

Supervision and Supervisory Controls

Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls

Comment Period Expires: June 13, 2008

Executive Summary

As part of the process of developing a new, consolidated rulebook (the Consolidated FINRA Rulebook),¹ FINRA is requesting comment on proposals relating to the FINRA supervision and supervisory control rules (the proposed rules). The proposed rules would re-write certain provisions of the existing supervision and supervisory control rules in a manner that provides firms with greater flexibility to tailor their supervisory and supervisory control procedures to reflect their business, size and organizational structure.

The text of the proposed rules is set forth in Attachment A.

Questions regarding this *Notice* should be directed to:

- ▶ Patricia Albrecht, Assistant General Counsel, Office of General Counsel (OGC), at (202) 728-8026;
- ▶ Brant Brown, Associate General Counsel, OGC, at (202) 728-6927; or
- ▶ Kosha Dalal, Associate Vice President and Associate General Counsel, OGC, at (202) 728-6903.

May 2008

Notice Type

- ▶ Request for Comment
- ▶ Consolidated FINRA Rulebook

Suggested Routing

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

Key Topic(s)

- ▶ Branch Offices
- ▶ Correspondence
- ▶ Offices of Supervisory Jurisdiction
- ▶ Private Securities Transactions
- ▶ Registration
- ▶ Supervision
- ▶ Supervisory Control Systems

Referenced Rules & Notices

- ▶ NASD IM-1000-4
- ▶ NASD Rule 3010
- ▶ NASD IM-3010-1
- ▶ NASD Rule 3012
- ▶ NASD Rule 3040
- ▶ NASD Rule 3110
- ▶ NYSE Rule 342
- ▶ NYSE Rule 343
- ▶ NYSE Rule 351
- ▶ NYSE Rule 354
- ▶ NYSE Rule 401
- ▶ NYSE Rule 407

Action Requested

FINRA encourages all interested parties to comment on the proposals. Comments must be received by June 13, 2008. Comments received after the close of the comment period will not be considered, although interested parties will have further opportunity to comment when the proposals resulting from this *Notice* process are filed with the SEC for approval.

Member firms and other interested parties can submit their comments using 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

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

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA Web site. Generally, FINRA will post comments on its site one week after the end of the comment period.²

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the Federal Register.³

Background & Discussion

A. Background

NASD Rule 3010 (Supervision) requires a firm to establish a supervisory system and corresponding written procedures to supervise its businesses and associated persons' activities. NASD Rule 3012 (Supervisory Control System) requires a firm to have supervisory control procedures that test and verify that a firm's supervisory procedures are reasonably designed to achieve compliance with the applicable securities laws and regulations and NASD rules and, where necessary, amend or create additional supervisory procedures. NASD Rule 3012 also requires specific procedures to supervise producing managers (*i.e.*, persons with supervisory obligations who also service customer accounts) and to review and monitor certain specific activities (*e.g.*, transmittals of funds and securities, customer changes of address and investment objectives).

NYSE Rule 342 (Offices—Approval, Supervision and Control) and its related supplementary material and interpretations impose similar supervisory requirements. However, NYSE Rule 342 and its related material also contain a number of detailed requirements that are not included in the NASD supervision rules.

As part of the consolidation, FINRA is proposing to adopt new FINRA Rules 3110 and 3120 regarding supervision and supervisory controls, respectively.⁴ Although the proposed rules are based in large part on NASD Rules 3010 and 3012, as further detailed below, they differ in some respects. Among other things, the proposed rules:

- reflect a more flexible approach to certain supervision requirements;
- relocate certain provisions in NASD Rule 3012 to Proposed FINRA Rule 3110 (Supervision) in an effort to group all provisions relating to supervisory systems together;
- re-write supervisory requirements to make them clearer;
- delete NASD Rule 3040 (Private Securities Transactions of an Associated Person), regarding the supervision of associated persons' outside securities activities, as a separate rule and relocate a revised rule for such supervision within Proposed FINRA Rule 3110;
- codify FINRA staff guidance in such areas as supervision of electronic communications;
- incorporate—on a tiered basis—certain provisions from NYSE rules, such as requiring heightened compliance reporting for some firms as set forth in NYSE Rule 342; and
- eliminate obsolete or duplicative requirements.

B. Proposed FINRA Rule 3110 (Supervision)

Proposed FINRA Rule 3110 is based on requirements in NASD Rule 3010 and NYSE Rule 342 relating to, among other things, supervisory systems, written procedures, internal inspections and review of correspondence. Proposed FINRA Rule 3110 also would incorporate provisions in other NASD rules that pertain to supervision, including NASD Rules 3012 and 3040.

The proposed changes are described below:

1. *Proposed FINRA Rule 3110(a): Supervisory System*

Proposed FINRA Rule 3110(a), which addresses a member firm's supervisory systems, would replace NASD Rule 3010(a) and makes two notable changes. NASD Rule 3010(a)(2) currently requires a firm to designate an appropriately registered principal(s) with authority to supervise each type of business in which the firm engages that requires registration as a broker-dealer.

FINRA proposes to amend this provision to require the designation of an appropriately registered principal(s) with authority to supervise each type of business in which the firm engages, regardless of whether registration as a broker-dealer is required for that activity. This amendment is consistent with NASD Rule 3010(b) that currently requires a firm to have supervisory procedures for all business activities in which it engages.⁵

In addition, FINRA proposes to move those provisions in NASD Rule 3010(a)(3) setting forth certain factors a firm should consider in designating locations as offices of supervisory jurisdiction (OSJs) into Supplementary Material with no substantive changes.

2. *Proposed FINRA Rule 3110(b): Written Procedures*

FINRA proposes to consolidate various provisions and rules that currently require written procedures into Proposed FINRA Rule 3110(b). Provisions from NASD Rule 3010(d)(1) relating to the supervision of registered representatives, NASD Rule 3040 relating to the supervision of outside securities activities and NYSE Rule 401A relating to review of customer complaints would be incorporated within Proposed FINRA Rule 3110(b). In addition, Supplementary Material would be added to clarify or expand guidance in this area. NASD Rule 3010(b)(2) (Tape Recording of Conversations) would be reconstituted as a separate standalone rule.

