

Client Alert

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New FINRA Supervision Rules Impact Broker-Dealers' Insider Trading Procedures and Supervisory Controls

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Financial Industry Regulatory Authority (FINRA) rules require member firms to establish and maintain a system of written procedures to supervise the activities of its members. On December 23, 2013, the SEC approved new FINRA rules. Among other provisions, the new rules require procedures for detecting and reporting insider trading and impose heightened standards on supervisory controls. Member firms should ensure that their actions conform to the updated regulatory scheme, which is part of FINRA's continuing efforts to harmonize the NASD and NYSE supervisory rules into one consolidated FINRA rulebook.

THE PROPOSED RULE CHANGES

The two new FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) consolidate and replace NASD Rules 3010 and 3012¹ and impact:

- (i) which personnel are permitted to act as supervisors;
- (ii) which personnel may perform office inspections;
- (iii) requirements for review of certain internal communications; and
- (iv) obligations to actively monitor for insider trading, including the duty to conduct internal investigations and report information related to those internal investigations back to FINRA.

This Alert will focus on the most significant changes.

INSIDER TRADING: INTERNAL INVESTIGATIONS AND EXTERNAL REPORTING REQUIREMENTS

New FINRA Rule 3110(d) (Transaction Review and Investigation) requires a member to have supervisory procedures in place to review securities transactions made on behalf of a member's or its associated persons' accounts, as well as any other "covered account," in order to identify trades that may violate a provision of the Act, its regulations, or FINRA rules. In addition, the new rule requires members to promptly conduct an internal investigation into any questionable trades to determine whether a violation occurred. The definition of covered account includes any account introduced or carried by the member and held by: (1) the spouse of a person associated with the member; (2) a child of the person associated with the member or such person's spouse,

¹ In addition to the supervision and controls rule revisions, the SEC also approved new FINRA Rule 3150 (Holding of Customer Mail), which would replace NASD Rule 3110(i), and new FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms), which would replace NASD Rule 3010(b)(2).

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provided that the child resides in the same household as or is financially dependent upon the person associated with the member; (3) any other related individual over whose account the person associated with the member has control; or (4) any other individual over whose account the associated person of the member has control and to whose financial support such person materially contributes. This new rule stems from the former NYSE Rule 342.21, outlining the procedures for review and investigation of potential insider trading.

Rule 3110(d) also requires member firms engaged in investment banking services to provide FINRA with (i) a report within five days of the completion of an internal investigation associated with insider trading or a violation of any anti-manipulation provisions and (ii) a quarterly report describing information about insider trading and related internal investigations initiated, ongoing, or concluded within the prior quarter. This reporting obligation is only triggered after an investigation has been initiated. This obligation appears to continue the emphasis on self-reporting reflected by Rule 4530, which, among other things, requires a firm to report to FINRA within 30 calendar days after the firm has concluded, or reasonably should have concluded, on its own that the firm or an associated person of the firm has violated any securities, insurance, commodities, financial or investment-related laws, rules, regulations or standards of conduct.

With respect to this obligation, FINRA stated that firms are permitted to use a risk-based approach to monitor transactions. The risk-based approach may take into account a firm's specific business model, including the type of underwriting activity the firm performs. Further, firms can use their judgment to determine which departments or employees are at a greater risk of violating the new Rule 3110(d), and which accounts warrant further inspection and review. For example, FINRA explained that firms with underwriting activity limited to mutual funds can adopt significantly different review procedures than firms engaged in more traditional investment banking activity. The type of investment banking services a firm performs and the level of risk of insider trading associated with those activities are factors to consider when evaluating the reasonableness of a firm's chosen procedures.

In sum, the amended language of the Rule requires a firm to include in its supervisory procedures a process for the review of securities transactions reasonably designed and appropriately tailored to identify potentially violative trading activity. Firms should also establish guidelines to follow up on trades that the firms believes may violate provisions of the Exchange Act and the rules thereunder, or FINRA rules prohibiting insider trading and manipulative or deceptive devices.

