to monitor firms' transaction reporting in Treasury securities. The patterns identify instances of late reporting, failing to report inter-dealer trades, misreporting of inter-dealer trades and inaccurate execution time reporting, and we remain focused on these issues in 2018.

In addition, FINRA will expand our examinations to include Treasury securities in our reviews for complete, timely and accurate reporting of TRACE-eligible securities. A crucial aspect of these reviews involves electronic communications with customers and potential discrepancies in the transaction information contained in the electronic communications compared to the firms' records or reports to TRACE.

Options

FINRA developed a surveillance pattern to detect potential front running in correlated options products in 2017 and will remain focused on this area in 2018. We designed the surveillance pattern to detect related scenarios involving options where a market participant may engage in transactions in one product while having knowledge of a pending transaction in a correlated product prior to the public dissemination of the terms of the order. This activity may improperly benefit the participant that engaged in the front running activity, to the potential detriment of other market participants.

FINRA will also focus on options “marking the close” activity where orders are being sent immediately prior to the close that impact the final national best bid or offer (NBBO) to benefit positions held by that account or accounts with which they are acting in concert. FINRA has identified a number of firms with deficient or non-existent supervisory systems relating to “marking the close” activity.

FINRA will continue to conduct reviews of potential options-related violations of SEA Rule 14e-4, which governs partial tender offers and requires that participants tender no greater than their “net long position.” SEA Rule 14e-4 provides that if a market participant sells call options after the tender offer is announced with a strike price less than the tender offer price, it must reduce its long position by the shares underlying the options for purposes of calculating its net long position. Those tendering in excess of their net long position by not offsetting the options may improperly receive a greater share of the tender offer consideration, to the detriment of other market participants. During 2017, FINRA identified participants who have not properly accounted for their options positions when tendering shares in the offer.

Market Access

FINRA will continue to review broker-dealers’ compliance with SEA Rule 15c3-5 (the Market Access Rule). The Market Access Rule requires that broker-dealers establish reasonable pre-trade financial controls, among other things. FINRA has seen instances where broker-dealers have not maintained reasonable documentation to support financial limits and have not conducted periodic reviews to assess the reasonableness of those thresholds (through a credit or capital utilization review, for example). Firms should review the Examination Findings Report for additional information about FINRA’s observations regarding concerns and effective practices related to market access.

Alternative Trading System Surveillance

As registered broker-dealers and FINRA members, alternative trading systems are required to maintain supervisory systems that are reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA rules, including, for example, rules on disruptive or manipulative quoting and trading activity. FINRA will review alternative trading systems’ supervisory systems in the context of reviews opened as a result of surveillance alerts related to potential manipulative activity occurring on or through an alternative trading system.

Report Cards

In 2018, FINRA will launch several new report cards to assist firms with their compliance efforts, and we will review whether and how firms make use of these report cards.

- ▶ The Auto Execution Manipulation Report Card will highlight and assist firms with their supervision efforts to identify instances in which a market participant uses non-*bona fide* orders to move the NBBO.
- ▶ The Alternative Trading System Cross Manipulation Report Card will identify instances in which a market participant engages in potential manipulation of the NBBO, which results in the modification of a security's prevailing midpoint price on an alternative trading system crossing venue.
- ▶ The Fixed Income Mark-up Report Card will provide information to firms—including median and mean percentage mark-ups for each firm—and the industry, which firms will be able to display based on certain criteria such as investment rating, product (*e.g.*, corporate or agency) and length of time to maturity. FINRA will consider adding additional products in the future.

New Rules

FINRA draws firms' attention to some significant new rules that are currently scheduled to become applicable in 2018. FINRA may discuss with some firms the steps they are taking to implement the obligations under these rules.

- ▶ **Financial Exploitation of Specified Adults:** FINRA Rule 2165 will become effective February 5, 2018, and permits members to place temporary holds on disbursements of funds or securities from the accounts of specified customers where there is a reasonable belief of financial exploitation of these customers.
- ▶ **Amendments to FINRA Rule 4512 (Customer Account Information):** An amendment to FINRA Rule 4512 requires members to make reasonable efforts to obtain the name of and contact information for a trusted contact person for a non-institutional customer's account. The amendment will become effective February 5, 2018.
- ▶ **The Financial Crimes Enforcement Network's (FinCEN) Customer Due Diligence Rule (CDD Rule):** Firms have until May 11, 2018, to comply with FinCEN's CDD Rule.⁹ FinCEN issued the CDD Rule to clarify and strengthen customer due diligence for covered financial institutions, including broker-dealers. In the CDD Rule, FinCEN identifies four components of customer due diligence: (1) customer identification and verification; (2) beneficial ownership identification and verification; (3) understanding the nature and purpose of customer relationships; and (4) ongoing monitoring for reporting suspicious transactions and, on a risk basis, maintaining and updating customer information.¹⁰
- ▶ **Amendments to FINRA Rule 2232 (Customer Confirmations):** The amended FINRA Rule 2232 requires a member to disclose the amount of mark-up or mark-down it applies to trades with retail customers in corporate or agency debt securities if the member also executes offsetting principal trades in the same security on the same trading day. The amended rule also requires members to disclose two additional items on all retail customer confirmations for corporate and agency debt security trades: (1) a reference,

and a hyperlink if the confirmation is electronic, to a web page hosted by FINRA that contains publicly available trading data for the specific security that was traded and (2) the execution time of the transaction, expressed to the second. These amendments are scheduled to become effective on May 14, 2018.

- ▶ **Margin Requirements for Covered Agency Transactions (Amendments to FINRA Rule 4210):**¹¹ FINRA's new margin requirements for Covered Agency Transactions are scheduled to become effective on June 25, 2018. Covered Agency Transactions include (1) To Be Announced (TBA) transactions, inclusive of adjustable rate mortgage (ARM) transactions; (2) Specified Pool Transactions; and (3) transactions in Collateralized Mortgage Obligations (CMOs), issued in conformity with a program of an agency or Government-Sponsored Enterprise (GSE), with forward settlement dates. Members are reminded that the risk limit determination requirements under the amendments to Rule 4210 became effective on December 15, 2016.
- ▶ **Consolidated FINRA Registration Rules:** The consolidated FINRA registration rules (FINRA Rules 1210 through 1240) will become effective October 1, 2018. The consolidated rules streamline, and bring consistency and uniformity to, the qualification and registration requirements. Among other things, FINRA has restructured the representative-level qualification examination program into a more efficient format whereby all representative-level applicants will take a general knowledge examination and a tailored, specialized knowledge examination (a revised representative-level qualification examination) for their particular registered role. Individuals who are not associated persons of firms, such as members of the general public, are also eligible to take the Securities Industry Essentials Exam. The restructured program, among other things, eliminates duplicative testing of general securities knowledge on representative-level examinations and eliminates several representative-level registration categories that have become outdated or have limited utility.

Conclusion

This letter outlines FINRA's areas of focus as of the beginning of 2018, and FINRA urges firms to use it as a point of reference for their compliance, supervisory and risk management programs and to prepare for FINRA examinations. FINRA may adjust its priorities as circumstances change. As always, we urge you to contact your firm's FINRA regulatory coordinator with specific questions or comments. In addition, if you have general comments regarding this letter or suggestions on how we can improve it, please send them to Steven Polansky, Senior Director, Regulatory Operations/Shared Services, at steven.polansky@finra.org.

Endnotes

- 1 See FinCEN [Advisory](#).
 - 2 See [“Protecting Investors From Bad Actors,”](#) Robert W. Cook, President and CEO, FINRA, at the McDonough School of Business, Georgetown University, June 12, 2017.
 - 3 Following a FINRA360 retrospective review of rules regarding registered representatives’ outside business activities and private securities transactions, FINRA’s Board of Governors approved the publication of a *Regulatory Notice* seeking comment on a proposal that would reduce unnecessary burdens while maintaining strong investor protections.
 - 4 See *Regulatory Notices* [03-71](#), [05-26](#), [05-59](#), [09-31](#), [09-73](#), [10-09](#), [11-02](#), [11-25](#), [12-03](#), [12-25](#), [12-55](#) and [13-31](#).
 - 5 See [Regulatory Notice 13-45](#).
 - 6 See FINRA Investor Alerts [Don’t Fall for Cryptocurrency-Related Stock Scams](#), December 21, 2017, and [Initial Coin Offerings: Know Before You Invest](#), August 31, 2017.
 - 7 In November 2015, FINRA issued [Regulatory Notice 15-46](#), which reiterated that simply obtaining the best bid or best offer may not satisfy a firm’s best execution obligation when routing order flow for automated execution, or internally executing such order flow, particularly for small orders.
 - 8 A 10 percent or more decrease in the price of a security from its closing price on the prior day triggers an SSCB.
 - 9 See FinCEN [Customer Due Diligence Requirements for Financial Institutions](#), 81 FR 29397 (May 11, 2016).
 - 10 See [Regulatory Notice 17-40](#).
 - 11 See [Regulatory Notice 16-31](#) (announcing the SEC’s approval of amendments to FINRA Rule 4210 to establish margin requirements for Covered Agency Transactions) and [Regulatory Notice 17-28](#) (extending the effective date of the new margin requirements to June 25, 2018, and announcing the availability of a set of frequently asked questions and guidance to assist members in complying with the new requirements).
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Report on Conflicts of Interest

OCTOBER 2013

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EXECUTIVE SUMMARY

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

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

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

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

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

- ▶ enterprise-level frameworks to identify and manage conflicts of interest;
- ▶ approaches to handling conflicts of interest in manufacturing and distributing new financial products; and
- ▶ approaches to compensating their associated persons, particularly those acting as brokers for private clients.

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

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

This report is a point-in-time review of several facets of conflicts of interest. Given conflicts’ pervasiveness and potential to cause customer harm, FINRA will continue to assess firms’ conflicts management practices and the effectiveness of those practices in protecting customers’ interests. FINRA will also monitor the effectiveness of approaches to conflicts regulation used internationally.

FINRA expects firms to consider the practices presented in this report, and to implement a strong conflict management framework. If firms do not make adequate progress on conflicts management, FINRA will evaluate whether rulemaking to require reasonable policies to identify, manage and mitigate conflicts would enhance investor protection.

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

Conflicts of Interest Framework

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

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

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

- ▶ defining escalation procedures for conflicts of interest within and across business lines;
- ▶ avoiding severe conflicts, even if that avoidance means foregoing an otherwise attractive business opportunity;
- ▶ disclosing conflicts of interest to clients, taking into consideration the different needs of retail and institutional clients;
- ▶ training staff to identify and manage conflicts in accordance with firm policies and procedures; and
- ▶ reporting on significant conflicts issues, including on a firm's own measures to identify and manage conflicts, to the Chief Executive Officer (CEO) and board.

New Product Conflicts

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

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

Second, firms should disclose those conflicts in plain English, with the objective of helping ensure that customers comprehend the conflicts that a firm or registered representative have in recommending a product.⁶ These conflicts may be particularly acute where complex financial products are sold to less knowledgeable investors, including retail investors.⁷

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

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

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

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

Compensation Practices

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

The use of "product agnostic" compensation grids (also referred to as "neutral grids") can be an effective practice to reduce incentives for registered representatives to prefer one type of product (e.g., equities, bonds, mutual funds, variable annuities) over another.⁸ These grids typically pay a flat percentage of the revenue a registered representative generates, regardless of product recommended. FINRA notes, however, that while this eliminates one variable that may influence recommendations, registered representatives still have an incentive to favor products with higher commissions because these produce larger payouts. Consequently, to reduce conflicts, firms should take measures to mitigate biases that differences in compensation by product may create.

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

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

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

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

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

Questions/Further Information

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ENTERPRISE-LEVEL CONFLICTS GOVERNANCE FRAMEWORK

Introduction

Virtually every financial firm, including those regulated by FINRA, faces potential conflicts of interest in its business. In order to address those conflicts, a firm should be able to recognize conflict situations and take measures to manage them appropriately. Firms should address conflicts through proactive decision making, not ad hoc responses to conflicts-related events. The framework for this proactive decision making depends on the scope and scale of a firm's business.⁹ It will look vastly different for a small introducing broker than for a large firm with multiple affiliates engaged in a broad range of businesses on a national or global scale.

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

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

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

Effective Practices Summary: Comprehensive Conflicts Governance Framework

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

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

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- ▶ proactive and systematic identification of conflicts of interest in a firm's business on an ongoing and periodic basis;
- ▶ transparency of material conflicts to executive management and the board; and
- ▶ periodic testing of the firm's conflicts management framework;
- ▶ a willingness to avoid severe conflicts, even if that avoidance means foregoing an otherwise attractive business opportunity;
- ▶ effective disclosure to clients, taking into consideration the different needs of retail and institutional clients;
- ▶ hiring practices that rigorously review potential employees' ethical, financial and regulatory history;
- ▶ training that focuses on ethical treatment of customers and enables staff to identify and manage conflicts; and
- ▶ an information technology infrastructure that supports conflicts management in a comprehensive manner.

“Tone from the Top,” Firm Culture and Conflicts of Interest

An effective practice for all firms is the establishment of a “tone from the top” that stresses the importance of ethical decision making and fair treatment of customers. This tone is set by a firm's executive management in their day-to-day actions and decisions. It is incumbent upon them to consistently communicate and demonstrate the values to which they expect their employees to adhere, and to monitor employees' behavior to ensure that it aligns with the firm's stated values.

Without the proper tone from the top, many of the measures discussed later in this report will be ineffective. Leadership that singlemindedly drives the distribution of proprietary products may undermine the effectiveness of new product review processes intended to protect customer interests. Conflict management frameworks cannot be expected to succeed without the strong support of a firm's leaders.

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

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

Conflicts Management Structures

A number of firms with which FINRA met manage conflicts at the enterprise level using either a distributed or centrally managed approach. Another group of firms neither defines conflicts management structures nor articulates the roles and responsibilities of senior management, firm committees and staff with respect to conflicts management.

An effective practice is for a firm to establish carefully designed and articulated structures to manage conflicts of interest that arise in its business. This includes clearly defining the roles and responsibilities of the individuals, committees and other bodies that play key roles in that structure. Both the distributed and centrally managed approaches may be appropriate for a firm depending on its specific circumstances. FINRA underscores that a firm's conflict management structure does not need to be complex, but it needs to be effective.

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

Distributed Model

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

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

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

Centralized Model

The second approach uses a centralized conflicts office to manage a firm's conflicts framework. Firms that take this approach emphasize that although they operate a centralized office, responsibility for identifying conflicts rests first and foremost with the business. FINRA observed this model in two versions. In one version, a dedicated conflicts office is part of firm management. The office has both a transactional and business practice focus. In the former role, the office oversees the firm's conflict management framework and works with business units to manage potentially significant conflicts within, and across, business units. In the latter role, the office works with business units to review and assess business practice conflicts on an ongoing basis, as well as to support presentation of thematic conflicts reviews to a senior firm management committee.

In the second version of the centralized approach, conflicts management is integrated into an existing, compliance-related group. This office is responsible for, among other things, the firm's Code of Ethics and certain other enterprise-level conflicts policies. The office coordinates line-of-business "conflicts officers" (discussed below) and works with business units to identify and manage unique conflict situations. The office maintains a log of non-standard conflicts, in part to help identify areas where training may be needed. In contrast to the dedicated conflicts office approach, the integrated conflicts office does not operate the firm's transactional review process.

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

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

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

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

No Defined Structure

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

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

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

Committees and Other Ad Hoc Bodies

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

Conflicts Management Policies

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

Code of Conduct

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

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

An effective practice is to add to a firm's code of conduct, or other appropriate documents, a best-interest-of-the-customer standard that applies to registered representatives' personalized recommendations to retail customers. Under this Code standard, a broker should make only those recommendations that are consistent with the customer's best interests.¹⁰ A firm's code establishes an essential starting point—a yardstick against which the behavior of employees may be measured. Of course, to be meaningful, the rhetoric of a code should be supported by firm policies and procedures and implementation by firm leadership.

Enterprise-level Conflict Policy

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

- ▶ **A statement on objectives, policy or rationale:** These elements typically acknowledge that the firm operates in a business where it faces actual and potential conflicts of interest, and that a failure to manage these conflicts effectively may result in reputational damage to the firm.

- ▶ **A discussion of the types of conflicts a firm may face:** Firms' enterprise-level conflicts policies typically provide general guidance on the factors that can lead to a conflict of interest, in some cases supported by examples of specific conflicts relevant to a firm's business. (See Conflicts of Interest Examples from Firms' Enterprise-level Conflicts Policies, below, for a description and examples of common conflict categories some firms use.)
- ▶ **A description of roles and responsibilities:** Most firms' policies articulate the role of senior management and, in some cases, employees in managing conflicts. Firms with both a distributed and centralized approach to conflicts management use this section of the policy to place responsibility for identifying and addressing conflicts with the business lines. For example, the policy of one firm with a distributed approach to conflicts management states "(s)enior management of each Division is responsible for ensuring that Conflicts relating to its business are identified and addressed"; other firms have similar statements in their policies. Similarly, the policy of a firm with a centralized approach states, "(s)enior management of each Business Unit...is responsible for ensuring that Conflicts relating to its business are identified and addressed including escalating, as appropriate to the Franchise Committee process."
- ▶ **A description of conflict escalation procedures:** Most firms' policies describe an escalation process for handling those conflicts of interest that cannot be handled through other firm policies, including a description of individuals' roles and responsibilities and appropriate organizational contact points for escalation.

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

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

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

- ▶ **Firm vs. client conflicts**
 - ▶ The firm offers or recommends products for which the firm receives greater fees/compensation than other products, or that may not be suitable for certain clients.
 - ▶ The firm performs multiple roles with respect to a client or transaction (*e.g.*, advisor, underwriter, lender, principal counterparty, derivative counterparty).
 - ▶ The firm engages in business and trading activities for its own account or client accounts while other clients are active in relevant markets at the same time.
 - ▶ The firm may provide investment advice or discretionary portfolio management services to its clients, and the firm may also recommend or sell products that it or affiliated companies issue.
- ▶ **Client vs. client conflicts**
 - ▶ The firm is the discretionary portfolio manager for more than one client or fund, in particular with respect to issues related to allocation.
 - ▶ The firm has multiple clients interested in acquiring the same company or assets.
 - ▶ The firm charges clients in the same investment strategy or program different fees.
 - ▶ The firm may be in initial discussions with clients on both sides of a deal.

continued

► **Employee vs. client conflicts**

- The compensation arrangements or incentives for the firm or its employees could affect whether employees recommend or offer a particular security or transaction to a client.
- An employee is engaged in outside business activities with an issuer about which the employee may make a recommendation.

► **Employee vs. firm conflicts**

- An employee may compete with the firm for the purchase or sale of property, assets, services or other interests.
- An employee engages in personal trading or outside business activities (including board memberships/directorships) that could conflict with a client or with the firm.

► **Vendor vs. client conflicts**

- A vendor may misuse, or inadequately protect, confidential customer information.
- A vendor may fail adequately to protect confidential customer information after its relationship with the firm is terminated.

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

Business Activity and Other Policies

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

Conflicts Management Processes

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

Escalation Procedures

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

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

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

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

Conflicts Inventory Reviews

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

Firms that engage in conflicts reviews—on either a periodic or ongoing basis—stated that the process was extremely useful, both in identifying conflicts and in establishing or refining conflicts-related structures, policies and processes. Some firms conduct regular, periodic reviews of conflicts within their business, sometimes in the context of a broader annual risk assessment, and record this information in a conflicts register. Firms conduct these reviews annually or biennially. In another instance, a firm shifted from conducting periodic reviews to an ongoing conflicts review process. This firm finds the ongoing review process more effective than the periodic approach.

FINRA observed one firm that included, as part of its enterprise-level conflicts policy, a template of issues—*e.g.*, changes in business, organizational and informational structure and compensation/incentive structures—business lines should consider in conducting their conflicts review.

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

Disclosure

The U.S. regulatory regime relies heavily on disclosure to customers as a tool to mitigate conflicts that may arise in the course of a firm's business. The specific nature of a firm's disclosure obligations depends on the facts and circumstances of a given situation, and these obligations are established in various places in statute, regulation and case law.¹¹ A broker-dealer's duty under the anti-fraud provisions of the federal securities laws to disclose material information depends upon the nature of its relationship with a customer.¹² When recommending a security, a broker-dealer may be liable if it does not "give honest and complete information" or does not disclose "material adverse facts of which it is aware".¹³ Broker-dealers have also been found liable for failures to disclose conflicts, such as their role as a market maker; their trading in a principal capacity; the existence of multiple share classes of a recommended mutual fund; and their receipt of revenue sharing payments.¹⁴ FINRA rules require extensive disclosure to customers in a number of circumstances (*see Table 2: Examples of conflicts-related disclosure requirements and regulatory prohibitions*, page 37).

State law also may impose disclosure obligations on broker-dealers. The Delaware Court of Chancery emphasized the importance of conflicts disclosure in mergers and acquisitions where a firm involved in advising and financing a transaction represents multiple clients, or has a proprietary interest in the transaction.¹⁵

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

A test to evaluate the effectiveness of their disclosure is asking, in the event of a reasonably foreseeable adverse product outcome, could an investor legitimately say, "I did not realize that could happen" on the basis of information the firm provided apart from the prospectus. If the answer is "yes," the firm should reconsider how it presents information about that product to customers. In the context of an advised sale where the firm provided its own sales materials, it is not sufficient that the relevant risk information was contained solely in the product prospectus.¹⁶

A further effective practice is to require investors to attest to their understanding of more complex products before purchase. The process of going through this attestation may reinforce to customers the need to understand the products they purchase.

For firms representing multiple institutional clients, or with a proprietary interest in an advisory or financing transaction, the firm should make the customer aware of the multiple roles the firm plays and seek consent, preferably in writing, from the customer to the firm serving multiple parties' interests.

Hiring Practices

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

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

In light of the negative impact individuals with poor ethical standards can have on a firm, FINRA remains concerned about the number of firms willing to hire associated persons with problematic disciplinary histories.¹⁷ This creates risks for customers as well as reputational risk to firms. FINRA's concerns are heightened when we see firms hiring multiple individuals with these problematic backgrounds and FINRA reiterates firms' obligations to use hiring practices that may help mitigate conflicts of interest.

Hiring Associated Persons With a Problematic Disciplinary History

A firm hiring an associated person must affirmatively determine that the associated person satisfies FINRA's qualification requirements and is not subject to a "statutory disqualification" (whether or not that individual is required to be a registered person).¹⁸ In addition to determining the eligibility of all potential associated persons, firms have a duty to investigate the character, business repute and experience of any person prior to submitting a Form U4 on behalf of the individual. There are a number of questions firms should consider before hiring an associated person.¹⁹ In the case of registered representatives, firms should consider how that potential employee's book of business will fit with the firm's current business mix. Is the firm sufficiently familiar with all of the securities products the representative intends to offer? Does the representative engage in the sale of penny stocks and, if so, is the firm adequately equipped to supervise those transactions or recommendations? Is the firm comfortable that the products the representative intends to recommend to customers meet suitability requirements? Does the firm have the appropriate supervisory and compliance infrastructure (principals, licenses, operational personnel) to support any new business being brought on by the representative? Does the representative's financial background (*e.g.*, credit or bankruptcy history) raise concerns about the individual's financial probity and potential pressure to generate revenue through excessive trading or unsuitable recommendations?

continued

Firms should pay particular attention to, and exercise due care before hiring an individual with a problematic disciplinary history. If an individual has an employment history that includes items such as a large number of customer complaints, recent terminations for cause/permitted to resign, arbitration proceedings, disciplinary actions, frequent changes in employer, and a disproportionate number of disclosures of liens and judgments, firms should carefully assess the prudence of hiring such a person. In making this assessment, a firm should weigh its ability to appropriately supervise the individual with heightened procedures. In addition, firms should assess the likelihood of the individual repeating his or her past actions in the future, which could result in possible customer harm.²⁰ And, if a person is statutorily disqualified, firms must ensure that applications for association are completed that contain heightened supervisory plans and that the individual is appropriately supervised.

Hiring individuals who were previously associated with a “disciplined firm” can also have an adverse impact on a firm’s compliance culture and supervisory systems. A disciplined firm is one that in connection with sales practices misconduct involving the offer, purchase or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the SEC revoking its registration as a broker-dealer. When hiring registered representatives from a disciplined firm, the hiring firm should evaluate whether it must adopt and implement special supervisory requirements that include taping systems to monitor the actions of these associated persons.²¹

Training

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

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

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

One firm noted that the conflicts inventory, discussed earlier, is a useful tool in providing conflicts-related training across the organization. This firm found that training staff on how conflicts arise in other business units helped them understand better how conflicts arise in the firm’s business as a whole as well as in their own business unit. In addition, the firm found that the inventory helped identify situations where the firm had failed effectively to manage conflicts in the past. These situations provided valuable training materials and learning opportunities.

In addition to broad conflicts management and ethics training, firms noted that they may provide targeted conflicts training to address conflicts issues that may arise in a particular business area, for example on a trading desk. Some firms also require registered representatives to complete specialized training on structured or complex products—including on the conflicts that may be associated with such products—before advising customers on these products.

Information Technology

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

Conflicts Clearance and Business Selection

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

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

Structures

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

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

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

continued

Process

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

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

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

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

NEW BUSINESS AND NEW PRODUCT CONFLICTS REVIEW

Introduction

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

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

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

FINRA evaluated firms' new business conflicts frameworks primarily through the lens of firms' new product assessments.²² This product focus reflects FINRA's concerns about the increased sale of complex products to retail investors who may struggle to understand the features, risks and conflicts associated with these products. The firms with which FINRA met, manufacture, distribute, or both manufacture and distribute financial products. FINRA explored firms' new product reviews in each of these capacities.

Effective Practices Summary: New Product Conflicts Review

FINRA observed firms engaging in a number of effective practices to identify and manage conflicts of interest that may arise through the launch of a new product or service:²³

- ▶ Firms' new product review committees include a mandate to identify and mitigate conflicts of interest that may be associated with a new product. This mandate is supported by a "tone from the top" and firm culture that encourages robust analysis and debate with the objective of protecting customer interests.
- ▶ Where a conflict of interest poses the potential for serious harm to customers, and the firm cannot effectively mitigate that conflict, firms decline to offer the product to customers.
- ▶ Firms differentiate product eligibility between institutional and retail clients. With respect to the latter, some firms restrict eligibility to purchase more complex products to customers whose accounts have been approved for options trading or establish other criteria that enable the firm to ascertain an individual's ability to understand and evaluate the risks associated with the product.²⁴
- ▶ Product manufacturing firms implement strong KYD policies and processes to assess potential distributors' financial soundness, marketing and sales controls, sales practice and compliance mindset, quality of distribution network and technical capabilities before allowing them to sell a manufacturer's products.
- ▶ Firms conduct post-launch reviews to assess whether a product has performed as expected.

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- ▶ Firms evaluate registered representatives' ability to understand a product, provide training where it is necessary and limit registered representatives' access to products for which they cannot 1) demonstrate sufficient understanding to perform a suitability analysis and 2) effectively explain a product and its risks to customers.
- ▶ Firms disclose product risks to customers, including easily understandable explanations of the impact of adverse scenarios on a product's performance.
- ▶ Firms require written attestations that clients understand a product and its risks for certain potentially more complex products.

Manufacturing

Conflicts Reviews and New Product Review Committees

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

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

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

In part to reduce the conflict of interest that would exist if a business unit were responsible for vetting its own initiative, a new business initiative committee typically includes business, support and control functions, including information technology, operations, finance, legal, compliance and risk management. The participation of the latter functions is intended to provide a view independent from the proposing business unit on the new business initiative. The vetting process may involve various levels of seniority in the firm, depending on the perceived risk and complexity in the new product approval and can include senior firm executives.²⁵ In several firms, the risk management department has final sign-off authority on a product launch and in at least one instance, risk management is responsible for coordinating the review process.

Typically the new product review addresses two aspects of a new product launch: 1) Is the firm prepared to introduce the new business and 2) Will the new business adversely affect the firm's broader business and reputation? Each manufacturing firm emphasized the importance it attaches to identifying and thoroughly assessing conflicts that may be present in a product. One firm's new business review policy calls for escalating all proposals that involve conflicts of interest, reputational risk or suitability concerns. In addition, and as noted earlier, other firm committees may review a new business initiative and include conflicts within their scope of responsibility.

These approaches to mitigating potential conflicts in firms' internal processes are highly dependent for success on the culture of the firm and the specific committees involved. Reliance on the committees, and relevant control functions' nominal independence, to help mitigate conflicts of interest will be ineffective without a culture that encourages robust debate with the objective of protecting customer interests.

Expanding Product Availability

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

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

Reverse Inquiry

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

Know-Your-Distributor Policies and Procedures

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

The following elements of a KYD process reflect effective practices:

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

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

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

Post-launch Product Reviews

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

Embedded Conflicts

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

Structured and Complex Products and Embedded Conflicts

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

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

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

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

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

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

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

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

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

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

Distribution

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

Conflicts Reviews and New Product Review Committees

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

In the context of firms that engage in both product manufacturing and private wealth management businesses, FINRA underscores the importance for conflicts controls of the private wealth business operating with appropriate independence from other business lines within a firm. Firms should maintain effective safeguards, including through the use of new product review committees in the private wealth business, against pressure to prefer proprietary products to the detriment of customers' interests. This is particularly important as firms seek to leverage their brokerage and other platforms to cross-sell products and services. Equally important, firms with revenue sharing or other partnering arrangements with third-party product (or service) providers should exercise the necessary diligence and independent judgment to protect their customers' interests.

Some retail distribution firms use new product review departments separate from the business line. In one instance, a firm's research department makes recommendations about which products are brought onto the firm's distribution platform. Compensation for the research staff is at least partially based on how well the products they recommend perform. These recommendations are subject to further review by other firm committees. In another instance, a separate legal entity makes recommendations about mutual funds to be brought onto a firm's list of recommended mutual funds; this structure is intended to make these decisions independent of the firm's relationship with the fund providers. Several firms identified products they do not offer to customers because of suitability concerns, including leveraged exchange traded funds and structured products.

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

Open Product Architecture and Revenue Sharing

Conflicts can arise when a firm distributes proprietary products or investment company products for which a firm receives revenue sharing payments.²⁶ The funds for which a firm receives revenue-sharing payments often will be placed on a "preferred" list of funds the firm offers. Proprietary products and revenue sharing arrangements may involve significant financial incentives for firms to favor these products over others. Although registered representatives do not share in the revenue sharing payments directly, they still may favor funds on preferred lists, because of training the issuer provides or because the mechanics of order processing are, in some cases, easier for funds on the preferred list. This can limit customer choice or may, in some cases, adversely affect the independence of a firm's new product review process or a registered representative's recommendations. Nevertheless, many firms disclose the arrangements, and their written disclosures related to revenue sharing were, in many cases, clear and direct.

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

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

Reverse Inquiry

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

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

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

COMPENSATION AND OVERSIGHT

Introduction

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

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

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

As an initial matter, the federal securities laws and FINRA rules require broker-dealer mark-ups, commissions and fees for services to be fair and reasonable.²⁷ The SEC and the courts have held that the antifraud provisions of the federal securities laws require broker-dealers to sell securities at prices reasonably related to the market price.²⁸

Effective Practices Summary: Compensation and Oversight

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

Effective practices include the following:

- ▶ **Compensation thresholds:** Firms avoid creating thresholds in their compensation structures that enable a registered representative to increase her compensation disproportionately through an incremental increase in sales.
- ▶ **Monitoring activity of representatives approaching compensation thresholds:** Firms' supervisory programs include specialized measures to assess whether a registered representative's recommendations may be influenced by thresholds in a firm's compensation structure. Some firms perform specialized surveillance as registered representatives approach thresholds that:
 - ▶ move the registered representative to a higher payout percentage in a firm's compensation grid;
 - ▶ qualify a representative to receive a back-end bonus; or
 - ▶ qualify a representative to participate in a recognition club, such as a President's Club.
- ▶ **Neutral grid:** Firms minimize incentives in their compensation structure for registered representatives to favor one type of product (e.g., equities, mutual funds, variable annuities) over another.

continued

- ▶ **Fee-capping:** Firms reduce incentives for a registered representative to favor one mutual fund or variable annuity fund over another by capping the Gross Dealer Concession that will be credited to a representative's production.
- ▶ **Compensation for proprietary or preferred provider products:** For comparable products, firms refrain from providing higher compensation, or providing other rewards, for the sale of proprietary products or products from providers with which the firm has entered into revenue-sharing agreements.
- ▶ **Customer liquidity events and suitability monitoring:** Firms monitor the suitability of registered representatives' recommendations around key liquidity events in an investor's lifecycle where the impact of those recommendations may be particularly significant, for example, at the point where an investor rolls over his pension or 401(k).
- ▶ **Compensation penalties:** Firms adjust compensation for employees who do not properly manage conflicts of interest. Using red flag processes and clawbacks can support this objective.

Compensation Grids

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

Structure and Mechanics

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

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

	Product Neutral Grid	Non-Neutral Grid		
Gross Commission/ Sales Charge (figures in 000s)	Payout %	Payout %: Equities, bonds, ETFs	Payout %: Options and futures	Payout %: Investment company products
\$200-300	28%	28%	26%	30%
\$300-400	35%	35%	33%	39%
\$400-500	36%	36%	34%	42%
\$500-650	38%	38%	35%	44%
\$650-800	40%	40%	38%	46%
\$800-1,000	42%	42%	40%	49%
\$1,000-1,500	44%	45%	40%	49%
\$1,500-2,500	45%	45%	41%	49%
\$2,500 +	48%	45%	41%	50%

(The figures in this table are for illustrative purpose only and do not reflect any particular firm's grid structure.)

The payout percentage a registered representative receives typically increases as the broker's production rises. A \$1 million producer will typically earn a higher percentage of gross revenue than a \$500,000 producer with the same firm. FINRA observed a variety of payout ranges, from 28 – 47 percent at one firm to 25 – 43 percent at another and 22 – 48 percent at a third. These figures are representative for only some firms, others' payout rates may be higher. Firms with an independent contractor model may pay out a substantially higher percentage to registered representatives, but these firms also charge those representatives more for expenses associated with their business. In addition, one of the firms with which we met takes a notably different approach to its grid: This firm pays a flat 50 percent after the first \$10,000 of monthly production.