Highlights of the proposal are as follows:

a. Proposed FINRA Rule 3110(b)(1): General Requirements

FINRA is proposing to retain the requirement in NASD Rule 3010(b)(1) requiring each member firm to establish, maintain and enforce written procedures to supervise the types of business in which it engages.

b. Proposed FINRA Rule 3110(b)(2): Review of Member's Investment Banking and Securities Business

FINRA is proposing to retain the requirement in NASD Rule 3010(d)(1) requiring principal review, evidenced in writing, of all transactions, but relocating the provision into a separate paragraph (Proposed FINRA Rule 3110(b)(2)). FINRA is also proposing to amend the provision to clarify that such review include all transactions relating to the investment banking and securities business of the member firm. In addition, FINRA is proposing to add new Supplementary Material clarifying that the review of such transactions may be risk-based.

c. Proposed FINRA Rule 3110(b)(3): Supervision of Outside Securities Activities

FINRA is proposing to delete NASD Rule 3040 and replace it with new streamlined provisions in Proposed FINRA Rule 3110(b)(3) that require an associated person to obtain the member firm's prior written approval before engaging in any outside investment banking or securities business, regardless of whether the associated person receives any compensation, as set forth in NASD Rule 3040. If the member firm gives its written approval, the activity is within the scope of the member firm's business and must be supervised in accordance with Proposed FINRA Rule 3110. The proposed provision would bring uniformity to the supervisory requirements regarding outside securities activities recognizing that such activity, once approved by the member firm, becomes the business of the member firm and must be supervised accordingly (with the exception of bank-related securities activity conducted pursuant to an exemption from broker-dealer registration in accordance with federal law, discussed below).

To address the concerns surrounding the functional regulation of banks and broker-dealers, FINRA is proposing an exception from the general supervisory requirements of Proposed FINRA Rule 3110(b) for bank-related securities activities of a dual employee⁶ to the extent such securities activities fall within any of the statutory or regulatory exemptions from registration as a broker or dealer. To rely on the exception, the member firm must receive written notice of and approve such securities activities. However, to guard against fraud committed by persons who conduct securities activities in a broker-dealer

and a bank, a member firm would not be able to approve a dual employee to engage in investment banking or securities business in a bank unless the member firm has written assurance that:

- the bank, or a supervised bank affiliate, will have a comprehensive view of the dual employee's securities activities;
- the bank or the supervised bank affiliate employs policies and procedures reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws; and
- the bank or the supervised bank affiliate will promptly notify the member firm of any violation of the policies and procedures by the dual employee.⁷

FINRA is also proposing additional rule text and Supplementary Material addressing a firm's obligations to reevaluate its reliance on a bank's or supervised bank affiliate's anti-fraud policies and procedures after receiving notice that a dual employee has violated those policies and procedures.

d. Proposed FINRA Rule 3110(b)(4): Review of Correspondence and Internal Communications

Proposed FINRA Rule 3110(b)(4) generally incorporates the substance of NASD Rule 3010(d) requiring appropriate procedures for the review of correspondence, but has been streamlined.

e. Proposed FINRA Rule 3110(b)(5): Review of Customer Complaints

NYSE Rule 401A (Customer Complaints) specifically requires firms to "capture, acknowledge, and respond to" all written and oral customer complaints. FINRA is proposing to incorporate NYSE Rule 401A within Proposed FINRA Rule 3110(b)(5), but limit the requirement to include only written (including electronic) customer complaints. Written customer complaints are more easily documented and retained. In contrast, oral complaints are more difficult to capture and assess, and they raise competing views as to the substance of the complaint being alleged; consequently, oral complaints do not lend themselves as effectively to an examination program as written complaints. FINRA encourages all customers to document their complaints in writing.

f. Proposed FINRA Rule 3110(b)(6): Documentation and Supervision of Supervisory Personnel

Proposed FINRA Rule 3110(b)(6) is based largely on existing provisions in NASD Rule 3010(b)(3) and includes certain provisions presently found in NASD Rule 3012. FINRA is proposing to delete the prescriptive provisions in NASD Rule 3012 concerning the supervision of producing manager's customer account activity, including the requirement to impose heightened supervision when any producing manager's revenues rise above a specific threshold, and replace them with a new provision in Proposed FINRA Rule 3110(b)(6) that would address potential abuses in connection with the supervision of supervisors.

The proposed rule would require member firms to have procedures:

- prohibiting supervisory personnel from supervising their own activities or from reporting to, or having their compensation or continued employment determined by, someone they are supervising; and
- preventing the diminution of supervision, in terms of its nature, scope and response, to detected non-compliant conduct due to any conflicts of interest that may be present, such as the associated person's position, the amount of the revenue generated by such person or any other factor that would present a conflict.

Under the proposal, a member firm that, because of the firm's size or a supervisor's very senior position within the firm, could not prohibit a supervisor from supervising his or her own activities or reporting to someone he or she is supervising would have to document why it could not do so and have a supervisory arrangement that otherwise complies with Proposed FINRA Rule 3110(a).

3. *Proposed FINRA Rule 3110(c): Internal Inspections*

Proposed FINRA Rule 3110(c) is largely based on NASD Rule 3010(c). However, FINRA is proposing to revise NASD Rule 3010(c)(3)'s provisions prohibiting certain persons from conducting office inspections to make the provisions less prescriptive. To that end, the proposed rule would eliminate the heightened office inspection requirements member firms must implement if the branch office manager and the person conducting the office inspection report to the same person. These provisions would be replaced with provisions requiring a member firm to:

- prevent the effectiveness of the inspection from being lessened in any manner due to any conflicts of interest that may be present; and
- have a location inspected by someone who is not an associated person of that location or supervised by someone at that location.

If a member firm could not comply with this last condition due to its size or business model, it would have to document why it could not comply and how the inspection otherwise prohibits conflicts of interest from lessening the effectiveness of the inspection.

FINRA is also proposing to relocate certain provisions in NASD Rule 3012 requiring procedures to review and monitor certain specific activities, such as transmittals of funds and securities, and customer changes of address and investment objectives, into Proposed FINRA Rule 3110(c).

4. *Proposed FINRA Rule 3110(d): Branch Office and OSJ Definitions and Standards for Review of Offices*

FINRA is proposing to retain the definitions of “branch office” and “office of supervisory jurisdiction” in NASD Rule 3010(g) and NASD IM-3010-1 (Standards of Reasonable Review) relating to standards for reasonable review of offices, which have already been harmonized with the analogous NYSE rules. Additionally, FINRA is proposing to incorporate into Proposed FINRA Rule 3110 the requirement in NASD IM-1000-4 (Branch Offices and Offices of Supervisory Jurisdiction) that all branch offices and OSJs must be registered as either a branch office or OSJ.

