

IN THE DISTRICT COURT IN AND FOR OKLAHOMA COUNTY, OKLAHOMA

FILED IN DISTRICT COURT OKLAHOMA COUNTY

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SOUTHEAST INVESTMENTS, N.C. INC., )  
A NORTH CAROLINA CORPORATION; and )  
FRANK H. BLACK, )

Plaintiffs/Petitioners, )

vs. )

Case No. CV-2015-86

THE STATE OF OKLAHOMA *ex rel.* )  
THE OKLAHOMA SECURITIES COMMISSION )

Defendant. )

PETITIONERS' REPLY BRIEF

Submitted by:

Patrick O. Waddel, OBA #9254  
J. David Jorgenson, OBA #4839  
SNEED LANG PC  
One West Third Street, Suite 1700  
Tulsa, OK 74103  
(918) 588-1313  
(918) 588-1314 Facsimile

*Counsel for Frank H. Black and Southeast Investments, N.C. Inc.*

## **PETITIONERS' REPLY BRIEF**

In accordance with the Court's Scheduling Order filed herein on August 11, 2015, Petitioners file this reply brief. All terms defined in Petitioners' Opening Brief filed August 17, 2015 ("POB") have the same meaning here. *See* Glossary of Terms attached to the POB. The Oklahoma Department of Securities brief filed herein on September 17, 2015 is called herein "the OSC Brief."

### **I. ARGUMENT AND AUTHORITIES**

#### **A. OSC ENFORCEMENT OF FINRA RULES IS PREEMPTED.**

In the POB, Petitioners argued that "[h]ere the OSC, without any prior FINRA action or any FINRA finding of failure to supervise, purported to engage in direct enforcement of FINRA rules." Plainly, Petitioners argued further, "the federal system preempts state enforcement of *the FINRA rules* as such. See POB at 11(emphasis in original). The OSC's sole response to that argument is this: "In no way, did the Department intend to prove violations of federal securities laws" [sic]. OSC Brief at 8. But that is exactly what the Department did endeavor to do. That is true because, as the POB shows, the FINRA rules themselves are made pursuant to a delegation of authority from Congress. And the rules are *enforced* under a Congressional delegation of authority, with the SEC, and *only* the SEC, sitting as an appeal tribunal.

It is noteworthy in this connection that, in its brief filed in *this Court*, the OSC has carefully avoided reference to the specific FINRA rules that, overwhelmingly, formed the basis for the Department's prosecution of Southeast and Black. For example, in its internal appeal brief to the OSC, the Department cited NASD Rule 3010 twelve times by Petitioners' count. *See* ROA Tab 64 at pp. 10-20. The Department rested its argument about failure to report an address change upon FINRA Rule 1122. The OSC Brief filed in this Court will be searched in

vain for a single citation to either NASD/FINRA rule, a tacit concession: (i) that this Court's ruling cannot be predicated upon anything except actual Oklahoma law, and (ii) that the OSC Order was *not* so predicated (unless it is assumed that the OSC ignored the Department's brief in adopting *in toto* the order of the Administrator of that very Department). The OSC Order should be reversed for that reason alone.

B. THE OSC LACKS NATIONWIDE ENFORCEMENT POWER.

Closely related to the preemption issue is the overarching issue of the OSC's encroachment upon the federal government's geographic jurisdiction. The latter jurisdiction, of course, is nationwide. The OSC's jurisdiction is not. The Department unwittingly underscores its own lack of geographic jurisdiction. It tells the Court that Southeast's core violation of OSC Rule 660:11-5-42(22) (the OSC's highly generalized rules on "supervisory procedures") was its failure to supervise its 140 agents that are scattered across the United States. Only a handful of those agents are in Oklahoma. The OSC, which bore the burden of proof in the OSC proceedings, never even bothered to identify the Oklahoma agents, save one. The "one," of course, is Rodney Watkins, who the Department gave a clean bill of health – this just before the Department's eleventh-hour conversion of the OSC case into an omnibus attack on Southeast's nationwide supervisory system. But it is now undisputed (at least in the briefing to date) that Congress has vested *nationwide* rule-making and enforcement authority in the SEC and, by delegation, to FINRA. The cease and desist order ("C & D Order") contained within the OSC Order, on its face, fails to limit its application to supervision of Oklahoma agents. Hence on its face that order exceeds OSC jurisdiction.<sup>1</sup>