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

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

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

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

Other Approaches

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

Compensation and Oversight Structures

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

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

Neutral Grids

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

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

Commission-based vs. Fee-based Accounts

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

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

Compensation for Proprietary or Preferred Provider Products

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

Fee-capping

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

Supervision, Surveillance and Conflicts Management

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

Supervision of Sales Activity Near Compensation Thresholds

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

A second effective practice is to monitor registered representatives who are close to achieving the production level required for entry into recognition programs. In at least one firm with which FINRA met, this type of surveillance program is used to review the suitability of transactions that place registered representatives over the threshold to gain recognition in a firm's "President's Club" or similar recognition circle.

A third effective practice is to monitor registered representatives' recommendations and trading activity as they approach milestones for "back-end" recruitment bonus payments. Firms generally make these payments if the recruited registered representative achieves a certain level of production by an anniversary date of hiring. Several firms monitor the compensation trends of each registered representative who is within three months of a back-end bonus milestone date. Compliance analysts monitor production spikes or spikes in product sales for each of the three months before the award date or the expiration of the bonus milestone. Another firm reviews changes in the type of products the representatives sell and suitability assessments of the recommendations they make to customers.

Supervision of Sales Activity at Investor Lifecycle Milestone Events

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

Other Effective Supervisory Practices

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

Compensation for Supervisory and Branch Management Staff

Financial incentives to registered representatives in firms' retail and private wealth businesses are one source of conflicts of interest; the financial incentives to their managers and supervisors are another. Financial incentives for these personnel could encourage them to, among other things, push registered representatives to achieve branch or broader business unit financial performance targets without proper regard for suitability, hire poorly qualified registered representatives to meet hiring targets or perform oversight tasks in a manner favoring productivity standards over quality of oversight.

Most firms' compensation structures for supervisory staff, branch office managers and their superiors are comprised of a base salary and discretionary bonus. The discretionary bonus may include elements that create potential conflicts of interest. Firms noted that they typically consider a variety of quantitative and qualitative factors in determining compensation for supervisors and managers. Examples of quantitative metrics include branch revenue and growth, profitability, net new assets and lending growth. Examples of the qualitative factors include an individual's development of staff and the quality of a manager's interaction with control functions.

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

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

Deterrents to Poor Conflicts Management

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

Red Flags

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

The firms with which FINRA met use processes with varying degrees of formality and structure to gather qualitative and quantitative data—or red flags—about employee behavior and apply that to their compensation and performance assessment programs.³¹ On one end of this spectrum are firms that collect relatively little data, do not implement performance assessments, and whose registered representatives' compensation structure is mostly or entirely commission-driven with little or no non-formulaic variable compensation, *i.e.*, bonus. On the other end of the spectrum are firms that have highly formalized data collection, data review and performance assessment processes and whose employees receive a significant portion of variable compensation as a percentage of total compensation.

Firms with more formalized programs collect a broad range of information from multiple departments, including legal, compliance, human resources, risk management, sales supervision, operations and accounting. The types of information they accumulate includes registration and training lapses, trade input errors, suitability concerns, the frequency and severity of customer complaints, inappropriate or hostile behavior and other misconduct, excessive velocity, investment concentrations, mutual fund or annuity switching, audit or examination finding and credit limit violations. (Many of these measures do not relate directly to conflicts of interest concerns.) Depending on the firm, the human resources, compliance or risk management department may aggregate this information and then use it in performance evaluations as well as promotion and compensation decisions.

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

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

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

Clawbacks

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

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

Scope and Content of Policies

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

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

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

Performance-based

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

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

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

Risk-based

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

Behavior-based

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

A few firms' policies provide for claw back of vested deferred compensation. One firm can seek repayment of the value of awards already vested, but unpaid, if an employee was, or could have been, terminated for cause or engages in conduct that results in financial or reputational harm. Another firm can recoup vested compensation in the case of gross misconduct.

Review Processes

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

CONCLUSION

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

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

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

Looking forward, FINRA will continue to focus on conflicts issues through its regulatory programs and will evaluate the effectiveness of firms' conflicts management efforts. If firms make inadequate progress generally, FINRA will evaluate whether conflicts-focused rulemaking is necessary to enhance investor protection.

APPENDIX I—CONFLICTS REGULATION IN THE UNITED STATES AND SELECTED INTERNATIONAL JURISDICTIONS

United States

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

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

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

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

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

International Organization of Securities Commissions

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

Australia, Canada and the European Union

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

Best Interest of the Client Standard

Australia, Canada and the European Union have all implemented a “best interests of the client” standard with respect to how firms address conflicts of interest. In Europe, under the Markets in Financial Instruments Directive (MiFID) the “best interests of the client” standard governs all aspects of the investment firm-client relationship, including conflicts of interest. In Australia, the “best interest of the client” standard applies to the provision of personal advice by financial licensees to retail clients and the “best interests” standard for investment dealers in Canada applies specifically to the management of conflicts of interest.

Conflicts of Interest Policies and Procedures

All three jurisdictions require that firms put in place policies and procedures to manage all material conflicts of interest. Among other things, these policies and procedures must clearly identify all material potential conflicts of interest and specify how an investment firm intends to address each potential conflict (e.g., by controlling, avoiding or disclosing these conflicts). Once the conflicts of interest policies, procedures and controls have been implemented, investment firms must put in place supervision and monitoring systems to ensure that they are properly implemented, maintained and updated. All three jurisdictions agree that the management of conflicts of interest cannot be achieved solely through disclosure, and that investment firms should seek first to avoid or control conflicts before relying on disclosure to resolve the conflict.

Disclosure of Conflicts of Interest

All three jurisdictions agree that when firms cannot avoid or control a conflict, they must disclose it. Canada requires that unless a firm avoids and controls a conflict in a way that “effectively ensures with reasonable confidence that the risk of loss to the customer has been eliminated,” the firm must disclose it to the customer.³³ Once a firm determines that it must disclose a conflict, all three jurisdictions agree that the firm must disclose the conflict in a manner that provides sufficient information and time for the customer to take this information into account before making an investment decision.

Compensation-related Conflicts of Interest

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

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

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

APPENDIX II—TEXT OF FINRA LETTER TO FIRMS ANNOUNCING CONFLICTS REVIEW

July 2012

Re: Conflicts of Interest

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

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

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

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

APPENDIX III—SUMMARY OF CONFLICTS IDENTIFIED BY FIRMS

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

General Conflicts

Firms identified a number of conflicts that cut across firm activities or that were not related to specific business lines. These conflicts include:

- ▶ outside business interests: employees may engage in outside business activities which could create conflicts of interest with the firm or with a client;
- ▶ gifts and entertainment: offering or receiving a gift or entertainment could create a conflict of interest;
- ▶ political contributions: providing political contributions could create the perception that the company is seeking a *quid pro quo*;
- ▶ charitable donations: firm or employees charitable donations could create the perception that the company or employee is seeking a *quid pro quo*; and
- ▶ confidentiality: confidential information may be used inappropriately to benefit the firm, an employee, or a client.

Supervision and Compliance Conflicts

Some firms identified potential conflicts between a firm's supervision and compliance departments' oversight roles and responsibilities and a firm's or individual's revenue generation objectives:

- ▶ producing managers may spend more time on revenue generating activities than performing needed supervision; and
- ▶ supervisory and/or compliance staff could be subject to pressure from sales management to protect revenue generating financial advisors.

Research-related Conflicts

A number of firms identified various forms of research-related conflicts of interest. These conflicts include:

- ▶ timeliness of dissemination: research may be disseminated to clients at different times thereby potentially favoring one client over another, this could include internal clients, e.g., sales and trading;
- ▶ pressure from investment bankers: research may be subject to pressure from investment bankers to issue reports, or change existing ratings, to help win or sustain investment banking business;
- ▶ pressure from issuers: issuers could pressure research to issue favorable reports in return for investment banking or other business;
- ▶ preferential access to research: a firm may provide preferential access to desk strategists' market commentary and trading ideas; and
- ▶ pressure from sales and trading: research may be biased to support the firm's sales and trading activities.

Banking and Capital Markets

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

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

Retail/Private Wealth

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

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

ENDNOTES

1. See, e.g., the Securities Act of 1933, the Securities Exchange Act of 1934, the Glass-Steagall Banking Act of 1933, the Investment Company Act of 1940 and the Investment Advisor Act of 1940.
2. As the SEC noted in a 2005 release, “[b]roker-dealers are subject to extensive oversight by the Commission and one or more self-regulatory organizations under the Exchange Act. The Exchange Act, Commission rules, and SRO rules provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder.” See Securities Exchange Act Rel. No. 50980 (January 14, 2005).
3. FINRA rules also impose high ethical obligations on broker-dealers. See, e.g., FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and FINRA Rule 2111 (Suitability).
4. See Appendix II for a copy of FINRA’s letter informing firms of the review and requesting that they provide certain information to FINRA.
5. See Appendix III for a summary of conflicts firms identified in their responses to FINRA.
6. All recommendations are, of course, subject to FINRA Rule 2111 (Suitability). This rule requires firms to, among other things, conduct both reasonable basis and customer-specific determinations before recommending a transaction or investment strategy involving a security. A reasonable basis suitability determination is necessary to ensure that a transaction or investment strategy is suitable for at least some investors. The customer-specific suitability determination must be performed on an investor-by-investor basis.
7. FINRA believes that the increasing “retailization” of complex products requires increased review of these products by the firms. The inherent conflicts in these products—e.g., use of proprietary indices, certain call or extension features or use of affiliated calculation agents—and their typical complexity raise serious issues for a firm preparing to sell them to retail investors. Given these concerns, some firms impose heightened criteria for eligible customers before a complex product could be recommended. In the retail context, FINRA remains concerned that reliance on disclosure may be an inadequate antidote to conflicts, unless the firm is confident that the customer can effectively evaluate these disclosures and make sound judgments about their potential impact on an investment recommendation.
8. “Compensation grid” refers to the compensation schedule many firms use to pay brokers. Typically, the more commission revenue the registered representative generates, the larger the percentage of that revenue the representative may keep. Compensation grids are discussed in greater detail in the compensation section.
9. The federal securities laws and FINRA rules require broker-dealers to have comprehensive supervisory structures. Under Section 15(b) of the Securities Exchange Act, a firm and its supervisory personnel may be held liable for failing to supervise an individual who engages in bad behavior unless (i) the firm has established supervisory procedures and a system for applying the procedures, and (ii) individuals reasonably discharged their supervisory responsibilities. FINRA also requires comprehensive supervision. NASD Rule 3010 requires each firm, among other things, to establish, maintain and enforce a written supervisory system; designate supervisory personnel; and conduct an annual internal inspection. NASD Rule 3012 details the requirements for a firm’s supervisory control system.
10. FINRA Rule 2111 (Suitability) [Frequently Asked Questions](#) 7.1., page 11.
11. In addition to the anti-fraud provisions discussed here, these also include rules under the Securities Exchange Act, e.g., Rule 10b-10. This rule generally requires a broker-dealer to provide confirmation statements for transactions, which must note, among other information, the firm’s compensation and whether it is acting as agent or principal. Rules 15c1-5 and 15c1-6 require a broker-dealer to disclose in writing to the customer if it has any control, affiliation, or interest in a security it is offering or in the issuer of the security.
12. As noted by the SEC staff, when a broker-dealer merely processes a customer’s order, but does not recommend securities or solicit the customer, the broker-dealer’s obligations are generally limited to information related to the consummation of the transaction. See January 2011 SEC Staff Study on Investment Advisers and Broker-Dealers, at 55 (SEC Staff Study).
13. *Id.*
14. *Id.*
15. *In re El Paso Corp. Shareholder Litigation*, 41 A.3d 432 (Del. Ch. 2012) and *In re Del Monte Foods Co. Shareholder Litigation*, 25 A.3d 813 (Del. Ch. 2011).
16. FINRA has stated on a number of occasions that firms must take care to present a fair and balanced picture of the risks, costs and benefits of investing in a product. In promoting the advantages of a product, firms must balance their promotional materials with disclosures concerning the attendant risks. Simply providing a prospectus does not cure unfair or unbalanced sales or promotional materials, whether prepared by the firm or the issuer. See, for example, [Regulatory Notice 09-31](#), FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds, June 2009; [Regulatory Notice 08-81](#), FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment, December 2008; [Notice to Members 04-30](#), NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds, April 2004; and [Notice to Members 03-71](#), Non-Conventional Investments: NASD Reminds Members of Obligations When Selling Non-Conventional Investments, November 2003.
17. See earlier guidance on this issue, for example, [Regulatory Notice 07-55](#), Personnel Background Investigations: FINRA Reminds Member Firms of Their Obligations Regarding Background Investigations of Prospective Personnel, November, 2007; [Notice to Members 97-19](#), NASD Regulation And New York Stock Exchange Memorandum Discusses Sweep Report And Provides Guidance On Heightened Supervision Recommendations, April 1997; and, with respect to supervisory visits to office with personnel who have disciplinary records, [Notice to Members 98-38](#), NASD Reminds Members Of Supervisory And Inspection Obligations, May 1998. [Notice to Members 99-45](#), NASD Provides Guidance On Supervisory Responsibilities, June, 1999.

18. Firms need to determine whether a prospective employee is a statutorily “disqualified” person. The term disqualification is defined in Article III, Section 3 of the FINRA By-Laws, and among other things, renders FINRA member firms and their associated persons ineligible for membership, continued membership, association or continued association with FINRA.
19. See NASD Rule 3010(e).
20. See NASD Rule 3010(e) for greater specificity on the obligations of FINRA member firms and their hiring practices.
21. See NASD Rule 3010(b).
22. FINRA recognizes that in many firms a number of committees may review new business initiatives and that some of these may include conflict concerns as part of their remit. Here, FINRA focuses on the dedicated new business initiative review since firms identified this as the primary gateway for identifying and managing conflicts of interest in a new product launch.
23. In [Notice to Members 05-26](#), New Products: NASD Recommends Best Practices for Reviewing New Products, April 2005, FINRA identifies a number of good practices that include, but also go beyond, conflicts of interest. In the current report, FINRA focuses on how firms address conflicts of interest in their new product review.
24. See also [Regulatory Notice 12-03](#), Complex Products: Heightened Supervision of Complex Products, January 2012, and [Notice to Members 05-59](#), Structured Products: NASD Provides Guidance Concerning the Sale of Structured Products, September, 2005.
25. Large firms typically have a variety of committees outside the new business initiative committee where issues, including those related to conflicts, may arise. FINRA’s focus in this section is on the new business initiative committee.
26. Revenue-sharing payments can take many different forms. For example, a fund company may pay a firm additional amounts at year end based on the amount a firm’s customers currently hold in the offeror’s funds, or based on the firm’s total sales of the offeror’s funds in the previous year. They can also take the form of other cash payments, such as an offeror helping to pay the costs of a firm’s annual sales meeting. See, e.g., Securities Act Release No. 8358 (Jan. 24, 2004), 69 FR 6438 (Feb. 10, 2004), at 6441 n.17.
27. There are a number of FINRA rules which address compensation, including: NASD Rule 2440 (Fair Price and Commissions), IM-2440-1 (Mark-Up Policy), IM-2440-2 (Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities), FINRA Rule 5110 (Underwriting Compensation), FINRA Rule 5250 (Payments for Market-Making), NASD Rule 2830 (Investment Company Securities), FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company) and 5110 (Corporate Financing Rule—Underwriting Terms and Arrangements), and NASD Rule 2830 (Non-Cash Compensation).
28. The Commission has stated that undisclosed markups of more than 10 percent on an equity security are fraudulent, and that a markup of less than 10 percent may be fraudulent depending on the circumstances. Acceptable markups on debt securities are significantly lower.
29. See Timothy Edward Daly, FINRA Letter of Acceptance Waiver and Consent (April 27, 2012) for an example of inappropriate behavior with regard to commission-based vs. fee-based accounts.
30. U.S. Government Accountability Office, 401(K) Plans: Labor and IRS Could Improve the Rollover Process for Participants, GAO-13-30, March 7, 2013, p. 10.
31. Not all firms implement performance appraisals of their registered representatives. In addition, legal restrictions may limit firms’ ability to reduce the non-discretionary salary portions of individuals’ compensation.
32. See, for example, *Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest*, Report of the Board of IOSCO, December 2012; *Guidelines for the Regulation of Conflicts of Interest Facing Market Intermediaries*, Report of the Emerging Markets Committee of IOSCO, November 2010; *Private Equity Conflicts of Interest*, Report of the Technical Committee of IOSCO, November 2010; *Market Intermediary Management of Conflicts that Arise in Securities Offerings - Final Report*, Report of the Technical Committee of IOSCO, November 2007; and *IOSCO Statement Of Principles For Addressing Sell-Side Securities Analyst Conflicts Of Interest*, Statement of the Technical Committee of IOSCO, September 2003.
33. Investment Industry Regulatory Organization of Canada, IIROC Rule 42.4 Guidance.

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**STAFF SUMMARY REPORT ON EXAMINATIONS OF
INFORMATION BARRIERS:
BROKER-DEALER PRACTICES UNDER
SECTION 15(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

By the staff of the Office of Compliance Inspections and Examinations

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
September 27, 2012

The SEC, as a matter of policy, disclaims any responsibility for any 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 and do not reflect the views of the Commission or of others at the SEC.

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I. EXECUTIVE SUMMARY

Overview: The examination staff of the Securities and Exchange Commission (“SEC” or the “Commission”), FINRA, and the New York Stock Exchange’s (“NYSE”) Division of Market Regulation conducted examinations of the programs that exist at broker-dealers¹ to protect against the misuse of material nonpublic information (“MNPI”). The purpose of the review was to assess broker-dealer compliance with regulatory requirements surrounding MNPI, primarily pursuant to Section 15(g) of the Securities Exchange Act of 1934 (“Exchange Act”),² and to evaluate how broker-dealers consider and analyze new business practices, new technologies, and new controls that may impact their compliance efforts. This report contains numerous defined terms, which are set forth in Appendix A to this report.³ *This report, which discusses the staff’s observations during these examinations, reflects the views of staff and does not represent findings or conclusions of the Commission. This document should not be considered legal advice.*

Information Barriers:

In many instances, broker-dealers may receive nonpublic information regarding their clients and market events as part of their business operations, including financial advisory,⁴ origination,⁵ and trading activities, often under circumstances in which a duty of trust and confidence may be owed to the client or an involved party.⁶ When nonpublic

¹ Examiners from the Commission (the “staff”) examined six of the largest broker-dealers. Examiners from the NYSE and from FINRA examined an additional thirteen broker-dealers, and their observations were incorporated into this report. The FINRA examinations included examination of three broker-dealers that were small in size when compared to the other broker-dealers being examined and had business activities focused on private investment in public equity (“PIPE”) transactions.

² 15 U.S.C. §78o(g). The Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”) added Section 15(f) to the Exchange Act, which was later renumbered as Section 15(g) by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank Act”).

³ These definitions are used only for purposes of this report and are not intended for any other context. Some of the definitions are based on existing statutes, laws, and cases as of the date of this report. Other definitions are derived from commonly used industry terms.

⁴ “Financial advisory” is an industry term that refers to advice to business organizations such as corporations, usually by members of an Investment Banking Department, including as to the structure of mergers and acquisitions. The term does not indicate any regulatory requirement or status.

⁵ “Origination” refers to the creation and issuance of a financial instrument that may represent either equity or debt of an issuer.

⁶ Exchange Act Rule 10b5-2 (17 C.F.R. §240.10b5-2) provides a nonexclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the “misappropriation” theory of insider trading under Exchange Act Section 10(b) and Rule 10b-5 (the law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5). In relevant part, Rule 10b5-2 states that a “duty of trust or confidence” exists in the following circumstances, among others: whenever a person agrees to maintain information in confidence; and whenever the person communicating the MNPI and the person to whom information is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the MNPI expects that the recipient will maintain its confidentiality.

information is material,⁷ Exchange Act Section 15(g) requires that registered broker-dealers establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of their business, to prevent its misuse in violation of the securities laws by the broker-dealer or its associated persons. Such misuse may occur through, among other activities, insider trading prohibited under Exchange Act Section 10(b) and Rule 10b-5;⁸ through trading during a tender offer in violation of Exchange Act Rules 14e-3 and 14e-5;⁹ or through issuance of a research report based on MNPI.¹⁰ Such policies and procedures created to prevent misuse of MNPI are commonly referred to as “information barriers.”

Other federal securities laws may impact information barriers in place at broker-dealers. Section 204A of the Investment Advisers Act of 1940 (the “Advisers Act”) places similar obligations on registered investment advisers.¹¹ Because broker-dealers may be dually registered as investment advisers or may be closely integrated with an affiliated investment adviser (as were most broker-dealers reviewed by the staff), broker-dealers may need to consider the specific challenges such circumstances present in designing their controls.¹² In addition to Exchange Act Section 15(g), broker-dealers may have

⁷ The terms “material” and “nonpublic” are not defined in Exchange Act Section 15(g), which relies on existing definitions of the terms established in case law. Information is material if “there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision or if the information “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information available.” *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); see *Basic Incorporated v. Levinson* 485 U.S. 224, 238 (1988) (materiality with respect to contingent or speculative events will depend on a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity); *Matrixx Initiatives, Inc. v. Siracusano*, No. 09-1156, 131 S.Ct. 1309 (2011) (Information that is not statistically significant may still be material if there is a substantial likelihood that reasonable investors would view the information as significantly altering the total mix of information available); see also Rule 405 under the Securities Act of 1933, 17 C.F.R. § 230.405; Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2; Staff Accounting Bulletin No. 99 (August 12, 1999) (64 FR 45150) (discussing materiality for purposes of financial statements).

Information is nonpublic if it has not been disseminated in a manner making it available to investors generally. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971). For purposes of insider trading law, insiders must wait a “reasonable” time after disclosure before trading. What constitutes a reasonable time depends on the circumstances of the dissemination. *Faberge, Inc.*, 45 S.E.C. 249, 255 (1973), citing *Texas Gulf Sulphur*, 401 F.2d at 854.

⁸ 15 U.S.C. §78j(b) and 17 C.F.R. §240.10b-5.

⁹ 17 C.F.R. §240.14e-3 and 17 C.F.R. §240.14e-5.

¹⁰ *SEC v. Citigroup Global Markets Inc., f/k/a/ Salomon Smith Barney Inc.*, Civil Action No. 03-CV-2945 (WHP) (S.D.N.Y.), Litigation Release No. 18111 (April 28, 2003), settled action (broker-dealer, among other issues, did not maintain written policies and procedures reasonably designed to prevent the sharing and misuse of MNPI between an affiliated person who served as director of another company and a research analyst covering that company).

¹¹ 15 U.S.C. §80b-4a.

¹² See, e.g., the settled injunctive action *SEC v. Charles Schwab Investment Management et al.*, Civil Action No. CV-11-0136 EMC (N.D. Cal.), Litigation Release No. 21806 and Release No. 34-63693 (January 11, 2011).

information barriers programs in order to rely on an exception or affirmative defense found elsewhere in the federal securities laws.¹³

The Report:

This report discusses the staff's observations from its examinations regarding potential sources of MNPI and some of the controls registered broker-dealers have in place to fulfill their Exchange Act Section 15(g) obligations. The report also discusses instances in which a broker-dealer(s) did not appear to have reasonably designed controls. Finally, the staff's review identified concerns that the staff will continue to monitor and that broker-dealers should periodically evaluate as to consistency with their obligations under Exchange Act Section 15(g).

Specific concerns that we noted in the course of these examinations include:

- A significant amount of interaction between groups that have MNPI and internal and external groups that have sales and trading responsibilities occurred on an informal (undocumented) basis. Broker-dealers instructed groups with MNPI to refrain from discussing MNPI (and sometimes any specific issuer) and instructed groups with sales and trading responsibility to identify themselves as groups that should not be provided with MNPI. However, the frequency of the discussions and the absence of documentation may make it difficult to trace any inadvertent (or even intentional) disclosures that may occur.
- At some broker-dealers, senior executives, referred to as "above-the-wall," received MNPI with no related monitoring or restrictions. Many of these senior executives had managerial responsibilities for business units involved in sales and trading on behalf of the broker-dealer. The absence of any documentation that these executives were receiving MNPI, in view of the natural motivation to have business units within one's areas of responsibility excel, as well as the apparent absence of related monitoring or other controls, raises serious concerns about the ability of broker-dealers to guard adequately against misuse of MNPI in firm and customer trading.
- Formal and documented discussions may occur between two internal business groups of a broker-dealer, in which MNPI is provided to sales, trading or research personnel for business purposes. Broker-dealers must make judgment calls between the need for information against the restrictions required, such as on the trading of securities or issuance of research reports in companies to which the MNPI related. In some cases, broker-dealers were not conducting any focused review of the trading that occurred after traders were provided with MNPI.
- The staff identified gaps in oversight coverage at most broker-dealers, although such gaps differed. Some broker-dealers did not review trading within accounts of institutional customers, asset management affiliates, or retail customers; or did not conduct any review when MNPI came through business activities outside of

¹³

See, e.g., Exchange Act Rule 14e-5(b)(8), 17 C.F.R. §240.14e-5(b)(8), and Exchange Act Rule 10b5-1(c)(2), 17 C.F.R. §240.10b5-1(c)(2).

the Investment Banking Department (“Investment Banking”) – such as participation in bankruptcy committees, employees serving on the boards of directors of public companies, changes in research ratings, or insiders of companies placing unusual trades.

These concerns by themselves may not necessarily suggest violations of Section 15(g), but broker-dealers may find it helpful to consider them in reviewing their policies and procedures.

We also highlight practices we believe to be effective:

- Broker-dealers were developing processes that differentiated between types of MNPI based on the source (e.g., business unit) from which the information originated within the broker-dealer or the nature (e.g., transaction type) of the information. In some cases, broker-dealers were creating tailored exception reports that took into account the different characteristics of the information.
- Broker-dealers were expanding the scope of instruments that they reviewed for potential misuse of MNPI by traders, including: credit default swaps, equity or total return swaps, loans, components of pooled securities such as unit investment trusts and exchange traded funds, warrants, and bond options.

Considering these practices may assist broker-dealers in reviewing their own policies and procedures. However, a practice that is effective in one context may be less effective in another. The effective practices described in this report are not an exhaustive list, and they constitute neither a safe harbor nor a “checklist.” Other practices besides those highlighted here may be appropriate as alternatives or supplements to these practices. To comply with Section 15(g), a broker-dealer must not only establish but also must maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI. Whether the controls described in this report would be appropriate for a particular broker-dealer would depend on the broker-dealer’s size and business model. In addition, broker-dealers may identify and implement other controls that are reasonably designed to meet the goals of Section 15(g).

II. BACKGROUND

In November 1988, ITSFEA was enacted, adopting Exchange Act Section 15(g). In March 1990, the Division of Market Regulation issued a report, “Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information” (“1990 Report”).¹⁴ The 1990 Report provided an overview of then-current broker-dealer information barrier practices and identified common practices, including the maintenance of watch and restricted lists and the accompanying review of employee and proprietary trading, written procedures, and documentation of reviews.

¹⁴ www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf. See, also, joint statement issued by the NASD and NYSE, available at NASD NTM 91-45; and *Broker-Dealer Internal Control Procedures for High Yield Securities*, a report by the Division of Market Regulation (1993), available at <http://www.sec.gov/divisions/marketreg/15freport1093.pdf>.

Information barrier programs, as described in the 1990 Report and as currently observed by the staff, have certain common features: employee training in legal and firm requirements; review and restrictions on trading; physical barriers; formal over-the-wall¹⁵ procedures prior to sharing information with public-side employees; and surveillance. The basic practices and procedures described in the 1990 Report have provided a framework to which enhanced information barriers have been added as business models and business tools have changed. The 1990 Report described practices that raised concerns, and the staff's current examinations generally found that the concerns have since been addressed by the broker-dealers examined – creation of more formal training programs, greater documentation when employees are brought over-the-wall, and significantly increased broker-dealer compliance staff involvement in determining what matters are to be added to the watch list.

Within the context of the current examinations, the staff observed that areas with ongoing access to MNPI are identified as “private-side,” and applicable physical barriers and trading restrictions are in place. Areas that have sales and trading responsibilities (“Sales and Trading”) are identified as “public-side,” and have restricted or monitored access to MNPI. Most broker-dealers centralize responsibility for managing the information barriers program into one group within the Compliance Department. The group is commonly referred to as the “Control Group” or the “Control Room,” and such terms are used interchangeably in this report.

This report does not restate the conclusions of the 1990 report, which remain generally appropriate. For example, this report does not go into detail about written procedures and employee training. Processes and controls that broker-dealers implement to meet their Section 15(g) obligations, which may include those described in this report, must be incorporated into written procedures. Employees generally should be appropriately trained on the requirements. To the extent the staff identified gaps in a broker-dealer's written procedures and training, the staff raised the issue with the broker-dealer.

In order to comply with Section 15(g), broker-dealers should continually reassess both potential sources and uses of MNPI and whether reasonable controls are in place. Practices that are sufficient for a broker-dealer at one time may not adequately comply with its legal obligations at other times. Importantly, written and implemented controls that are deemed reasonable may likely vary among broker-dealers depending on factors such as size and business model.

III. SOURCES OF MATERIAL NONPUBLIC INFORMATION

In assessing their Section 15(g) programs, broker-dealers should be aware of information flows – the MNPI directly accessible by internal broker-dealer groups, how such information is used, and whether and which internal and external parties may have access

¹⁵ The over-the-wall process is discussed in more detail below in V.C.1.

to the information.¹⁶ Some sources provide confidential information that at times is MNPI.¹⁷ The staff’s review identified the activities discussed below as those that may result in broker-dealers coming into possession of MNPI.

A. Corporate Clients

The staff has observed that the primary source of MNPI is information provided by clients of the broker-dealer that are companies with publicly traded securities.¹⁸ These corporate clients provide MNPI to broker-dealers for general advice and for specific transactions. Some corporate clients have relationship bankers within Investment Banking to provide ongoing advice. The relationship bankers at larger broker-dealers tend to specialize by industry (e.g., health care or transportation) or region (e.g., Latin America).

1. Mergers and Acquisitions

The staff has observed that information concerning mergers and acquisitions (“M&A”), also referred to as strategic transactions, appears to have a high degree of materiality. Most Investment Banking Departments have M&A specialists who work with the relationship banker in structuring the transaction. The broker-dealer could be representing either a potential seller (e.g., a company selling itself or certain assets) or the potential purchaser (e.g., a company or institutional investor seeking to purchase a company or certain assets). The broker-dealer’s involvement could begin after two companies have already reached a deal in principle or could begin when a company is looking to engage a broker-dealer to search for potential buyers or potential acquisition targets. In some cases, the broker-dealer is approached not with an offer of mandate but to compete with other broker-dealers to be engaged.

The staff observed that internally, employees from other areas of the broker-dealer, including Capital Markets groups (“Capital Markets,” see the description in the next section), the Credit Department (“Credit”), and Derivative Sales groups (“Derivative Sales,” frequently within Capital Markets) sometimes work on the transaction and therefore have access to the information. Capital Markets assists if the M&A transaction includes a securities offering or restructuring. Credit must approve any financing commitments. Derivative Sales may provide a price quote on a derivative as part of the

¹⁶ The staff’s review was conducted prior to the enactment of the “Stop Trading on Congressional Knowledge Act of 2012,” commonly referred to as the STOCK Act, which was signed into law on April 4, 2012, and this report does not address the implications of such Act. In designing their information barriers, broker-dealers should consider whether information gathered as part of their government affairs or lobbying efforts may constitute MNPI.

¹⁷ “Confidential information,” as used in this report, refers to information received under a duty of trust or confidence.

¹⁸ The staff’s review observed that the majority of MNPI received by broker-dealers related to public corporations. Similar analysis would apply to other types of entities with outstanding securities concerning which the broker-dealer received MNPI.

M&A transaction.¹⁹ Other business units or groups within the broker-dealer may be consulted for information – the Research Department (“Research”) or Sales and Trading.

Investment bankers may discuss transactions with clients that are external investment groups (e.g., advisors for private equity funds (“Private Equity”) and hedge funds).²⁰ Staff observed that typically, a group within Investment Banking, sometimes called the Financial Sponsors Group, has ongoing discussions with institutional investors.²¹ Initial discussions may be oral, and later information may be provided through virtual data rooms, private websites on which the nonpublic documents are posted for review.

2. Capital Markets / Syndicate

Many corporations raise capital for general corporate purposes or specific transactions through the issuance of equity and/or debt. Corporations also repurchase or restructure outstanding equity or debt, for example through a tender offer, stock buyback, or consent solicitation.²² Capital Markets facilitates such issuances, repurchases, or restructurings for corporate clients by assessing market interest in pending transactions, coordinating due diligence, and advising on the structure of the deal. The syndicate group (“Syndicate”) manages the issuance (e.g., building the book of purchasers and managing the settlement process). These functions are frequently either within Investment Banking or within a unit that jointly reports into Investment Banking and Sales and Trading. Capital Markets and Syndicate sometimes serve as the conduit in communications between Investment Banking and external parties such as other broker-dealers or institutional investors and between Investment Banking and Sales and Trading.

The Capital Markets and Syndicate functions are usually divided based on types of issuance – equity, high grade or investment grade debt, high yield debt, credit facilities and loans, and commercial paper, although in some cases the Capital Markets function is integrated for various debt instruments (bonds, credit facilities, and/or loans). The MNPI that may originate from these transactions include information about the company learned during the due diligence process, information regarding use of the proceeds, or information regarding the capital markets transaction itself. For example, the broker-dealer may learn the corporation will have reduced earnings through the due diligence

¹⁹ For example, if an acquisition is agreed to between a U.S. and non-U.S. entity with currency exchange risk, the broker-dealer or its affiliate may offer to enter into a foreign exchange swap to “lock in” the current exchange rate for the buyer’s acquisition price. Similarly, broker-dealers or their affiliates may sell over-the-counter interest rate derivatives to issuers in bond offerings to permit the issuer to hedge long-term interest rate exposure.