5. *Proposed FINRA Rule 3110 Supplementary Material*

In addition to the proposals to the text of the supervision rule described above, FINRA is proposing Supplementary Material to Proposed FINRA Rule 3110 that would codify existing FINRA staff guidance or move rule text from NASD Rule 3010 into Supplementary Material regarding:

- registration of main offices as either branch offices or OSJs if the locations meet the definitions;
- designation of additional OSJs;
- supervision of one-person OSJs;
- supervision of multiple OSJs by a single principal;
- a general presumption of a three-year limit for periodic inspection schedules at non-branch locations; and
- delivery methods for the annual compliance meeting required for registered personnel.

In addition, FINRA is proposing to add Supplementary Material to Proposed FINRA Rule 3110 that would clarify and/or assist firms in complying with the provisions of Proposed FINRA Rule 3110 described above, specifically provisions relating to:

- risk-based review of a member firm’s investment banking and securities business;
- reliance by a member firm on a bank or supervised bank affiliate to supervise dual employees;
- risk-based review of correspondence (including hard copy and electronic) and internal communications;
- methods to evidence review of correspondence and internal communications;
- delegation of certain functions relating to the review of correspondence and internal communications;

- retention requirements for correspondence and internal communications;
- permissible exceptions to prohibiting supervisory personnel from supervising their own activities; and
- permissible exceptions to prohibiting certain persons from conducting office inspections.

FINRA is also proposing to adopt as Supplementary Material a provision based on the NYSE requirements that a firm's insider trading procedures specifically include the review of trades that are effected for the firm's account or for the accounts of the firm's employees and family members for potential insider trading. The Insider Trading & Securities Fraud Enforcement Act of 1988 (ITSFEA) requires every broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the broker-dealer or any associated person of the broker-dealer.⁸

NYSE Rule 342.21 (Trade Review and Investigation) sets forth specific supervisory procedures for compliance with ITSFEA by requiring firms to review trades in NYSE-listed securities and related financial instruments that are effected for the firm's account or for the accounts of the firm's employees and family members. NYSE Rule 342.21 also requires firms to promptly conduct an internal investigation into any trade the firm identifies that may have violated insider trading laws or rules.

FINRA is proposing to incorporate the provisions of NYSE Rule 342.21 into the Proposed FINRA Rule 3110 Supplementary Material and extend the requirement beyond NYSE-listed securities and related financial instruments. The proposed Supplementary Material would require internal investigations into suspicious trades and would require firms that engage in "investment banking services," as that term will be defined in the consolidated research analyst rules, to provide reports to FINRA regarding such investigations.

C. Proposed FINRA Rule 3120 (Supervisory Control System)

FINRA is proposing to replace NASD Rule 3012 (Supervisory Control System) with Proposed FINRA Rule 3120. Proposed FINRA Rule 3120 retains the NASD Rule 3012 testing and verification requirements, including the requirement to prepare and submit to the firm's senior management a report at least annually summarizing the test results and any necessary amendments. FINRA is also proposing to apply certain content requirements in NYSE Rule 342.30 (Annual Report and Certification) to firms that reported \$150 million or more in gross revenue on their FOCUS reports in the prior calendar year.

Under the proposed rule, firms subject to the supplemental information requirement would have to include in the following year's reports a tabulation of the previous year's customer complaints and a discussion of the previous year's compliance efforts in a number of specified areas, such as trading and market activities, investment banking activities and sales practices. FINRA believes the \$150 million threshold serves as an appropriate benchmark to identify those firms for which this additional information is most beneficial given the nature and complexity of the firms' activities, and by using FOCUS report data, firms can easily and readily determine whether they are subject to the enhanced information requirement. This supplemental information was a valuable tool for the NYSE regulatory program and will also be valuable information for FINRA's regulatory program going forward.

As noted above, FINRA is also proposing to relocate several of NASD Rule 3012's provisions (as proposed to be amended) into Proposed FINRA Rule 3110.

D. Proposed FINRA Rule 3150 (Holding of Customer Mail)

NASD Rule 3110(i) (Holding of Customer Mail) imposes particular time limits for member firms holding mail for a customer. FINRA is proposing that the rule be re-written as a standalone rule to allow member firms generally to hold customer mail in accordance with the customer's instructions.

E. Proposed FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms)

FINRA is proposing to relocate the provisions in NASD Rule 3010(b)(2) (often referred to as the "Taping Rule") to a standalone supervision rule, subject to minor changes to make it more clear.

F. Proposed FINRA Rule 1260 (Responsibility of Member to Investigate Applicants for Registration)

FINRA is proposing to relocate the requirements concerning a member firm's responsibilities during a person's registration as a representative or principal in NASD Rule 3010(e) (Qualifications Investigated) to a standalone registration rule.⁹

G. Proposal to Eliminate Other NASD and NYSE Rules

As noted above, FINRA is proposing to eliminate certain NASD rules after either incorporating their requirements within Proposed FINRA Rule 3110 or its Supplementary Material, or creating a standalone rule. Those eliminated rules include NASD IM-1000-4, NASD Rule 3040 and NASD Rule 3110(i).

FINRA is also proposing to eliminate several of NYSE Rule 342's provisions, supplementary material and interpretations as they are, in main part, either duplicative of the proposed FINRA supervision requirements described in this *Notice* or do not align with the recommended changes.

The NYSE rule provisions concerning supervision that FINRA is proposing to eliminate include:

- Rule 342.10 (Definition of Branch Office);
- Rule 342.12 (Foreign Branch Offices);
- Rule 342.13 (Acceptability of Supervisors);
- Rule 342.14 (Experience of Senior Management);
- Rule 342.15 (Small Offices) and Interpretations 342.15/01-05;
- Rule 342.16 (Supervision of Registered Representatives);
- Rule 342.19 (Supervision of Producing Managers);
- Rule 351(e) (Reporting Requirements);
- Rule 354 (Reports to Control Persons); and
- Rule 401(b) (Business Conduct).

FINRA is also proposing to delete those parts of NYSE Rule 407(b) (Transactions—Employees of Members, Member Organizations and the Exchange) and NYSE Rule 407.11 that are analogous to the requirements of NASD Rule 3040 regarding the supervision of outside securities activities.

