

# Notice to Members

MAY 2006

## SUGGESTED ROUTING

Legal & Compliance  
Regulatory  
Senior Management

## KEY TOPICS

Financial and Operations Principal (FINOPs)  
NASD Rule 1022  
SEC Rule 15c3-1 (Net Capital Rule)

## GUIDANCE

### Financial and Operations Principals (FINOPs)

NASD Reminds FINOPs of their Obligations under NASD Rule 1022 and Issues Guidance to FINOPS who Work Part-Time, Work Off-Site or Hold Multiple Registrations

#### Executive Summary

NASD is issuing this *Notice to Members* to remind member firms and registered financial and operations principals (FINOPs) of a FINOP's duties and responsibilities under Rule 1022 (Categories of Principal Registration). These duties are applicable to all FINOPs, regardless of whether they are employed full-time or part-time, perform such duties on-site or off-site of the member firm or hold registrations with more than one firm. This *Notice* also provides additional guidance to assist FINOPs who are employed part-time, operate off-site or hold multiple registrations in fulfilling their duties. Additionally, NASD reminds members and FINOPs that their failure to meet their responsibilities can result in disciplinary actions against both the FINOP and the member firm employing the FINOP.

#### Questions/Further Information

Questions concerning this *Notice* may be directed to Susan M. DeMando, Associate Vice President, Financial Operations, Department of Member Regulation, at (202) 728-8411; or Daniel M. Sibears, Executive Vice President & Deputy, Department of Member Regulation, at (202) 728-6911.

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## Background

Rule 1022 requires each member to designate a qualified financial and operational principal (FINOP). Depending upon a member's net capital requirement, the FINOP will be registered pursuant to either Rule 1022(b) (Limited Principal – Financial and Operations)<sup>1</sup> or Rule 1022(c) (Limited Principal – Introducing Broker/Dealer Financial and Operations).<sup>2</sup> The FINOP plays an important role in ensuring investor protection by being responsible for the firm's compliance with applicable net capital, recordkeeping and other financial and operational rules. Rule 1022 outlines the specific duties a FINOP must perform to discharge this responsibility:<sup>3</sup>

- ◆ Final approval and responsibility for the accuracy of financial reports submitted to any duly established securities industry regulatory body;
- ◆ Final preparation of such reports;
- ◆ Supervision of individuals who assist in the preparation of such reports;
- ◆ Supervision of and responsibility for individuals who are involved in the actual maintenance of the member's books and records from which such reports are derived;
- ◆ Supervision and/or performance of the member's responsibilities under all financial responsibility rules promulgated pursuant to the provisions of the Securities Exchange Act of 1934 (Exchange Act);
- ◆ Overall supervision of and responsibility for the individuals who are involved in the administration and maintenance of the member's back office operations; and
- ◆ Any other matter involving the financial and operational management of the member.

In 1999, NASD advised members that all FINOPs are fully responsible for each of the above-mentioned duties and that FINOPs are not relieved of these responsibilities because they are employed off-site, work only part-time or hold multiple registrations with different member firms.<sup>4</sup> NASD also advised members employing a part-time FINOP to establish procedures that describe the FINOP's duties, thoroughly outline the part-time FINOP's responsibilities so that the firm will properly and timely maintain its financial books and records, and make sure that the part-time FINOP understands and remains current with the federal and state laws and regulations and self-regulatory organization (SRO) rules relating to financial and operational responsibility.<sup>5</sup>

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## Discussion

During the intervening years since NASD has issued that referenced guidance, members have continued to use part-time FINOPs.<sup>6</sup> However, the results of recent Securities and Exchange Commission (SEC) examinations of 36 broker-dealers employing part-time FINOPs reflect that not all members and their part-time FINOPs have been successfully implementing that guidance. Specifically, the SECs examinations, which focused on compliance with the books and records and financial responsibility rules of the Exchange Act, as well as applicable SRO rules, revealed material net capital deficiencies in several firms, as well as net capital computation inaccuracies in firms' books and records at 18 of the 36 firms (50 percent) reviewed. SEC staff observed that these inaccuracies occurred because many of the FINOPs had no role in the supervision or creation, or the maintenance, of the firms' books and records, as required by Rule 1022. The SEC staff also concluded that some of the firms' FINOPs could be over-extended, as at least six of the FINOPs were registered at 16 or more firms. In addition to the SEC's findings in their examination of these 36 firms referenced above, NASD has also found similar regulatory issues during its routine and special financial examinations of firms using the services of part-time FINOPs.