²⁰ At the time of the staff’s review, the investment groups might include the broker-dealer’s internal principal investment areas and affiliated funds.

²¹ At the time of the staff’s review, Private Equity tended to be involved in M&A transactions, and hedge funds tended to be involved with capital markets offerings.

²² Issuer tender offers are subject to Exchange Act Rule 13e-4 (17 C.F.R. §240.13e-4), which requires a filing with the Commission, among other requirements. An issuer buyback is an open market repurchase of securities, usually under the safe harbor of Exchange Act Rule 10b-18 (17 C.F.R. §240.10b-18). A consent solicitation is a vote by shareholders to waive a provision of the debt covenants, which may be held pursuant to the proxy rules.

process. The broker-dealer may discover that the proceeds will be used to acquire certain assets. The information regarding the issuance may be material, depending on factors such as: size of the issuance compared to the overall capital structure of the company; substantial revisions to the terms (e.g., interest rate) on which the corporation borrows; changes to the corporate structure – such as a put option on change in control; or impact on concerns about the company (such as the company’s ability to borrow).

In addition to Capital Markets and Syndicate, other areas may be involved with capital markets transactions. The Investment Banking relationship manager may have initiated the matter. An interest rate derivative may be offered to be used by the client to manage exposure resulting from the offering. Traders sometimes provide color on the market appetite for certain types of offerings. Issuer buybacks are generally forwarded to a trading desk for execution, which is sometimes a private-side group dedicated to processing transactions for corporate clients.²³

3. Derivative Sales

Corporate clients may wish to enter into a derivative with the broker-dealer or its affiliate in the context of an M&A deal or in the context of a securities offering. The M&A deal may be external to the broker-dealer and its affiliates (i.e., neither the broker-dealer nor its affiliates is acting as financial advisor to either the M&A buyer or the seller). Some broker-dealers represented that if they are not engaged to work on the original M&A deal, the M&A deal will have been already announced publicly prior to Derivative Sales’s involvement.

Derivative Sales has ongoing discussions with corporate clients.²⁴ For example, a corporate client may want to enter into foreign exchange derivatives if it expects to have income or liabilities accrued outside the U.S. that must be converted into dollars. As a result, Derivative Sales may obtain MNPI, such as unannounced earnings, from corporate clients through its business interactions.

4. Credit

Credit will have contacts with corporate clients in the context of review and approval of extensions of credit to finance an M&A or for ongoing operations.²⁵ Credit must also review and approve the creditworthiness of corporations as counterparties in derivative

²³ The issuer must disclose purchases in its next Form 10-K or 10-Q, pursuant to Section 703 of Regulation S-K (17 C.F.R. §229.703). However, if the transaction is material, the issuer may need to disclose the transaction prior to execution.

²⁴ The staff observed two unique derivative sales groups – one with corporate clients and one with institutional investor clients. Derivatives Sales as discussed in this report focuses on corporate clients.

²⁵ Each of the registered broker-dealers reviewed by the staff had one integrated Credit Department that provided services to the broker-dealer as well as affiliates of the broker-dealer and was physically integrated within the broker-dealer’s location. Section 15(g) requires that broker-dealers’ information barriers be reasonably designed to prevent the misuse of MNPI by any person associated with such broker or dealer. 15 U.S.C. §78o(g).

transactions. Credit conducts initial due diligence and receives ongoing confidential information, which at times may be MNPI, from the corporations as required by the credit or derivatives agreement between the two parties.

Credit may receive MNPI both through the periodic reports of the corporate client as well as activity under the credit extensions such as unanticipated material draws on credit facilities. Based on information received from corporate clients, Credit establishes an internal credit rating(s). As a result, Credit's internal credit rating for a corporate client may at times be based on MNPI.

B. Corporate Borrowers

As discussed above, Capital Markets will advise companies on raising capital, and during that process companies provide MNPI to Capital Markets. After the capital raising has been completed, the process to disclose information to existing holders of financial instruments differs based on product. Information on public securities must be disseminated to security holders and the public through public statements and filings. In contrast, information provided to lenders of credit may be nonpublic at the time of the lenders' receipt. Both during the origination and during the term of credit facilities (which include commitments to lend, lines of credit, term loans, revolving credit, among other financing vehicles, referred to collectively herein as a "loan"), the borrower typically is circulating confidential information, which at times may be MNPI, to the lenders privately through web sites hosted by external vendors ("Loan Sites").²⁶

One financial firm, which may be a broker-dealer or its affiliate, typically will act as administrative agent for the initial issuance of the loan. That administrative agent will have responsibility for, among other things, creating a Loan Site, granting and removing access to lenders and potential lenders, and maintaining records of current lenders. Other broker-dealers or their affiliates may participate in the loan as syndicate members, purchasing interests in the loan and receiving the confidential information to review.

After the initial issuance of the loan, loan interests are frequently traded among financial institutions, including broker-dealers, and institutional investors. Once a loan interest is purchased, the purchaser has the contractual right to review the confidential information contained on the Loan Site. Loan purchasers must decide whether to act as a private-side or public-side group. When acting as a private-side group, the traders access the Loan Site, including any MNPI contained on the site but may not trade securities based on the MNPI. When acting as a public-side group, the traders choose not to access the confidential information contained on the Loan Site so that they may freely trade both loan interests and securities such as equities and bonds of the same companies. Public-side groups may go private on certain companies, with resulting trading restrictions only on that company. If the trading group holding the loan interests is designated as public-side, the lender must select another internal group to access the Loan Site on behalf of the

²⁶ Typically, two Loan Sites are created – one for the origination process and one for the secondary trading market.

trading group (“Loan Site Monitors”).²⁷ The Loan Site Monitors will then receive the confidential information the borrower must provide to lenders.

As a result, broker-dealers may have access to MNPI through the following contact points:²⁸

- as administrative agent (usually through the loan origination function, which is frequently within Investment Banking or Capital Markets),
- as syndicate member (through the loan origination function or Loan Sales),
- as holder of interests in the loan purchased during origination (through the loan origination function, Credit, or a special purpose group),
- as manager of the Loan Site (an administrative group),
- as loan trader (trading group or principal investment area of the broker-dealer),
- as Loan Site Monitors for public-side groups to monitor information coming through the Loan Site, and
- as a member of the bankruptcy committee if the loans default.

The MNPI provided to broker-dealers may include information about the borrower, as well as the borrower’s affiliates, parent, or guarantor, such as:

- enhancements to liquidity (or limitations on liquidity based on borrowing conducted under a line of credit),
- use of proceeds for non-routine transactions,
- information required to be provided pursuant to the loan agreement (e.g., material litigation), or
- failure to meet certain loan covenants.

C. Non-Corporate Issuer Clients

The staff’s review identified two categories of non-corporate securities that could result in broker-dealers receiving MNPI when engaged to work on the origination: public finance securities and securitized products. Public finance securities are issued by governmental entities other than the federal government.²⁹ Securitized products are created when an entity sells an asset or assets to a special purpose vehicle (“SPV”). The

²⁷ No specific industry term exists for this group, which is frequently within Credit or an operations group (“Operations”).

²⁸ The staff notes that in some cases, an affiliate of the broker-dealer may be the legal entity contractually specified to fulfill these roles. However, the broker-dealer may have possession of MNPI because its employees, registered personnel, or associated persons are engaged in the activities specified in this section.

²⁹ The term “public finance securities” is used in this report to be synonymous with municipal securities as defined in Exchange Act Section 3(a)(29). 15 U.S.C. §78c(a)(29). However, more broker-dealers are using the term “public finance securities” or “public sector” to reflect that such securities are frequently issued by governmental entities other than municipalities.

SPV then issues securities, with the securityholders receiving payments generally dependent on the performance of the assets owned by the SPV.³⁰

Registered broker-dealers examined by the staff asserted that activities involved in the original issuance of such securities did not result in the broker-dealer receiving MNPI because any nonpublic information obtained is unrelated to any outstanding security or security-based swap. Specifically, the broker-dealers examined by the staff expressed the view that the information they obtained during due diligence is only relevant to that specific security, which does not yet have a market.³¹ The staff believes that broker-dealers should consider the extent to which any nonpublic information obtained may be MNPI, for example, if the information is material to an outstanding class of securities or is material to the new class of securities and is not fully disclosed prior to the commencement of public trading of such securities.

Once the securities are issued, it is possible that the broker-dealer may receive MNPI on the outstanding securities based on its continuing role as financial advisor to the issuer. Examined broker-dealers thought this was less likely in the case of public finance issuers, given the issuers' disclosures of information that may be made pursuant to a written agreement entered into as described by Exchange Act Rule 15c2-12. It is possible that the broker-dealer may get advanced word that the outstanding securities are about to default or re-fund. Broker-dealers also identified the following potential MNPI that may be received from public finance issuers: ratings changes, liquidity problems, substitution of property underlying the securities, modifications to the rights of security holders, regulatory investigations, and failure of the liquidity providers to perform. MNPI relating to securitized products may include information regarding defaults in the underlying assets or regarding the financial difficulties of any guarantor of the securitized product.

D. Investment Areas

Different groups within or associated with a broker-dealer may monitor the financial condition of issuers. Principal investment or trading groups (collectively, "Proprietary Groups") may invest or trade firm capital in public companies either in private

³⁰ Securitized product is an industry term for products that are sometimes also referred to as asset-backed securities, structured finance securities, or structured finance products. This section covers securitized products in which the entity sponsoring the issuance purchased the underlying assets in the secondary market, usually for the purpose of creating a securitized product. The discussion in this section is not intended to cover instances in which a corporate issuer securitizes its assets, which may have been created or originated by the corporate issuer. The staff believes that such transactions are more likely to provide MNPI consistent with other corporate capital markets transactions described in III.A.2, and the broker-dealers examined by the staff generally established information barriers controls for securitized products originations initiated by public corporations similar to information barriers controls in place for other corporate originations.

³¹ Broker-dealers gave as examples: public finance securities based on the revenue stream of a specific project rather than the general creditworthiness of the municipality, or instances in which the value of securitized product is derived from the pool of assets solely underlying that specific issuance.

transactions or in the open market.³² Other groups within the broker-dealer or associated with the broker-dealer may monitor issuers on behalf of customers – either broker-dealers’ institutional sales groups or internal or affiliated asset management groups (“Asset Management”, and collectively with Proprietary Groups, “Investment Groups”). With respect to Asset Management, Private Equity tends to have more frequent contacts with their portfolio companies as well as with corporations seeking potential investments.

As a holder of a substantial interest in a corporation, Investment Groups may receive confidential information, which at times may be MNPI, directly from the corporation. For example, the Investment Group may have an employee serving on the board of directors of the company or a shareholder committee. If a company has financial difficulty, a representative from the Investment Group may be invited to participate in bankruptcy or creditor committees of distressed companies (or even pre-bankruptcy committees).³³

Investment Groups may also obtain MNPI as part of the investment process. The information may be obtained by discussions between the employee and an insider of the company. For example, Investment Groups may be approached about investing in an offering that has not yet been publicly disclosed (e.g., a PIPE).³⁴

E. Institutional Investor Customers

Broker-dealers receive confidential information from institutional investors through taking orders for execution in the secondary markets and in processing and clearing such transactions as prime broker.³⁵ The order information received from institutional investors may be material to the securities being purchased, and Section 15(g) requires broker-dealers to have policies and procedures reasonably designed to prevent misuse of

³² Section 619 of the Dodd Frank Act places limitations on the ability of banking entities and certain nonbanking financial companies to engage in proprietary trading or to acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.

³³ Such a committee may be a formal committee established by the bankruptcy court or an informal committee established by a group of creditors. See, e.g., *In the Matter of Greenfield and Blue River Capital LLC*, Release No. 34-52744 (November 7, 2005), and *SEC v. Barclays Bank PLC and Steven J. Landzberg*, Civil Action No. 07-CV-04427 (S.D.N.Y.) Litigation Release No. 20132 (May 30, 2007), settled actions.

³⁴ Section 15(g) cases have been brought against broker-dealers for failure to prevent the misuse of MNPI received by an employee as board member and officer of unrelated company (*SEC v. Citigroup Global Markets Inc., f/k/a/ Salomon Smith Barney Inc.*, Civil Action No. 03-CV-2945 (WHP) (S.D.N.Y.), Litigation Release No. 18111 (April 28, 2003), settled action; *In the Matter of Gabelli & Company, Inc.*; and *Gamco Investors, Inc.*, Release No. 34-35057 (December 8, 1994), settled action); and information regarding a proposed PIPE transaction (*In the Matter of Friedman, Billings, Ramsey & Co., Inc.*, Release No. 34-55105 (December 20, 2006), settled action; *SEC v. Friedman, Billings, Ramsey & Co., Inc. et al.*, Civil Action No. 06-CV-02160 (D.D.C.), Litigation Release No. 19950 (December 20, 2006), settled action).

³⁵ Prime brokerage departments offer custody and clearing services to institutional clients, including securities lending. Prime brokerage departments may also obtain other nonpublic information relating to shareholder activities, for example, through processing tenders made in response to a tender offer.

MNPI, which may include customer order information.³⁶ Customer order information is received by groups within Sales and Trading, usually located on open trading floors. After execution, information on the positions held by the institutional investor, including large short positions, as well as institutional investors' trading strategy, may be material.

Other areas within Sales and Trading may gain access to customer information – personnel building trading models and stock loan desks. Broker-dealers also routed aggregate information on order flow to other areas of the broker-dealer and to external parties. Broker-dealers represented that this information, referred to as market color, is intended not to be based on a specific customer but overall market trends. However, the staff believes that market color should be evaluated for whether it represents MNPI, particularly when the information provided is based on or largely represents a specific customer's order.

F. Insider Customers

Certain customers of the broker-dealer are also insiders of a public corporation or other similar entities with access to MNPI. Generally, broker-dealers dealt with two categories of insiders. Corporate officers and directors may be customers of broker-dealers' individual investor businesses. Large institutional investors may have acquired sufficient ownership of a corporation as to become an insider. Insider customers provide two types of MNPI. First, they have information gathered from their role as insider (e.g., the customer is a Chief Executive Officer about to retire). Second, insiders' personal transactions in the stock of their company may be material. Information concerning the order, which may constitute MNPI, is forwarded to certain internal groups, sometimes in Operations, with responsibility for processing insider transactions. The staff believes that broker-dealers should consider which internal groups have access to MNPI and evaluate the controls (e.g., physical barriers and personal trading reviews) in place to prevent the misuse of such information.

G. Research

Information within Research, such as the initiation of research coverage or changes in price targets, may be MNPI.³⁷ Broker-dealers are starting to incorporate into their information barriers programs other publications and ratings systems that may be

³⁶ The Commission has found violations of Section 15(g) by a broker-dealer that allowed traders without customer order execution responsibility to see customer order information on the customer facilitation traders' computer screens and hear market makers discuss customer orders. *See In the Matter of Merrill Lynch, Pierce, Fenner & Smith Incorporated*, Release No. 34-63760 (January 25, 2011), settled action. The Commission has also found violations of Section 15(g) based on a broker-dealer's failure to have appropriate controls over the squawk boxes used to disseminate customer order information. *See In the Matter of Merrill Lynch, Pierce, Fenner, & Smith Incorporated*, Release No. 34-59555 (March 11, 2009), settled action.

³⁷ *See In the Matter of Goldman, Sachs & Co.*, Release No. 34-66791 (April 12, 2012); *In the Matter of the Buckingham Research Group, Inc.*, Release No. 34-63323 (November 17, 2010); and *In the Matter of Banc of America Securities LLC*, Release No. 34-55466 (March 14, 2007); settled actions. *See, generally* FINRA Rule 5280 (regarding trading ahead of research reports).

material. For example, Research may maintain lists containing a subset of their buy and sell recommendations to highlight certain ratings for investors. The addition or deletion of names from the list may be material. Research may issue short term views on securities, with an analyst having recommendations for both a short term investment horizon and longer term investing. The short term rating may raise concerns if it, in effect, provides advanced notice of a change in a long term rating to a select group.

H. Secondary Sources of Material NonPublic Information

MNPI provided to broker-dealers is frequently incorporated into secondary sources. For example, MNPI is reported into the Control Room and incorporated into a database there. The resulting database becomes a new potential source of MNPI. The Conflicts area of the broker-dealer (“Conflicts”) also receives MNPI on potential deals and creates its own database.³⁸ Various support functions – such as information technology (“IT”), Operations, and risk monitoring groups such as Credit – have ongoing access to the MNPI initially sourced by one of the functions described above. In some cases, groups, using the MNPI, create a document or analysis that itself may be MNPI (for example, see the discussion above on internal credit ratings).

IV. CONTROL STRUCTURE

The staff’s review observed broker-dealers generally categorized various groups, functions, activities, and information for control purposes. The category into which each is placed impacts the treatment.

A. Public-Side vs. Private-Side Business Groups

Broker-dealers classify business groups as “public-side” or “private-side.” In order to manage the different types of MNPI within a broker-dealer, the controls typically consider factors beyond public or private classifications. For example, the staff observed that private-side and public-side groups frequently were segregated from other private-side and public-side groups. More broker-dealers are adopting this approach, with pockets created based on the type of MNPI to which each group has access.

Private-side groups are areas that have routine or ongoing access to MNPI. As a result, broker-dealers generally physically segregate such groups. The groups typically are restricted from personal and firm trading in securities for which the group has MNPI, regardless of actual knowledge of the individual. In effect, once classified as private-side, the broker-dealer assumes that persons within these groups do have MNPI. Private-side groups typically include Investment Banking, Credit, Capital Markets, Syndicate (and origination functions generally), certain Investment Groups, and support and control personnel supporting these areas.

³⁸ All broker-dealers have a system to check individuals and the broker-dealer generally for conflicts between the project and other projects worked on by the broker-dealer or those employees (e.g., if the broker-dealer has an exclusive agreement with one client that would preclude working for a competitor).

Public-side groups are areas that do not have access to MNPI on a routine basis. If an employee within a public-side group does receive access, that employee is supposed to be identified to the Control Room as being over-the-wall in the corporation/security (see discussion at V.C.1 below). Public-side groups are allowed by the broker-dealer to trade in securities for which the broker-dealer has MNPI as long as that trader does not have access to the MNPI (or is not directed to trade by someone with access). Most Sales and Trading groups are public-side groups. Research may be considered a public-side group by some broker-dealers. Research itself may have MNPI such as ratings changes, and the physical barriers in place between private-side and public-side groups tend to exist between Research and Sales and Trading even if both are identified as public-side.³⁹

Certain public-side groups are organized to allow them to be private on specific names. When the public-side group “goes private” on a name, the group has MNPI on that name (a company) and is restricted from trading in securities of that company. In order to accommodate the mixing of public and private, most broker-dealers either segregate the group from other public-side groups or apply the restriction to all Trading groups within the same physical location.

A few broker-dealers use an “above-the-wall” classification for certain persons and groups. Under the classification, the person and/or group are neither public-side nor private-side. As an above-the-wall category, broker-dealers allow certain MNPI to be provided on a need to know limited basis without going through the over-the-wall process. Physical barriers, documentation, or other controls may be limited or non-existent. The staff is concerned about the use of the above-the-wall category and believes that broker-dealers should consider whether the category is appropriate and whether additional controls should be in place. The staff observed the above-the-wall category used at some broker-dealers in three different situations – certain senior management to permit them to obtain MNPI for wall crossings, Research, and the syndicate group. The lack of documentation or other controls when MNPI is disclosed to above-the-wall executives may, in certain circumstances, result in activities in violation of the securities laws, such as Exchange Act Sections 10(b) and 15(g). For example, when the person receiving unreported, unmonitored MNPI has management responsibility over business units involved in sales or trading activity, staff believes that such circumstances could run the risk of facilitating rather than preventing the misuse of MNPI in firm trading. Staff expects regulated entities to be especially mindful of this risk when assessing whether an executive needs to be “above-the-wall.” For those senior executives deemed to have an actual need to know MNPI without pre-approval, broker-dealers are strongly encouraged to consider the benefits, in terms of statutory compliance, of maintaining a MNPI disclosure reporting and monitoring requirement for above-the-wall executives and others in such a category.

³⁹ While Research may routinely have MNPI (e.g., changes to research ratings), broker-dealers may need to address the adequacy of controls over the group’s receipt of MNPI from external sources, which could impact the ability to issue research. *SEC v. Citigroup Global Markets Inc.*, f/k/a/ *Salomon Smith Barney Inc.*, Civil Action No. 03-CV-2945 (WHP) (S.D.N.Y.), Litigation Release No. 18111 (April 28, 2003), settled action.

B. Types of Material NonPublic Information Sources

The sourcing of MNPI has one of three broad characteristics. The broker-dealer may work on a transaction and through the work receives MNPI concerning the transaction and other information gathered as part of the transaction. The broker-dealer may have ongoing contacts with an information source, through which MNPI is received on a one-off basis (e.g., the corporate insider reveals that the corporation is having reduced earnings). The broker-dealer may have sources that provide on an ongoing basis confidential information, which at times may be MNPI. The type of information source has significance with respect to how broker-dealers are able to capture MNPI within their information barriers programs.

1. Transaction Sourced Material NonPublic Information

Investment Banking, Capital Markets/origination, private-side Investment Groups, or Sales and Trading may receive transactional MNPI. Information regarding the transaction is forwarded to the Control Room for consideration of placement on monitoring lists (see IV.C. for a discussion of monitoring lists). While most transaction sourced information is sourced from private-side groups, public-side groups sometimes receive transactional MNPI (e.g., when the group purchases in a PIPE).

a. *Method of Notifying the Control Room*

A common practice in the past was reliance on the deal team phoning the Control Room to report the transaction. Because the deal team members can be busy developing the project, they may not put priority on providing notice. The staff's review observed that all broker-dealers had at least some instances in which the Control Room did not receive notice or received delayed notice and so did not have adequate controls in place to prevent misuse of such MNPI. The staff observed the following factors at some broker-dealers that may have contributed to the absence of timely notice: sole reliance by the Control Room on the Investment Banking team to determine whether and when a matter should be placed on a monitoring list; little written guidance as to when information should be reported to the Control Room and what matters would trigger the notice requirement; and absence of a process to test whether the appropriate information was in fact being placed on the lists as necessary.

Some broker-dealers had put controls in place to address absence or delays in notice:

- More broker-dealers are developing systems to notify automatically the Control Room based on information entered into computer systems used for deal management or for conflicts checks.
- Some Control Rooms review pipeline reports, commitment committee minutes, or news articles that reference the broker-dealer to identify items missed. However, the staff noted that such information may be received after significant work has been done on the transaction.

- Some broker-dealers conducted lookback reviews of trading activity that took into account possible delays, including a standard review of a few weeks prior to placement on the watch list or a special purpose review when a delay in placement was identified.

b. Materiality

Information reported into the Control Room is assessed for materiality with respect to public companies (issuer, target, acquirer, competitor, or shareholders that are public companies) to determine whether that specific company should be placed on a monitoring list to check for possible improper trading.⁴⁰ For example, the acquisition of a small company by a larger company may be material to the securities of the smaller company only or may be material to both companies' securities. Broker-dealers stated that such materiality determinations permitted them to focus surveillance on significant transactions. Typically the Control Room, after discussions with deal team members, determines materiality.

The staff believes that registered broker-dealers have a responsibility to make reasonable judgments regarding the materiality of such information. If in fact the transaction is determined later to be material, broker-dealers should be prepared to justify their decisions not to monitor a transaction.

The staff observed the following practices at some broker-dealers that may make it difficult for broker-dealers to monitor and evaluate whether their materiality determinations were reasonable:

- failure to memorialize transactions deemed immaterial, although all broker-dealers reviewed by staff had changed this practice during the course of the review,
- failure to document the basis of the determination of immateriality,
- lack of any specific factors used to assess materiality, and
- failure to identify later receipt of MNPI (e.g., the transaction size is increased significantly).

One broker-dealer excluded all transactions within certain categories from monitoring lists, such as investment grade securities offerings and credit extensions. However, the staff observed that some such offerings and extensions were considered significant by contemporaneous public commenters. Most broker-dealers did assess materiality of investment grade securities offerings and credit extensions and included at least some of

⁴⁰ In order to evaluate materiality, some broker-dealers use measures such as the relative size of a transaction compared to the size of the companies, with some assessment of likely impact on share price. The monitoring list referred to here is used for automated surveillance of public securities, and private companies are not generally included on such list. This discussion should not be interpreted to limit the scope of Section 15(g), which is not limited to misuse of MNPI related to public companies.

these transactions on monitoring lists. To the extent that such transactions are material, failure to include such MNPI within the broker-dealer's information barrier program may be a violation of Section 15(g). As such, the staff would strongly urge broker-dealers not to exclude categorically transactions.

As discussed above, transaction sourced information may provide MNPI both regarding the transaction and information received while working on the transaction (e.g., through the due diligence process). When broker-dealers exclude transactions from monitoring lists because they deem information about the transaction immaterial, the staff notes that the broker-dealer may later come into possession of MNPI through the due diligence process. The staff believes that broker-dealers need to have a process to identify such MNPI, and some broker-dealers did rely on the process described in IV.B.2 on item-specific MNPI to identify which items should be placed on a monitoring list.

c. Placement on a Monitoring List

The purpose of notification to the Control Room is to trigger placement on a monitoring list (discussed in more detail below). While all broker-dealers reviewed had policies to place material transactions on a monitoring list,⁴¹ broker-dealers could not give a bright line test as to when this would occur. Broker-dealers stated that corporations frequently discuss potential transactions, many of which never proceed beyond generalized discussions. Broker-dealers stated that they would make judgment calls as to when the transaction was of reasonable certainty prior to placing on a monitoring list. The staff's review confirmed the variations that may occur between potential transactions. In some cases, the broker-dealer is approached because a corporation wants to discuss potential assets or companies to be purchased but has no specific candidates identified and no definitive intention to proceed with any acquisition. However, in some cases, the first contact conveys MNPI to the broker-dealer as in the case of a corporation that has already received an offer to be acquired, and the staff believes that even a tentative offer may constitute MNPI.⁴²

The staff observed two practices that resulted in a delay in placement on the monitoring list. Some broker-dealers focused on whether they were formally mandated by a client to evaluate for placement on a monitoring list. However, the staff observed that mandate frequently occurred only shortly prior to announcement and/or after significant work by the broker-dealer had taken place. Some broker-dealers wait until the materiality assessment has been conducted. As a result, the processes delayed placement on a monitoring list even though the broker-dealers already had possession of MNPI.

⁴¹ The staff observed that broker-dealers create monitoring list entries based on specific matters or transactions. For example, if a broker-dealer is engaged to work on an offering for a corporate client and is also engaged to work on an acquisition for the same client, two separate entries will be created. The staff believes that this practice may assist broker-dealers monitor for misuse of the information, as potential misuse (e.g., purchasing or selling the related security) will differ based on the matter involved.

⁴² See footnote 7.

Broker-dealers are sometimes provided with MNPI while seeking a specific engagement, and in some cases another broker-dealer is selected to work on the transaction. As a result, the broker-dealer may have MNPI regarding the existence of the transaction, although it would be unaware of ongoing developments within the deal. Some broker-dealers continued to monitor trading in the company's stock even if they were not hired if they had reasonable certainty that the transaction was progressing at another broker-dealer (see V.G. for a discussion of the scope of monitoring). Some broker-dealers immediately remove the item from any monitoring list and so may not have adequate controls in place for MNPI in their possession.

The staff also noted another practice that may result in an absence of monitoring that it believes may be inconsistent with Section 15(g). Some broker-dealers removed items from any monitoring list upon public announcement or shortly thereafter. While the information regarding the transaction is now public, the broker-dealer continues to work on the transaction until closing and may receive additional MNPI regarding the transaction. For example, the broker-dealer may be aware of the progress towards getting shareholder approval or may be aware that one of the parties is considering terminating or renegotiating the transaction.

2. Item-Specific Material NonPublic Information

Various public-side and private-side groups within the broker-dealer may have ongoing contacts with insiders outside the context of any transaction. The relationship between private-side and insiders may contemplate at times that MNPI will be provided (e.g., for financial advisory purposes). The relationship between public-side and insiders is generally intended to be based on public information only, but private information may be inadvertently disclosed. Broker-dealers generally provide written policies to employees as to their obligation to notify the Control Group.

Two broker-dealers did not require MNPI within the possession of the Credit Department to be reported into the Control Room. The staff raised this as a concern with the broker-dealers, and the broker-dealers responded by implementing new procedures directing the Credit Department to report MNPI into the Control Room.

3. Ongoing Sources of Confidential Information

Certain sources provide ongoing access to confidential information that at times may be MNPI. Sales and Trading, Investment Banking, Capital Markets, and Credit may access information given to lenders under a credit agreement or information obtained as a large investor in a corporation. Typically, the recipient must execute a confidentiality agreement prior to being granted access. Employees sometimes serve as directors of public companies, as members of bankruptcy committees, or as the broker-dealer's contact when the broker-dealer owns a large percentage of the company. Employees also may serve on board of directors as the result of an outside business interest.

Broker-dealers should take into account when a public-side group with investment or trading responsibilities has ongoing access to confidential information that may at times be MNPI.⁴³ The *Gabelli* action illustrates concerns with reliance on a public-side employee to self-report when a specific instance of MNPI arises. The staff believes that similar concerns are presented when the public-side employee has ongoing access to confidential information, which at times is MNPI, through other sources (e.g., Loan Sites).

The staff's review observed that broker-dealers did differentiate between public-side and private-side business units with access. In most instances, broker-dealers immediately alerted the Control Group when a public-side area is receiving the confidential information for monitoring purposes. For private-side areas, the information was usually not forwarded to the Control Room unless the private-side employee believed that a specific item constituted MNPI (i.e., as discussed under the prior section). The staff identified instances in which public-side employees who served as directors of public corporations were not monitored, and the staff raised this concern with the broker-dealers.

Information from Research generally is not reported into the Control Room until shortly prior to being publicly released. However, usually all information within a given category is reported in (e.g., all upgrades and downgrades), without a materiality determination for each specific item. Two other sources of confidential information (that are at times MNPI) are generally not reported into the Control Room: institutional customer information (e.g., orders) and corporate insider customers, although other controls are in place as discussed below.

C. Monitoring Lists

The 1990 Report focused on watch lists and restricted lists. Current information barriers are more complex. Matters reported into the Control Room receive different treatment based on the information source. All broker-dealers examined by the staff maintain a watch or grey list, as described in the 1990 report. Broker-dealers also maintain other lists, which were sometimes called private names lists, confidential lists, or control lists or did not have any specific name at all. Because no industry standard term is in use, the staff will discuss the lists by their function.

Information reported into the Control Room is generally entered into a database ("Control Database"), which then generates the lists discussed below. Each list is generated based on the coding or fields selected when the item is created or updated. In general, all items reported into the Control Room are entered into the Control Database. As discussed above, broker-dealers at one time did not record matters they deemed immaterial, but most have since altered their procedures.

⁴³ See *In the Matter of Gabelli & Company, Inc; and Gamco Investors, Inc*, Release No. 34-35057 (December 8, 1994), settled action.

1. General Surveillance Lists

The first type of list results in general surveillance of trading activity, as discussed below in V.G. Traditionally, the watch or grey list fulfilled this function. All large broker-dealers have a watch or grey list, which continues to capture instances in which a private-side group (and sometimes a public-side group) has possession of MNPI.⁴⁴ Some broker-dealers maintain additional lists for certain events (e.g., Credit risk ratings or over-the-wall),⁴⁵ and the resulting surveillance may be different, as discussed below in V.G. Most transaction sourced (IV.B.1) and item-specific MNPI (IV.B.2) will be placed on a general surveillance list, although some items may instead be placed on one of the other lists discussed below.

2. Hybrid Restricted and Surveillance Lists

The second type of list acts as a restricted list for certain specific groups and a surveillance list for the rest of the broker-dealer. The most common example of this type of list is when public-side groups have access to ongoing sources of confidential information, which at times may be material, referred to as “going private on a name”. Broker-dealers may create lists that implement a complete restriction on trading by that group and other groups that share the same physical space. The list generally serves to monitor trading by other public-side groups that are physically segregated and employee trading generally. One broker-dealer maintained surveillance lists that restricted the specific group that had access to the MNPI but did not result in surveillance of the rest of the broker-dealer, and the staff raised this as a concern.

3. Firmwide Restricted Lists

In some cases, broker-dealers may decide that certain sources of MNPI should be placed on a restricted list.⁴⁶ This process is more common when the placement does not indicate that MNPI has been received but rather that it could be received. The types of MNPI sources placed on a restricted list varied considerably by broker-dealers but may include: corporations on which employees served as directors; for which Trading groups accessed private Loan Sites; or for which the broker-dealer was facilitating a transaction by an insider.

Another example is the use of restricted lists after transactions have been announced. While the specific transaction has become public, the broker-dealer may continue to have two types of MNPI. First, some transactions are contingent upon certain conditions being

⁴⁴ Examiners identified a small broker-dealer that did not have a watch list and relied solely on its restricted list.

⁴⁵ Some broker-dealers maintain over-the-wall as a separate list, other broker-dealers annotate watch /grey list entries.

⁴⁶ The restricted lists discussed in this section differ from restricted lists based on legal requirements. Legal restricted lists incorporate restrictions mandated by specific regulatory requirements, such as Exchange Act Rule 14e-5, 17 C.F.R. § 240.14e-5; Regulation M, 17 C.F.R. § 242.100-105; and Regulation S, 17 C.F.R. § 230.901-905.

met. For example, the transaction may be completed only upon an affirmative shareholder vote, regulatory approval, or director approval. The broker-dealer may receive MNPI about the approval prior to public announcement.⁴⁷ In addition, the broker-dealer may receive MNPI about financial conditions of the corporation. For example, in the context of an offering, the broker-dealer may receive nonpublic information, such as unannounced earnings information, in order to assist the issuer in updating its filed but not yet effective registration statement to reflect unannounced earnings information.