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<sup>1</sup> The OSC Order is problematic for another reason as well. Petitioners commend to the Court the following question upon the Court's own reading of that order: what exactly has Southeast been ordered to cease and desist *from*? To rephrase in the positive: what has Southeast been ordered to do *in any state*?

C. THE OSC HAS IGNORED MATERIALITY REQUIREMENTS.

The POB discusses at length the materiality requirements incorporated in the OSC rules, the Oklahoma Securities Act, and the NASD/FINRA rules (the latter being the rules upon which, in reality, the OSC relied). *See* POB at pp. 13-15. The OSC Brief ignores the materiality requirements altogether and simply proceeds to detail the supposed violations. The OSC may not simply ignore the materiality requirements imposed *by law*. Under the standards of review cited by both parties, this Court may review, *de novo*, the OSC's failure to take legal requirements into account. *See, e.g.*, OSC Brief at 3 (citing cases).

Ironically, the OSC's detailing of the putative violations serves to underscore how trivial, i.e., how *nonmaterial*, these putative violations were. A recap of the most serious -- supposedly material -- violations follows, each accompanied by a summary of Petitioners' response. (The POB responds to each OSC charge in greater detail). *See* POB at pp. 13-20.

- Watkins' address change was belatedly reported on his CRD.

As the POB notes, this "violation" is particularly trivial and technical. Watkins did not conduct any securities business at all between September 19, 2012 and his reinstatement in the spring of 2014. *See* ROA at Tab 1 (3-26-13 Recommendation) at p. 4, ¶ 24 *and* ROA at Tab 54, Exhibits "C" (Watkins testimony concerning sales activities) and "D" (customer affidavits).

Plainly the address information could not have affected any customer during the year and a half

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Should it terminate some of its agents? Should it establish additional OSJs? How many OSJs and where? Has the OSC ordered Southeast to establish an OSJ, say, *in California*? These are just a few of the questions that are unanswered by the vague terms of the C & D Order. A directive "in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential of due process of law." *In re Berry*, 68 Cal. 2d 137, 156 (Cal. 1968), quoting *Connally v. General Constr. Co.*, 269 U.S. 385, 391 (1926) and applying the holding there to an injunction order.

that Watkins was not engaged in the transaction of securities business. In any event the CRD has been updated, making the “ceases and desist” instruction meaningless as applied to the address-change issue.

- Southeast failed to supervise its agents nationwide adequately.

Setting aside the glaring jurisdictional issues discussed in this brief and in the POB, the record makes clear that Southeast’s non-North Carolina agents devote the majority of their time to financial services activities other than to the sale of securities.<sup>2</sup> So the Department’s parading of disasters that *might* occur (the OSC does not identify any that have *actually* occurred) is simply a red herring.<sup>3</sup> Assuming that the C&D order can even be understood to command Southeast to establish more OSJs in non-Oklahoma jurisdictions, the OSC is simply trying to tell Southeast how to run its business. *See* especially POB at 17-18 (quoting at length the FINRA rule allowing broker-dealers discretion to take account of their own business models in determining supervisory procedures).<sup>4</sup>

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<sup>2</sup> By way of example, if the brokers spend 10% of their time on securities work, supervising 140 brokers would be the equivalent workload of supervising 14 full-time securities traders.

<sup>3</sup> The record reflects that, insofar as supervision of Watkins was an issue, the Department itself required that Watkins be supervised by another licensed broker in Tulsa, Lamar Guillory. Southeast complied. The lack of an OSJ in Oklahoma was never an issue in the OSC proceedings until the Department filed its eleventh-hour amendment.