Finally, FINRA is proposing to delete the requirements of NYSE Rule 343 (Offices—Branch Office Space-Sharing Arrangements and Main Office of Business Hours) and related Supplementary Material. Certain provisions relating to disclosure of space-sharing arrangements are duplicative of information currently reported on Form BR. Certain other provisions contain outdated requirements relating to hours of operation, display of membership certificates and permissible space-sharing arrangements.

Endnotes

- 1 The current FINRA rulebook consists of two sets of rules: (1) NASD rules and (2) rules incorporated from NYSE (Incorporated NYSE Rules) (together referred to hereinafter as the Transitional Rulebook). The Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (Dual Members). Dual Members also must comply with NASD rules. For more information about the rulebook consolidation process, see *FINRA Information Notice, March 12, 2008* (Rulebook Consolidation Process).
- 2 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 *NASD Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
- 3 Section 19 of the Securities Exchange Act of 1934 (SEA or Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See SEA Section 19 and rules thereunder.
- 4 The proposed rules may be renumbered as part of the final Consolidated FINRA Rulebook.
- 5 Proposed FINRA Rule 3110(b), which mirrors in large part NASD Rule 3010(b), requires a member firm to have written supervisory procedures for all business activities in which it engages.
- 6 The proposed rule defines a “dual employee” as “a natural person who has prior written approval from the member to perform as both an associated person of a member and a bank employee.”
- 7 The proposed rule defines a “supervised bank affiliate” as a “bank affiliate that is subject to consolidated supervision by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation or the Director of the Office of Thrift Supervision.”
- 8 See Exchange Act Section 15(f).
- 9 FINRA is also proposing to delete NASD Rule 3010(f) (Applicant’s Responsibility) requiring an applicant for registration to provide, upon a member’s request, a copy of his or her Form U5. The provision is no longer necessary as a member has electronic access to an applicant’s Form U5 through FINRA’s Registration and Disclosure Department.

©2008. FINRA. All rights reserved. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

Attachment A

Below is the text of the proposed rule change. New language is underlined; deletions are in brackets.

* * * * *

PROPOSED FINRA SUPERVISION RULES

3110[3010]. Supervision¹

(a) Supervisory System

Each member shall establish and maintain a system to supervise the activities of each [registered representative, registered principal, and other] associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable [NASD]FINRA and Municipal Securities Rulemaking Board (MSRB) [R]rules. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) The establishment and maintenance of written procedures as required by paragraphs (b) and (c) of this Rule.

(2) The designation, where applicable, of an appropriately registered principal(s) 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].

(3) The registration and designation as a branch office and/or an office of supervisory jurisdiction (OSJ) of each location, including the main office, that meets the definitions contained in paragraph[(g)](d) of this Rule. [Each member shall also designate such other OSJs as it determines to be necessary in order to supervise its registered representatives, registered principals, and other associated persons in accordance with the standards set forth in this Rule, taking into consideration the following factors:]

[(A) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;]

[(B) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;]

¹ The draft text is marked to show changes between NASD Rule 3010 and Proposed FINRA Rule 3110.

[(C) whether the location is geographically distant from another OSJ of the firm;]

[(D) whether the member's registered persons are geographically dispersed; and]

[(E) whether the securities activities at such location are diverse and/or complex.]

(4) The designation of one or more appropriately registered principals in each OSJ[, including the main office,] and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.

(5) No change.

(6) The use of [R]reasonable efforts to determine that all supervisory personnel are qualified, either by virtue of experience or training, to carry out their assigned responsibilities.

(7) No change.

(b) Written Procedures

(1) General Requirements

Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and [to supervise]the activities of its[registered representatives, registered principals, and other] associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with [the] applicable FINRA and MSRB [R]rules [of NASD].

[(2) Tape recording of conversations]²

(2) Review of Member's Investment Banking and Securities Business

The supervisory procedures required by this paragraph (b) shall include procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the investment banking or securities business of the member.

2 NASD Rule 3010(b)(2) (Tape Recording of Conversations) would be reconstituted as a separate standalone supervision rule, without substantive change. *See Notice*, Section E.

(3) Supervision of Outside Securities Activities

(A) Unless a member provides prior written approval, no associated person may conduct any investment banking or securities business outside the scope of the member's business. If the member gives such written approval, such activity is within the scope of the member's business and shall be supervised in accordance with this Rule, subject to the exceptions set forth in subparagraph (B).

(B) Dual Employees

(i) The supervision required by subparagraph (A) shall not be required with respect to the bank-related securities activities of dual employees when such activities are included within any of the statutory or regulatory exemptions from registration as a broker or dealer, provided that the member receives written notice of, and approves, such activities.

(ii) A member shall not approve the activities of dual employees pursuant to subparagraph (i) unless the member has written assurance that the bank or a supervised bank affiliate will:

a. have a comprehensive view of the dual employee's securities activities;

b. employ policies and procedures reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws; and

c. give prompt notice to the member of any dual employee's violation of such policies and procedures.

(iii) A member may rely upon the written representation of any enumerated entity in subparagraph (ii) that it is employing the policies and procedures required in subparagraph b. provided the member supplies access and information, in compliance with SEC Regulation S-P, as is necessary for the execution of such policies and procedures. Upon receiving notice of a dual employee's violation of the policies and procedures required in subparagraph b., the member shall assure itself that the policies and procedures of the enumerated entity in subparagraph (ii) are reasonably designed to achieve compliance with the anti-fraud

provisions of the federal securities laws or have been amended to achieve such compliance. In the event a member cannot reach such assurance, the member must revoke its approval of the dual employee's bank-related securities activities.

(iv) For purposes of this subparagraph (B), the term "dual employee" means a natural person who has prior written approval from the member to perform as both an associated person of a member and a bank employee.

(v) For purposes of this subparagraph (B), the term "supervised bank affiliate" means a bank affiliate that is subject to consolidated supervision by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Director of the Office of Thrift Supervision.

(4) Review of Correspondence and Internal Communications

The supervisory procedures required by this paragraph (b) shall include procedures for the review of incoming and outgoing written (including electronic) correspondence with the public and internal communications relating to the member's investment banking or securities business. The supervisory procedures must be appropriate for the member's business, size, structure, and customers. The supervisory procedures must ensure that the member properly identifies and handles in accordance with firm procedures, customer complaints, customer instructions, funds and securities, and communications that are of a subject matter that require review under FINRA and MSRB rules and federal securities laws. Reviews of correspondence with the public and internal communications must be conducted by a registered principal and must be evidenced in writing, either electronically or on paper.