Some broker-dealers have implemented trade-through policies that permit certain types of firm accounts to trade without restriction in restricted list securities and allow other types of firm accounts to trade below certain thresholds. The staff is concerned that restricted list surveillance only reviews whether the account is trading consistently with any applicable restrictions rather than a review to determine whether such trades may be based on MNPI.

In order to implement the restriction, broker-dealers must disseminate information to the groups that are restricted. At one time, it was common to relay information to traders on restrictions through emails or a list posted on the intranet. The effectiveness of such notice is questionable for high volume traders who may not have time to consult a list (with several hundred names) prior to each trade. More broker-dealers are implementing other methods of notice that may be more effective, such as coding of order entry systems, pop-up notices in the trading systems, or hard blocks in trading systems that require a code from Compliance in order to complete the transaction.

V. CONTROLS

After establishing the overall control structure, broker-dealers must implement controls reasonably designed to prevent inadvertent or deliberate accessing of MNPI by unauthorized persons and to identify instances in which it appears that an unauthorized person has accessed MNPI.⁴⁸ The staff's review identified the following controls implemented to address potential misuse of MNPI.

⁴⁷ The potential for leakage of information may be greater at this point because public-side traders are more likely to be brought over-the-wall after public announcement of the transaction.

⁴⁸ The report of the House Committee on Energy and Commerce on ITSFEA stated: "The requirements of these new statutory provisions reflect the Committee's belief that broker-dealers . . . must not only adopt and disseminate written policies and procedures to prevent the misuse of material, nonpublic information, but also must vigilantly review, update, and enforce them. . . . the Committee expects that institutions subject to the requirements of this provision will adopt policies and procedures appropriate to restrict communication of nonpublic information and to monitor its dissemination, such as restraining access to files likely to contain such information; providing continuing education programs concerning insider trading; restricting or monitoring trading in securities relating to which the firm's employees possess nonpublic information; and vigorously monitoring and reviewing trading for the account of the firm or of individuals." H. Rep. No. 100-910 at 21-22 (1988).

A. Limiting Authorized Access

The staff believes that one important component of an information barriers program is restricting access to MNPI only to those persons that need to know the information. Examined broker-dealers placed limitations on access to nonpublic information generally regardless of whether the employee is public-side or private-side. Most broker-dealers have written policies that instruct personnel not to discuss confidential information with other public-side and private-side personnel unless they need to know the information.

1. Deal Team Members

Initially, information on M&A and capital markets transactions is generally limited to deal team members, both to address concerns about conflicts and to limit dissemination of MNPI. Broker-dealers have processes to add employees to the deal team working on a transaction. Public-side employees must go through an over-the-wall process prior to being given access (see discussion at V.C.1 below). Some broker-dealers also use the over-the-wall process when a private-side employee outside of Investment Banking is to join the deal team, which may assist broker-dealers in monitoring the dissemination of information. Within Investment Banking, most broker-dealers rely on Conflicts to approve the addition of a private-side employee to the deal team.

2. Sharing of Information

General information about transactions is circulated to the Control Room to incorporate into the Control Database. At most broker-dealers, only the Control Room has direct access to the Control Database. However, certain groups may have limited access to certain information within the database. For example, some broker-dealers provide supervisory analysts within Research only with the corporate names in order to compare to research reports being prepared for publication. Other broker-dealers send all draft research reports to the Control Room to perform the review. When broker-dealers did provide limited Control Database access to select Research employees, information barriers generally covered such employees similar to other private-side groups, such as physical separation from the rest of Research.

Conflicts also receives information on corporate client transactions. Broker-dealers generally either integrated the group physically within Investment Banking or walled the group off into an area separate from all other groups.

One broker-dealer provided deal information regularly to its unregulated parent. The information included both the deals worked on and ongoing information as to deal developments. The broker-dealer did not evaluate whether the parent had any controls over use of the information. Examiners raised this as a concern with the broker-dealer.

Some broker-dealers have established cross-selling groups between Asset Management and Investment Banking.⁴⁹ The access provided to the cross-selling groups varies among broker-dealers. In some cases, the cross-selling group is provided with access to information generally about transactions within Investment Banking. Other broker-dealers have Investment Banking personnel forward only certain transactions to the cross-selling group for consideration. The staff observed that some broker-dealers have detailed processes designed to limit when the Asset Management personnel may be given information on the potential client. The staff observed concerns with some broker-dealers' practices – failure to document when the cross-selling group was given access to Investment Banking information or lack of adequate physical barriers surrounding the group.

3. Dual Function Employees

Access to MNPI inconsistent with Section 15(g) may result when an employee has dual job responsibilities.⁵⁰ For example, internal committees (e.g., commitment committees) review and approve Investment Banking transactions prior to public disclosure. Broker-dealers should be careful not to include as committee members employees who have trading responsibilities or otherwise have controls reasonably designed to prevent misuse of the information. The staff's review identified different processes at broker-dealers to prevent misuse by public-side employees. Some broker-dealers only permit private-side employees to serve on the approval committees. Other broker-dealers allow public-side employees to serve on approval committees, but they must either leave the meeting prior to discussion of any MNPI or be logged over-the-wall.

4. Informal Discussions

Private-side employees on occasion have general discussions with employees in other areas of the broker-dealer, which creates a potential for unauthorized disclosure of MNPI. Most of the interactions occur on an informal (undocumented) basis, with procedures specifying that all such discussions may not be related to any specific transaction. Broker-dealers state that Investment Banking employees may speak with employees in certain public-side areas of the broker-dealer to obtain background information on a client (Research, Investment Groups) or on market trading conditions (Sales and Trading). Sales and Trading employees sometimes speak to Research employees. Broker-dealers instructed the private-side personnel to refrain from discussing MNPI (and sometimes any specific issuer) and instructed the public-side personnel to identify themselves as such to any private-side personnel. The staff is concerned that the

⁴⁹ The cross-selling efforts could include identifying employees of Investment Banking clients who will have funds to invest after completion of a deal and referring the client to Asset Management. Alternatively, Asset Management customers (e.g., CEOs of companies) could be referred to Investment Banking.

⁵⁰ See *SEC v. Friedman, Billings, Ramsey & Co., Inc.*; Civil Action No. 06-cv-02160 (D.D.C.), Litigation Release No. 19950 (December 20, 2006), settled action. See, also, *SEC v. Charles Schwab Investment Management et al.*, Civil Action No. CV-11-0136 EMC (N.D. Cal.), Litigation Release No. 21806 (January 11, 2011), settled action.

frequency of the discussions and the absence of documentation may make it difficult to monitor for any inadvertent (or even intentional) disclosures that may occur.

B. Preventing Unauthorized Access

As discussed in the 1990 Report, controls to prevent unauthorized access to MNPI have been a long standing practice of broker-dealers. The initial focus was on physical barriers such as locked doors with key card access. Broker-dealers have incorporated other controls to prevent unauthorized access of MNPI. The movement to electronic copies required evaluation of access to network systems or potential leakage of information through electronic media (e.g., flash drives) or through emails. Broker-dealers remove authorized access when employees move from private-side to other areas of the broker-dealer or terminate their employment. Hardcopy documents are disposed of through secure methods to protect MNPI.

1. Physical Barriers

The staff's review noted that broker-dealers were moving more groups into separate physical spaces with key card access: Investment Banking, Capital Markets (including Derivative Sales), Syndicate, Credit, and Research. Some broker-dealers impose at least some physical separation between public-side groups that routinely receive MNPI and are brought over-the-wall and other Sales and Trading areas. As discussed above, broker-dealers are considering which groups need to be kept separate based on the information within the group.

Some broker-dealers limit key card access to physical spaces by department, others restrict key card access further by floor. In other words, if Investment Banking is divided into multiple floors, some broker-dealers grant access to a specific floor only to employees permanently assigned to that floor. In addition to the employees working on each floor, access will also be given to certain control persons (e.g., Compliance) and senior managers. Some broker-dealers periodically review the access lists to confirm that each person should still have access. In addition, access may be limited to certain hours.

Broker-dealers generally implemented a higher degree of physical separation for Investment Banking, Credit, Corporate Capital Markets and Syndicate, Private Equity, Research covering corporate issuers, Conflicts, and Control Room than for other private-side areas. These private-side areas frequently were on their own floor or (less frequently) were walled off with a separate entrance from other groups on the floor. The staff identified concerns at some broker-dealers where the origination functions for non-corporate issuers⁵¹ were located near trading floors. In contrast, some broker-dealers placed origination groups for non-corporate issuers within the physically segregated Capital Markets floors. Physical barriers may also be in place for certain public-side groups with access to confidential and sometimes material information: prime brokerage, stock lending, certain Investment Groups, and issuer buyback desks.

⁵¹ Origination for non-corporate issuers is discussed above at III.C.

The staff identified concerns with the adequacy of the physical barriers. Some private-side areas had glass walls, permitting visual access to information. Some broker-dealers had private-side groups on the trading floor (e.g., Derivative Sales). The staff raised these concerns with the broker-dealer(s).

Some broker-dealers did not have physical barriers surrounding certain groups that support private-side areas, such as IT, Operations, or the Loan Site Monitors.⁵² The lack of physical barriers may result in unauthorized access through the IT systems to which the support personnel have access. For example, sensitive information may be viewable on computer screens, or the electronic systems may be accessible when employees step away from their desks. Broker-dealers may need to consider controls to prevent unauthorized access through these systems.

The staff also observed that the Financial Sponsors Group within Investment Banking and Private Equity groups are sometimes integrated with other Investment Banking groups. The staff is concerned about potential conflicts between the interests of the Financial Sponsors Group and Private Equity compared to interests of the corporate clientele of other Investment Banking groups.

2. Technology Barriers

The staff observed that most information is stored electronically on network computer drives. Some broker-dealers have automated systems within Investment Banking to limit access to information by deal so that only approved deal members may access the information. Employees are able to log in only after Conflicts has approved them to work on the project. Other broker-dealers permit access to employees by department or group so that all of Investment Banking (or a unit within Investment Banking) may access the documents. The staff believes that broker-dealers should consider limiting access based on the need to know principle as well as to prevent conflicts between deal team members working for competing corporations.

Some broker-dealers prevent access to Investment Banking computer systems in public areas of the broker-dealer (i.e., no remote log-ins). More broker-dealers disable the ability to download information to removable storage from computers. Requests to download the information must be approved by a supervisor and forwarded to the appropriate support group. Documents may not be downloaded or printed when accessing the network remotely.

3. Printing and Production

Most broker-dealers maintain reprographics and desktop publishing areas (collectively, “Printing and Production”). Broker-dealers stated that the overwhelming majority of users came from Investment Banking and Capital Markets. The reprographics areas are

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See discussion in III.B. regarding the information handled by the Loan Site Monitors.

responsible for taking electronic files and (less frequently) hard copy documents and creating multiple copies. The desktop publishing areas create presentations or word documents. Most large broker-dealers have a centralized Printing and Production with a few smaller satellite locations. Broker-dealers generally created physical barriers around these groups.

Personnel external to Printing and Production may need to enter through a single door, which provides access only to a limited visitors section. In some cases, broker-dealers created separate entrances for public-side vs. private-side areas. Work jobs for private-side employees might be identified as such by cover sheet. Some centers use different machines to copy private-side vs. public-side documents. Print jobs may be locked up between production and being picked up. Broker-dealers might check the identification card of persons picking up the job and confirm that the person is from the correct office. Other broker-dealers require that only the person or their specifically named designee can pick up the print job.

4. Disposal of Confidential Documents

Most private-side areas have document disposal policies to prevent MNPI being disseminated through discarded paper. Broker-dealers may have two sets of paper bins – one for regular recycled trash and locked bins for MNPI. Broker-dealers had processes to move the locked bins from each floor to the disposal truck. The processes may include a security escort, movement from one locked bin to another locked bin for transport, and/or a transport bin that incorporates a paper shredder. Some broker-dealers shred all paper that is removed from a private-side area, while other broker-dealers only shred those documents placed by the private-side personnel in the locked bins. The staff believes that the shredding of all paper from private-side may prevent inadvertent disclosures when MNPI accidentally gets mixed in with the normal recycle bins. Given the high percentage of MNPI within certain private-side groups, the staff believes that broker-dealers should consider expanding the scope of disposed documents shredded.

C. Controls over Information Given to Public-Side Employees

As discussed above, public-side employees are not supposed to access routinely MNPI. Broker-dealers need to be able to monitor when public-side employees have or will have access to MNPI so that appropriate controls may be implemented.

1. Information Provided by Internal Groups

Public-side groups at times have a limited number of employees who receive access to MNPI related to a specific company through the over-the-wall process. The over-the-wall process involves the private-side group with MNPI identifying to the Control Room the names of the public-side employees who will be given access to MNPI regarding a specific company. As a result, the over-the-wall employee is prohibited from both personal and firm trading in any security of that company. Some broker-dealers' over-the-wall processes require pre-approval by Compliance, which may help to ensure that

Compliance receives timely notice of over-the-wall crossings. For other broker-dealers, if Compliance is not required to pre-approve access to the information, it must be notified in a timely fashion. The over-the-wall employee generally is logged into the Control Database. The staff observed concerns at some broker-dealers that did not maintain complete listings of individuals who were deemed over-the-wall and may have had access to MNPI.

Most broker-dealers will contact the supervisor of the employee to be crossed to obtain authorization. Some broker-dealers do not log the supervisor over-the-wall, and this may create an issue if the supervisor is provided with sufficient information to allow them to identify the MNPI. Some broker-dealers will bring an entire desk over-the-wall if a large number of employees have access to the MNPI. Some broker-dealers also maintain some level of physical separation between groups routinely over-the-wall and other public-side personnel.

Credit creates an internal credit rating, which may at times be based on MNPI. Some broker-dealers do not provide internal credit ratings outside of Credit and a small select group of private-side personnel. Some broker-dealers provide the credit rating to public-side personnel only if not based on MNPI.

2. Information Provided by External Groups

Investment Groups may receive MNPI from external parties. The information may be provided as a solicitation to participate in a transaction (e.g., purchase in an offering) or may be accessed through the monitoring of current investments.

a. *Information Received Pursuant to a Confidentiality Agreement -- Electronic Sources of Information*

Confidential information, which at times constitutes MNPI, frequently is circulated through electronic websites requiring authorization to access. For example, corporate borrowers provide confidential information to lenders through Loan Sites. As discussed above, a public-side group will either forgo receipt of confidential information or will go private on the name.⁵³ Most broker-dealers implemented controls to identify when a public-side group accessed confidential information without having gone through the formal process. The controls typically involved periodic review of reports from the website as to public-side employees' access of information. Alternatively, broker-dealers may prevent public-side employees from directly accessing the website. Instead, another group will download and forward information consistent with the group's authorized access.

Some Loan Sites have implemented controls that permit broker-dealers selectively to block access by their employees to information contained on Loan Sites. For example, the broker-dealer may block all public-side employees from accessing private-side

⁵³ See discussion at IV.C.2 for the impact of going private on a name.

webpages, as well as webpages that do not differentiate between public and private information. The broker-dealer selects a gatekeeper, such as someone within the Control Group. The gatekeeper has the ability to grant or deny access to employees to access private information. Broker-dealers then are able to confirm that public-side groups have been logged as private on the name prior to accessing the information.

When the public-side group has decided not to receive confidential information on a company, the Loan Site Monitors will review the information being provided. At times, this information may be significant or may require that the lender take action. For example, a borrower may request that all lenders agree to waive a loan covenant, such as cash flow requirements or minimum equity levels. Some broker-dealers have the Loan Site Monitors forward the information to the Legal or Compliance Department for their determination as to whether the public-side group should be informed and made private on the name. Some broker-dealers have Loan Site Monitors vote consistently with the majority of external lenders or with other groups within the broker-dealer or its affiliates that are lenders (e.g., Asset Management).

b. Information Received Pursuant to a Confidentiality Agreement – Oral or Written Sources of Information

Public-side groups may receive orally confidential information, which at times may be MNPI, typically for specific transactions rather than ongoing sharing of information. For example, public-side groups may be approached by external underwriters to invest in an unannounced offering. The information provided regarding the existence of the offering may be MNPI, and additional MNPI may be received during the investment process. Broker-dealers generally relied on identifying the provision of information based on the signing of a written confidentiality agreement. Broker-dealers stated that Legal would review any confidentiality agreements and would notify the Control Group if appropriate.

The staff's review noted that a written confidentiality agreement may only be required in certain circumstances. Some MNPI may be provided based on informal confidentiality agreements – oral discussions followed by emailed confirmation or emailed informal agreements to maintain confidentiality. No broker-dealer indicated that it had a control to identify emailed or oral confidentiality agreements entered into without notification to the Control Group. The staff is concerned that the lack of controls in these circumstances impacts the Control Group's ability to monitor receipt of confidential information by the business unit.

Some broker-dealers have instituted surveillance to monitor for possible disclosures to their public trading groups of external deals, including M&A and PIPEs. For example, upon announcement of a material M&A transaction for which the broker-dealer did not have a role, the broker-dealer may review the positions established by their trading groups. Broker-dealers may also review short positions created in advance of announcements of PIPEs.

c. *Informal Discussions*

Public-side employees have ongoing discussions with persons in possession of confidential information and sometimes MNPI. For example, public-side traders have discussions with insiders of corporations or with consultants who may have confidential information, which at times is MNPI.⁵⁴ The only control identified to the staff was a written procedure directing employees to identify themselves as public-side to the insider and to self-report receipt of MNPI to the Control Room. No documentation was maintained of the contacts made, and no specific controls were in place. Broker-dealers stated that the contacts were too numerous to document. The staff is concerned about information barriers that consist solely of a written procedure directing employees not to engage in certain behaviors and to self-report when they come into possession of MNPI.⁵⁵

3. Public-Private Transitions

The staff's review observed informal controls over the transition from public to private and vice versa. For example, private-side employees on occasion transfer to public-side business units. At that point, the employee may still have MNPI. The staff inquired about controls over the transition process. Most broker-dealers did not have any formal processes and relied on employees self-reporting. The staff is concerned that no systematic reviews are conducted of employee transfers from private-side areas. One broker-dealer will review transfers for the purpose of eliminating physical key card and electronic systems access. However, the staff did not observe any formal broker-dealer processes to monitor potential misuse of the MNPI in possession of the now-public-side employee.

Most broker-dealers do not have a process for identifying when private corporations become public corporations through issuance of securities, which may result in an absence of monitoring inconsistent with Section 15(g). Public-side employees sometimes are permitted by broker-dealers to access MNPI on private corporations,⁵⁶ which were not included within automated surveillance. The staff's review observed instances in which broker-dealers' monitoring processes were incomplete because corporations continued to be categorized as private by the Control Group after the corporation had a securities distribution. The gap in coverage remained for extended periods of time, and the staff raised this as an issue with the relevant broker-dealers.

⁵⁴ The Commission has brought Section 15(g) actions based on the failure to have procedures reasonably designed to prevent misuse of MNPI obtained through interactions with company insiders (*In the Matter of Guy P. Wyser-Pratte*, Release No. 34-44283 (May 9, 2001)); and received from consultants relating to an announcement regarding 30 year U.S. Treasury bonds (*In the Matter of Goldman, Sachs & Co.*, Release No. 34-48436 (September 4, 2003)), settled actions.

⁵⁵ See e.g., *In the Matter of Gabelli & Company, Inc. and Gamco Investors, Inc.*, Release No. 34-35057 (December 8, 1994), settled action.

⁵⁶ In the instances reviewed by the staff, a private corporation was typically owned by a limited number (e.g., one or two) private equity funds, and securities interests were not traded on even a limited basis.

The staff believes that broker-dealers also need controls for instances in which an employee or group had MNPI and related restrictions (e.g., over-the-wall or private on a name) and now wants removal of the restrictions. Some broker-dealers establish a set period – two reporting periods (i.e., the company has filed two Forms 10Q/10K) between the time the group accessed the MNPI and when they may begin trading. Other broker-dealers have no such periods and analyze the information accessed to determine when stale. While the reliance on two reporting periods does provide an opportunity for the corporation to make public disclosure and a bright line test for broker-dealers to follow, the staff believes that broker-dealers should have some type of control procedures to protect specific nonpublic information with continued materiality.

D. Controls over Information Given to External Parties

Various groups within the broker-dealer may have discussions with external institutional investors, both on an informal basis and with respect to unannounced transactions. Institutional investors are generally considered by the industry to be either public or private. Private institutional investors, which include Private Equity, trade mainly in the primary market (e.g., Rule 144A purchases). Public institutional investors, which include many hedge funds, trade in the primary and secondary trading market. Some institutional investors have both private and public investment areas. The staff's review observed that confidential information, at times MNPI, may be provided to institutional investors. The most common instances are when institutional investors are approached to participate in M&A transactions, capital markets transactions, and loans.

1. Specific Transactions

Broker-dealers represented that private institutional investors were more likely to be contacted on M&A transactions, and public institutional investors were more likely to be contacted on capital markets transactions.⁵⁷ The staff's review noted that broker-dealers are developing control procedures over providing information in both contexts. Some broker-dealers might pre-qualify institutional investors, including determining the appropriate contact person or procedure established by that institutional investor. For example, some investors prefer that all contacts be initiated with the investor's Legal or Compliance staff. Other investors select a specific person within their organization who is authorized to access MNPI. The broker-dealer's M&A control procedures may require an internal conflicts check prior to discussions with an institutional investor. Controls around capital markets transactions may include provision of limited information with the contact made only shortly prior to public disclosure. The control procedures typically specify the information that may be provided based on the type of confidentiality

⁵⁷ With respect to M&A transactions, institutional investors are invited to participate in purchasing assets or an interest in a company. The transaction typically is not announced until agreement is reached. With respect to capital markets transactions, the investor is queried as to market interest (aka sounding the market) in purchasing in an offering. The offering may or may not be publicly disclosed prior to completion of the deal (depending on whether it is a public offering or private placement).

agreement obtained: oral with an email confirmation by the broker-dealer, oral with an affirmative email reply from the investor, or a written agreement. Most broker-dealers reviewed by the staff maintain a log of contacts made with investors. The contact is recorded even if the investor declines to participate and does not receive MNPI.

While some broker-dealers require at least an oral confidentiality agreement followed by an email confirmation of the agreement prior to providing the name of the corporation that is the subject of the transaction, some broker-dealers provided information based solely on oral confidentiality agreements. Documentation that information was provided may be limited, potentially impacting the broker-dealers' ability to monitor for misuse of MNPI.

Information regarding a transaction may be circulated to investors through an electronic website, referred to as a virtual data room. Broker-dealers stated that virtual data rooms were used more frequently in M&A transactions rather than offerings. Broker-dealers also indicated that the virtual data rooms were more likely to come into play later in the transaction when the potential buy-side participants had gone through initial rounds of discussions. Access to virtual data rooms is based on specific users, so that each individual within an institutional investor will have a unique log-on. Broker-dealers stated that either the sell-side participant or its financial advisor could control access to the data room. The broker-dealers stated that no formal process was used to remove access from buy-side participants that had exited the negotiations. Broker-dealers believed that if the investor continued to access the data room after exiting negotiations, the broker-dealer or the sell-side participant would notice the activity. While audit trails were maintained of the accessing of information, broker-dealers were divided as to whether the documents would be maintained after the transaction had closed. The staff is concerned about the informal nature of controls surrounding virtual data rooms, including the lack of documentation, written procedures, and absence of an audit trail.

2. General Discussions

Institutional investors frequently request wide-ranging discussions with private-side employees, such as investment bankers. Some broker-dealers have instituted controls surrounding the discussions. The controls include requiring that questions be submitted in advance, pre-qualifying the institutional investor, requiring that senior bankers participate in the discussion, and maintaining a log of meetings held. Implementing such requirements or prohibiting them from occurring are relevant controls to prevent misuse of MNPI.

Public-side employees provide information to institutional investors referred to as market color. The information is developed from customer confidential information. Some broker-dealers create detailed matrices for the public-side as to how the public-side anonymizes the information. For example, the information may need to be based on a minimum number of customers, and no single customer may represent more than a certain percentage of the color. The broker-dealer allows customers to specify that their

trading information may not be used in developing market color. Providing clear guidelines to employees may prevent inadvertent disclosure of customer trading orders.

3. Credit Extensions

During the loan origination process, institutional investors are given access to Loan Sites in evaluating whether to lend. In the secondary market, the administrative agent⁵⁸ for the borrower grants and removes access to Loan Sites to institutional investors and other lenders. The administrator of the loan controls the granting and removing of site access based on purchases and sales of the loan.

During the initial sale of loan interests, some broker-dealers create lists of potential lenders to grant access to the Loan Site based on credible investors. Institutional investors are given access to the borrower's confidential information in order to evaluate loans for purchase. If such institution is routinely accessing the information without purchasing loans, this may indicate that the institution does not have a legitimate need to know the information. Some broker-dealers indicated informally that they might eliminate access to potential investors with a history of accessing sites without participating in the issuance. In some cases, a supervisor must specifically approve the list of potential investors. Other broker-dealers could not articulate when they would or would not grant access to the Loan Site to potential investors. The staff observed that the controls in this area remain informal and without any specific standards and believes that broker-dealers should consider where additional controls may be needed.

Broker-dealers or their affiliates may have control over the addition and removal of third party investors from the ongoing Loan Site. The staff's review noted that broker-dealers are creating better controls to limit access to actual lenders. Some broker-dealers have processes to grant access to Loan Sites only upon purchase of a loan interest and to remove access upon sale of a loan interest. The process may include reviewing trading reports to identify lenders that no longer hold interests and comparing against access to the Loan Sites. Some broker-dealers have processes to identify institutional investors' designated contact for the Loan Sites and the same contact is used for all access to the Loan Site (or to authorize others within the institutional investor to access the Loan Site). Some broker-dealers only grant access to Loan Sites to user email addresses that include the institution's name (e.g., user@institution.com) and not to user email addresses that use generic third party services.⁵⁹

⁵⁸ At most of the broker-dealers examined by the staff, a group within the Investment Banking Department performed the functions of administrative agent during the loan origination, while a group within the Investment Banking Department or Operations performed the functions during secondary market trading.

⁵⁹ The use of generic email addresses creates significant risk that there will be a failure to identify when an individual contact person has left the financial institution or may otherwise create concerns regarding the use of false identities.

E. Email Controls

The use of emails to transmit MNPI between persons working on a transaction is common. Within a specific department, information is shared between employees through a network drive. However, when employees across departments work on a transaction, the information is usually emailed to the employee. In addition, emails may be sent between broker-dealer employees and external clients. The staff's review observed instances in which emails were sent to the wrong party so that unauthorized public-side employees and external parties received MNPI. Broker-dealers were implementing controls to minimize misdirected emails. Some broker-dealers require private-side employees affirmatively to identify emails as appropriate to be sent outside of the department or outside of the broker-dealer. Some broker-dealers turned off the autocomplete function of email systems to require employees to type in the full email address. Some broker-dealers created pop-ups to identify to the employee that the email was being sent externally.

Broker-dealers generally review emails for information barriers concerns (e.g., inappropriate disclosures of MNPI). Broker-dealers represented that email review systems do not have keyword sets to take into account information barriers issues. As a result, broker-dealers must develop other techniques. At the most basic level, most broker-dealers conduct random samplings of emails to identify potential concerns. Some broker-dealers have targeted reviews for when an "internal use only" document is sent outside the broker-dealer or for large attachments sent to generic internet email domains. Some broker-dealers will conduct ad hoc email reviews when surveillance identifies concerns in trading or based on announced deals.

The staff did observe specific gaps in the email review process, and the gaps were discussed with the broker-dealers. Some broker-dealers did not review emails of personnel within control functions with access to MNPI, including Compliance and IT. Some broker-dealers only required reviews of the names of the sender and recipient without any assessment of the content of the email. One broker-dealer did not review any internal emails so that no controls existed over emails between private-side and public-side groups.⁶⁰ Some broker-dealers did not monitor internal communications through chat rooms.

F. Employee Trading Pre-clearances

Most broker-dealers require pre-clearance of employee trading throughout the broker-dealer, and pre-trade clearance processes differ for public and private-side employees. At some broker-dealers, public-side employees only pre-clear through their supervisor, although employees in Research (which may or may not be classified as public) may also pre-clear through Compliance. Other broker-dealers require public-side employees to pre-clear with Compliance, which will review against the watch list, although the trade

⁶⁰ The 1990 Report noted the need for substantial control, preferably by Compliance, of interdepartmental communications.

will not necessarily be denied.⁶¹ At some broker-dealers, all personal trade requests of private-side employees are denied if the matter is on the watch list. Other broker-dealers make a case-by-case analysis based on the employee's job function. Broker-dealers were moving to require pre-clearance of personal trades by contingent workers (e.g., persons performing work on behalf of and as directed by the broker-dealer but employed by third parties) and control/support functions if the worker/employee has access to MNPI. Broker-dealers are taking into account whether the employee was over-the-wall in approving or denying the request. Certain pre-clearances may be done to take into account specific information held by the employee. For example, employees in areas that process trades for corporate insiders may have scrutiny of their personal trades against pending and recent orders.

Broker-dealers generally exempt employee managed accounts from the pre-clearance process. Some broker-dealers select certain permitted managed products, none of which were individually managed accounts, and employees were only allowed to choose from the broker-dealer specified list. The staff had concerns about practices at broker-dealers that permit employees to use any external manager and do not conduct any scrutiny as to the ability of the employee to influence trading in the account (e.g., individually managed accounts or managers with any connections, familial, business, or otherwise, with the employee that might allow the employee to influence the trading in the account).

Most broker-dealers compare executions of employee trades against pre-clearances obtained. Broker-dealers were less effective in tracking and/or responding to multiple failures to pre-clear. One broker-dealer responded to multiple failures to pre-clear with a "letter of education," and the employee failed to pre-clear subsequent to receiving the letter. In response to the staff's concerns, the broker-dealer revised its procedures to place restrictions on employees who failed to pre-clear multiple times. In responding to failures to pre-clear, some broker-dealers did not have any specific remedy and only reversed if the trade would not have been approved. As a result, the employees did not have a significant deterrent from trading without clearance. Some broker-dealers have policies to reverse trades made without pre-trade authorizations even if the trade would have been approved, which may be an effective deterrent and cause employees to pre-clear.

G. Surveillance

The placement of a matter on a monitoring list triggers surveillance.⁶² The ability to surveil adequately may be circumscribed based on excessive volume as well as limited

⁶¹ Broker-dealers should be alert to the possibility that the denial of the trade of a public-side employee based on a watch list entry may in effect tip off the employee that the broker-dealer has possession of MNPI regarding the security. In designing its controls around employee pre-clearance, broker-dealers should evaluate the use of controls, such as heightened surveillance or over-the-wall processes, to prevent misuse of the information when the denial may result in the employee identifying the MNPI.

⁶² Some broker-dealers integrate information barriers surveillance in the Control Group; other broker-dealers place the surveillance responsibility within the Surveillance group. Both groups are usually within Compliance.

information access (e.g., the reviewer may not know that a significant milestone had occurred, such as a definitive agreement). The staff observed that while some broker-dealers continued to rely on manually intensive reviews, improvements, as described below, have been made and continue to be made in review scope and review process.

1. Scope of Review

Historically, surveillance focused on employee and firm accounts. Surveillance scope has expanded to capture trading in other types of accounts that may indicate misuse of MNPI. Broker-dealers may review activity of institutional customers, Asset Management affiliates, and retail customers. Broker-dealers are reviewing the trading done by contingent workers to whom the broker-dealer has given access to MNPI.⁶³

Broker-dealers were expanding the scope of their review to take into account all products that could be used to profit from MNPI. For example, broker-dealers may review transactions in related derivatives – credit default swaps, single stock futures, equity or total return swaps, warrants, and bond options. Broker-dealers also may review interests in companies held through loans or as components of pooled securities such as unit investment trusts and exchange traded funds. When such instruments may not be easily captured by automated surveillance reports, some broker-dealers respond by reviewing reports of all such instruments traded. Other broker-dealers conducted targeted reviews by searching the trade blotters when a deal is announced. The staff notes that the lack of automation and standardization has hindered broker-dealers from reviewing derivative products in the same manner as other securities. The staff is encouraged that some broker-dealers are continuing to enhance their review as technology becomes available. The staff believes that broker-dealers should consider all instruments that may be used to profit from the MNPI. For example, some broker-dealers issue structured products for which it or an affiliate is the issuing entity. If the structured product references specific securities and the broker-dealer has MNPI regarding the reference security, the broker-dealer may need to have controls to prevent the issuance of the structured product from being based on MNPI.

Broker-dealers may conduct lookbacks to determine if there are unusual trading patterns preceding a significant event or receipt of MNPI. In some cases, broker-dealers consider transactions for which the broker-dealers did not have any involvement when conducting lookback reviews. For example, the broker-dealer may follow up if one of its employees made a trade prior to the announcement of a major merger for which other broker-dealers served as financial advisors.

2. Pattern Surveillance

Broker-dealers are enhancing the types of reviews being conducted to allow identification of behavior patterns. When an employee trades in a security on the monitoring list, the

⁶³ Some broker-dealers hire personnel as an outside contractor or consultant to fill some support positions such as IT and Printing and Production. The staff observed that these persons could be referred to as consultants, contractors, or vendors.

report might identify all trades by the employee in the security during the prior few months. Surveillance of firm trading accounts might identify the pattern of trading by the accounts during a time frame, noting when the account has built a position over time. Other pattern analysis might create exceptions based on accounts that trade in multiple securities on the monitoring lists, accounts that have not historically traded in the security, accounts that are newly open, or positions in monitoring list securities that constitute a substantial percentage of the account. With respect to firm accounts, most broker-dealers establish size cut-offs based on dollar value or percentage change in position so that only significant exceptions are reviewed.⁶⁴ While the staff agrees that excluding de minimis trading may help broker-dealers focus on significant concerns, the staff is concerned that the cut-offs were very high (\$5 million at one broker-dealer) or did not take into account positions that are built over several days.