Based on these findings, examinations will continue to focus on the types of deficiencies detected during the examinations referenced above. This is not to say that any *per se* violations or deficiencies derive from the use of part-time FINOPs. Moreover, given the continued use of part-time FINOPs and recent regulatory findings, NASD believes that it is appropriate to remind members of the existing guidance mentioned above regarding the use of part-time FINOPs and to urge members to examine their practices to ensure that they are following those guidelines. NASD is also taking this opportunity to remind FINOPs working part-time or off-site, or holding registrations with more than one firm, that their status does not relieve them of their responsibility to comply with all of the duties set forth in Rule 1022.

In addition, NASD is providing the following supplemental guidance to members that employ FINOPs who work part-time, work off-site, or hold multiple registrations. This guidance is designed to help these members assist their FINOPs in fulfilling Rule 1022's requirements.

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## Guidance Applicable to Part-Time, Off-Site or Multiply Registered FINOPs

### *On-Site Visits*

Registered FINOPs working part-time, off-site or holding multiple registrations should conduct a minimum number of on-site firm visits each calendar year to review the firm's books and records; that minimum number should be set by the FINOP in consultation with the firm. Some or all of these visits should be on a surprise basis. Additionally, as most firms utilizing the services of a part-time, off-site or multiply registered FINOP file quarterly FOCUS reports, the FINOP should consider making the visits in off-reporting months to ensure compliance with the SEC's Net Capital Rule (Net Capital Rule).<sup>7</sup> In addition to a review of the financial accounts and relevant supporting documentation, the FINOP should inquire about and review the following when conducting examinations on site:

- ◆ Contracts entered into by the member;
- ◆ Contracts entered into by an affiliate or parent of the member that may impact the firm (e.g., the parent company enters into a contract, but the assets of the member are pledged as collateral to ensure the parent's performance of its contractual obligations);
- ◆ Any ongoing liabilities that may impact the member's balance sheet, including for example settlements and/or arbitration awards;
- ◆ Any contingent liabilities that may impact the firm's aggregate indebtedness calculation;
- ◆ The nature and timing of capital contributions and capital withdrawals;
- ◆ The proper treatment/handling of Expense Sharing Agreements;<sup>8</sup> and
- ◆ A firm's activities to ensure that the proper net capital requirement, based on those activities, is being reported accurately on the firm's financial reports.<sup>9</sup>

### *On-Site Visit Documentation*

A FINOP should evidence each on-site review by initialing the books and records reviewed or, if impractical, creating a detailed log as to which records were reviewed. In addition, the FINOP should reduce the review to a written report to be submitted to the firm's senior management.

### *Access to Books and Records*

A member using a part-time, off-site or multiply registered FINOP should provide that person complete access to all of the firm's books and records. A member may not provide less access to a part-time, off-site or multiply registered FINOP than it would to a full-time, on-site FINOP.

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### ***Establish Procedures Regarding FINOP's Duties***

Members using part-time, off-site or multiply registered FINOPs are urged to establish procedures that describe the FINOP's duties and thoroughly outline the FINOP's responsibilities. A FINOP's responsibilities include understanding and remaining current with the applicable federal and state securities laws and regulations, and SRO rules relating to financial and operational responsibility. One way in which members can assist FINOPs in fulfilling this responsibility is to require that their FINOPs review *NASD Notices to Members* and other publications relating to their financial and operational work.