(5) Review of Customer Complaints

The supervisory procedures required by this paragraph (b) shall include procedures to capture, acknowledge, and respond to all written (including electronic) customer complaints.

(6) Documentation and Supervision of Supervisory Personnel

[(3)]The[member's written] supervisory procedures required by this paragraph (b) shall set forth the supervisory system established by the member pursuant to paragraph (a) above, and shall include:

(A) the titles, registration status, and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and FINRA and MSRB [the R]rules[of this Association].

(B) [The member shall maintain on an internal]a record, preserved by the member for a period of not less than three years, the first two years in an easily accessible place, of the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective.[Such record shall be preserved by the member for a period of not less than three years, the first two years in an easily accessible place.]

(C) procedures prohibiting associated persons who perform a supervisory function from:

- (i) supervising their own activities; and
- (ii) reporting to, or having their compensation or continued employment determined by, a person or persons they are supervising.

a. If a member determines, with respect to any of its supervisory personnel, that compliance with subparagraph (i) or (ii) above is not possible because of the member's size or a supervisory personnel's position within the firm, the member must:

1. document the factors the member used to reach such determination; and
2. have policies and procedures evidencing a supervisory arrangement with respect to such supervisory personnel that otherwise complies with the general supervision requirements of paragraph (a) of this Rule.

(D) procedures preventing the supervision required by this Rule from being lessened in any manner (such as the nature, scope and response to detected non-compliant conduct), due to any conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the firm, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised.

(7) Maintenance of Written Supervisory Procedures

[(4)]A copy of a member's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the member. Each member shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws or[and] regulations, including [the]FINRA and MSRB [R]rules[of this Association], and as changes occur in its supervisory system[, and e]. Each member [shall be]is responsible for communicating amendments throughout its organization.

(c) Internal Inspections

(1) Each member shall conduct a review, at least annually, of the businesses in which it engages.[, which]. The review shall be reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable [NASD]FINRA and MSRB rules. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses. Each member shall also retain a written record of the dates upon which each review and inspection is conducted.

(A) Each member shall inspect at least annually every [office of supervisory jurisdiction]OSJ and any branch office that supervises one or more non-branch locations.

(B) Each member shall inspect at least every three years every branch office that does not supervise one or more non-branch locations. In establishing how often to inspect each non-supervisory branch office, the [firm]member shall consider whether the nature and complexity of the securities activities for which the location is responsible, the volume of

business done at the location, and the number of associated persons assigned to the location require the non-supervisory branch office to be inspected more frequently than every three years. If a member establishes a more frequent inspection cycle, the member must ensure that at least every three years, the inspection requirements enumerated in paragraph (c)(2) have been met. The member's written supervisory and inspection procedures shall set forth [T]the non-supervisory branch office examination cycle, an explanation of the factors the member used in determining the frequency of the examinations in the cycle, and the manner in which a member will comply with paragraph (c)(2) if using more frequent inspections than every three years[shall be set forth in the member's written supervisory and inspection procedures].

(C) Each member shall inspect on a regular periodic schedule every non-branch location. In establishing such schedule, the [firm]member shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of contact with customers. The member's written supervisory and inspection procedures shall set forth[T]the schedule and an explanation regarding how the member determined the frequency of the examination.

[Each member shall retain a written record of the dates upon which each review and inspection is conducted.]

(2) An [office]inspection and review by a member pursuant to paragraph (c)(1) must be reduced to a written report and kept on file by the member for a minimum of three years, unless the inspection is being conducted pursuant to paragraph (c)(1)(C) and the regular periodic schedule is longer than a three-year cycle, in which case the report must be kept on file at least until the next inspection report has been written.

(A) The written inspection report must [also]include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in the following areas:

[A](i) [S]safeguarding of customer funds and securities;

[B](ii) [M]maintaining books and records;

[C](iii) [S]supervision of supervisory personnel[customer accounts serviced by branch office managers];

[D](iv) [Transmittal of funds between customers and registered representatives and between customers and third parties] transmittals of funds (e.g., wires or checks, etc.) or securities from customers to third party accounts (i.e., a transmittal that would result in a change of beneficial ownership); from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts to locations other than a customer's primary residence (e.g., post office box, "in care of" accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks; and

[E](v) changes of customer account information, including address and investment objectives changes and [V]validation of [customer address]such changes[; and].

[(F) Validation of changes in customer account information.]

(B) The policies and procedures required by paragraph (c)(2)(A)(iv) must include a means or method of customer confirmation, notification, or follow-up that can be documented. Members may use reasonable risk-based criteria to determine the authenticity of the transmittal instructions.

(C) The policies and procedures required by paragraph (c)(2)(A)(v) must include, for each change processed, a means or method of customer confirmation, notification, or follow-up that can be documented and that complies with SEA Rules 17a-3(a)(17)(i)(B)(2) and 17a-3(a)(17)(i)(B)(3).

(D) If a member does not engage in all of the activities enumerated in paragraphs (c)(2)(A)(i) through (c)(2)(A)(v)[above], the member's written supervisory procedures must identify those activities in which [it]the member does not engage [in the written inspection report] and document [in the report]that supervisory policies and procedures for such activities must be in place before the member can engage in them.

(3) [An office inspection by a]Each member must have procedures that are reasonably designed to[pursuant to paragraph (c)(1)]:

(A) ensure that the person conducting an inspection pursuant to paragraph (c)(1) is not an associated person assigned to the location or is not directly or indirectly supervised by, or otherwise reporting to, an associated person assigned to the location; and

(B) prevent the inspection from being lessened in any manner due to any conflicts of interest, including but not limited to, economic, commercial, or financial interests in the associated persons and businesses being inspected that may be present.

(i) If a member determines that compliance with paragraph (c)(3)(A) is not possible either because of a member's size or its business model, the member must document in the inspection report the factors the member used to make its determination and how the inspection otherwise comports with paragraph (c)(3)(B).[may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is directly or indirectly supervised by such person(s). However, if a member is so limited in size and resources that it cannot comply with this limitation (e.g., a member with only one office or a member has a business model where small or single-person offices report directly to an office of supervisory jurisdiction manager who is also considered the offices' branch office manager), the member may have a principal who has the requisite knowledge to conduct an office inspection perform the inspections. The member, however, must document in the office inspection reports the factors it has relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in this manner.]