Broker-dealers are also generating reports to take into account specific fact patterns. For example, reports may compare broker-dealer trading for transactions in which a trading employee is over-the-wall, identifying exceptions when the over-the-wall employee trades, other employees on the desk trade, or nearby desks trade. Reports may be generated based on instances in which a public-side area has become private on a specific name – which would include instances in which the desk has obtained borrower confidential information, has been invited to participate in a PIPE or other unannounced offering, or has received information through a bankruptcy committee. A report may review for concerns of cross-tipping – trading desks that are private on different names tip each other.

Restricted list placement typically also results in a lookback review. The lookback review provides heightened scrutiny of transactions prior to public announcement. At some broker-dealers, the lookback review is the only scrutiny of trading that occurred prior to publication of research reports. Other broker-dealers will place the subject of a research report on the general surveillance list a day or two prior to publication.

Certain types of MNPI are not generally placed on monitoring lists, including large customer orders, institutional investor information, and ongoing contacts with insider clients. Broker-dealers rely on surveillance reports to identify problematic behavior. Frontrunning reports review for trades prior to a large customer order. Shadowing reviews look for patterns of trading that appear to take advantage of customers' investment strategies. Registered representatives with insider customers may be subject to special scrutiny of their personal and customers' trades in those companies.

3. Compliance Access to Information

In order to perform their responsibilities, surveillance personnel need to have sufficient information in order to evaluate effectively trading activity. The staff noted that surveillance personnel are being provided greater access to developments that occur

⁶⁴ The staff observed that surveillances for broker-dealer positions are starting to take into account profit potential rather than size. The profit potential may be based on actual market movements or may be based on theoretical movements of price up and down.

within deals. At some broker-dealers, Compliance personnel have direct access to Investment Banking deal management systems. At other broker-dealers, the Control Database would contain detailed status updates, with Control Group personnel periodically speaking with the deal team in order to maintain awareness of current developments.

The staff's review did identify instances in which limited information was available to Compliance, which could impact the ability to monitor for misuse of MNPI. Compliance may be unaware of all deal team members. While Compliance may monitor developments in the deal, it generally does not obtain information regarding events that occurred prior to the first contact into the Control Room.⁶⁵ Some broker-dealers do not have mechanisms to identify transactions that are removed from all monitoring lists because they were terminated when they subsequently are reactivated.⁶⁶

4. Resolution of Matters

The staff reviewed the adequacy of how broker-dealers were researching and resolving surveillance items. At some broker-dealers, the staff was unable to determine that the broker-dealer was appropriately resolving matters because documentation was limited to a simple notation that the trade was reviewed. If the analyst researched the item, no documentation was maintained of the research or that the research was conducted. As a result, the staff was unable to conclude that the broker-dealer had an effective surveillance process. In contrast, some broker-dealers are enhancing the documentation maintained, with a brief description of the reason for resolving the exception (e.g., consistent with historical trading patterns).

The staff also observed that two broker-dealers resolved exceptions based solely on the assertions of the person being reviewed, without any independent confirmation. The staff believes that broker-dealers need to consider when the subject of surveillance has a motive to dissemble and therefore independent information should be obtained. The staff also is concerned when resolution is based on assumptions without verification – for example that trading by a customer-facing trading desk is for customer facilitation even though the desk is able to create and hold positions.

The staff has significant concerns about limited monitoring that may not be reasonably designed to identify misuse of MNPI. Most broker-dealers' analysis does not take into account when the broker-dealer first had possession of MNPI or other developments in the deal. An analysis is sometimes based on the historical trading patterns of an account,

⁶⁵ For example, the first entry in the Control Database may indicate that Investment Banking has been working on the transaction for a while. No documentation indicates that Compliance determines the date on which the project began. This information might be needed to determine whether trading in a company began before or after the broker-dealer first became aware of the transaction.

⁶⁶ For example, the Control Room may receive notice that the buyer and seller could not reach agreement and that all negotiations have stopped. The matter is then removed from the monitoring list. Shortly prior to announcement, the Control Room may learn that the negotiations were renewed and that it did not receive timely notification.

but the analysis does not necessarily consider whether an account began trading prior to or after the broker-dealer first began working on a transaction, or consider the possibility that a leak may have occurred as of a certain date. Instead, the compliance analyst might close out an exception based on the account having traded in the security before, even if the trading started after the broker-dealer first received MNPI. The staff also did not observe much in-depth analysis of trading – whether an account traded in multiple securities that may indicate a specific source of information, a position built over time in a security, or trading correlated with deal developments. Instead, most broker-dealers’ review tend to look for a “quick hit” type of trading, where an account purchases a large position in a single day in a transaction that is about to announce.

5. Risk Arbitrage

The 1990 Report discussed in-depth the concerns surrounding the risk arbitrage desk.⁶⁷ Because the risk arbitrage desk is building positions in announced M&A deals, it may be more difficult to distinguish between positions built on public information (including circulated rumors or speculation) or built on inside information. The staff noted that at the time of their review, broker-dealers had recently eliminated restrictions on risk arbitrage trading (which required pre-clearance or restricted their trading). The staff is concerned that no targeted or focused review of the desks’ trading activity was implemented at these broker-dealers. The concern may be reduced in part because most broker-dealers subsequently eliminated desks that focused on a risk arbitrage strategy. The staff believes that broker-dealers should consider controls to the extent that certain trading desks may engage in risk arbitrage.

VI. CONCLUSION

The staff’s review observed that broker-dealers were enhancing their controls in response to developments in business activities, technologies, and business structures. The staff’s review also identified gaps in controls, which were raised with the broker-dealers. Finally, the staff identified certain areas in which practices were more informal, and the staff plans to continue to review such areas in future examinations.

The examination staff members who participated in these exams are:

Headquarters-DC: Christine Sibille, Juanita Hamlett, Roberta Boyd, Jane Cash, Michelle B. Davis, Everardo DeArmas, Wanda Hunter, Judy Lee, Danielle Perfetuo, Lisa Wardlaw.

⁶⁷ Traditionally, risk arbitrage was considered the simultaneous purchase of stock in a company being acquired and the sale of stock of the acquirer. Modern risk arbitrage focuses on capturing the spreads between the market value of an announced takeover target and the eventual price at which the acquirer will buy the target's shares.

New York Regional Office: John M. Nee, Stephanie Morena, Theresa D. Gleason,
Hermann Vargas, Claudia Arroyo

APPENDIX A -- DEFINED TERMS USED IN THIS REPORT⁶⁸

1990 Report	Report issued by the Division of Market Regulation, “Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Nonpublic Information” (March 1990) http://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf
Asset Management	Area(s) with responsibility to manage assets and funds on behalf of individual and institutional customers, frequently on a pooled basis
Capital Markets	Area(s) that work on capital raising efforts for issuers, whether through equity, debt, securitizations, or other instruments
Confidential information	Information received under a duty of trust or confidence
Conflicts	Area(s) within a broker-dealer with responsibility to monitor for a broker-dealer’s conflicts of interests, such as those between clients of the broker-dealer and the interests of the broker-dealer in transactions on which the broker-dealer is engaged
Control Group or Control Room	Area(s) with responsibility to manage the information barriers program
Control Database	Database maintained by the Control Room that identifies the MNPI being monitored by Compliance
Credit	Area(s) with responsibility to monitor the financial standing of entities to which the broker-dealer has extended credit
Derivative Sales	Collectively, area(s) that have a corporate client base with a focus on facilitating transactions in swaps and other over-the-counter derivatives
Dodd Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Exchange Act	Securities Exchange Act of 1934
Financial Advisory	Industry term referring to advice given to business organizations, such as corporations, usually by employees in a broker-dealer’s Investment Banking Department

⁶⁸ These definitions are used only for purposes of this report and are not intended for any other context. Some of the definitions are based on existing statutes, laws, and cases as of the date of this report. Other definitions are derived from commonly used industry terms.

Information Barriers	Controls, procedures, and processes required to be established under Exchange Act Section 15(g)
Investment Banking	Area(s) that provide financial advisory services to corporate clients relating to, among other things, M&A, restructurings, and strategic alternatives
Investment Groups	Collectively, Proprietary Groups and Asset Management
IT	Information technology, area(s) within the broker-dealer responsible for computer systems, software, and networks
ITSFEA	Insider Trading and Securities Fraud Enforcement Act of 1988
Loan Sites	Electronic systems offered by vendors used to provide information from borrowers to lenders, frequently through websites, as required under credit agreements
Loan Site Monitors	Area(s) selected to review information on Loan Sites on behalf of the broker-dealer's trading group
M&A	Mergers and acquisitions
MNPI	Material NonPublic Information
Operations	Area(s) within the broker-dealer with processing and other physical functional responsibilities (e.g., confirmations, payments, and settlements) related to broker-dealers' financial services
Origination	Creation and issuance of a financial instrument that may represent either equity or debt of an issuer
PIPE	Private investment in public equities
Printing and Production	Area(s) within the broker-dealer with responsibility to create presentation materials, photocopy materials, or provide other publishing support
Private-Side Areas	Areas with ongoing access to MNPI
Private Equity	Area(s) with responsibility to invest funds (sometimes on behalf of external clients and sometimes on behalf of the broker-dealer or its parent or affiliate) typically in private companies or in public companies that are brought private

Proprietary Groups	Principal investment or trading area(s) that trade on behalf of the broker-dealer using firm capital not for the purpose of facilitating customer order flow
Public-Side Areas	Areas generally without access to MNPI, typically with sales, trading, or investment responsibilities
Research	Area(s) within the broker-dealer that analyze companies, securities, and markets and provide related written analysis and investment recommendations to customers
Sales and Trading	Area(s) within the broker-dealer that engage in trading or sales activity with respect to equities or fixed income securities
Syndicate	Area(s) within the broker-dealer with responsibility to manage offerings of securities

APPENDIX B – SUMMARY OF EFFECTIVE PRACTICES AND POTENTIAL CONCERNS

Below is a summary of the staff’s observations of effective practices and potential concerns discussed in more detail in the report. Exchange Act Section 15(g) requires a broker-dealer to establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of a broker-dealer’s business, to prevent the misuse of material nonpublic information. As such, the list below is not intended to be prescriptive. Different practices may be necessary or appropriate depending on the facts and circumstances. The effective practices described below are not an exhaustive list, and they constitute neither a safe harbor nor a “checklist”. Other practices besides those highlighted here may be appropriate as alternatives or supplements to these practices.

EFFECTIVE PRACTICES - OBSERVATIONS AND CONSIDERATIONS. The staff observed the following practices used by broker-dealers to comply with Exchange Act Section 15(g).

Identification of Companies/Securities for which Monitoring Should Occur

- Independent control functions, such as the Control Room, did not rely solely on notice from the business unit but had other controls and information sources available to identify when the broker-dealer may come into possession of material non-public information or MNPI, including:
 - automatic notices from computer systems responsible for managing investment banking deals or for conflicts checks,
 - reviews of pipeline reports or commitment committee minutes,
 - reviews of confidentiality agreements,
 - reviews of access reports for electronic information services, and
 - blocked access to electronic information services to public-side employees until authorization is given and the item is coded for monitoring.
- The Control Room had responsibility for determining the materiality of nonpublic information, after discussions with the relevant business unit. The Control Room maintained a list of items not placed on a monitoring list based on a determination that such information was not material.
- The assessment of whether the broker-dealer had possession of MNPI was not limited to transactions on which the broker-dealer was engaged but also included instances when employees had knowledge of transactions for which another broker-dealer had been engaged. Broker-dealers also assessed when they came into possession of non-transactional MNPI, such as unannounced earnings.

Sharing of Information

- Broker-dealers had formal over-the-wall processes that were used prior to sharing MNPI with public-side employees.
 - Compliance pre-approved the sharing of information.

- Compliance logged the names of public-side employees given the information.
 - Compliance logged an entire desk as over-the-wall if a large number of employees within the desk have the information.
 - Some level of physical separation existed between groups that routinely received MNPI and other Sales and Trading employees.
 - Over-the-wall processes were used for sharing information between two private-side groups to monitor the flow of information.
- Broker-dealers had controls over other sources of potential MNPI and generally limited access based on a need to know. For example, the following information sources had restrictions on access:
- databases containing internal credit ratings,
 - committees that approved engagements on nonpublic transactions, and
 - databases containing information received from borrowers.
- Broker-dealers had formal written processes and documentation surrounding the sharing of MNPI between two private-side groups and between private-side groups and internal public-side groups or external parties.
- Broker-dealers had physical barriers to prevent unauthorized access to MNPI.
- Physical barriers were used to separate two functions that had different types of MNPI (e.g., Investment Banking and Research) or two public-side functions when one of the public-side functions routinely had MNPI (and related trading restrictions).
 - Access to segregated spaces was limited by key card access, and such access was periodically reviewed to remove unauthorized personnel.
 - Physical barriers took into account support functions such as Printing and Production, Operations, and Information Technology.
 - Access to confidential paper documents was limited through controlled disposal techniques.
- Broker-dealers had technology barriers to prevent unauthorized access to information.
- Private-side employees were blocked from remotely logging-in to their computers from public-side physical space.
 - The ability to download electronic files to removable storage was blocked.
 - Controls were in place to minimize misdirected emails, such as pop-up messages for external emails and eliminating autocomplete addressing functions.
 - Access to electronic documents on network drives was limited, in some cases to the specific employees with a need to know (e.g., members of a deal team). Access rights were periodically reviewed.

Surveillance and Monitoring

- Broker-dealers had expanded the scope of their surveillance of trading as well as enhanced the process for identifying anomalous trading.
 - The type of transactions and instruments being reviewed included: credit default swaps, single stock futures, equity or total return swaps, warrants, and bond options.
 - Lookback reviews were conducted upon the announcement of information or in instances in which the broker-dealer failed to begin monitoring upon receipt of MNPI.
 - Pattern-based surveillance assessed historical patterns or accumulations of positions over time. Surveillance evaluated trading based on potential scenarios that could take advantage of the MNPI and based on trading patterns and trends.
 - Surveillance was triggered not only by transactions on which the broker-dealer was involved but also by non-transactional MNPI within the broker-dealer's possession and by transactions on which the broker-dealer did not have involvement to take into account information provided by external sources to their employees.
 - Surveillance personnel were being provided greater access to relevant information such as developments that occur within deals.
 - The documentation maintained provided descriptions of the reasons for resolving the exceptions.
- Broker-dealers reviewed emails for information barriers concerns, including targeted reviews when an "internal use only" document was sent outside the broker-dealer or for large attachments sent to generic internet email domains. Some broker-dealers conducted ad hoc email reviews when surveillance identified concerns in trading or when deals were announced.
- Controls around employee trading captured trading by contingent workers (e.g., persons performing work on behalf of and as directed by the broker-dealer but employed by third parties) and control/support functions if the worker/employee had access to MNPI.

POTENTIAL CONCERNS. The staff observed the following concerns at some broker-dealers that may raise questions about the broker-dealers' compliance with Section 15(g).

Identification of Companies/Securities for which Monitoring Should Occur

- The independent control function at some broker-dealers did not actively identify when the broker-dealer came into possession of MNPI. Instead, the group was dependent on the business unit notifying them of possession of MNPI. Procedures for the business units may be generic across the broker-dealer, so that employees within specific business functions had little guidance as to the types of information that should be reported. The independent control function did not test

whether it was being notified of information as required under the broker-dealer's procedures.

- The coding and removal of coding for monitoring within the Control Database was not timed based on the broker-dealer's possession of MNPI.
 - Placement on a monitoring list did not occur until formal mandate had been received or a materiality assessment had been conducted.
 - Some broker-dealers removed items from all monitoring lists upon public announcement or shortly thereafter. While the information regarding the existence of the transactions was public, the broker-dealer continued to work on the transactions until closing and received additional MNPI regarding the transactions.
 - Some broker-dealers removed items based on a specified period of time elapsing without any assessment as to whether the information continued to be MNPI.
 - Some broker-dealers lacked processes to identify events that could impact monitoring, such as a private company having a securities distribution or significant changes to the status of the transaction (e.g., a change in timing or a formerly inactive deal being re-activated).
- Certain practices raised concerns about the ability of the broker-dealer to monitor and evaluate whether its materiality determinations were reasonable, including a lack of documentation, a lack of factors to assess materiality, and a lack of a process to identify later receipt of MNPI (e.g., through the due diligence process or based on an altered transaction structure).
- Some broker-dealers excluded certain information types or departments categorically from monitoring without any assessment of whether specific information was material. Exclusions observed related to:
 - debt transactions for corporations rated as investment grade,
 - information within the Credit Department obtained as a result of their monitoring or contacts with insiders of corporations, and
 - information obtained by public-side employees who served as directors of public corporations.

Sharing of Information

- Broker-dealers provided MNPI to certain public-side employees and senior supervisors or external parties without any documentation or other controls. As such, the ability to identify potential misuse of such information was curtailed.
 - Some broker-dealers created categories of employees who had supervisory responsibility over trading groups and who were authorized to receive MNPI without any restrictions or monitoring. At some broker-dealers, this was referred to as "above-the-wall." In the staff's view, this practice limits the ability of the Control Group to investigate effectively suspicious

- firm or other trading and significantly impedes the broker-dealer's ability to prevent the misuse of MNPI.
 - Supervisors who approved bringing employees over-the-wall were not themselves logged over-the-wall at some broker-dealers, even though they were aware of the company involved and potentially the nature of the transaction.
 - Private-side employees were permitted to have informal discussions with public-side areas of the broker-dealer, and the frequency of the discussions and the absence of documentation limited the ability to monitor for potential disclosures of MNPI.
 - Information regarding unannounced transactions was shared with external parties without any documented confidentiality agreement.
 - Controls surrounding virtual data rooms were informal, including the lack of documentation, written procedures, and absence of audit trails.
- Broker-dealers did not take into account conflicting interests between two groups of private-side personnel and so permitted information to be freely shared without any documentation or other controls.
 - The Financial Sponsors Groups within Investment Banking Departments have institutional investor clients, while other Investment Banking groups have corporate clients.
 - Broker-dealers had cross-selling groups that were organizationally within the asset management function but were provided with Investment Banking information regarding unannounced transactions.
- One broker-dealer provided deal information regularly to its unregulated parent. The information included both the deals worked on and ongoing information as to deal developments. The broker-dealer did not evaluate whether the parent had any controls over use of the information.
- The physical barriers at some broker-dealers did not prevent the possible access of MNPI. Some private-side areas had glass walls or only had walls of half-height, permitting visual access to information.
- Some groups with access to MNPI were not physically segregated. The groups included sales functions with corporate clientele, origination functions for non-corporate issuers, as well as certain groups that support private-side areas, such as Information Technology and Operations.

Surveillance and Monitoring

- Surveillance and monitoring focused solely on a broker-dealer's formal processes rather than potential misuse of MNPI. For example, restricted list surveillance only assessed whether accounts were trading consistently with any applicable restrictions rather than reviewing to determine whether such trades were based on

MNPI.

- Surveillance did not have sufficient information to resolve adequately exceptions.
 - Surveillance was unaware of employees who transferred from the private-side to the public-side and continued to have knowledge of MNPI.
 - Some broker-dealers only monitored trading in entities with public securities and failed to identify when a formerly private corporation created a public securities market.
 - Compliance was unaware of all employees working on a transaction or did not obtain information regarding events that occurred prior to the first contact into the Control Room.
 - Compliance relied solely on the assertions of the person being reviewed without any independent confirmation.
 - Surveillance reports only identified large positions built on a single day and did not take into account positions that were built over several days.
- Monitoring functions excluded relevant groups.
 - Email monitoring excluded groups with access to MNPI, including Compliance and Information Technology. Other broker-dealers failed to review internal emails for information barriers purposes.
 - Employee trade surveillance excluded managed accounts without any consideration that the manager could have personal connections with an employee.
 - Some broker-dealers did not review activities of asset management affiliates, institutional customers, or customer facilitation trading groups.
- Broker-dealers did not adequately track ongoing or recurring concerns.
 - Documentation of surveillance was limited to a simple notation that the trade was reviewed. No documentation was maintained of any analysis or research conducted to resolve the item.
 - Broker-dealers did not enforce their policies and procedures when employees failed to pre-clear personal trades.

Outside Business Activities

FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities and Private Securities Transactions

Comment Period Expires: April 27, 2018

Summary

FINRA seeks comment on a proposed new rule to address the outside business activities of registered persons. The proposal is the result of FINRA's recent retrospective review of FINRA's rules governing outside business activities and private securities transactions, FINRA Rule 3270 (Outside Business Activities of Registered Persons) and FINRA Rule 3280 (Private Securities Transactions of an Associated Person), respectively. The proposed rule would replace FINRA Rules 3270 and 3280 and is intended to reduce unnecessary burdens while strengthening investor protections relating to outside activities.

The proposed rule text is available in *Attachment A*.

Questions regarding this *Notice* should be directed to:

- ▶ James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8270; or
- ▶ Meredith Cordisco, Associate General Counsel, OGC, at (202) 728-8018.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 27, 2018.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

February 26, 2018

Notice Type

- ▶ Request for Comment

Suggested Routing

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

Key Topics

- ▶ Outside Business Activities
- ▶ Private Securities Transactions
- ▶ Recordkeeping
- ▶ Supervision

Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ FINRA Rule 3210
- ▶ FINRA Rule 3270
- ▶ FINRA Rule 3280
- ▶ FINRA Rule 5130
- ▶ Notice to Members 85-21
- ▶ Notice to Members 94-44
- ▶ Notice to Members 96-33
- ▶ Regulatory Notice 17-20



To help FINRA process comments more efficiently, persons should use only one method to comment.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.¹

Before becoming effective, the proposed rule change must be filed with the Securities and Exchange Commission (SEC or Commission) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).²

Background & Discussion

In May 2017, FINRA launched a retrospective review of its outside business activities and private securities transactions rules to assess their effectiveness and efficiency.³ These rules serve important goals – they seek to protect the investing public when a member’s registered or associated persons engage in potentially problematic activities that are unknown to the member but could be perceived by the investing public as part of the member’s business. An ancillary benefit is that the rules protect the member from resulting reputational and litigation risks.

The retrospective rule review confirmed the continuing importance of rules relating to outside activities, but also indicated that the current rules, as well as related guidance,⁴ could benefit from changes to better align the investor protection goals with the current regulatory landscape and business practices.⁵ In particular, FINRA received significant feedback on members’ obligations with respect to the investment advisory (IA) activities of their registered persons, which is addressed in detail below.

Consistent with a number of recommendations by stakeholders⁶ during the retrospective review, FINRA is proposing a single streamlined rule to address the outside business activities of registered persons.⁷ The proposed rule would clarify the obligations in this area and reduce unnecessary burdens while strengthening protections relating to activities that may pose a greater risk to the investing public. The proposed rule would require registered persons to provide their members with prior written notice of a broad range of outside activities, while imposing on members a responsibility to perform a reasonable risk assessment of a narrower set of activities that are investment related, allowing members to focus on outside activities that are most likely to raise investor protection concerns. The proposed rule also would generally exclude from the rule a registered person’s personal investments (sometimes referred to as “buying away”) and work performed on behalf of a member’s affiliates. Moreover, the proposed rule would not impose supervisory and recordkeeping obligations for most other outside activities, including IA activities at an unaffiliated third-party IA. At the same time, the proposal would hold a member responsible for approved activities that could not take place but for the registered person’s association with a member.

The following illustration summarizes core concepts of the proposed rule, which are discussed in greater detail in this *Notice*.



Registered Persons' Obligation to Provide Notice of Outside Activities

A majority of stakeholders that provided feedback during the retrospective review believed that the scope of activities subject to the outside business activities rule, Rule 3270, should be narrowed.⁸ On the other hand, a significant minority of stakeholders favored the rule's current notice requirement to ensure that registered persons report a broad range of outside activities to their employing firms. Moreover, a number of stakeholders believed that notice of private securities transactions under Rule 3280 should not be narrowed.⁹ The proposed rule takes a balanced approach that would ensure that members are apprised of their registered persons' outside activities, while tailoring members' responsibilities to those activities that are most likely to raise investor protection concerns.

To that end, FINRA is proposing a single rule that would require registered persons to provide their firms with prior written notice for all investment-related or other business activities outside the scope of their relationship with the member. The proposed rule would require that a registered person include in the notice a description of the proposed activity and the registered person's proposed role therein, and that the registered person update the notice in the event of a material change to the activity.¹⁰ With respect to investment-related activities only, a registered person would be required to receive prior written approval from the member before participating in the activity.

The rule would define "investment-related" as "pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association)." This definition is also used for purposes of the Uniform Application for Securities Industry Registration or Transfer (Form U4) and would better harmonize the Form U4 reporting requirements and the notice obligations under FINRA rules, an issue frequently raised during the retrospective review.¹¹ The concept of "business activity" would be similar to current Rule 3270, with minor clarifying changes, and would be defined in the rule as (1) acting as an employee, independent contractor, sole proprietor, officer, director or partner of another person; or (2) receiving compensation, or having the reasonable expectation of compensation, from any other person as a result of the activity.¹²

Similar to current Rule 3270, the proposed rule would apply only to the outside activities of registered persons. It would not apply to the activities of members' non-registered associated persons because the risk of potential conflicts is more prevalent with regard to registered persons.¹³ However, the proposed rule would not preclude members from instituting policies and procedures relating to the outside activities of associated persons more broadly.

Members' Responsibilities Upon Receiving Notice

Although the proposed rule would require registered persons to provide prior written notice of a broad range of outside activities, the focus of a member's responsibilities is on investment-related activities.¹⁴ If an activity is not investment related, the member has no obligation under the rule. If the activity is investment related, then the member would be required to perform a reasonable risk assessment, as described below.

Assessment

Upon receiving written notice of an outside *investment-related* activity, the proposed rule would require that a member perform an upfront reasonable assessment of the risks created by the engagement of the registered person in the proposed activity. Specifically, the member would be required to evaluate whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or (2) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. These considerations are similar to those required by current Rule 3270 and are aimed at assessing possible conflicts that could negatively impact the member's customers or the investing public. Although the risk assessment must be reasonable and will vary depending on the facts and circumstances, the rule's focus is on the registered person's participation in the activity and ordinarily would not require the member to perform an analysis of the underlying outside business activity.¹⁵ In addition to this risk assessment, the member would be required to consider whether the person is relying on a member's registration as a broker or dealer to conduct the activity, in which case the activity would be deemed to be that of the member, if approved.¹⁶

Then, based on the foregoing, the member would determine whether to approve the registered person's participation, to approve it subject to conditions or limitations or to disapprove it. The member would be required to advise the registered person in writing of its determination.

By focusing the member's assessment on investment-related activities, the proposed rule would allow members to concentrate their compliance resources on those activities that may pose a greater chance of harm to investors. Members would no longer be required to conduct a risk assessment on a non-investment-related activity, such as a registered person driving for a car service or holding seasonal retail employment, regardless of whether the registered person receives compensation.¹⁷

Supervision

The proposed rule would impose a supervisory obligation in two situations. First, if a member imposes conditions or limitations on a registered person's participation in an investment-related activity, the member would be required to reasonably supervise the registered person's compliance with those conditions or limitations. The proposed rule would not require members to supervise the underlying activities. For example, after conducting the required risk assessment of an investment-related activity, a member may approve a registered person to act as a registered investment adviser through an unaffiliated, third-party IA; however, the member also may condition that approval on the IA's custody of its clients' advisory assets with the member. In this example, the proposed rule would require the member to reasonably supervise the registered person's adherence to that condition, but the member would not be required by the rule to otherwise supervise the IA activity.¹⁸

Second, to the extent that a member approves a registered person's participation in a proposed investment-related activity and such activity would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity would be deemed to be the member's business. In other words, if the person can only legally engage in the outside business activity because the person is associated with a member, the member approving that activity must treat it as its own. Accordingly, all applicable securities laws and regulations and FINRA rules, including supervision and recordkeeping, would apply to the member with respect to that activity. This provision serves a critical investor protection interest and requires the member's supervision over the types of activities that the private securities transactions rule was originally adopted to address.¹⁹ It would ensure that a registered person's outside broker-dealer activity – for example, selling private placements away from the member in a manner that would require broker-dealer registration – would be reported to the member and that such activity, if approved, would be under the supervision and control of a broker-dealer and subject to the same supervisory safeguards as any of the member's other broker-dealer business.

Under this second scenario, if the registered person is associated with more than one member, the proposed rule would allow members to develop a formal allocation arrangement whereby at least one member agrees in writing with specificity to comply with all applicable securities laws and regulations and FINRA rules regarding the proposed activity, including those covering supervision and recordkeeping.²⁰

Recordkeeping

The proposed rule would require a member to maintain and preserve records demonstrating compliance with the obligations of the rule for at least three years after the registered person's employment or association with the member has terminated.²¹ Records required to demonstrate compliance with the rule would depend upon the facts and circumstances, but would include, for example, the registered person's written notice of the proposed activity, a record of the member's risk assessment, the member's written determination and whether any conditions or limitations are imposed. The proposed rule would not impose a general obligation to record transactions resulting from a registered person's outside activities on the member's books and records, except in the circumstance discussed above where a member approves an activity for which the registered person is relying on a member's broker-dealer registration.

Proposed Exclusions from the Rule

The proposed rule has several exclusions that would reduce unnecessary burdens without lessening investor protection. First, the proposal would exclude from the rule's coverage registered persons' personal investments (*e.g.*, buying away), which commenters and stakeholders consistently noted do not raise the same investor protection concerns as selling away activities. Second, the proposed rule would exclude activities conducted on behalf of a member's affiliate, unless those activities would require registration as a broker or dealer if not for the person's association with a member. Therefore, a registered person generally would not be required to provide prior written notice, and a member would not be required to conduct the assessment required by the proposed rule, of any non-broker-dealer activity conducted for a member's affiliate, such as an affiliated IA, insurance entity or bank. In addition, any non-broker-dealer activity conducted on behalf of the member (*e.g.*, any IA activities for a dually registered broker-dealer/investment adviser (BD/IA)) would not be subject to the rule. These exclusions recognize members' ability to implement meaningful controls across business lines and are consistent with functional regulation – that such activities are subject to other regulatory regimes and oversight.²² They also ensure that dually registered BD/IAs or members that share employees with affiliates are not faced with unnecessary additional burdens. The rule would define an “affiliate” as “any entity that controls, is controlled by or is under common control with a member,” which is consistent with other FINRA rules.²³ For these purposes, a member would not be deemed to control an IA firm merely because it is owned by the member's registered person.

Finally, similar to the current private securities transactions rule, the proposed rule would not apply to transactions in accounts that are subject to FINRA Rule 3210 or to transactions on behalf of the registered person's immediate family members (as defined in FINRA Rule 5130) for which the registered person receives no transaction-related compensation.²⁴

Application to Registered Persons' Investment Advisory Activities

The proposed rule would change the current approach with respect to IA activities of registered persons. Under Rule 3280 and related guidance, members must supervise and record on the members' books and records the transactions resulting from most outside IA activities of their associated persons.²⁵ This approach has caused significant confusion and practical challenges, including, for example, privacy challenges with a member obtaining account information for customers of an unaffiliated IA through which a member's registered person may be acting in an IA capacity. Given these challenges, and in light of the fact that these activities are subject to another regulatory regime, some stakeholders argued that the current approach imposes unnecessary burdens without providing meaningful investor protections over the activities.

Based on FINRA's review of the rules, public comment and other stakeholder feedback, and the evolving environment in which members operate, modifications to the current approach appear appropriate. Under the proposed rule, as discussed above, any IA activity conducted on behalf of a dually registered BD/IA or for an IA affiliate of a member would be excluded from the rule. Any IA activity conducted for a third-party, non-affiliated IA would constitute an "investment-related" activity under the rule. As such, the rule would require that the registered person provide prior written notice of such activity, and the member would be required to conduct the upfront risk assessment described above and, based on its assessment, to approve the registered person's participation, to approve it subject to conditions or limitations or to disapprove it. However, the proposed rule would not impose a general supervisory obligation over the IA activities and would not require the member to record on its books and records transactions resulting from such IA activities. Although this proposed approach streamlines members' obligations over IA activities, these IA activities would continue to be subject to regulatory oversight by the SEC and states under a different regulatory scheme.²⁶

Economic Impact of the Proposal

Regulatory Need

FINRA's recent review of the current rules on outside business activities and private securities transactions and industry and stakeholder input indicate that the current rules may benefit from substantive changes that clarify the obligations and tailor them to better achieve investor protection.

Economic Baseline

The current rules governing member employees' business and securities activities outside the regular course or scope of their employment with their firms, Rules 3270 and 3280, and related guidance, serve as the economic baseline for the analysis. These rules impact a broad spectrum of members, irrespective of business model, client base and product type.

A survey on the rules sent to all FINRA members provided insights into the extent to which registered and associated persons are conducting, or proposing to engage in, activities subject to the rules.

Rule 3270 requires registered persons to provide prior written notice before engaging in an outside business activity. Approximately 80 percent of the members responding to the survey stated that they have received at least one written notice in the last five years pursuant to Rule 3270. Approximately 40 percent of the registered persons within those members provided written notices. Also, approximately 89 percent of the respondents stated that they had internal policies to limit or prohibit outside business activities, and 42 percent stated that they have limited or prohibited a registered person's participation in an outside business activity before, mostly due to potential conflicts of interest and potential confusion by the customer as to whether the activity falls within the firm's business.

Rule 3280 requires associated persons to provide prior written notice before participating in any manner in private securities transactions. In the survey, approximately 40 percent of the responding members stated that they have received at least one written notice in the last five years pursuant to Rule 3280. Approximately 19 percent of the associated persons within those members provided written notices. Also, approximately 89 percent of the respondents stated that they had internal policies to limit or prohibit private securities transactions for compensation to address the potential conflicts of interest between associated persons and the firm or its customers and to mitigate the litigation risk.