<sup>4</sup> FINRA has recently reiterated the importance of reasonableness and flexibility in the application of its rules to member firms. Thus:

[A] firm’s supervisory system [must] be reasonably designed to achieve compliance with applicable federal securities laws and regulations and FINRA rules. ... [A]supervisory system cannot guarantee firm-wide compliance with all applicable laws and regulation and FINRA rules.”

\* \* \*

“The ‘reasonably designed’ standard requires that the system ‘be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member’s business’” (quoting an earlier NASD circular).

FINRA Regulatory Notice 14-10 (March 2014) at Endnote 4. *See also id* at Endnote 45. Both are reprinted at: <http://www.finra.org/industry/notices/14-10> (copy attached hereto as Exhibit 1).

- Southeast did not follow its own WSPs relating to order form procedures.

Again this putative violation is nonmaterial, bordering on trivial. The Department here is complaining about the brokers' failures to send orders to the home office on a printed form. The Department does not even allege that orders were not written up; it just alleges that the *contents* of the order were phoned in (a distinction with barely a difference). It must be assumed that the Department would also criticize Southeast if the orders were e-mailed and if the e-mails contained identical information to that which otherwise would be filled into the blanks in the form. *Again the orders are not even submitted to the clearinghouse by the brokers.* The Southeast home office does that after a careful review of each order (part of Southeast's sound system of policing its agents' activities and insuring the suitability of its customers' investments).

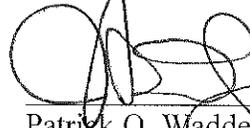
- Southeast failed to conduct annual compliance interviews with each of its agents.

The testimony before the OSC was that the annual interviews were in fact conducted. Both parties agreed to submit the case to the OSC before the interview notes were ever produced. In addition, both FINRA itself and Southeast provide compliance training to Southeast representatives. Southeast distributes many compliance materials throughout the year and it requires bi-annual representative written declarations. *See* POB at 19 (discussing FINRA rules that allow member firms discretion in following procedures that are "reasonably designed to achieve compliance with applicable securities laws and regulations"). Again FINRA itself "passed" Southeast's practices during the periods under review by the OSC.

## II. CONCLUSION

For the reasons set forth herein and in the POB, the OSC Order should be reversed and this cause remanded to the OSC with appropriate instructions.

Respectfully submitted,



Patrick O. Waddel, OBA #9254

J. David Jorgenson, OBA #4839

SNEED LANG PC

One West Third Street, Suite 1700

Tulsa, OK 74103

(918) 588-1313

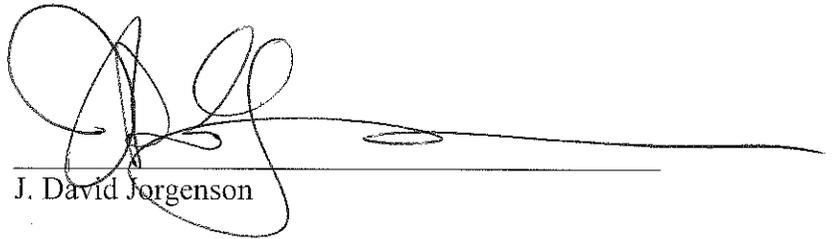
(918) 588-1314 Facsimile

*Counsel for Frank H. Black and Southeast  
Investments, N.C. Inc.*

**Certificate of Mailing**

I, the undersigned, do hereby certify that on this 28th day of September, 2015, a true and correct copy of the above and foregoing *Petitioner's Reply Brief* was sent by U.S. Mail, postage prepaid, to:

Jennifer Shaw/Amanda Cornmesser  
OK Dept. of Securities  
204 North Robinson, Suite 400  
Oklahoma City, OK 73102-7001



J. David Jorgenson

# Regulatory Notice

# 14-10

## Consolidated Supervision Rules

### SEC Approves New Supervision Rules

Effective Date: December 1, 2014

#### Executive Summary

The SEC approved FINRA's new consolidated rules governing supervision.<sup>1</sup> The new Rules 3110, 3120, 3150 and 3170 replace NASD Rules 3010, 3012 and 3110(i) and other corresponding NYSE rule provisions.<sup>2</sup> The new rules become effective on December 1, 2014.