### ***Ongoing Capabilities Assessments***

A member using a part-time, off-site or multiply registered FINOP should conduct ongoing assessments of its FINOP's ability to perform his or her duties. Factors a member may need to take into consideration include whether the FINOP has adequate resources to perform all of the required duties (e.g., financial software, access to applicable current federal laws and regulations, and SRO rules, or ability to meet continuing education requirements), whether a FINOP has any other duties that may make it difficult to perform all of the required duties or whether changes to a firm, such as significant growth in the firm's financial and business operations, would make it difficult for anyone other than a full-time, on-site FINOP to perform the required duties.

### **NASD Disciplinary Actions against Firms and FINOPs for Violations of the Net Capital Rule**

Finally, NASD reminds members that it may take disciplinary action against both the FINOP and the member firm employing the FINOP when it finds violations of the Net Capital Rule, other federal securities or regulations, or any SRO rules relating to financial and operational responsibility.<sup>10</sup> The Sanction Guidelines for violations of the Net Capital Rule recommend a fine of \$1,000 to \$50,000 against the firm, the FINOP, or both. The Sanction Guidelines also recommend suspending the firm with respect to any or all activities or functions for up to 30 business days, and suspending the FINOP in any or all capacities for up to 30 business days. In egregious cases, a firm could receive a lengthier suspension of up to two years or expulsion, and the FINOP could receive a suspension of up to two years or a bar.

Finally, a disciplinary action against a FINOP for misconduct at one firm could have serious consequences for other firms that engage the same FINOP, particularly if the FINOP is barred, suspended or required to re-qualify by examination.<sup>11</sup>

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## Endnotes

- 1 A person holding this registration category must have taken and passed the Series 27 Financial and Operations Principal Qualification Examination.
- 2 A person holding this registration category must have taken and passed the Series 28 Introducing Broker/Dealer Financial and Operations Principal Qualification Examination.
- 3 See Rule 1022(b)(2)(A) through (G) and (c)(2)(A) through (G).
- 4 NASD Regulatory & Compliance Alert, Volume 13, Number 4, Winter 1999 (pages 15-16).
- 5 *Id.*
- 6 Approximately 11 percent of NASD designated firms use the services of a part-time FINOP.
- 7 SEC Rule 15c3-1.
- 8 See NASD *Notice to Members 03-63* (SEC Issues Guidance in the Recording of Expenses and Liabilities by Broker/Dealers) and the attached letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Elaine Michitsch, NYSE, and Susan DeMando, NASD (July 11, 2003).
- 9 For example, a firm with a net capital requirement of \$50,000 may receive customer securities, but must promptly forward those securities or be subject to a net capital requirement of \$250,000. See SEC Rule 15c3-1(a)(2)(i) and (iv). An introducing firm otherwise subject to a net capital requirement of only \$5,000 that routinely accepts checks in its own name would be subject to a \$250,000 net capital requirement. See SEC Rule 15c3-1(a)(2)(i) and (vi).
- 10 See *Fox & Co., Inv.*, Exchange Act Release No. 52697, 2005 SEC LEXIS 2822 (Oct. 28, 2005) (SEC sustained NASD disciplinary action against a firm and the person who was the firm's primary owner, president and FINOP and upheld the bar against the person from associating with any member firm as a FINOP) at [www.sec.gov/litigation/opinions/34-52697.pdf](http://www.sec.gov/litigation/opinions/34-52697.pdf). FINOPs and firms that violate the Net Capital Rule also may face SEC disciplinary action. See *Harrison Sec. Inc.*, Exchange Act Release No. 50614, 2004 SEC LEXIS 2477 (Oct. 29, 2004) (SEC administrative proceeding against a firm, the firm's CEO and the firm's FINOP for violations of the Exchange Act's net capital, books and records and reporting provisions) at [www.sec.gov/litigation/ljdecl/ld256jtk.htm](http://www.sec.gov/litigation/ljdecl/ld256jtk.htm).
- 11 NASD Sanctions Guidelines (online edition available at [www.nasd.com/sanctionguidelines](http://www.nasd.com/sanctionguidelines)).

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