[A member must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. For the purposes of this subsection only, the term "heightened inspection" shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis.]

[(d) Review of Transactions and Correspondence]³

[(e) Qualifications Investigated]⁴

[(f) Applicant's Responsibility]⁵

[(g)](d) Definitions

(1) "Office of Supervisory Jurisdiction" means any office of a member at which any one or more of the following functions take place:

- (A) order execution and/or market making;
- (B) structuring of public offerings or private placements;
- (C) maintaining custody of customers' funds and/or securities;
- (D) final acceptance (approval) of new accounts on behalf of the member;
- (E) review and endorsement of customer orders, pursuant to paragraph [(d)](b)(2) above;
- (F) final approval of advertising or sales literature for use by persons associated with the member, pursuant to NASD Rule 2210(b)(1), except for an office that solely conducts final approval of research reports; or
- (G) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

(2)(A) A "branch office" is any location where one or more associated persons of a member regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or is held out as such, excluding:

- (i) Any location that is established solely for customer service and/or back office type functions where no sales activities are conducted and that is not held out to the public as a branch office;

3 The supervision requirements for review of transactions and correspondence would be rewritten and relocated in Proposed FINRA Rule 3110 and its Supplementary Material. *See Notice*, Section B.2.b. and B.2.d. The text of such proposed Supplementary Material is set forth in this Attachment A.

4 NASD Rule 3010(e) would be reconstituted as Proposed FINRA Rule 1260. *See Notice*, Section F. The text of Proposed FINRA Rule 1260 is set forth in this Attachment A.

5 NASD Rule 3010(f) would be deleted as obsolete. *See Notice*, endnote 9.

- (ii) Any location that is the associated person's primary residence; provided that
- a. Only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family, conduct business at the location;
 - b. The location is not held out to the public as an office and the associated person does not meet with customers at the location;
 - c. Neither customer funds nor securities are handled at that location;
 - d. The associated person is assigned to a designated branch office, and such designated branch office is reflected on all business cards, stationery, advertisements and other communications to the public by such associated person;
 - e. The associated person's correspondence and communications with the public are subject to the firm's supervision in accordance with this Rule[3010];
 - f. Electronic communications (e.g., e-mail) are made through the member's electronic system;
 - g. All orders are entered through the designated branch office or an electronic system established by the member that is reviewable at the branch office;
 - h. Written supervisory procedures pertaining to supervision of sales activities conducted at the residence are maintained by the member; and
 - i. A list of the residence locations is maintained by the member;
- (iii) Any location, other than a primary residence, that is used for securities business for less than 30 business days in any one calendar year, provided the member complies with the provisions of subparagraph [(A)](2)(A)(ii)a. through h. above;

(iv) Any office of convenience, where associated persons occasionally and exclusively by appointment meet with customers, which is not held out to the public as an office; *

(v) Any location that is used primarily to engage in non-securities activities and from which the associated person(s) effects no more than 25 securities transactions in any one calendar year; provided that any advertisement or sales literature identifying such location also sets forth the address and telephone number of the location from which the associated person(s) conducting business at the non-branch locations are directly supervised;

(vi) The Floor of a registered national securities exchange where a member conducts a direct access business with public customers; or

(vii) A temporary location established in response to the implementation of a business continuity plan.

(B) Notwithstanding the exclusions in subparagraph (2)(A), any location that is responsible for supervising the activities of persons associated with the member at one or more non-branch locations of the member is considered to be a branch office.

(C) The term “business day” as used in paragraph [Rule 3010(g)](d)(2)(A) of this Rule shall not include any partial business day provided that the associated person spends at least four hours on such business day at his or her designated branch office during the hours that such office is normally open for business.

* Where such office of convenience is located on bank premises, signage necessary to comply with applicable federal and state laws, rules and regulations and applicable rules and regulations of [the NYSE,] other self-regulatory organizations, and securities and banking regulators may be displayed and shall not be deemed “holding out” for purposes of this section.

••• Supplementary Material:

.01 Registration of Main Office. – A member’s main office location is required to be registered and designated as a branch office and/or OSJ if it meets the definitions of a “branch office” and/or “office of supervisory jurisdiction” as set forth in Rule 3110(d). In general, the nature of activities conducted at a main office will satisfy the requirements of such terms.

.02 Designation of Additional OSJs. – In addition to the locations that meet the definition of OSJ in Rule 3110(d), each member shall also register and designate other offices as OSJs as is necessary to supervise its associated persons in accordance with the standards set forth in Rule 3110. In making a determination as to whether to designate a location as an OSJ, the member should consider the following factors:

(a) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;

(b) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;

(c) whether the location is geographically distant from another OSJ of the firm;

(d) whether the member's registered persons are geographically dispersed; and

(e) whether the securities activities at such location are diverse and/or complex.

.03 One-Person OSJs. – A location with only one registered person that either meets the definition of OSJ in Rule 3110(d) or that the member has selected as an additional OSJ pursuant to .02 above, must be registered and designated as an OSJ. The registered person must be an appropriately registered principal and designated, pursuant to Rule 3110(a)(4), to carry out supervisory responsibilities assigned to that office ("on-site principal"). If the on-site principal is authorized to engage in business activities other than the supervision of associated persons or other offices as enumerated in Rule 3110(d)(1)(D) through (G), the principal cannot supervise his or her own activities. Such one-person OSJ location must be under the close supervision and control of another appropriately registered principal ("senior principal"). The senior principal will be responsible for supervising the activities of the on-site principal at such office. The senior principal must conduct on-site supervision of such OSJ location on a regular periodic schedule to be determined by the member. In establishing such schedule, the member shall consider, among other factors, the nature and complexity of the securities activities for which the location is responsible, the nature and extent of contact with customers, and the disciplinary history of the on-site principal.