Economic Impacts

The proposed rule would directly impact registered persons that seek to engage in outside investment-related or other business activities and the members that employ them, and may potentially provide benefits for customers through better investor protection.

Streamlining the rules into a single combined rule will benefit both members and registered persons by reducing the likelihood of regulatory confusion, as raised by stakeholders and identified in the survey, and should make it easier for both members and registered persons to determine the activities that are within the proposed rule's scope. Stakeholders noted that the potential overlap between the two rules may lead to inconsistent interpretation and application of the rules. Moreover, some outside business activities may evolve into private securities transactions, resulting in confusion over which rule applies. The simplified approach may encourage registered persons who have previously avoided these activities because of the perceived regulatory uncertainty to pursue outside activities.

The proposal's requirement that registered persons provide their firms with prior written notice for all investment-related or other business activities will benefit members by ensuring they receive notice of a broad range of registered persons' outside activities. At the same time, there could be marginal costs for registered persons who would be required

to report a broad range of activities. It may also increase compliance costs for members to the extent that members must determine which of the reported activities are subject to a risk assessment under the rule.

With respect to a narrower set of activities – investment-related activities – the rule requires the member to conduct a reasonable assessment of the risks created by the registered person’s engagement in the proposed activity and to approve or disapprove the registered person’s participation. Imposing these requirements on the narrower set of activities will reduce unnecessary burdens to members of having to conduct a risk assessment of non-investment-related activities that may pose little harm to the member or the investing public. Specifically, members may benefit from employing compliance resources on those outside activities that are more likely to raise investor protection concerns.

Unlike current Rule 3270, the proposed rule imposes a requirement, with respect to investment-related activities only, to determine whether to approve or disapprove the activity, and to provide the registered person with written notice of this determination. Although FINRA understands that many members already do so, members may incur compliance costs associated with the proposal in providing written responses to registered persons regarding approval or disapproval decisions. On the other hand, this requirement will provide clarity for registered persons, as they will have a clear understanding of the member’s determination. However, it may delay registered persons’ participation in the activity until the member’s written approval decision, if provided, which could result in additional costs to registered persons up to and including the possibility of lost business opportunities. At the same time, where the member disapproves of the investment-related activity, ex post costs of such prohibition would be relatively lower under the proposal as the registered person receives the information before engaging in the activity. In addition, requiring registered persons to receive an approval determination before engaging in an investment-related activity may also benefit the investing public as registered persons will not have the opportunity to engage in activities that the member ultimately disapproves.²⁷

The current rules apply to different populations, with Rule 3270 applying to registered persons and Rule 3280 applying to associated persons. The proposed rule would eliminate this disparate treatment and apply uniformly to registered persons. In doing so, the proposal relieves associated persons from some obligations, which could potentially impact behaviors. Because non-registered associated persons would not be subject to the rule, they would have lower costs to engage in the covered activities under the proposal. This may create an incentive for associated persons to remain unregistered, to the extent that costs associated with the notification and, with respect to investment-related activities, assessment and approval requirements outweigh the benefits of being a registered person. The possible negative impact of this hypothetical may be tempered, however, by the fact that many activities require a person to be registered in one capacity or another before the person may engage in them.

Under current Rule 3280, if a member approves an associated person's participation in a private securities transaction for compensation, the member must record the transaction on the member's books and records and supervise the associated person's participation as if the transaction were executed on behalf of the member. The proposed rule, which imposes supervision only in the two limited situations described above, would eliminate those current requirements with respect to the majority of activities that fall within the current rule and, accordingly, should simplify the supervisory efforts and lower the direct compliance costs.

In addition, the proposed rule excludes non-broker-dealer activities conducted on behalf of a dually registered firm, such as IA or banking activities, and activities conducted for an affiliate of the member (unless those activities would require registration as a broker or dealer if not for the person's association with a member). These exclusions should potentially alleviate some of the burdens that are associated with reporting and assessing outside activities that may pose relatively little risk to the member and investing public.

FINRA also considered the potential impacts of the proposed amendments on investors. Limiting the risk assessment and approval requirements of the proposed rule to investment-related activities, as defined in the Form U4, mitigates the confusion and misalignment between the Form U4 and Rule 3270, and should enhance the investor protection purpose of the rule.

Alternatives Considered

FINRA staff also considered a principles-based approach, as suggested by some stakeholders, which potentially would provide members with more flexibility in developing the systems and the protocols to assess and approve or disapprove outside business activities and private securities transactions. However, the approach presented here was deemed to better balance the costs and benefits of governing registered persons' outside business and private securities activities. It also takes into account the views of numerous other stakeholders that favored a rules-based approach with specific requirements.

Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues:

1. What are the alternative approaches, other than the proposal, that FINRA should consider?
2. How would consolidation of the rules governing outside business activities and private securities transactions in this proposal simplify compliance? What impact would it have on the cost of compliance?

3. Unlike Rule 3280, the proposed rule would apply to registered persons, rather than to associated persons. Should the proposed rule be expanded to apply to all associated persons? If so, why?
4. Is the proposed scope of the notice requirement appropriately tailored to balance the interest of members to receive information regarding their registered persons' outside activities and any investor protection concerns?
 - a. Should the proposal be modified to require registered persons to provide notice with respect to a narrower set of activities? If so, should notice be required only with respect to investment-related or some other categorization of activities?
 - b. Would narrowing the scope of the proposal impose any additional risks to investors?
5. A member's obligation to conduct a risk assessment is only triggered under the proposal with respect to investment-related activities.
 - a. Does limiting the required risk assessment to activities that are "investment-related" properly balance the interest of allowing members to focus compliance efforts on activities that pose the greatest concerns and any potential harm to investors?
 - b. Is the definition of "investment-related," which is based on the definition used by the Form U4, appropriate given the regulatory objectives of the proposal, or should other activities be included in or excluded from the definition? If so, why?
 - c. The proposed rule's focus is on assessing the risks created by the registered person's engagement in the outside investment-related activity, rather than the underlying activity itself. Is this an appropriate focus? Should the risk assessment include a requirement for the member to perform due diligence of the underlying outside activity?
 - d. The member would be required in the risk assessment to evaluate whether the proposed activity will: (i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or (ii) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. Are these appropriate criteria to evaluate conflicts of interests and other potential areas of harm to investors?
6. The proposal has several exclusions, including for registered persons' personal investments and activities conducted on behalf of an affiliate of a member, unless those activities would require registration as a broker or dealer if not for the person's association with a member. Are the proposed exclusions appropriate?
 - a. Should any other activities be excluded from the rule? If so, why?

- b. Should the proposed exclusions, including the exclusion for activities on behalf of affiliates, be limited in any manner? For example, should the exclusion be limited to activities on behalf of affiliates that are subject to federal or state financial registration or licensing requirements, such as registered investment advisers, banks and insurance companies?
- 7. Unlike current Rule 3280 and related guidance, the proposed rule would not impose a general supervisory obligation over IA activities and would not require the member to record on its books and records transactions resulting from such IA activities. Does the treatment of IA activities under the proposed rule appropriately address investor protection concerns while recognizing that separate obligations exist under the IA regulatory regime?
- 8. Under paragraph (b)(4), if a member approves a person's participation in a proposed activity that would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act, the activity is deemed to be the member's business and the member must supervise accordingly.
 - a. Is registration under the Exchange Act the appropriate trigger for this provision?
 - b. Should paragraph (b)(4) be expanded to require a member to supervise a registered person's sale of securities through an entity that is not required to register under the Exchange Act?
 - c. When the registered person is associated with more than one member, the proposed rule allows members to develop a formal allocation arrangement whereby at least one member has the regulatory responsibility, including the supervision and recordkeeping of the proposed outside business activity. Are there any competitive effects of such allocation arrangements? Does this flexibility potentially create a disadvantage for some firms regarding how the costs are allocated? Should FINRA consider any other approaches?
- 9. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposal? If so:
 - a. What are these economic impacts and what are their primary sources?
 - b. To what extent would these economic impacts differ by business attributes, such as size of firm or differences in business models?
 - c. What would be the magnitude of these impacts, including costs and benefits?
- 10. Are there any expected economic impacts associated with the proposal not discussed in this *Notice*? What are they and what are the estimates of those impacts?

Endnotes

1. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (Online Availability of Comments) (November 2003) for more information.
2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. *See Regulatory Notice 17-20* (May 2017).
4. *See, e.g., Notice to Members 94-44* (May 1994); *Notice to Members 96-33* (May 1996).
5. FINRA Rule 3270 is incorporated by reference into the Capital Acquisition Broker (CAB) Rules. *See* CAB Rule 327. Persons associated with a capital acquisition broker may not participate in any manner in a private securities transaction as defined in Rule 3280(e). *See* CAB Rule 328. FINRA will consider whether conforming changes to the CAB rules are appropriate as a result of any changes to FINRA Rules 3270 and 3280.
6. The term “stakeholder” is used to describe those entities, organizations and persons who may be impacted by or otherwise have an interest in FINRA Rules 3270 and 3280 and this proposed rule.
7. A number of stakeholders commented on the similar notice requirements of Rules 3270 and 3280 and noted confusion over the often overlapping concepts. A combined rule would eliminate this confusion and streamline the requirements.
8. Subject to specified exemptions, Rule 3270 prohibits a registered person from being an employee, independent contractor, sole proprietor, officer, director or partner of another person, or being compensated, or having the reasonable expectation of compensation, from another person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member. In a survey sent to all FINRA members as part of the retrospective review, approximately 60 percent of the respondents believed that there are outside business activities that should not be included within the scope of Rule 3270.
9. Rule 3280 provides that, prior to participating in any private securities transaction, an associated person must provide written notice to the member with which he or she is associated, describing the transaction and the associated person’s role, and disclosing whether the associated person has received or may receive selling compensation in connection with the transaction. The rule defines “private securities transaction” as any securities transaction outside the regular course or scope of an associated person’s employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, but excludes transactions subject to the notification requirements of FINRA Rule 3210 (Accounts At Other Broker-Dealers and Financial Institutions), transactions among immediate family members (as defined in FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings)), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities.

10. For example, some stakeholders noted that an outside business activity that appears on its face to pose little risk to the investing public may evolve into a private securities transaction if the registered person seeks to sell interests in an outside business. Such a material change in the activity would require the registered person to provide updated written notice and, in this example, would trigger the member to conduct a risk assessment and, depending on the activity and whether the member approves the registered person's participation, may require the member's supervision.
11. See Form U4 Explanation of Terms, available at <https://www.finra.org/file/explanation-terms-crd-forms>.
12. FINRA notes that, irrespective of whether an outside activity is investment related, other rules may apply, depending on the facts and circumstances, to business-related conduct, including FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).
13. FINRA Rule 3270 applies to registered persons, while FINRA Rule 3280 applies to associated persons. The proposed rule would harmonize this distinction, which was an issue raised by stakeholders during the retrospective review.
14. Because a member's obligations under the rule apply with respect to investment-related activities, a member necessarily must have a process for reasonably determining which activities are investment related.
15. As part of the risk assessment, FINRA would expect a member, for example, to consider the registered person's proposed role in the activity, whether the registered person intends to use separate or shared facilities or electronic presence, whether the registered person intends to solicit the member's customers and the general nature of the underlying activity. A member also must consider any "red flags" indicating problematic activities that raise the risks of the engagement of the registered person in the proposed activity. See, e.g., *Dep't of Enforcement v. Fox Fin. Mgmt. Corp.*, Complaint No. 2012030724101, 2017 FINRA Discip. LEXIS 3, at *17-18 (FINRA NAC Jan. 6, 2017) (stating that the "supervisory duties imposed under NASD Rule 3010 include a responsibility to investigate and act upon 'red flags' that reveal irregularities or the potential for misconduct" and finding that the firm failed to investigate and act upon red flags indicating that an outside business activity in fact involved private securities transactions); *Dep't of Enforcement v. Merrimac Corp. Securities, Inc.*, Complaint No. 2009017195204, 2015 FINRA Discip. LEXIS 4, at *9 (FINRA NAC Apr. 29, 2015) (affirming the imposition of sanctions for the firm's failure to adequately consider red flags of outside business activities and private securities transactions, for example, by neglecting "to investigate after it learned of allegations on a website that one of the outside businesses was a Ponzi scheme and was suffering serious financial difficulties").
16. As discussed more fully *infra*, in this circumstance, a firm would be responsible for complying with all applicable securities laws and FINRA rules, including supervision and recordkeeping.
17. The rule would not prohibit a member from deciding for its own business reasons to create additional obligations and procedures for its registered or associated persons regarding outside business activities.
18. In this example, the member would have other obligations related to its custodial role, but those are separate and apart from the proposed rule's treatment of *outside* business activities.

19. *See, e.g., Notice to Members 85-21* (March 1985) (requesting comment on private securities transactions rule, which was aimed at addressing transactions that had long been a regulatory concern, namely “transactions in which an associated person is selling securities to public investors on behalf of another party, *e.g.*, as part of a private offering of limited partnership interests, without the participation of the person’s employer firm”).
20. This provision is consistent with current guidance regarding the application of the private securities transactions rule to the activities of registered persons employed by more than one member. *See Notice to Members 96-33* (May 1996), Question 5 (allowing members to develop a detailed, formal allocation arrangement whereby at least one member agrees and is able to provide required supervision and recordkeeping under the private securities transactions rule with respect to outside investment advisory activities of a registered person employed with more than one member).
21. This retention period is consistent with the retention period in the current rule on outside business activities and with the retention period of other records relating to associated persons required to be made and preserved under the Exchange Act. *See* SEA Rule 17a-4(e)(1) (setting forth the retention period for specified records relating to associated persons).
22. For example, investment advisers registered with the SEC are overseen by the SEC and subject to the obligations of the Investment Advisers Act of 1940 (Advisers Act) and the regulations and rules promulgated thereunder. Other investment advisers are subject to state registration systems, many of which have requirements similar to the Advisers Act.
23. *See, e.g.,* FINRA Rule 5121(f)(1) (defining “affiliate” for purposes of the rule governing public offerings of securities when a participating firm has a conflict of interest); FINRA Rule 6710(ee) (defining “Non-member Affiliate” for purposes of the rules relating to the Trade Reporting and Compliance Engine (TRACE)).
24. The proposal would not alter the obligations under FINRA Rule 3210.
25. *See* Rule 3280(c)(2) (requiring a member that approves an associated person’s participation in a private securities transaction for compensation to record the transaction on the member’s books and records and supervise the associated person’s participation as if the transaction were executed on behalf of the member); *see also Notice to Members 94-44* (May 1994) (providing that an associated person is considered to be participating in the execution of the transaction, and, therefore, triggering the application of Rule 3280, if the person’s investment advisory activities exceed the mere recommendation of securities).
26. *See supra* note 22. To the extent that FINRA becomes aware of potentially problematic IA or other non-broker-dealer activities during the course of its oversight of broker-dealers, FINRA would take appropriate action within the scope of its authority, including, but not limited to, referring the matter to the SEC or states.
27. Under Rule 3270, a registered person must provide prior written notice to the firm of outside business activity, but there is no requirement in the rule that the member approve the activity before the registered person may engage in it.

ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined.

* * * * *

3290. Outside Business Activities

(a) Obligations of a Registered Person

No registered person may participate in any manner in an investment-related or other business activity outside the scope of the relationship with the person's member firm unless the person provides prior written notice to and, with respect to any investment-related activity, receives prior written approval from, the member. In the case of a material change to the activity, a registered person must provide the member with updated prior written notice and, with respect to any investment-related activity, receive updated prior approval. The notification shall be provided in such form as specified by the member, describing the proposed activity and the person's proposed role therein. If the member disapproves the proposed activity or places conditions or limitations on it, the registered person shall not participate in the activity or shall comply with such conditions or limitations.

(b) Obligations of a Member Receiving Notice of an Investment-Related Activity

(1) Upon receipt of a written notice of any investment-related activity, a member shall:

(A) perform a reasonable assessment of the risks created by the engagement of the registered person in the proposed activity, including an evaluation of whether the proposed activity will:

(i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or

(ii) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered;

(B) consider whether the activity would require the person's registration as a broker or dealer under the Exchange Act if not for the person's association with a member; and

(C) make a reasonable determination of whether to approve the registered person's participation in the proposed activity, to approve it subject to specific conditions or limitations, or to disapprove it.

(2) Upon completion of the member's assessment, a member shall advise the registered person in writing whether the member:

(A) approves the person's participation in the proposed activity and imposes any conditions or limitations on that participation; or

(B) disapproves the person's participation in the proposed activity.

(3) If the member imposes conditions or limitations on its approval of the person's participation in the proposed activity, the member shall reasonably supervise the registered person's compliance with such conditions or limitations.

(4) If the member approves the person's participation in the proposed activity and such activity would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity shall be deemed to be that of the member and the member shall be subject to all applicable securities laws and regulations and FINRA rules, including those requiring supervision and recordkeeping, with respect to that activity. If the person is associated with more than one member, the members may develop a detailed, formal allocation arrangement, which must be in writing, whereby at least one member agrees to be responsible for compliance with respect to all applicable securities laws and regulations and FINRA rules regarding the proposed activity, including those requiring supervision and recordkeeping.

(5) A member must keep a record demonstrating its compliance with the obligations pursuant to this Rule and must preserve this record at least three years after the registered person's employment or association with the member has terminated.

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

.01 This Rule shall not apply to:

(a) a registered person's personal investments (including transactions in accounts that are subject to FINRA Rule 3210);

(b) transactions on behalf of the registered person's immediate family members (as defined in FINRA Rule 5130) for which the registered person receives no transaction-related compensation;

(c) activities conducted on behalf of a member's affiliate, unless those activities would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered; or

(d) a member's non-broker-dealer activities.

.02 For purposes of this Rule:

(a) "Affiliate" means any entity that controls, is controlled by or is under common control with a member.

(b) "Business activity" means: (i) acting as an employee, independent contractor, sole proprietor, officer, director or partner of another person; or (ii) receiving compensation, or having the reasonable expectation of compensation, from any other person as a result of the activity.

(c) "Investment-related" means pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association).

Regulatory Notice

16-29

Gifts, Gratuities and Non-Cash Compensation Rules

FINRA Requests Comment on Proposed Amendments to Its Gifts, Gratuities and Non-Cash Compensation Rules

Comment Period Expires: September 23, 2016

Executive Summary

FINRA is seeking comment on proposed amendments to FINRA Rule 3220 (Influencing or Rewarding Employees of Others), as well as on proposed FINRA Rule 3221 (Restrictions on Non-Cash Compensation), and proposed FINRA Rule 3222 (Business Entertainment).

The proposed rule text is available in Attachment A.

Questions concerning this *Notice* should be directed to:

- ▶ Victoria Crane, Associate General Counsel, Office of General Counsel, at (202) 728-8104; or
- ▶ Joseph Savage, Vice President and Counsel, Regulatory Policy, at (240) 386-4534.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by September 23, 2016.

Comments must be submitted through one of the following methods:

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

August 2016

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Investment Companies
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management
- ▶ Variable Contracts

Key Topics

- ▶ Business Entertainment
- ▶ Commercial Bribery
- ▶ Gifts
- ▶ Gratuities
- ▶ Non-Cash Compensation

Referenced Rules & Notices

- ▶ FINRA Rule 2310
- ▶ FINRA Rule 2320
- ▶ FINRA Rule 3220
- ▶ FINRA Rule 3221
- ▶ FINRA Rule 3222
- ▶ FINRA Rule 5110
- ▶ NASD Rule 2830
- ▶ Notice to Members 06-69



Financial Industry Regulatory Authority

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

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).²

Background & Discussion

In April 2014, FINRA launched a retrospective review of its gifts, gratuities and non-cash compensation rules to assess their effectiveness and efficiency. In December 2014, FINRA published a report on its review.³ The report concluded that while the rules have met their intended investor protection objectives, they could benefit from some updating to better align the investor protection benefits and the economic impacts. To that end, FINRA recommended exploring a combination of proposed rule amendments and guidance.

As discussed further below, FINRA is proposing amendments to the gifts, gratuities and non-cash compensation rules to, among other things: (1) consolidate the rules under a single rule series in the FINRA rulebook; (2) increase the gift limit from \$100 to \$175 per person per year and include a *de minimis* threshold below which firms would not have to keep records of gifts given or received; (3) amend the non-cash compensation rules to cover all securities products, rather than only direct participation programs (DPPs), variable insurance contracts, investment company securities and public offerings of securities; and (4) incorporate existing guidance and interpretive letters into the rules.

In addition, FINRA is proposing a revised approach to internal sales contests for non-cash compensation such that if payment or reimbursement of expenses associated with the non-cash compensation arrangement is preconditioned on achievement of a sales target, the non-cash compensation arrangement must: (1) be based on the total production with respect to all securities products; and (2) not be based on conditions that would encourage an associated person to recommend particular securities or categories of securities.

Finally, FINRA is proposing to incorporate into the amended rules a principles-based standard for business entertainment that would require firms to adopt written policies and supervisory procedures for business entertainment.

Proposed Rule Amendments

A. Gifts

FINRA Rule 3220 (Influencing or Rewarding Employees of Others)⁴ (the Gifts Rule) prohibits any member or person associated with a member, directly or indirectly, from giving anything of value in excess of \$100 per year to any person where such payment is in relation to the business of the recipient's employer. The rule also requires members to keep separate records regarding gifts and gratuities.⁵ The rule seeks both to avoid improprieties that may arise when a member firm or its associated persons give anything of value to an employee of a customer or counterparty and to preserve an employee's duty to act in the best interests of that customer.

1. \$100 Gift Limit

FINRA proposes to increase the gift limit from \$100 to \$175 per person per year.⁶ FINRA believes that an increase in the gift limit to \$175 is appropriate because it takes into account the rate of inflation since adoption of the \$100 gift limit.⁷

2. Incorporation of Existing Guidance and Interpretive Positions

In 2006, FINRA issued [*Notice to Members \(NTM\) 06-69*](#) addressing gifts and business entertainment to clarify the gifts that are subject to the Gifts Rule; that members must aggregate all gifts given by the firm and its associated persons to a particular recipient over the course of a year; the manner by which to value gifts; and the supervision and recordkeeping requirements for gifts.⁸ In addition, over the years, in response to inquiries regarding the Gifts Rule, the staff has issued various interpretive letters, including a letter regarding the application of the Gifts Rule to bereavement gifts.⁹

FINRA proposes to incorporate, without material change, the guidance in *NTM 06-69* as well as its interpretation regarding the application of the Gifts Rule to bereavement gifts into FINRA Rule 3220 as Supplementary Material. Thus, the Supplementary Material would provide that: (1) there is no express exclusion from the Gifts Rule for gifts given during the course of business entertainment, unless the gift is of *de minimis* value, or a promotional or commemorative item; (2) gifts must be valued at the higher of cost or market value;¹⁰ (3) members must aggregate all gifts given by the member and each associated person of the member to a particular recipient over the course of the year; (4) bereavement gifts that are customary and reasonable are not considered to be in relation to the business of the recipient and, therefore, are not subject to the restrictions of the Gifts Rule or its recordkeeping requirements; (5) gifts given for infrequent life events (*e.g.*, a wedding gift or congratulatory gift for the birth of a child) are not subject to the restrictions of the Gifts Rule or its recordkeeping requirements provided the gifts are customary and reasonable, personal in nature and not in relation to the business of the employer of the recipient; and

(6) gifts of a *de minimis* value, promotional items of nominal value and commemorative items are not subject to the restrictions of the Gifts Rule or its recordkeeping requirements provided they meet the conditions specified in the Supplementary Material.¹¹ In addition, FINRA proposes to incorporate into the Supplementary Material to FINRA Rule 3220 the guidance in [NTM 06-69](#) regarding supervision and recordkeeping requirements for gifts.

B. Restrictions on Non-Cash Compensation

FINRA and NASD rules generally prohibit members and their associated persons from directly or indirectly accepting or making payments or offers of non-cash compensation in connection with the sale of variable insurance contracts,¹² investment company securities,¹³ DPPs¹⁴ and the public offerings of debt and equity securities.¹⁵ These prohibitions are subject to specified exceptions that permit:

- ▶ gifts that do not exceed an annual amount per person fixed by the FINRA Board of Governors (currently \$100) and are not preconditioned on achievement of a sales target;
- ▶ an occasional meal, a ticket to a sporting event or the theater, or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target;
- ▶ payment or reimbursement by “offerors” (product issuers, advisers, underwriters and their affiliates) in connection with training or education meetings, subject to specified conditions, including meeting location restrictions and not preconditioning attendance on achievement of a sales target; and
- ▶ internal firm non-cash compensation arrangements that are based on total production and equal weighting of product sales.¹⁶

1. Proposed FINRA Rule 3221

a. Application to Any Security

FINRA believes that the general prohibitions regarding the payment or receipt of non-cash compensation should be extended beyond investment company securities, variable insurance contracts, DPPs and public offerings of securities as the conflicts underlying these prohibitions exist with respect to all securities. Accordingly, FINRA proposes to eliminate the existing non-cash compensation rules and replace them with proposed FINRA Rule 3221, which would apply to the payment or receipt of non-cash compensation in connection with the sale of any security. Specifically, proposed FINRA Rule 3221(b) would provide that “No member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation in connection with the sale of securities.” This prohibition would be subject to the exceptions discussed below.

b. Exceptions to the Prohibition on Non-Cash Compensation Arrangements

i. Gifts From Offerors

Consistent with the existing non-cash compensation rules, the proposal would except from the prohibitions on non-cash compensation arrangements gifts from offerors¹⁷ that do not exceed a specified threshold per individual per year and are not preconditioned on the achievement of a sales target.

The proposal would define the term “preconditioned on the achievement of a sales target” as describing a non-cash compensation arrangement in which an offeror or member communicates in advance that an associated person will receive non-cash compensation only if the associated person achieves either a dollar-denominated goal for selling securities or a goal of finishing within a defined number of top sellers of securities.¹⁸ As with the dollar threshold under the proposed amendments to the Gifts Rule, FINRA proposes to limit the gifts exception under proposed FINRA Rule 3221 to \$175.

ii. Training or Education Meetings

The proposal would permit an offeror to make payments or reimbursements of associated persons’ expenses in connection with a training or education meeting held by an offeror or a member, provided that the meeting meets the following conditions:

- ▶ Associated persons must obtain the member’s prior approval to attend the meeting and attendance, as well as the payment or reimbursement by the offeror, must not be preconditioned on the achievement of a sales target.
- ▶ The location must be appropriate to the purpose of the meeting. The proposal would establish appropriate locations to be a U.S. office of the offeror or member holding the meeting, a facility located in the vicinity of such office, a U.S. regional location with respect to meetings of associated persons who work within that region or, with respect to meetings dealing with DPPs or real estate investment trusts (REITs), a U.S. location at which a significant or representative asset of the program or REIT is located.
- ▶ Payment or reimbursement by the offeror must apply only to the training, education, meals, lodging and transportation for associated persons. The proposed rule would make clear that the offeror could not pay or provide reimbursement for the entertainment or expenses of guests of associated persons or for the entertainment of associated persons.
- ▶ FINRA believes that the conditions relating to training or education meetings are largely consistent with the restrictions relating to such meetings in the existing non-cash compensation rules as well as staff interpretations relating to those rules.¹⁹

iii. Internal Sales Contests

The existing non-cash compensation rules permit non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that: (1) the member's or non-member's non-cash compensation arrangement, if it includes variable contract securities or investment company securities, is based on the total production of associated persons with respect to all variable contract securities or investment company securities, as applicable, distributed by the member; (2) the non-cash compensation arrangement requires that the credit received for each variable contract security or investment company security, as applicable, is equally weighted; (3) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and (4) the recordkeeping requirement relating to member compensation is satisfied.²⁰

FINRA proposes to continue to permit non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member if payment or reimbursement of expenses associated with the non-cash compensation arrangement is not preconditioned on achievement of a sales target. If payment or reimbursement is preconditioned on achievement of a sales target, the non-cash compensation arrangement must: (1) be based on the total production of associated persons with respect to all securities distributed by the member; and (2) not be based on conditions that would encourage an associated person to recommend particular securities or categories of securities. In addition, no unaffiliated non-member company or other unaffiliated member may directly or indirectly participate in the member's or non-member's organization of a permissible non-cash compensation arrangement.²¹

Thus, the proposal would permit members to continue to pay non-cash compensation to their associated persons outside the context of an internal sales contest. For example, this provision would permit a member to send its associated persons to an internal training meeting that is not tied to achievement of a sales target. The meeting would not have to meet the same requirements as a training or education meeting sponsored by a third-party offeror, but no unaffiliated entity could participate in the organization of these types of arrangements.

Unlike the existing non-cash compensation rules, however, the proposal would not permit product-specific internal sales contests. FINRA believes that internal sales contests that favor one security (*e.g.*, a proprietary investment company) or one type of security (*e.g.*, investment companies or stocks) potentially create an incentive to engage in sales conduct contrary to the best interests of customers. Consequently, "stock of the day" and similar promotions would be impermissible under the proposal.

Although the proposed rule change relating to internal sales contests is a significant substantive change to the existing rules, FINRA's impression is that product-specific internal sales contests for non-cash compensation are not widely used today. Moreover, to the extent that firms engage in internal sales contests, FINRA believes that requiring payment or reimbursement to be based on the total production of associated persons with respect to all securities distributed by the member and not be based on conditions that would encourage an associated person to recommend particular securities or categories of securities would reduce the potential for conflicts of interest and risk of abuse.

c. Incorporation of Existing Guidance and Interpretive Positions

FINRA proposes to incorporate into proposed FINRA Rule 3221 as Supplementary Material language similar to the language discussed above in connection with the proposed Supplementary Material to the Gifts Rule. Thus, the Supplementary Material would provide that: (1) there is no express exclusion from the restrictions in the non-cash compensation rule for gifts given during the course of business entertainment, unless the gift is of a *de minimis* value, or a promotional or commemorative item; (2) gifts must be valued at the higher of cost or market value;²² (3) members must aggregate all gifts given by the member and each associated person of the member to a particular recipient over the course of the year; (4) gifts given for infrequent life events (*e.g.*, a wedding gift or congratulatory gift for the birth of a child) are not subject to the restrictions of the non-cash compensation rule or its recordkeeping requirements provided the gifts are customary and reasonable and personal in nature; and (5) gifts of a *de minimis* value, promotional items of nominal value and commemorative items are not subject to the restrictions of the non-cash compensation rule provided they meet the conditions specified in the Supplementary Material.²³

In addition, FINRA proposes to incorporate into the Supplementary Material prior guidance it has provided regarding training or education meetings. Specifically, the Supplementary Material would provide that the proposed rule's training or education exception "must first and foremost be intended to provide training or education to an associated person. Any training must occupy substantially all of the work day. Payment or reimbursement for any related meals, lodging and transportation is permissible, but reimbursement or payment for outings (*e.g.*, golf outings), tours, or other forms of entertainment while at the location for the purpose of training or education is impermissible."²⁴

d. Recordkeeping

The proposal would require a member to retain records of all non-cash compensation provided or received by the member or its associated persons for arrangements permitted under the proposed rule. The records must include: the names of the offerors, non-members or other members making the non-cash compensation contribution; the names of associated persons receiving the non-cash compensation under the arrangements; the nature and value of non-cash compensation provided or received; the location of training or education meetings; and any other information that evidences compliance by the member and its associated persons with the rule.

The proposed recordkeeping requirements differ from the existing non-cash compensation rules' recordkeeping requirements in that the proposal would require members to retain records of non-cash compensation provided or received by a member or its associated person. The existing non-cash compensation rules require members to maintain records of non-cash compensation received by a member or its associated persons. FINRA believes it would be important for members to retain records of non-cash compensation provided and received to help ensure that members comply with the provisions of the non-cash compensation rule.

C. Business Entertainment

In 1999, FINRA staff issued an interpretive letter stating that the Gifts Rule does not prohibit "ordinary and usual business entertainment" (such as an occasional meal, sporting event, theater production or comparable entertainment event) provided that the entertainment "is neither so frequent nor so extensive as to raise any question of propriety."²⁵ The 1999 letter noted that the interpretation was based, in part, on FINRA's rules governing non-cash compensation in connection with the offer and sale of investment company shares and variable annuities.

FINRA proposes to replace the business entertainment standard in the existing non-cash compensation rules and 1999 letter with proposed FINRA Rule 3222, which would require each member to adopt written policies and supervisory procedures relating to business entertainment tailored to its business needs.²⁶ The proposed rule would explicitly address the content of those policies and procedures and would incorporate elements of the business entertainment standard in the existing non-cash compensation rules and the 1999 letter. Specifically, proposed FINRA Rule 3222 would require that each member's written policies and supervisory procedures: (1) are designed to detect and prevent business entertainment that is intended as, or could reasonably be perceived as intended as, an improper *quid pro quo*; (2) define forms of permissible and impermissible business entertainment based on the location, nature, frequency and dollar amount of the business entertainment provided, as well as the type and dollar amount of any accommodations or transportation provided in connection with such business entertainment;²⁷ (3) require that the offeror, member or one or more of the member's associated persons hosts the business entertainment; (4) specify that the business entertainment must not be preconditioned on the achievement of a sales target; and (5) require appropriate training and education of all personnel who supervise, administer or are subject to the written policies and supervisory procedures.

In addition, the proposed rule change would require that each member's written policies and supervisory procedures must require the maintenance of detailed records of business entertainment expenses, including the names of all persons providing and receiving business entertainment, the location, nature, frequency and dollar amount of the business entertainment, and the type and dollar amount of any accommodations or transportation provided.

Economic Impact Assessment

Regulatory Need

The assessment phase of FINRA's retrospective review of the gifts, gratuities and non-cash compensation rules concluded that these rules have been largely effective in meeting their intended investor protection objectives, but there are certain areas where the investor protection benefits may not align with the associated economic costs. For example, the views expressed by the stakeholders during the assessment suggested that a \$100 gift limit is too low and that raising the limit would not undermine the purposes of the gifts and non-cash compensation rules. Stakeholders also raised concerns that the gifts, gratuities and non-cash compensation rules are scattered throughout the FINRA rulebook causing difficulties from a reference and compliance standpoint.