The text of the new rules is available at [www.finra.org/notices/14-10](http://www.finra.org/notices/14-10).

Questions concerning this Notice should be directed to:

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

#### Background & Discussion

The SEC recently approved new FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) to replace NASD Rules 3010 (Supervision), 3012 (Supervisory Control System) and corresponding provisions of the NYSE Rules and Interpretations.<sup>3</sup> In addition, new FINRA Rules 3150 (Holding of Customer Mail) and 3170 (Tape Recording of Registered Persons by Certain Firms) replace NASD Rules 3110(i) and 3010(b)(2) (often referred to as the "Taping Rule"), respectively. The new rules, discussed in detail below, become effective on December 1, 2014.

#### I. FINRA 3110 (Supervision)

##### A. Supervisory System

FINRA Rule 3110(a) (Supervisory System), based on NASD Rule 3010(a), requires a firm to have a supervisory system for the activities of its associated persons that is reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA rules, and sets forth the minimum requirements discussed below for a firm's supervisory system.<sup>4</sup>

March 2014

#### Notice Type

- ▶ Consolidated Rulebook

#### Suggested Routing

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

#### Key Topics

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

#### Referenced Rules & Notices

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

### 1. Establishing and Maintaining Written Procedures and Designating Principals Responsible for Supervision

FINRA Rule 3110(a)(1) requires a firm's supervisory system to provide for the establishment and maintenance of written supervisory procedures. In addition, FINRA Rule 3110(a)(2) requires a firm to designate an appropriately registered principal(s) with authority to carry out the supervisory responsibilities for each type of business in which the firm engages for which registration as a broker-dealer is required.

### 2. Designating Offices of Supervisory Jurisdiction

FINRA Rule 3110(a)(3) requires a firm to register and designate as a branch office or an office of supervisory jurisdiction (OSJ) each location, including the main office, that meets the branch office and OSJ definitions in FINRA Rule 3110(e). In addition, FINRA Rules 3110(a)(3) and 3110.01 (Registration of Main Office) require all branch offices and OSJs to be registered. FINRA Rule 3110.02 (Designation of Additional OSJs) adopts, with no substantive changes, the provisions in NASD Rule 3010(a)(3) setting forth factors a firm should consider in designating additional locations as OSJs.<sup>5</sup>

### 3. Designating OSJ/Non-OSJ Branch Principals

FINRA Rule 3110(a)(4) requires a firm to designate one or more appropriately registered principals in each OSJ (defined in FINRA Rule 3110.03 as the "on-site principal") and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the firm.

FINRA Rule 3110.03 (Supervision of Multiple OSJs by a Single Principal) clarifies the requirement in FINRA Rule 3110(a)(4) for a firm to designate one or more appropriately registered principals in each OSJ with the authority to carry out the supervisory responsibilities assigned to that office. The designated on-site principal for each OSJ must have a physical presence, on a regular and routine basis, at each OSJ for which the principal has supervisory responsibilities. The rule establishes a general presumption that a principal will not be designated and assigned to be the on-site principal pursuant to Rule 3110(a)(4) to supervise more than one OSJ. If a firm determines it is necessary to designate and assign a principal to be the on-site principal supervising two or more OSJs, then the firm must consider, among other things, the following factors:

- ▶ whether the on-site principal is qualified by virtue of experience and training to supervise the activities and associated persons in each location;
- ▶ whether the on-site principal has the capacity and time to supervise the activities and associated persons in each location;
- ▶ whether the on-site principal is a producing registered representative;
- ▶ whether the OSJ locations are in sufficiently close proximity to ensure that the on-site principal is physically present at each location on a regular and routine basis; and

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

FINRA Rule 3110.03 further requires the firm to establish, maintain and enforce written supervisory procedures regarding the supervision of all OSJs. In all cases where a firm designates and assigns one on-site principal to supervise more than one OSJ, the firm must document in its written supervisory and inspection procedures the factors used to determine why the firm considers the supervisory structure to be reasonable. In addition, the rule provides that the determination by the firm will be subject to scrutiny by FINRA.