.04 Supervision of Multiple OSJs by a Single Principal. – Rule 3110(a)(4) requires a member to designate one or more appropriately registered principals in each OSJ with the authority to carry out the supervisory responsibilities assigned to that office. The designated principal for each OSJ must have a physical presence, on a regular and routine basis, at each OSJ for which the principal has supervisory responsibilities. Consequently, there is a general presumption that a principal will not be designated and assigned to supervise more than one OSJ. If a member determines it is necessary to designate and assign one appropriately registered principal to supervise two or more OSJs, the member must take into consideration, among others, the following factors:

- (a) whether the principal is qualified by virtue of experience and training to supervise the activities and associated persons in each location;
- (b) whether the principal has the capacity and time to supervise the activities and associated persons in each location;
- (c) whether the principal is a producing registered representative;
- (d) whether the OSJ locations are in sufficiently close proximity to ensure that the principal is physically present at each location on a regular and routine basis; and
- (e) the nature of activities at each location, including size and number of associated persons, scope of business activities, nature and complexity of products and services offered, volume of business done, the disciplinary history of persons assigned to such locations, and any other indicators of irregularities or misconduct.

The member must establish, maintain and enforce written supervisory procedures regarding the supervision of all OSJs. In all cases where a member designates and assigns one principal to supervise more than one OSJ, the member must document in the member's written supervisory and inspection procedures the factors used to determine why the member considers such supervisory structure to be reasonable.

There is a further general presumption that a determination by a member to designate and assign one principal to supervise more than two OSJs is unreasonable. If a member determines to designate and assign one principal to supervise more than two OSJs, the member's determination will be subject to greater scrutiny, and the member will have a greater burden to evidence the reasonableness of such structure.

.05 Annual Compliance Meeting. – A member is not required to conduct in-person meetings with each registered person or group of registered persons to comply with the annual compliance meeting (or interview) required by Rule 3110(a)(7). A member that chooses to conduct compliance meetings using other methods (i.e., on-demand webcast, video conference, interactive classroom setting, telephone, or other electronic means) must ensure, at a minimum, that each registered person attends the entire meeting (e.g., an on-demand annual compliance webcast would require each registered person to use a unique user ID and password to gain access and use a technology platform to track the time spent on the webcast, provide click-as-you go confirmation, and have an attestation of completion at the end of a webcast) and is able to ask questions to the presenter and receive answers from the presenter in a timely fashion (e.g., an on-demand annual compliance webcast that allows registered persons to ask questions via an email to a centralized address or telephone hotline with questions and the webcast presenter's timely responses posted on the member's intranet site).

.06 Risk-based Review of Member's Investment Banking and Securities Business. – A member may use a risk-based review system to comply with Rule 3110(b)(2), which requires the review by a registered principal, as evidenced in writing, of all transactions relating to the investment banking or securities business of the member.

.07 Reliance on Bank or Affiliated Entity to Supervise Dual Employees. – Rule 3110(b)(3)(B)(iii) requires a member to consider the sufficiency of the policies and procedures of the bank or the supervised bank affiliate on which the member is relying to supervise the conduct of dual employees (the supervisory system) in the event of a notice of a dual employee's violation of the referenced policies and procedures. However, it is understood that not every violation must result in the conclusion that the supervisory system being employed is insufficient or improperly designed. Members' conclusions in this regard must be reasonable and reached in good faith. Members should understand that repeated violations, violations that by their nature raise systemic problems, and/or violations of a long duration in time call into question the reasonableness of any determination that the supervisory system that was employed remains viable without the need for any amendments, reconfigurations, or altered control and oversight functions.

A member that cannot reach the reasonable determination that the supervisory system remains viable should revoke its approval of all dual employees being supervised under that supervisory system until such time as the member can assure itself that problems with the supervisory system have been corrected.

.08 Transaction review and investigation. – (a) To help ensure its compliance with the provisions of the Exchange Act, the rules thereunder, and FINRA rules prohibiting insider trading and manipulative and deceptive devices, each member shall:

(1) include in its supervisory procedures a process for the review of securities transactions that are effected for the account(s) of the member and/or the member's associated persons and their family members to identify trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices; and

(2) conduct promptly an internal investigation into any such trade to determine whether a violation of those laws or rules has occurred.

(b) A member engaging in investment banking services must file with FINRA, written reports, signed by a senior officer of the member, at such times and, without limitation, including such content, as follows:

(1) within ten business days of the initiation of the internal investigation of any trade pursuant to paragraph (a)(2), a written report that discloses the identity of the member, the date the internal investigation commenced, and the identity of the security, trades, accounts, employees, or employee's family members, under review, and that includes a copy of the member's policies and procedures required by paragraph (a)(1).

(2) a quarterly written report addressing the progress of each open internal investigation filed with FINRA pursuant to paragraph (b)(1) by the 15th day of the month following the quarter.

(3) within five business days of completion of the internal investigation pursuant to paragraph (a)(2), a written report detailing the completion of the investigation, including the results of the investigation, any internal disciplinary action taken, and any referral of the matter to FINRA, another self-regulatory organization, the SEC, or any other federal, state, or international regulatory authority.

(c) For purposes of paragraph (b), "investment banking services" include, without limitation, acting as an underwriter, participating in a selling group in an offering for the issuer or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital or equity lines of credit or serving as placement agent for the issuer or otherwise acting in furtherance of a private offering of the issuer.

.09 Risk-based Review of Correspondence and Internal Communications. – By employing risk-based principles, a member may decide the extent to which additional policies and procedures for the review of incoming and outgoing written (including electronic) correspondence with the public and internal communications that fall outside of the subject matters listed in Rule 3110(b)(4) are appropriate for its business and structure. If a member's procedures do not require that all correspondence be reviewed before use or distribution, the procedures must provide for:

- (a) the education and training of associated persons regarding the firm's procedures governing correspondence;
- (b) the documentation of such education and training; and
- (c) surveillance and follow-up to ensure that such procedures are implemented and followed.

.10 Evidence of Review of Correspondence and Internal Communications. – The evidence of review required in Rule 3110(b)(4) must be chronicled either electronically or on paper and must clearly identify the reviewer, the communication that was reviewed, the date of review, and the actions taken by the member as a result of any significant regulatory issues identified during the review. Merely opening a communication is not sufficient review.

.11 Delegation of Correspondence and Internal Communication Review Functions. – In the course of the supervision and review of correspondence with the public and internal communications required by Rule 3110(b)(4), a supervisor/principal may delegate certain functions to persons who need not be registered. However, the supervisor/principal remains ultimately responsible for the performance of all necessary supervisory reviews, irrespective of whether he or she delegates functions related to the review. Accordingly, supervisors must take reasonable and appropriate action to ensure delegated functions are properly executed and should evidence performance of their procedures sufficiently to demonstrate overall supervisory control.