The amendments in this rule proposal are intended to address these current limitations and better align the investor protection benefits and the economic impacts.

Economic Impacts

The proposed amendments would directly impact member firms that regularly engage in gift giving and non-cash compensation arrangements. The proposed consolidation of the rules under a single rule series in the FINRA rulebook should simplify the supervisory efforts and could potentially lead to better use of compliance resources elsewhere within the firms. The increase in the gift limit from \$100 to \$175 per person per year reflects the rate of inflation since adoption of the \$100 gift limit, and addresses the increase in not only the prices of goods, but also the shipping costs, taxes and other expenses. Furthermore, the inclusion of a *de minimis* threshold below which firms would not have to keep records of gifts given or received, and the exception regarding gifts related to specified life events—such as bereavement and wedding gifts, or gifts for the birth of a child—should reduce the costs associated with tracking and supervising such instances.

The proposal extends the general prohibitions regarding the payment or receipt of non-cash compensation in connection with the sale of investment company securities, variable insurance products, DPPs and public offerings of securities to the sale of all securities products. As mentioned above, such prohibitions on the payment or receipt of non-cash compensation are covered in several FINRA rules,²⁸ so only firm activities that fall outside the scope of the current rules would be impacted by the proposed extension. FINRA identified that a potential area that would be impacted is private placements of securities. Between December 2012 and March 2016, there were 6,702 private placements facilitated by 750 FINRA member firms. While FINRA understands that, due to the nature of the private placements, accepting or making payments or offers of non-cash compensation is not a common industry practice, there may still be instances where the proposed rule may potentially apply.

The proposal also requires member firms to adopt written policies and supervisory procedures to maintain detailed records of business entertainment expenses. Member firms that have no relevant policies and supervisory procedures in place must dedicate compliance resources to recording and tracking such expenses. In the past several years, FINRA's examination staff has found instances of poor recordkeeping of such expenses. Specifically, the firms' logs that were used to record gifts and business entertainment did not indicate the recipient of each employee's expenditures or its intended business purpose. Member firms are expected to benefit from the reinforcement of more effective recordkeeping requirements. Moreover, the proposed rule would establish a principles-based standard that would allow firms to tailor their written policies and supervisory procedures to meet their business needs and to take a risk-based approach, so that they can allocate compliance resources to more significant issues.

FINRA also considered the potential impacts of the proposed amendments on investors. FINRA believes the proposed prohibition of product-specific internal sales contests, which typically favor one security or one type of security, reduces the potential for sales of products that are not aligned with the best interests of customers.

Request for Comment

FINRA requests comment on all aspects of the proposed rules, including any potential costs and burdens of the proposed rules. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA particularly requests comment on the following questions:

1. The proposed amendments would increase the gift limit under FINRA Rule 3220 and proposed FINRA Rule 3221 to \$175. What risks, if any, might arise to customers by raising the gift limit? Should FINRA increase the limit to \$175? If not, what, if any, would be an appropriate limit?
2. The Gifts Rule applies to gifts a member firm or its associated persons give and not to gifts the member firm or its associated persons receive. Should the Gifts Rule apply to gifts received as well as gifts given?
3. The Gifts Rule does not apply to gifts a member firm gives to its own employees or from a member firm's employee to his or her individual retail clients or customers. Should the Gifts Rule apply to gifts a member firm gives to its own employees or from a member firm's employee to his or her individual retail clients or customers? Please explain.
4. FINRA is proposing a \$50 *de minimis* threshold below which member firms would not have to keep records of gifts given or received. Is a \$50 *de minimis* threshold appropriate? Should the threshold be higher or lower or should FINRA not include a *de minimis* threshold?

5. To what extent would FINRA's proposal to no longer allow product-specific internal sales contests for non-cash compensation impact member firms? In what ways, if any, could it potentially impact customers? Is FINRA's proposed approach to internal sales contests for non-cash compensation appropriate? Please explain.
6. Commenters have said that restricting entertainment at training sessions paid for by offerors is logically inconsistent with the rule's business entertainment approach. Should the requirements for training and education meetings allow entertainment that complies with the limitations on business entertainment provided by members?
7. Are the proposed recordkeeping requirements appropriately tailored to obtain information that would be relevant for purposes of monitoring for compliance with the proposed rules?
8. What are the estimated costs of drafting policies and procedures to comply with proposed Rule 3222 relating to business entertainment?
9. How would the consolidation of the rules governing gifts, gratuities and non-cash compensation in this proposal simplify compliance? What impact would it have on the costs of compliance?
10. What economic impact, if any, would be associated with the extension of the rules governing non-cash compensation to all securities?
11. Are there any expected economic impacts associated with the proposed rules not discussed in this *Notice*? What are they and what are the estimates of those impacts?

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.
2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. *See Retrospective Rule Review Report: Gifts, Gratuities and Non-Cash Compensation* (December 2014).
4. In 2008, the SEC approved the transfer of NASD Rule 3060 into the Consolidated FINRA Rulebook without material change and renumbered the rule as FINRA Rule 3220.
5. *See* FINRA Rule 3220(c).
6. The current \$100 gift limit has been in place since 1992, when the SEC approved an increase in the limit from \$50 to \$100. *See* Securities Exchange Act Release No. 31662 (December 28, 1992), 58 FR 370 (January 5, 1993) (Order Approving File No. SR-NASD-92-40). *See also* Securities Exchange Act Release No. 21074 (June 20, 1984), 49 FR 26330 (June 27, 1984) (Order Approving File No. SR-NASD-84-8) (increasing the gift limit from \$25 to \$50).
7. FINRA staff used the annual rate of inflation data for the United States from the [Federal Reserve Bank of St. Louis website](#) to estimate the change in consumer prices since 1992, when the SEC approved the increase in the limit from \$50 to \$100. The average rate of inflation over the 26 years is 2.34 percent and the compound increase in consumer prices over the period is 74.03 percent. Applying this increase to the \$100 gift limit results in \$174.03.
8. *See* [NTM 06-69](#) (December 2006).
9. *See* letter from Gary L. Goldsholle, Vice President & Associate General Counsel, FINRA, to Amal Aly, Managing Director & Associate General Counsel, SIFMA, dated December 17, 2007 (“Aly Letter”). In 1999, the staff issued an interpretive letter stating that the Gifts Rule does not prohibit “ordinary and usual business entertainment” provided that the entertainment “is neither so frequent nor so extensive as to raise any question of propriety.” That letter is discussed in more detail below in connection with proposed FINRA Rule 3222.
10. Tickets to sporting or other events would be valued at the higher of cost or face value.
11. In *NTM 06-69*, the staff stated that for a promotional item to be considered of nominal value its value must be substantially below \$100. In addition, the staff did not specify in *NTM 06-69* at what value it would consider a gift to be of *de minimis* value. Under the proposed rule change, FINRA proposes that gifts of *de minimis* value or promotional items of nominal value would not be subject to the restrictions of the Gifts Rule or its recordkeeping requirements provided that the value of the gift or promotional item is below \$50. A firm or its associated persons may not engage in patterns of providing gifts or promotional items of less than \$50 to circumvent the Gifts Rule’s restrictions and recordkeeping requirements.

12. See FINRA Rule 2320(g)(4) (Variable Contracts of an Insurance Company).
13. See NASD Rule 2830(l)(5) (Investment Company Securities).
14. See FINRA Rule 2310(c) (Direct Participation Programs).
15. See FINRA Rule 5110(h) (Corporate Financing Rule – Underwriting Terms and Arrangements).
16. See NASD Rule 2830(l)(5) and FINRA Rule 2320(g)(4). FINRA Rules 5110 and 2310 do not require internal firm non-cash compensation arrangements in connection with public offerings of securities or direct participation programs to be based on total production and equal weighting of product sales.
17. The proposed definition of “offeror” is based on the current definitions of “offeror” in the existing non-cash compensation rules. Specifically, the proposal would define the term “offeror” to mean: “(A) with respect to the sale and distribution of variable contracts, an insurance company, a separate account of an insurance company, an investment company that funds a separate account, any adviser to a separate account of an insurance company or an investment company that funds a separate account, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities; (B) with respect to the sale and distribution of investment company securities not sold through variable contracts, an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities; and (C) with respect to the sale and distribution of any other type of security, an issuer, sponsor, an adviser to an issuer or sponsor, an underwriter and any affiliated person of such entities.”
18. To fall within this definition, a communication may be either explicit or implicit. Thus, an arrangement normally would not be considered preconditioned on the achievement of a sales target if a member or an offeror designates persons to participate in the arrangement in recognition of past sales, without stating the goal in advance. If, however, after several events, the selection criteria of the member or offeror becomes reasonably apparent, there may have been an implicit communication of a goal, and any similar arrangement in the future might be deemed preconditioned on the achievement of a sales target.
19. See, e.g., [“Non-Cash Compensation – Training or Education Meetings,” NASD Regulatory & Compliance Alert 13](#) (Summer 2000), (interpreting the training or education meeting exception in the existing non-cash compensation rules “as an event that is first and foremost intended to provide training or education to an associated person. Any training meeting should occupy substantially all of the work day.”). FINRA subsequently published a letter reminding offerors that they may not pay for entertainment expenses of training or education meeting attendees. See [letter](#) from Mary L. Schapiro, President, NASD (March 7, 2001).
20. The total production and equal weighting requirements do not apply to arrangements involving DPPs or public offerings of securities.

21. Consistent with the existing non-cash compensation rules, the proposal would include a provision that would permit contributions by a non-member company or other member to a non-cash arrangement between a member and its associated persons, or contributions by a member to a non-cash compensation arrangement of a non-member, provided that it meets the requirements for such arrangements, including the total production standard.
22. As stated above, tickets to sporting or other events would be valued at the higher of cost or face value.
23. Consistent with the Gifts Rule, FINRA proposes a \$50 *de minimis* threshold. In addition, the proposal would specify that gifts of *de minimis* value, promotional items of nominal value and commemorative items would not be subject to the proposed recordkeeping requirements relating to non-cash compensation arrangements.
24. *See supra* note 19.
25. *See* [letter](#) from R. Clark Hooper, Executive Vice President, NASD, to Henry H. Hopkins, Director, and Sarah McCafferty, Vice President, T. Rowe Price Investment Services, Inc., dated June 10, 1999 ("1999 letter").
26. FINRA proposes to include in Supplementary Material to proposed FINRA Rule 3222 language that makes clear that the purpose of the rule is to govern business entertainment provided by a member or its associated persons, as well as business entertainment accepted by a member or its associated persons from an offeror. In addition, the Supplementary Material would provide that business entertainment includes, but is not limited to, an occasional meal, a ticket to an event (*e.g.*, sporting event) or theater and other comparable entertainment.
27. FINRA notes that a principles-based, rather than prescriptive, approach to what is permissible and impermissible business entertainment would satisfy this requirement of proposed Rule 3222.
28. *See supra* notes 12-15.

ATTACHMENT A

Below is the text of the amendments. New language is underlined; deletions are in brackets.

* * * * *

3220. Influencing or Rewarding Employees of Others

(a) No member or person associated with a member shall, directly or indirectly, give or permit to be given anything of value, including gratuities, in excess of [one hundred dollars] \$175 per individual per year to any person, principal, proprietor, employee, agent or representative of another person where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity. A gift of any kind is considered a gratuity.

(b) This Rule shall not apply to contracts of employment with₁ or [to] compensation for services rendered by₂ persons enumerated in paragraph (a) provided that there is in existence prior to the time of employment or before the services are rendered, a written agreement between the member and the person who is to be employed to perform such services. Such agreement shall include the nature of the proposed employment, the amount of the proposed compensation, and the written consent of such person's employer or principal.

(c) Subject to Supplementary Material .07, a[A] separate record of all payments or gratuities under this Rule in any amount known to the member, the employment agreement referred to in paragraph (b) and any employment compensation paid as a result thereof, shall be retained by the member for the period specified by SEA Rule 17a-4.

• • • Supplementary Material: -----

.01 Gifts Incidental to Business Entertainment. There is no express exclusion from the restrictions in paragraph (a) of this Rule for gifts given during the course of business entertainment, unless the gift is of de minimis value, or a promotional or commemorative item consistent with Supplementary Material .06.

.02 Valuation of Gifts. Gifts must be valued at the higher of cost or market value, exclusive of tax and delivery charges. When valuing tickets for sporting or other events, a member must use the higher of cost or face value. If gifts are given to multiple recipients, members must record the names of each recipient and calculate and record the value of the gift on a pro rata per recipient basis, for purposes of ensuring compliance with the \$175 limit in paragraph (a) of this Rule.

.03 Aggregation of Gifts. Members must aggregate all gifts given by the member and each associated person of the member to a particular recipient over the course of the year. In addition, each member must state in its procedures whether it is aggregating all gifts given by the member and its associated persons on a calendar year, fiscal year, or on a rolling basis beginning with the first gift to any particular recipient.

.04 Bereavement Gifts. Bereavement gifts that are customary and reasonable are not considered to be in relation to the business of the employer of the recipient and, therefore, are not subject to the restrictions in paragraph (a) of this Rule or the recordkeeping requirements in paragraph (c) of this Rule.

.05 Personal Gifts. Gifts that are given for infrequent life events (*e.g.*, a wedding gift or a congratulatory gift for the birth of a child) are not subject to the restrictions in paragraph (a) of this Rule or the recordkeeping requirements in paragraph (c) of this Rule, provided the gifts are customary and reasonable, personal in nature and not in relation to the business of the employer of the recipient. In determining whether a gift is “personal in nature and not in relation to the business of the employer of the recipient,” members should consider a number of factors, including the nature of any pre-existing personal or family relationship between the person giving the gift and the recipient and whether the associated person paid for the gift. When the member bears the cost of the gift, either directly or by reimbursing an associated person, FINRA presumes that such gift is not personal in nature and instead is in relation to the business of the employer of the recipient.

.06 De Minimis Gifts and Promotional or Commemorative Items. (a) Gifts of a de minimis value (*e.g.*, pens, notepads or modest desk ornaments) or promotional items of nominal value that display the member’s logo (*e.g.*, umbrellas, tote bags or shirts) are not subject to the restrictions in paragraph (a) of this Rule provided that the value of the gift or promotional item is below \$50. (b) Customary Lucite stones, plaques or other similar solely decorative items commemorating a business transaction are not subject to the restrictions in paragraph (a) of this Rule. The restrictions of this Rule shall apply, however, where the item is not solely decorative, irrespective of whether the item was intended to commemorate a business transaction.

.07 Supervision and Recordkeeping. Paragraph (c) of this Rule requires a separate record of payments and gratuities. Rule 3110 requires a member to have a supervisory system reasonably designed to achieve compliance with Rule 3220. To meet these standards, members are required to have systems and procedures reasonably designed to ensure that payments and gratuities in relation to the business of the employer of the recipient given

by the member and its associated persons to employees of clients of the member are: (i) reported to the member; (ii) reviewed for compliance with this Rule; and (iii) maintained in the member's records. Such procedures must include provisions reasonably designed to ensure that supervisory personnel, other than the associated person who gives or is permitted to give a payment or gratuity, determines whether such payment or gratuity is personal in nature rather than in relation to the business of the recipient's employer. Gifts of *de minimis* value or nominal promotional or commemorative items consistent with Supplementary Material .06 are not subject to the recordkeeping requirements of paragraph (c) of this Rule.

3221. Restrictions on Non-Cash Compensation

(a) Definitions

(1) "Affiliated Member" shall mean a member that, directly or indirectly, controls, is controlled by or is under common control with a non-member company.

(2) "Cash compensation" shall mean any discount, concession, fee, service fee, commission, asset-based sales charge, loan, override or cash employee benefit received in connection with the sale and distribution of securities.

(3) "Non-cash compensation" shall mean any form of compensation that is not cash compensation, including but not limited to merchandise, gifts and prizes, travel expenses, meals and lodging.

(4) "Offeror" shall mean:

(A) with respect to the sale and distribution of variable contracts, an insurance company, a separate account of an insurance company, an investment company that funds a separate account, any adviser to a separate account of an insurance company or an investment company that funds a separate account, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities;

(B) with respect to the sale and distribution of investment company securities not sold through variable contracts, an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities; and

(C) with respect to the sale and distribution of any other type of security, an issuer, a sponsor, an adviser to an issuer or sponsor, an underwriter and any affiliated person of such entities.

(5) “Preconditioned on the achievement of a sales target” shall describe a non-cash compensation arrangement in which an offeror or member communicates in advance that an associated person will receive non-cash compensation only if the associated person achieves either a dollar-denominated goal for selling securities or a goal of finishing within a defined number of top sellers of securities.

(b) Non-Cash Compensation Arrangements

No member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation in connection with the sale of securities, except the following:

(1) Gifts from offerors that do not exceed \$175 per individual per year and are not preconditioned on the achievement of a sales target.

(2) Payment or reimbursement by an offeror in connection with a meeting held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(A) associated persons obtain the member’s prior approval to attend the meeting and attendance by a member’s associated persons is not preconditioned on the achievement of a sales target;

(B) the location is appropriate to the purpose of the meeting, which shall mean a United States office of the offeror or the member holding the meeting, or a facility located in the vicinity of such office, or a United States regional location with respect to meetings of associated persons who work within that region or, with respect to meetings dealing with direct participation programs or real estate investment trusts, a United States location at which a significant or representative asset of the program or real estate investment trust is located;

(C) the payment or reimbursement applies only to training, education, meals, lodging and transportation for associated persons and is not applied to the entertainment or expenses of guests of associated persons or to the entertainment of associated persons; and

(D) the payment or reimbursement by the offeror is not preconditioned on the achievement of a sales target.

(3) Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an Affiliated Member, provided that:

(A) (i) payment or reimbursement of expenses associated with the non-cash compensation arrangement is not preconditioned on the achievement of a sales target; or

(ii) if payment or reimbursement of expenses associated with the non-cash compensation arrangement is preconditioned on the achievement of a sales target, the non-cash compensation arrangement is:

(a) based on the total production of associated persons with respect to all securities distributed by the member; and

(b) not based on conditions that would encourage an associated person to recommend particular securities or categories of securities; and

(B) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement.

(4) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, or contributions by a member to a non-cash compensation arrangement of a non-member, provided that the arrangement meets the criteria in paragraph (b)(3).

(c) Recordkeeping

A member shall retain records of all non-cash compensation provided or received by the member or its associated persons for arrangements permitted by paragraph (b) for the period specified by SEA Rule 17a-4. The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contribution; the names of associated persons receiving the non-cash compensation under the arrangements; the nature and value of non-cash compensation provided or received; the location of training or education meetings; and any other information that evidences compliance by the member and its associated persons with paragraph (b).

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

.01 Gifts Incidental to Business Entertainment. There is no express exclusion from the restrictions in paragraph (b) of this Rule for gifts given during the course of business entertainment, unless the gift is of *de minimis* value, or a promotional or commemorative item consistent with Supplementary Material .05.

.02 Valuation of Gifts. Gifts must be valued at the higher of cost or market value, exclusive of tax and delivery charges. When valuing tickets for sporting or other events, a member must use the higher of cost or face value. If gifts are given to multiple recipients, members must record the names of each recipient and calculate and record the value of the gift on a pro rata per recipient basis, for purposes of ensuring compliance with the \$175 limit in paragraph (b) of this Rule.

.03 Aggregation of Gifts. Members must aggregate all gifts received or given by the member and each associated person of the member over the course of the year for purposes of ensuring compliance with the \$175 limit in paragraph (b) of this Rule. In addition, each member must state in its procedures whether it is aggregating all gifts received or given by the member and its associated persons on a calendar year, fiscal year, or on a rolling basis beginning with the first gift received or given.

.04 Personal Gifts. Gifts that are given for infrequent life events (*e.g.*, a wedding gift or a congratulatory gift for the birth of a child) are not subject to the restrictions in paragraph (b), or the recordkeeping requirements of paragraph (c), of this Rule provided the gifts are customary and reasonable and personal in nature.

.05 De Minimis Gifts and Promotional or Commemorative Items. (a) Gifts of a de minimis value (*e.g.*, pens, notepads or modest desk ornaments) or promotional items of nominal value that display the offeror's logo (*e.g.*, umbrellas, tote bags or shirts) are not subject to the restrictions in paragraph (b) of this Rule provided that the value of the gift or promotional item is below \$50. (b) Customary Lucite stones, plaques or other similar solely decorative items commemorating a business transaction are not subject to the restrictions in paragraph (b) of this Rule. The restrictions of this Rule shall apply, however, where the item is not solely decorative, irrespective of whether the item was intended to commemorate a business transaction. Gifts of de minimis value or nominal promotional or commemorative items consistent with Supplementary Material .05 are not subject to the recordkeeping requirements of paragraph (c) of this Rule.

.06 Training or Education Meetings. The training or education exception in paragraph (b)(2) of this Rule must first and foremost be intended to provide training or education to an associated person. Any training must occupy substantially all of the work day. Payment or reimbursement for any related meals, lodging and transportation is permissible, but reimbursement or payment for outings (e.g., golf outings), tours, or other forms of entertainment while at the location for the purpose of training or education is impermissible. In addition, there is no express exclusion from the restrictions in paragraph (b) of this Rule for gifts given during the course of training or education meetings, unless the gift is of de minimis value, or a promotional or commemorative item consistent with Supplementary Material .05.

3222. Business Entertainment

(a) Each member that engages in business entertainment must have written policies and supervisory procedures with respect to business entertainment that:

(1) Are designed to detect and prevent business entertainment that is intended as, or could reasonably be perceived as intended as, an improper quid pro quo;

(2) Define forms of permissible and impermissible business entertainment based on the location, nature, frequency and dollar amount of the business entertainment provided, as well as the type and dollar amount of any accommodations or transportation provided in connection with such business entertainment;

(3) Require that the offeror, member or one or more of the member's associated persons hosts the business entertainment;

(4) Specify that the business entertainment must not be pre-conditioned on the achievement of a sales target; and

(5) Require appropriate training and education of all personnel who supervise, administer or are subject to the written policies and supervisory procedures.

(b) Each member's written policies and supervisory procedures must require the maintenance of detailed records of business entertainment expenses, including the names of all persons providing and receiving the business entertainment, the location, nature, frequency and dollar amount of the business entertainment, and the type and dollar amount of any accommodations or transportation provided.

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

.01 Definitions. The terms “offeror” and “preconditioned on the achievement of a sales target” shall have the same meanings as in Rule 3221.

.02 Purpose. The purpose of Rule 3222 is to govern business entertainment provided by a member or its associated persons, as well as business entertainment accepted by a member or its associated persons from an offeror. Business entertainment includes, but is not limited to, an occasional meal, a ticket to an event (e.g., sporting event) or the theater and other comparable entertainment.

.03 Obligations of Persons Associated with a Member. Consistent with Rule 0140, persons associated with a member must comply with such member’s written policies and supervisory procedures as established pursuant to this Rule 3222. In addition, consistent with Rule 0140, it shall be a violation of this Rule for an associated person to engage in the conduct to be prevented (i.e., business entertainment that is intended as, or could reasonably be perceived as intended as, an improper quid pro quo) through the establishment, maintenance and enforcement of the policies and procedures required by this Rule.

3223. Exemptions

Pursuant to the Rule 9600 Series, FINRA staff, for good cause shown after taking into consideration all relevant factors, may conditionally or unconditionally grant an exemption from any provision of the 3200 Series to the extent that such exemption is consistent with the purpose of the 3200 Series, the protection of investors, and the public interest.

Regulatory Notice

16-21

Qualification and Registration of Associated Persons Relating to Algorithmic Trading

SEC Approves Rule to Require Registration of Associated Persons Involved in the Design, Development or Significant Modification of Algorithmic Trading Strategies

Effective Date: January 30, 2017

Executive Summary

The SEC approved an amendment to NASD Rule 1032(f) that expands the scope of persons required to register as a Securities Trader.¹ Specifically, beginning January 30, 2017, each associated person who is primarily responsible for the design, development or significant modification of an algorithmic trading strategy relating to equity, preferred or convertible debt securities, or who is responsible for the day-to-day supervision or direction of such activities, must pass the Series 57 exam and register as a Securities Trader. The rule text is available in the online FINRA Manual.

Questions regarding this *Notice* should be directed to:

- ▶ Susan Tibbs, Vice President, Quality of Markets, Market Regulation, at (240) 386-5082 or by email at susan.tibbs@finra.org;
- ▶ Joe McDonald, Senior Director, Testing and Continuing Education, at (240) 386-5065 or by email at joe.mcdonald@finra.org; or
- ▶ for legal and interpretive questions, Racquel Russell, Associate General Counsel, Office of General Counsel, at (202) 728-8363 or by email at racquel.russell@finra.org.

June 2016

Notice Type

- ▶ Rule Amendment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Technology
- ▶ Trading and Market Making

Key Topics

- ▶ Algorithmic Trading
- ▶ High Frequency Trading
- ▶ Securities Trader
- ▶ Series 57

Referenced Rules and Regulatory Notices

- ▶ FINRA Rule 3110
- ▶ NASD Rule 1032
- ▶ Regulatory Notice 15-09

Background and Discussion

On April 7, 2016, the SEC approved an amendment to NASD Rule 1032(f) to expand the scope of persons required to register as a Securities Trader. Specifically, the amendment requires each person associated with a member to register as a Securities Trader if such person is: (i) primarily responsible for the design, development or significant modification of an algorithmic trading strategy relating to equity, preferred or convertible debt securities; or (ii) responsible for the day-to-day supervision or direction of such activities. This amendment is part of FINRA's initiatives relating to equity market structure and automated trading activities, including high frequency trading.²

Scope of "Algorithmic Trading Strategy"

Under the rule, an "algorithmic trading strategy" is an automated system that generates or routes orders (including sending orders for routing and order-related messages, such as cancellations), but does not include an automated system that solely routes orders, in their entirety, to a market center. Covered systems include those that generate or route orders (or order-related messages) in any equity security (including options), preferred security or convertible debt security, whether sent to an exchange or handled over the counter. Examples of systems that are considered algorithmic trading strategies if they generate or route orders include:

- ▶ an arbitrage strategy, such as index or exchange-traded fund (ETF) arbitrage;
- ▶ a hedging or loss-limit algorithmic strategy that generates orders on an automated basis;
- ▶ a strategy that involves simultaneously trading two or more correlated securities due to the divergence in their prices or other trading attributes;
- ▶ an order generation, routing and execution program used for large-sized orders that involve dividing the order into smaller-sized orders less likely to result in market impact;
- ▶ an order routing strategy used to determine the price or size for routed orders, the use of "parent" or "child" orders, or displayed versus non-displayed trading interest;
- ▶ a trading strategy that becomes more or less aggressive to correlate with trading volume in specified securities;
- ▶ a trading strategy that generates orders based on moving reference prices;
- ▶ a trading strategy that minimizes intra-day slippage in connection with achieving volume-weighted average prices and time-weighted average prices; and
- ▶ a strategy that creates or liquidates baskets of securities, including those that track indexes or ETFs.

The above list is not an exhaustive list of the systems that fall within the scope of an “algorithmic trading strategy” today and, as markets change the systems that will fall within scope in the future will continue to evolve.

Because an automated system that solely routes orders received in their entirety to a market center is not considered an “algorithmic trading strategy” under the rule, a standard order router that routes retail orders in their entirety to a particular market center for handling and execution is not covered. If an order router performs any of the additional functions listed above it would be considered an “algorithmic trading strategy.”

Similarly, an algorithm that solely generates trading ideas or investment allocations, including an automated investment service that constructs portfolio recommendations, but that is not equipped to automatically generate orders or order-related messages to effectuate such trading ideas into the market (whether independently or via a linked router), would not constitute an algorithmic trading strategy under the rule. However, if an order router or investment algorithm performs additional functions that include the generation or routing of orders or order-related messages, such system would be considered an “algorithmic trading strategy.”

Persons Required to Register

The registration requirement applies to an associated person if such person is (i) primarily responsible for the design, development or significant modification³ of an algorithmic trading strategy relating to equity, preferred or convertible debt securities; or (ii) responsible for the day-to-day supervision or direction of such activities.

FINRA understands that workflows, structures and roles vary across firms. However, in identifying persons required to register as Securities Traders under the amendments to NASD Rule 1032(f), firms should keep in mind that, in adopting this requirement, FINRA’s goal is to ensure that firms identify and register one or more associated persons who possess knowledge of, and responsibility for, both the design of the intended trading strategy (e.g., the arbitrage strategy) and the technological implementation of such strategy (e.g., coding), sufficient to evaluate whether the resultant product is designed not only to achieve business objectives, but also regulatory compliance.

FINRA does not intend that the registration requirement apply to every associated person who touches or otherwise is involved in the design or development of a trading algorithm. However, each associated person who is primarily responsible for the design, development, or significant modification of an algorithmic trading strategy or the day-to-day supervision or direction of these activities must register. For example, if a sole associated person determines the design of the trading strategy employed by an algorithm, writes the code to effectuate such strategy, and executes or directs the significant modification of such code going forward, then that person alone would be required to register as a Securities Trader under the rule with respect to that algorithm.⁴

In addition, if, for example, a lead developer liaises with a head trader (and the head trader, a Securities Trader, is primarily responsible for the “design” of the trading strategy employed by the algorithm), but the lead developer is the associated person primarily responsible for the supervision of the development of the algorithm to meet such head trader’s objectives, such lead developer also must be a Securities Trader because the developer is the associated person “primarily responsible for the development of the algorithmic trading strategy” and the day-to-day “supervision or direction” of the team of developers. Individuals under the lead developer’s supervision would not be required to register if they are not primarily responsible for any covered activities with regard to an algorithmic trading strategy or are not responsible for the day-to-day supervision or direction of others on the team with regard to the design, development or significant modification of an algorithmic trading strategy. Thus, for example, a junior developer on the lead developer’s team presumably is not “primarily” responsible for the design, development or significant modification of an algorithmic trading strategy and, therefore, would not be required to register as a Securities Trader.⁵

FINRA notes that FINRA Rule 3110(a)(2) generally requires that all registered persons be designated to an appropriately registered principal or principals with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker-dealer is required. In addition, FINRA Rule 3110(a)(5) requires the assignment of each registered person to an appropriately registered representative or principal who will be responsible for supervising that person’s activities. With the addition of this new activity to the Securities Trader registration category, firms will be required to designate developers to registered persons for Rule 3110(a) purposes. In practice, these developers may not currently report to a registered person. In such instances, FINRA believes it is acceptable for firms to “assign” a lead algorithm developer (or other non-trading personnel) engaging in covered activities to one or more other registered persons of the firm that supervise trading activities outside such developer’s or other non-trader’s usual reporting line.

While the adequacy of a firm’s supervisory structure must be evaluated on a firm-by-firm basis, firms are afforded a degree of flexibility in arranging for the appropriate supervision of a lead developer (or other non-trading personnel) registered as a Securities Trader, such as by assigning such person to:

- ▶ a Securities Trader Principal in the firm’s trading business line (*e.g.*, the Securities Trader Principal in the reporting line of a Securities Trader primarily responsible for the design of any algorithmic trading strategy); or
- ▶ a Securities Trader in the firm’s trading business line (*e.g.*, a Securities Trader primarily responsible for the design of an algorithmic trading strategy, including the strategy developed by the lead developer); or
- ▶ more than one registered person, provided that the supervisor responsible for the lead algorithm developer’s activities requiring registration as a Securities Trader is registered as a Securities Trader or Securities Trader Principal.⁶

As such, depending upon a firm's structure, a lead developer's "business line" supervisor may not necessarily be required to register as a Securities Trader or Securities Trader Principal if that person is not involved in the day-to-day supervision or direction of the development process with regard to an algorithmic trading strategy or otherwise engaged in activities requiring registration as a Securities Trader. However, in all cases, the firm must ensure that it has designated an appropriately registered person to be responsible for supervising algorithmic trading strategy activities under the rule.

Third-Party Algorithms

In some cases, a firm may use an algorithmic trading strategy that did not originate in-house and, therefore, was not designed or built by the firm's associated persons. In such cases where the design and development of an algorithmic trading strategy was performed solely by a third-party, the registration requirement would not be triggered with respect to the firm's activities relating to the design or development of such algorithm. However, to the extent associated persons are able to significantly modify the algorithmic trading strategy in-house, such significant modifications must be performed by a Securities Trader.

In other cases, a firm may engage a third-party to custom-build an algorithmic trading strategy for the firm. In such cases, the associated person responsible for directing the third-party in the design or development of the algorithmic trading strategy must be a Securities Trader.⁷ If the firm directs a third-party to significantly modify an algorithmic trading strategy, such direction also must be by a Securities Trader. Similarly, after the firm has launched the externally built algorithm, the associated person primarily responsible for any significant modifications made in-house by the firm must be a Securities Trader.

As is the case today, associated persons responsible for monitoring or reviewing the performance of an algorithmic trading strategy must be registered pursuant to NASD Rule 1032(f); a firm's trading activity must always be supervised by an appropriately registered person. Therefore, even where a firm purchases an algorithm off-the-shelf and does not significantly modify the algorithm, the associated person responsible for monitoring or reviewing the performance of the algorithm must be a Securities Trader.

Effective Date

An associated person who is (i) primarily responsible for the design, development or significant modification of an algorithmic trading strategy relating to equity, preferred or convertible debt securities; or (ii) responsible for the day-to-day supervision or direction of such activities, may register voluntarily as a Securities Trader beginning on the date of this Notice and must be registered as a Securities Trader beginning on January 30, 2017.

Endnotes

1. See Securities Exchange Act Release No. 77551 (April 7, 2016), 81 FR 21914 (April 13, 2016) (Order Approving File No. SR-FINRA-2016-007).
2. See FINRA news release [“FINRA Board Approves Series of Equity Trading and Fixed Income Rulemaking Items”](#) dated September 19, 2014.
3. A “significant modification” to an algorithmic trading strategy generally would be any change to the code of the algorithm that impacts the logic and functioning of the trading strategy employed by the algorithm. Therefore, for example, a data feed/data vendor change generally would not be considered a “significant modification,” whereas a change to a benchmark (such as an index) used by the strategy generally would be considered a “significant modification.”