Insider trading continues to be a top priority for FINRA, the SEC and federal criminal law enforcement, as exemplified in FINRA's 2014 Regulatory and Examination Priorities Letter. In the Letter, FINRA states that firms should be routinely reviewing electronic communications of personnel within business units that may come into possession of material, non-public information during the normal course of business – specifically, the investment banking and research departments of member firms.² Moreover, the Letter directs firms to maintain appropriate information-barrier policies and procedures designed to limit or restrict the flow of material, non-public information within the firm. Firms should also be monitoring employee trading inside and outside the firm to identify any suspicious activity, and conduct regular reviews of customer trades, in addition to implementing employee training on the management of material, non-public information.

² See Financial Industry Regulatory Authority 2014 Regulatory and Examination Priorities Letter, 7-8, *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf>.

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HEIGHTENED SUPERVISORY CONTROLS

The new rules also impose new requirements on a member firm's supervisory structure and controls. A few of the more noteworthy changes are outlined below.

- FINRA Rule 3110(a) (Supervisory System) requires a member firm to have a supervisory system for the activities of its associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations. This rule remains largely unchanged, with only minor modifications. The Proposal does not retain the requirement FINRA proposed in 2011; it clarifies what was required under 3110(a)(4). Specifically, the original proposal required a designated senior principal be responsible for supervising the activities of the on-site principal at the one-person office of supervisory jurisdiction (OSJ) and conduct on-site supervision of the one-person OSJ on a regular periodic schedule to be determined by the member. Due to concerns about compliance costs and burdens associated with the requirement in the supplemental material, FINRA eliminated the proposed material in Amendment No. 1.
- FINRA Rule 3110(b)(2) (Review of a Member's Investment Banking and Securities Business) requires members to have supervisory procedures ready for review by a registered principal, evidenced in writing, of all transactions relating to the member's investment banking or securities business. This rule clarifies that such review should include *all transactions relating to the member's investment banking or securities business*. New Supplementary Material 3110.05 clarifies that a member should use a risk-based approach to review these transactions.³ Detailed reviews of each transaction are not required as long as a member has designed a reasonable system to provide a member with sufficient information to focus on any areas that pose the greatest risk of violation. FINRA also clarified that if a member does not engage in any transactions relating to its investment banking or securities business, then it is sufficient under Rule 3110(b)(2) for the member to acknowledge in its supervisory procedures that it does not engage in any such transactions, but that it must have supervisory policies and procedures in place before doing so.
- FINRA Rule 3110(b)(6) (Documentation and Supervision of Supervisory Personnel) is largely based on NASD Rule 3010(b)(3), requiring a member's supervisory procedures to set forth the member's supervisory system and to include a record of the member's supervisory personnel with such details as titles, registration status, locations, and responsibilities. The new FINRA rule includes two new provisions related to this rule:
 - Rule 3110(b)(6)(C) requires a member to institute procedures prohibiting its supervisory personnel from supervising their own activities and reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising.
 - Rule 3110(b)(6)(D) requires a member to have procedures in place to prevent the required standards of supervision from being compromised, that is, from being negatively impacted due to a conflict of interest with respect to the associated person being supervised, such as the person's position, the amount of revenue such person generates for the firm or any compensation that the supervisor may derive from the associated person being supervised. FINRA clarified that Rule 3110(b)(6)(D) does not create a strict liability obligation requiring identification and elimination of all conflicts of interest.

³ Risk-based review describes the type of methodology a member may use to identify and prioritize for review those areas that pose the greatest risk of violating securities laws and SRO rules.

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- FINRA Rule 3120 (Supervisory Control System) retains the requirements in NASD Rule 3012, requiring a member to test and verify its supervisory procedures and prepare and submit to its senior management a report on an annual basis summarizing the test results and any necessary amendments to its procedures. New Rule 3120(b) adds that for members reporting more than \$200 million in gross annual revenue, additional information must be provided in the report, including (i) a tabulation of reports made to FINRA during the year regarding customer complaints and internal investigations; and (ii) a discussion of the prior year's compliance efforts, including procedures and educational programs, relating to trading and market activities, investment banking, antifraud and sales practices, finance and operations, supervision, and anti-money laundering.

CONCLUSION

The new FINRA supervisory rules tighten the existing supervisory standards already imposed on member firms by FINRA rules and guidance. It would not be surprising to see FINRA examining member firms for compliance with these new rules in the near future.

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