.12 Retention of Correspondence and Internal Communication. – Each member shall retain the internal communications and correspondence of associated persons relating to the member's investment banking or securities business for the period of time and accessibility specified in SEA Rule 17a-4(b). The names of the persons who prepared outgoing correspondence and who reviewed the correspondence shall be ascertainable from the retained records, and the retained records shall be readily available to FINRA, upon request.

.13 Supervision of Supervisory Personnel. – A member’s determination that it is not possible to comply with paragraphs (b)(6)(C)(i) or (b)(6)(C)(ii) of Rule 3110 prohibiting supervisory personnel from supervising their own activities and from reporting to, or otherwise having compensation or continued employment determined by, a person or persons they are supervising generally will arise only in instances where:

(a) the member is a sole proprietor in a single-person firm;

(b) a registered person is the member’s most senior executive officer (or similar position); or

(c) a registered person is one of several of the member’s most senior executive officers (or similar positions).

.14 Standards for Reasonable Review. – In fulfilling its obligations under Rule 3110(c), each member must conduct a review, at least annually, of the businesses in which it engages. The review must be reasonably designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations and with FINRA and MSRB rules. Each member shall establish and maintain supervisory procedures that must take into consideration, among other things, the firm’s size, organizational structure, scope of business activities, number and location of the firm’s offices, the nature and complexity of the products and services offered by the firm, the volume of business done, the number of associated persons assigned to a location, the disciplinary history of registered representatives or associated persons, and any indicators of irregularities or misconduct (i.e., “red flags”), etc. The procedures established and reviews conducted must provide that the quality of supervision at remote locations is sufficient to ensure compliance with applicable securities laws and regulations and with FINRA and MSRB rules. A member must be especially diligent in establishing procedures and conducting reasonable reviews with respect to a non-branch location where a registered representative engages in securities activities. Based on the factors outlined above, members may need to impose reasonably designed supervisory procedures for certain locations and/or may need to provide for more frequent reviews of certain locations.

.15 General Presumption of Three-Year Limit for Periodic Inspection Schedules. – Rule 3110(c)(1)(C) requires a member to inspect on a regular periodic basis every non-branch location. In establishing a non-branch location inspection schedule, there is a general presumption that a non-branch location will be inspected at least every three years, even in the absence of any indicators of irregularities or misconduct (i.e., “red flags”). If a member establishes a longer periodic inspection schedule, the member must document in its written supervisory and inspection procedures the factors used in determining that a longer periodic inspection cycle is appropriate.

.16 Exception to Persons Prohibited from Conducting Inspections. – A member’s determination that it is not possible to comply with Rule 3110(c)(3)(A) with respect to who is not allowed to conduct a location’s inspection will generally arise only in instances where:

(a) the member has only one office; or

(b) the member has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices’ branch office manager.

* * * * *

3120[3012]. Supervisory Control System⁶

(a) [General Requirements]

[(1)] Each member shall designate and specifically identify to [NASD]FINRA one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that:

[(A)](1) test and verify that the member’s supervisory procedures are reasonably designed with respect to the activities of the member and its [registered representatives and] associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable [NASD]FINRA and Municipal Securities Rulemaking Board (MSRB) rules; and

[(B)](2) create additional or amend supervisory procedures where the need is identified by such testing and verification. The designated principal or principals must submit to the member’s senior management no less than annually, a report^[1] detailing each member’s system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

(b) Each report provided to senior management pursuant to paragraph (a) in the calendar year following a calendar year in which a member reported \$150 million or more in gross revenue must include:

(1) a tabulation of the reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year; and

6 The draft text is marked to show changes between NASD Rule 3012 and Proposed FINRA Rule 3120.

(2) discussion of the preceding year's compliance efforts, including procedures and educational programs, in each of the following areas:

(A) trading and market activities;

(B) investment banking activities;

(C) antifraud and sales practices;

(D) finance and operations;

(E) supervision;

(F) anti-money laundering; and

(G) risk management.

(c) For purposes of paragraph (b), "gross revenue" is defined as total revenue as reported on FOCUS Form Part II or IIA (line item 4030) less Commodities Revenue (line item 3990), if applicable.

[(2) through (3)]

[(b) Dual Member]

* * * * *

3150. Holding of Customer Mail⁷

A member may hold mail for a customer who will not be receiving mail at his or her usual address, provided that the member receives written instructions from the customer that include the time period during which the member is requested to hold the customer's mail. If the time period included in the instructions is for an extended time, the member must verify at reasonable intervals that the customer's instructions still apply. During the time that a member is holding mail for a customer, the member must be able to communicate with the customer in a timely manner to provide important account information, as necessary. A member holding a customer's mail pursuant to this Rule must take actions reasonably designed to ensure that the customer's mail is not tampered with, held without the customer's consent, or used by an associated person of the member in any manner that would violate FINRA rules, Municipal Securities Rulemaking Board rules, or the federal securities laws.

* * * * *

⁷ NASD Rule 3110(i) (Holding of Customer Mail) would be rewritten as Proposed FINRA Rule 3150. See Notice, Section D.

PROPOSED FINRA REGISTRATION RULE

1260. Responsibility of Member to Investigate Applicants for Registration

(a) Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making a certification in the application of such person for registration with FINRA. Where an applicant for registration has previously been registered with FINRA, the member shall review a copy of the Uniform Termination Notice of Securities Industry Registration (Form U5) filed with FINRA by such person's most recent previous FINRA member employer, together with any amendments thereto that may have been filed pursuant to Article V, Section 3 of the FINRA By-Laws. The member shall review the Form U5 as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to FINRA that it has made reasonable efforts to comply with the requirement. Further inquiry shall be made as warranted based on the background or other information developed, and the member shall then take such action as may be deemed appropriate.

(b) Where an applicant for registration has been previously registered with a registered futures association ("RFA") member that is or has been registered as a broker-dealer pursuant to Section 15(b)(11) of the Exchange Act ("notice-registered broker-dealer") with the SEC to trade security futures, the member shall review a copy of the Notice of Termination of Associated Person (Form 8-T) filed with the RFA by such person's most recent previous RFA member employer, together with any amendments thereto. The member shall review the Form 8-T as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to FINRA that it has made reasonable efforts to comply with the requirement. Further inquiry shall be made as warranted based on the background or other information developed, and the member shall then take such action as may be deemed appropriate.

* * * * *