FINRA notes that, even in cases where a modification is not significant and, therefore, would not be required to be performed by a Securities Trader, as stated in [Regulatory Notice 15-09](#), firms should also focus efforts on the development of algorithmic strategies and on how those strategies are tested and implemented, including, among other things, implementing a change management process that tracks the development of new trading code or material changes to existing code. An effective process should include a review of test results and a set of approval protocols that are appropriate given the scope of the code or any change(s) to the code. See [Regulatory Notice 15-09](#) (Guidance on Effective Supervision and Control Practices for Firms Engaging in Algorithmic Trading Strategies) (March 2015).
4. It is understood that various technology and other firm personnel are involved in additional tasks necessary to launch an algorithmic trading strategy into production—such as integrating the algorithm into the firm’s technological infrastructure and testing linkages. However, because these activities generally would not be considered to be design, development or significant modification activities with respect to the algorithm itself, such activities would not be required to be performed by a Securities Trader.
5. By limiting the registration requirements to those persons primarily responsible for the design, development or significant modification of algorithmic trading strategies (or responsible for the day-to-day supervision or direction of such activities), FINRA aims to ensure that the member has identified the individuals primarily responsible for the design, development, significant modification and day-to-day supervisory activities described in the rule and has equipped such persons with a basic level of familiarity with the regulatory obligations of the firm employing the algorithm by requiring them to register as Securities Traders. FINRA expects that the competency of these registered persons will inform the behaviors of those acting under their supervision or at their direction.
6. Another registered person—*e.g.*, a General Securities Representative—may be assigned to supervise the lead algorithm developer with regard to other general areas applicable to registered representatives, such as outside business activities. As always, if the activities of a registered representative are assigned to be supervised by more than one registered representative or principal, the member must clearly document which activities are assigned to be supervised by each responsible party.

7. FINRA notes that, irrespective of whether an algorithm is designed or developed in-house or by a third-party, the firm employing the algorithm continues to be responsible for the algorithm's activities. Thus, in all cases, robust supervisory procedures, both prior to and after deployment of an algorithmic trading strategy, are a key component in protecting against problematic behavior stemming from algorithmic trading.

Regulatory Notice

15-30

Equity Research

SEC Approves Consolidated Rule to Address Conflicts of Interest Relating to the Publication and Distribution of Equity Research Reports

Effective Date: September 25, 2015, or December 24, 2015

Executive Summary

The SEC approved the adoption of FINRA Rule 2241 (Research Analysts and Research Reports), a consolidated rule to address conflicts of interest relating to the publication and distribution of equity research reports.¹ Provisions of Rule 2241 become effective either on September 25, 2015, or December 24, 2015, as set forth below.

The rule text is available at www.finra.org/notices/15-30.

Questions regarding this *Notice* should be directed to:

- ▶ Philip Shaikun, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8451 or philip.shaikun@finra.org; or
- ▶ Jeanette Wingler, Assistant General Counsel, OGC, at (202) 728-8013 or Jeanette.wingler@finra.org.

Background and Discussion

NASD Rule 2711 and Incorporated NYSE Rule 472 (Communications with the Public) set forth requirements to foster objectivity and transparency in equity research and provide investors with more reliable and useful information to make investment decisions. The rules require disclosure of conflicts of interest in research reports and public appearances by research analysts and further prohibit conflicted conduct—investment banking personnel involvement in the content of research reports and determination of analyst compensation, for example—where the conflicts are too pronounced to be cured by disclosure. Several of the rules' provisions implement provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which mandates separation between research and investment banking, proscribes conduct that could compromise a research analyst's objectivity, and requires specific disclosures in research reports and public appearances.²

August 2015

Suggested Routing

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

Key Topics

- ▶ Conflicts of Interest
- ▶ Investment Banking
- ▶ Research Analysts
- ▶ Research Reports

Referenced Rules & Notices

- ▶ FINRA Rule 0140
- ▶ FINRA Rule 2210
- ▶ FINRA Rule 2241
- ▶ FINRA Rule 3110
- ▶ FINRA Rule 9600 Series
- ▶ Incorporated NYSE Rule 344
- ▶ Incorporated NYSE Rule 472
- ▶ NASD Rule 1050
- ▶ NASD Rule 2711

NASD Rule 1050 (Registration of Research Analysts) and Incorporated NYSE Rule 344 (Research Analysts and Supervisory Analysts) require any person associated with a member and who functions as a research analyst to be registered as such and pass the Series 86 and 87 exams, unless an exemption applies. Those rules define “research analyst” for registration purposes as an associated person who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report.

The SEC has approved a new consolidated FINRA Rule 2241.³ In general, the rule retains the core provisions of the current rules, broadens the obligations on members to identify and manage research-related conflicts of interest, restructures the rules to provide some flexibility in compliance without diminishing investor protection, extends protections where gaps have been identified, expands an exemption for firms with limited investment banking activity, and provides clarity to the applicability of existing rules. The SEC also approved an accompanying amendment to NASD Rule 1050 and Incorporated NYSE Rule 344 that creates a limited exception from the research analyst registration and qualification requirements for “research reports” produced by individuals whose primary job function is something other than producing investment research.

Definitions

The rule mostly maintains the definitions in current NASD Rule 2711, with the following modifications:

- ▶ Rule 2241(a)(5) clarifies that “investment banking services” includes all acts in furtherance of a public or private offering on behalf of an issuer.⁴
- ▶ Rule 2241(a)(9) clarifies that “research analyst account” does not apply to a registered investment company over which a research analyst or member of the research analyst’s household has discretion or control, provided that the research analyst or member of the research analyst’s household has no financial interest in the investment company, other than a performance or management fee.
- ▶ Rule 2241(a)(11) excludes from the definition of “research report” communications concerning open-end registered investment companies that are not listed or traded on an exchange.
- ▶ Rule 2241(a)(11)(D) excludes from the definition of “research report” communications that constitute private placement memoranda and comparable offering-related documents prepared in connection with investment banking services transactions, other than those that purport to be research.
- ▶ Rules 2241(a)(3) and (14) move into the definitional section the definitions of “independent third-party research report” and “third-party research report,” respectively, that are now in a separate provision of the rule.
- ▶ Rule 2241(a)(12) adopts a definition of “sales and trading personnel” to include persons in any department or division, whether or not identified as such, who perform any sales or trading service on behalf of a member.

Identifying and Managing Conflicts of Interest

The rule includes a new section entitled “Identifying and Managing Conflicts of Interest.” Rule 2241(b)(1) contains an overarching requirement to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to the preparation, content and distribution of research reports and public appearances by research analysts and the interaction between research analysts and persons outside of the research department, including investment banking and sales and trading personnel, the subject companies and customers. Rule 2241(b)(2) requires the written policies and procedures to be reasonably designed to promote objective and reliable research that reflects the truly held opinions of research analysts and to prevent the use of research or research analysts to manipulate or condition the market or favor the interests of the member or a current or prospective customer or class of customers. These provisions, therefore, set out the fundamental obligation for a member to establish and maintain a system to identify and mitigate conflicts to foster integrity and fairness in its research products and services. The required policies and procedures also must prohibit or restrict specified conduct, as set forth in more detail below.

Prepublication Review

The rule modifies the current restrictions on prepublication review of research reports. Rule 2241(b)(2)(A) requires the written policies and procedures to prohibit prepublication review, clearance or approval of research reports by persons engaged in investment banking services activities and restrict or prohibit such review, clearance or approval by other persons not directly responsible for the preparation, content and distribution of research reports, other than legal and compliance personnel. This provision effectively eliminates an exception in NASD Rule 2711 that allows investment bankers to review a research report prior to publication for factual accuracy or to assist in a conflicts review. A firm must specify in its policies and procedures the circumstances, if any, where prepublication review by other non-research personnel would be permitted as necessary and appropriate; for example, where non-research personnel are best situated to verify select facts or where administrative personnel review a research report for formatting.

Rule 2241(b)(2)(N) requires the written policies and procedures also to prohibit prepublication review of a research report by a subject company for purposes other than verification of facts. Supplementary Material .05 maintains the current guidance applicable to the prepublication submission of a research report to a subject company. Specifically, sections of a draft research report may be provided to non-investment banking personnel or the subject company for factual review, provided that:

1. the draft sections do not contain the research summary, research rating or price target;
2. a complete draft of the report is provided to legal or compliance personnel before sections are submitted to non-investment banking personnel or the subject company; and
3. any subsequent proposed changes to the rating or price target are accompanied by a written justification to legal or compliance and receive written authorization for the change.

The member also must retain copies of any draft and the final version of the report for three years.

Coverage Decisions

The rule includes a new provision that codifies an interpretation regarding investment banking input into research coverage decisions. Rule 2241(b)(2)(B) requires that the written policies and procedures restrict or limit input by the investment banking department into research coverage decisions to ensure that research management independently makes all final decisions regarding the research coverage plan. However, the provision does not preclude personnel from investment banking or any other department from conveying customer interests or providing input into coverage considerations, so long as final decisions regarding the coverage plan are made by research management. This provision makes express FINRA's interpretation that the separation requirements in NASD Rule 2711(b)(1) prohibit investment banking from making any final coverage decisions.

Supervision and Control of Research Analysts

The rule effectively retains the prohibitions regarding supervision and control of research analysts by investment banking personnel. Rule 2241(b)(2)(C) requires that the written policies and procedures prohibit persons engaged in investment banking activities from supervision or control of research analysts, including influence or control over research analyst compensation evaluation and determination. This provision is substantively the same as NASD Rule 2711(b).

Research Budget

The rule includes a new provision that codifies an interpretation with respect to research budget determination. Rule 2241(b)(2)(D) requires that the written policies and procedures limit determination of the research department budget to senior management, excluding senior management engaged in investment banking services activities. This provision makes express FINRA's interpretation that the separation requirements in current Rule 2711(b)(1) prohibit investment banking personnel from making any determination of research budget decisions.

Compensation

The rule effectively maintains the compensation determination requirements in NASD Rule 2711(d). Rule 2241(b)(2)(E) requires that the written policies and procedures prohibit compensation based upon specific investment banking services transactions or contributions to a member's investment banking services activities. Rule 2241(b)(2)(F) further provides that the written policies and procedures must require a committee that reports to the member's board of directors—or if none exists, a senior executive officer—to review and approve at least annually the compensation of any research analyst who is

primarily responsible for preparation of the substance of a research report. The committee may not have representation from a member's investment banking department. The committee must consider, among other things, the productivity of the research analyst and the quality of his or her research and must document the basis for each research analyst's compensation.

Information Barriers

The rule includes a new information barrier requirement drawn from Sarbanes-Oxley. Rule 2241(b)(2)(G) requires that the written policies and procedures establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking services activities or other persons, including sales and trading personnel, who might be biased in their judgment or supervision. FINRA believes the other policies and procedures required by the proposed rule change to identify and manage research-related conflicts of interest should effectively result in compliance with this provision. The provision is included to emphasize that the conflicts management must extend to persons other than investment banking personnel, including sales and trading personnel, who a firm may place in a position to supervise or influence the content of research reports or public appearances.

Retaliation

The rule modifies the current retaliation prohibition. Rule 2241(b)(2)(H) requires that the written policies and procedures prohibit direct or indirect retaliation or threat of retaliation against research analysts employed by the member or its affiliates by persons engaged in investment banking services activities or other employees as the result of an adverse, negative, or otherwise unfavorable research report or public appearance written or made by the research analyst that may adversely affect the member's present or prospective business interests. This provision is consistent with NASD Rule 2711(j), except that it extends the retaliation prohibition to employees other than investment banking personnel.

Quiet Periods

The rule modifies the quiet periods after an initial public offering (IPO) or secondary offering and before and after the expiration, waiver or termination of a lock-up agreement. Rule 2241(b)(2)(I) requires that the written policies and procedures define quiet periods of a minimum of 10 days following the date of an IPO, and a minimum of three days following the date of a secondary offering, during which the member must not publish or otherwise distribute research reports, and research analysts must not make public appearances, relating to the issuer if the member has participated as an underwriter or dealer in the IPO or, with respect to the quiet periods after a secondary offering, acted as a manager or co-manager of that offering.⁵ FINRA interprets the date of the offering to be the later of the effective date of the registration statement or the first date on which the securities were bona fide offered to the public.

The rule therefore reduces the current 40-day and 25-day IPO quiet periods to a minimum of 10 days after the date of the offering for any member that participated as an underwriter or dealer, and reduces the 10-day secondary offering quiet period to a minimum of three days after the completion of the offering for any member that has acted as a manager or co-manager in the secondary offering. The rule maintains exceptions to the quiet periods for research reports or public appearances concerning the effects of significant news or a significant event on the subject company and, for secondary offerings, research reports or public appearances pursuant to Securities Act Rule 139 regarding a subject company with “actively-traded securities.”

The rule also eliminates the current quiet periods 15 days before and after the expiration, waiver or termination of a lock-up agreement.

Personal Trading Restrictions

The rule establishes a new standard with respect to personal trading by research analysts, supervisors of research analysts, and persons with the ability to influence the content of a research report. Rule 2241(b)(2)(J) requires firms to establish written policies and procedures that restrict or limit research analyst account trading in securities, any derivatives of such securities and funds whose performance is materially dependent upon the performance of securities covered by the research analyst. Rule 2241(b)(2)(J)(i) requires the policies and procedures to ensure that research analyst accounts, supervisors of research analysts and associated persons with the ability to influence the content of research reports do not benefit in their trading from knowledge of the content or timing of a research report before the intended recipients of such research have had a reasonable opportunity to act on the information in the research report. Rule 2241(b)(2)(J)(ii) maintains the current prohibition on research analysts trading against their most recent recommendations, but allows firms to define financial hardship circumstances, if any, in which a research analyst would be permitted to trade against his or her most recent recommendation. Rule 2241(b)(2)(J)(iii) maintains the current prohibition on research analysts receiving pre-IPO shares in the sector they cover.

Supplementary Material .10 provides that FINRA would not consider a research analyst account to have traded in a manner inconsistent with a research analyst’s recommendation where a member has instituted a policy that prohibits any research analyst from holding securities, or options on or derivatives of such securities, of the companies in the research analyst’s coverage universe, provided that the member establishes a reasonable plan to liquidate such holdings consistent with the principles in paragraph (b)(2)(J)(i) and such plan is approved by the member’s legal or compliance department.

Promises of Favorable Research

The rule effectively maintains the current prohibition on promises of favorable research. Rule 2241(b)(2)(K) requires that the written policies and procedures prohibit explicit or implicit promises of favorable research, a particular research rating or recommendation or specific research content as inducement for the receipt of business or compensation. This provision is substantively the same as NASD Rule 2711(e).⁶

Solicitation and Marketing of Investment Banking Transactions

The rule effectively carries over the prohibitions on solicitation and marketing of investment banking transactions. Rule 2241(b)(2)(L) adds a requirement that the written policies and procedures restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity. These must include the existing prohibitions on participation in pitches and other solicitations of investment banking services transactions and road shows and other marketing on behalf of issuers related to such transactions. Consistent with existing guidance, analysts may listen to or view a live webcast of a transaction-related road show or other widely attended presentation by investment banking to investors or the sales force from a remote location, or another room if they are in the same location.⁷

Supplementary Material .01 codifies the existing interpretation that the solicitation provision prohibits members from including in pitch materials any information about a member's research capacity in a manner that suggests, directly or indirectly, that the member might provide favorable research coverage.⁸

Joint Due Diligence and Other Interactions With Investment Banking

The rule establishes a new proscription with respect to joint due diligence activities—*i.e.*, due diligence by the research analyst in the presence of investment banking department personnel. Supplementary Material .02 states that FINRA interprets the overarching principle requiring members to, among other things, establish, maintain and enforce written policies and procedures that address the interaction between research analysts and those outside of the research department, including investment banking and sales and trading personnel, subject companies and customers, to prohibit the performance of joint due diligence prior to the selection of underwriters for the investment banking services transaction.

FINRA will interpret this provision to apply only to the extent it is not contrary to the JOBS Act. Among other things, the JOBS Act prohibits FINRA from restricting an analyst from participating in any communications with the management of an emerging growth company (EGC) that is also attended by another associated person of a broker-dealer whose functional role is other than as a research analyst. Thus, for example, FINRA does not interpret the joint due diligence prohibition to apply where the joint due diligence activities involve a communication with the management of an EGC that is attended by both the research analyst and an investment banker.

Rule 2241(b)(2)(M) continues to prohibit investment banking department personnel from directly or indirectly directing a research analyst to engage in sales or marketing efforts related to an investment banking services transaction, and directing a research analyst to engage in any communication with a current or prospective customer about an investment banking services transaction. Supplementary Material .03 clarifies that three-way meetings

between research analysts and a current or prospective customer in the presence of investment banking department personnel or company management about an investment banking services transaction are prohibited by this provision. Supplementary Material .03 also retains the current requirement that any written or oral communication by a research analyst with a current or prospective customer or internal personnel related to an investment banking services transaction must be fair, balanced and not misleading, taking into consideration the overall context in which the communication is made.

Content and Disclosure in Research Reports

With a couple of modifications, the rule maintains the current disclosure requirements. Rule 2241(c)(1)(A) adds a requirement that a firm must establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in its research reports are based on reliable information. Rule 2241(c)(1)(B) requires that the policies and procedures also must be reasonably designed to ensure that any recommendation, rating or price target has a reasonable basis and be accompanied by a clear explanation of any valuation method used and a fair presentation of the risks that may impede achievement of the recommendation, rating or price target. That provision is consistent with NASD Rule 2711(h)(7).

Rule 2241(c)(2) maintains the requirement that a firm that employs a ratings system must clearly define the meaning of each rating, including the time horizon and any benchmarks on which a ratings is based. The ratings definitions must be consistent with their plain meanings. In addition, Rules 2241(c)(2)(A) and (B) require that, irrespective of the ratings system a firm employs, it must disclose in each research report the percentage of all securities rated to which the firm would assign a “buy,” “hold,” or “sell” rating, as well as the percentage of subject companies within each category for which the firm has provided investment banking services in the previous 12 months. Rule 2241(c)(2)(C) requires this information to be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the publication date of the research report is less than 15 days after the most recent calendar quarter. These provisions are consistent with NASD Rules 2711(h)(4) and (5).

Rule 2241(c)(3) further retains the price chart provision in NASD Rule 2711(h)(6), which requires for any research report that contains a rating or price target, a line graph of the security’s daily closing prices for the period that the member has assigned any rating or price target or for a three-year period, whichever is shorter. The chart must indicate the dates on which the firm assigned or change each rating or price target. The provision applies where a firm has assigned a rating or price target for at least one year and must be current as of the end of the most recent calendar quarter or the second most recent calendar quarter if the publication date of the research report is less than 15 days after the most recent calendar quarter.

In addition, the rule carries over in substance⁹ from NASD Rule 2711 the following disclosure requirements that must be made in any research report at the time of publication or distribution of the report:

- ▶ if the research analyst or a member of the research analyst's household has a financial interest in the debt or equity securities of the subject company (including, without limitation, whether it consists of any option, right, warrant, future, long or short position), and the nature of such interest (Rule 2241(c)(4)(A));
- ▶ if the research analyst has received compensation based upon (among other factors) the member's investment banking revenues (Rule 2241(c)(4)(B));
- ▶ if the member or any of its affiliates: (i) managed or co-managed a public offering of securities for the subject company in the past 12 months; (ii) received compensation for investment banking services from the subject company in the past 12 months; or (iii) expects to receive or intends to seek compensation for investment banking services from the subject company in the next three months (Rule 2241(c)(4)(C));
- ▶ if, as of the end of the month immediately preceding the date of publication or distribution of a research report (or the end of the second most recent month if the publication or distribution date is less than 30 calendar days after the end of the most recent month), the member or its affiliates have received from the subject company any compensation for products or services other than investment banking services in the previous 12 months (Rule 2241(c)(4)(D));
- ▶ if the subject company is, or over the 12-month period preceding the date of publication or distribution of the research report has been, a client of the member, and if so, the types of services provided to the issuer. Such services, if applicable, must be identified as either investment banking services, non-investment banking services, non-investment banking securities-related services or non-securities services (Rule 2241(c)(4)(E));
- ▶ if the member or its affiliates beneficially own 1 percent or more of any class of common equity securities of the subject company (Rule 2241(c)(4)(F));¹⁰
- ▶ if the member was making a market in the securities of the subject company at the time of publication or distribution of the research report (Rule 2241(c)(4)(G)); and
- ▶ if the research analyst received any compensation from the subject company in the previous 12 months (Rule 2241(c)(4)(H)).

The rule expands upon the current "catch-all" disclosure in NASD Rule 2711(h)(1)(C), which mandates disclosure of any other material conflict of interest of the research analyst or member that the research analyst knows or has reason to know of at the time of the publication or distribution of a research report. Rule 2241(c)(4)(I) requires disclosure of material conflicts known not only by the research analyst, but also by any "associated person of the member with the ability to influence the content of a research report."

Supplementary Material .08 defines a person with the “ability to influence the content of a research report” as an associated person who is required to review the content of the research report or has exercised authority to review or change the research report prior to publication or distribution. This term does not include legal or compliance personnel who may review a research report for compliance purposes but are not authorized to dictate a particular recommendation, rating or price target. The “reason to know” standard in this provision does not impose a duty of inquiry on the research analyst or others who can influence the content of a research report. Rather, it covers disclosure of those conflicts that should reasonably be discovered by those persons in the ordinary course of discharging their functions.

Rule 2241(c)(5) modifies the current exception in Rule 2711(h)(2)(C) for disclosure that would reveal material non-public information regarding specific potential future investment banking transactions of the subject company to include specific potential future investment banking transactions of other companies, such as a competitor of the subject company.

As with the current rules, Rule 2241(c)(6) provides that all disclosures must be presented on the front page of a research report or the front page must refer to the page on which the disclosures are found. Electronic research reports may provide a hyperlink directly to the required disclosures. All disclosures and references to disclosures must be clear, comprehensive and prominent. Rule 2241(c)(7) also continues to permit a member that distributes a research report covering six or more companies (compendium report) to direct the reader in a clear manner as to where the applicable disclosures can be found. An electronic compendium research report may hyperlink to those disclosures. A paper compendium report must include a toll-free number or a postal address where the reader may request the disclosures. In addition, paper compendium reports may include a Web address where the disclosures can be found.

Disclosures in Public Appearances

Rule 2241(d) groups in a separate provision the disclosures required when a research analyst makes a public appearance, but the required disclosures remain substantively the same as under the current rules.¹¹ The disclosures include if the member or its affiliates beneficially own 1 percent or more of any class of common equity securities of the subject company, as computed in accordance with Section 13(d) of the Exchange Act. Unlike in research reports, the “catch all” disclosure requirement in public appearances applies only to a conflict of interest of the research analyst or member that the research analyst knows or has reason to know at the time of the public appearance and does not extend to persons with the ability to influence the content of a research report. Rule 2241(d)(2) provides that a research analyst need not make an otherwise required disclosure during a public appearance if it would reveal material non-public information regarding specific future investment banking transactions of the subject company. Rule 2241(d)(3) also retains the current requirement in NASD Rule 2711(h)(12) to maintain records of public appearances sufficient to demonstrate compliance by research analysts with the applicable disclosure requirements.

Disclosure Required by Other Provisions

With respect to both research reports and public appearances, Rule 2241(e) continues to require members and research analysts to comply with applicable disclosure provisions of FINRA Rule 2210 and the federal securities laws.

Termination of Coverage

Rule 2241(f) retains with non-substantive modifications the provision in the current rule that requires a member to notify its customers if it intends to terminate coverage of a subject company. Such notification must be made promptly¹² using the member's ordinary means to disseminate research reports on the subject company to its various customers. Unless impracticable, the notice must be accompanied by a final research report, comparable in scope and detail to prior research reports, and include a final recommendation or rating. If impracticable to provide a final research report, recommendation or rating, a firm must disclose to its customers the reason for terminating coverage.

Distribution of Member Research Reports

The rule includes a new provision with respect to selective dissemination of research reports. Rule 2241(g) requires firms to establish, maintain and enforce written policies and procedures reasonably designed to ensure that a research report is not distributed selectively to internal trading personnel or a particular customer or class of customers in advance of other customers that the firm has previously determined are entitled to receive the research report. The rule includes further guidance in Supplementary Material .07 to explain that firms may provide different research products and services to different classes of customers, provided the products are not differentiated based on the timing of receipt of potentially market moving information and the firm informs its other customers that its alternative research products and services may reach different conclusions or recommendations that could impact the price of the equity security. The notification need not be included in every research report; however, a customer must be notified of the alternative research products, services and dissemination practices prior to receiving or accessing a research report for the first time and promptly after any material changes to the firm's research products, services or dissemination practices.

Distribution of Third-party Research Reports

Rule 2241(h) maintains the existing third-party disclosure requirements,¹³ incorporating the change to the "catch-all" provision to include material conflicts of interest that an associated person of the member with the ability to influence the content of a research report knows or has reason to know at the time of the distribution of the third-party research report. Rule 2241(h)(4) also requires members to disclose any other material conflict of interest that can reasonably be expected to have influenced the member's choice of a third-party research provider or the subject company of a third-party research report.

In addition, the rule continues to address qualitative aspects of third-party research reports. For example, the rule maintains, but in the form of policies and procedures, the existing requirement that a registered principal or supervisory analyst review and approve third-party research reports distributed by a member. To that end, the Rules 2241(h)(1) and (3) require a member to establish, maintain and enforce written policies and procedures reasonably designed to ensure that any third-party research it distributes contains no untrue statement of material fact and is otherwise not false or misleading. For the purpose of this requirement, a member's obligation to review a third-party research report extends to any untrue statement of material fact or any false or misleading information that should be known from reading the research report or is known based on information otherwise possessed by the member. Rule 2241(h)(2) further prohibits a member from distributing third-party research if it knows or has reason to know that such research is not objective or reliable.

The rule maintains the existing exceptions for "independent third-party research reports." Specifically, Rules 2241(h)(5) and (6) provide that those research reports do not require principal pre-approval or, where the third-party research is not "pushed out," the third-party disclosures. As to the latter, a member will not be considered to have distributed independent third-party research where the research is made available by the member: (a) upon request; (b) through a member-maintained website; or (c) to a customer in connection with a solicited order in which the registered representative has informed the customer, during the solicitation, of the availability of independent research on the solicited equity security and the customer requests such independent research.

Finally, Rule 2241(h)(7) also includes a new requirement that members ensure that a third-party research report is clearly labeled as such and that there is no confusion on the part of the recipient as to the person or entity that prepared the research report.

Obligations of Persons Associated With a Member

The rule includes new supplementary material to address the obligations of associated persons with respect to policies-based provisions. Consistent with FINRA Rule 0140, Supplementary Material .09 provides that persons associated with a member must comply with the member's policies and procedures as established pursuant to the Rule 2241.¹⁴ In addition, consistent with Rule 0140, Supplementary Material .09 states that it shall be a violation of the rule for an associated person to engage in the restricted or prohibited conduct to be addressed through the establishment, maintenance and enforcement of policies and procedures required by Rule 2241, including applicable Supplementary Material.

Exemption for Firms With Limited Investment Banking Activity

The rule expands the current exemption for firms with limited investment banking activity. The current rule exempts firms with limited investment banking activity—those that over the previous three years, on average per year, have managed or co-managed 10 or fewer investment banking transactions and generated \$5 million or less in gross revenues from those transactions—from the provisions that prohibit a research analyst from being subject to the supervision or control of an investment banking department employee.¹⁵ However, those firms currently remain subject to the provision that requires the compensation of a research analyst to be reviewed and approved annually by a committee that reports to a member's board of directors, or a senior executive officer if the member has no board of directors.¹⁶ That provision further prohibits representation on the committee by investment banking department personnel and requires the committee to consider the following factors when reviewing a research analyst's compensation: (1) the research analyst's individual performance, including the research analyst's productivity and the quality of research; (2) the correlation between the research analyst's recommendations and the performance of the recommended securities; and (3) the overall ratings received from clients, the sales force and peers independent of investment banking, and other independent ratings services.¹⁷

Rule 2241(i) maintains the same parameters for the exemption for firms with limited investment banking activity and extends the exemption to include the compensation committee provision in Rule 2241(b)(2)(E). However, the rule still prohibits these firms from compensating a research analyst based upon specific investment banking services transactions or contributions to a member's investment banking services activities.

Rule 2241(i) further exempts firms with limited investment banking activity from the provisions restricting or limiting research coverage decisions and budget determination. In addition, the provision exempts eligible firms from the requirement to establish information barriers or other institutional safeguards to insulate research analysts from the review or oversight by investment banking personnel or other persons, including sales and trading personnel, who may be biased in their judgment or supervision. However, those firms still are required to establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from pressure by investment banking and other non-research personnel who might be biased in their judgment or supervision.

Exemption From Registration Requirements for Certain “Research Analysts”

The rule change also creates a new limited exemption from the research registration and qualification requirements. It amends the definition of “research analyst” in NASD Rule 1050(b) and Incorporated NYSE Rule 344.10 to limit the scope of the registration and qualification requirements to persons who produce “research reports” and whose primary job function is to provide investment research. FINRA cautions that the revised definition

is not intended to carve out anyone for whom the preparation of research is a significant component of their job; rather, it is intended to provide relief for those who produce research reports on an occasional basis. FINRA notes that, in accordance with the mandates of the Sarbanes-Oxley, both NASD Rule 2711 and FINRA Rule 2241 are constructed such that the person who is primarily responsible for the preparation of the substance of a communication that meets the definition of a “research report” is a “research analyst,” irrespective of his or her title or primary job (*e.g.*, it could include a registered representative or a trader).

Attestation Requirement

The rule no longer contains a requirement to attest annually that the firm has in place written supervisory policies and procedures reasonably designed to achieve compliance with the applicable provisions of the rules. However, FINRA notes that the underlying supervisory obligations continue to attach pursuant to FINRA Rule 3110.

General Exemptive Authority

The rule includes new general exemptive authority for FINRA. Rule 2241(j) provides FINRA, pursuant to the Rule 9600 Series, with authority to conditionally or unconditionally grant, in exceptional and unusual circumstances, an exemption from any requirement of the proposed rule for good cause shown, after taking into account all relevant factors and provided that such exemption is consistent with the purposes of the rule, the protection of investors, and the public interest.

Implementation Schedule

The rule changes will be implemented in two stages:

Effective on September 25, 2015

- ▶ Amendments to NASD Rule 1050 and Incorporated NYSE Rule 344.10 (registration of research analysts)
- ▶ Rule 2241(b)(2)(i) and deletion of NASD Rules 2711(f)(1) through (5) and Incorporated NYSE Rules 472(f)(1) through (6) (quiet periods)
- ▶ Rule 2241(j) (exemption for good cause)
- ▶ Rule 2241.10 (divesting research analyst holdings)
- ▶ Deletion of NASD Rule 2711(i) and Incorporated NYSE Rule 351 (annual attestation requirement)

Effective on December 24, 2015

- ▶ All other provisions

Endnotes

1. See Securities Exchange Act Rel. No. 75471 (July 16, 2015), 80 FR 43482 (July 22, 2015) (Order Approving File No. SR-FINRA-2014-047).
2. 15 U.S.C. 78q-6.
3. The SEC separately approved FINRA's proposal to adopt FINRA Rule 2242 (Debt Research Analysts and Debt Research Reports) to address conflicts of interest relating to the publication and distribution of debt research reports. See Securities Exchange Act Rel. No. 75472 (July 16, 2015), 80 FR 43528 (July 22, 2015) (Order Approving File No. SR-FINRA-2014-048). See also [Regulatory Notice 15-31](#).
4. The current definition in NASD Rule 2711(a)(3) includes, without limitation, many common types of investment banking services. The rule adds the language "or otherwise acting in furtherance of" either a public or private offering to further emphasize that the term "investment banking services" is meant to be construed broadly.
5. Consistent with the Jumpstart Our Business Startups Act (JOBS Act), those quiet periods do not apply following the IPO or secondary offering of an Emerging Growth Company (EGC), as that term is defined in Section 3(a)(80) of the Exchange Act.
6. For additional guidance, see generally [Regulatory Notice 11-41](#) (September 2011) and [Research Rules Frequently Asked Questions](#).
7. See [Notice to Members 07-04](#) (January 2007) and NYSE Information Memo 07-11 (January 2007).
8. See FINRA Rule 2241.01 and [Notice to Members 07-04](#) (January 2007). For additional guidance on the solicitation prohibition, see generally [Research Rules Frequently Asked Questions](#).
9. In some instances, Rule 2241 makes minor word or grammatical changes, uses streamlined language or moves some text to Supplementary Material, but has not changed the substantive disclosure requirements of these provisions.
10. The determination of beneficial ownership continues to be based upon the standards used to compute ownership for the purposes of the reporting requirements under Section 13(d) of the Exchange Act.
11. See NASD Rules 2711(h)(1), (h)(2)(B) and (C), (h)(3) and (h)(9).
12. While NASD Rule 2711(f)(6) does not contain the word "promptly," FINRA has interpreted the provision to require prompt notification of termination of coverage of a subject company.
13. NASD Rule 2711(h)(13)(A) currently requires the distributing member firm to disclose the following, if applicable: (1) if the member owns 1 percent or more of any class of equity securities of the subject company; (2) if the member or any affiliate has managed or co-managed a public offering of securities of the subject company or received compensation for investment banking services from the subject company in the past 12 months, or expects to receive or intends to seek compensation for such services in the next three months; (3) if the member makes a market in the subject company's securities; and (4) any other actual, material conflict of interest of the research analyst or member of which the research analyst knows or has reason to know at the time the research report is distributed or made available.
14. FINRA Rule 0140(a), among other things, provides that persons associated with a member shall have the same duties and obligations as a member under the Rules.
15. See NASD Rule 2711(k).
16. See NASD Rule 2711(d)(2).
17. See NASD Rule 2711(d) and (k).

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