#### 4. Supervision of One-Person OSJs

One-person OSJs are subject to the requirement set forth in FINRA Rule 3110(a)(5) that all registered persons must be assigned to an appropriately registered representative(s) or principal(s) who is responsible for supervising that person's activities, as well as FINRA Rule 3110(b)(6), which requires procedures prohibiting supervisory personnel from, among other things, supervising their own activities. FINRA reminds firms to conduct focused reviews of one-person OSJ locations, especially in light of possible conflicts of interest that may arise.<sup>6</sup> For its part, FINRA will continue to monitor one-person OSJs to determine whether a firm adequately supervises such locations including, but not limited to, supervision addressing possible conflicts of interest or sales practice violations.

#### 5. Assigning Supervisors for Registered Representatives and Determining Qualifications of Supervisory Personnel

FINRA Rule 3110(a)(5) requires that each registered person be assigned to an appropriately registered representative(s) or principal(s) who is responsible for supervising that person's activities. FINRA Rule 3110(a)(6) requires a firm to use reasonable efforts to determine that all supervisory personnel have the necessary experience or training to be qualified to carry out their assigned responsibilities.

#### 6. Annual Compliance Meeting

FINRA Rule 3110(a)(7) requires each registered representative and registered principal to participate, at least once each year, in an interview or meeting at which compliance matters relevant to the particular representative or principal are discussed. These meetings need not be in person.<sup>7</sup> However, a firm that chooses to conduct compliance meetings using other methods (*e.g.*, on-demand webcast or course, video conference, interactive classroom setting, telephone or other electronic means) must ensure, at a minimum, that each registered person attends the entire meeting. For example, the firm might use on-demand annual compliance webcast requiring each registered person to use a unique user ID and password to gain access and use a technology platform to track the time spent on the webcast, provide click-as-you-go confirmation and have an attestation of completion at the end of a webcast. The firm also must ensure that registered persons are able to ask

questions regarding the presentation and receive answers in a timely fashion. For example, a firm could host an on-demand annual compliance webcast that allows registered persons to ask questions via an email to a presenter or a centralized address or via a telephone hotline and receive timely responses directly or view such responses on the firm's intranet site.

## B. Written Procedures

FINRA Rule 3110(b) (Written Procedures), based on NASD Rule 3010(b), requires a firm to establish, maintain and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules.<sup>8</sup>

### 1. Transaction Review and Use of Risk-Based Review

FINRA Rule 3110(b)(2) (Review of Member's Investment Banking and Securities Business), based on NASD Rule 3010(d)(1), requires a firm to have supervisory procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the firm's investment banking or securities business. However, FINRA Rule 3110.05 (Risk-based Review of Member's Investment Banking and Securities Business) permits a firm to use a risk-based system to review its transactions. The term "risk-based" describes the type of methodology a firm may use to identify and prioritize for review those areas that pose the greatest risk of potential securities laws and self-regulatory organization (SRO) rule violations. In this regard, a firm is not required to conduct detailed reviews of each transaction if the firm is using a reasonably designed risk-based review system that provides the firm with sufficient information to enable the firm to focus on the areas that pose the greatest numbers and risks of violation.

If a firm's procedures for the review of its transactions by a registered principal include the use of technology-based review systems with parameters designed to assess which transactions merit further review, a principal must review the parameters and document the review in writing. As is always the case with the exercise of supervision under FINRA rules, a principal using an automated supervisory system, aid or tool for the discharge of supervisory duties remains responsible for the discharge of supervisory responsibilities in compliance with FINRA Rule 3110(b)(2). Also, a principal relying on a risk-based review system is responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed.<sup>9</sup>

A firm that does not engage in any transactions relating to its investment banking or securities business (*e.g.*, firm conducting only a mutual fund underwriting business that effects no transactions) does not have any review obligations pursuant to FINRA Rule 3110(b)(2). Moreover, the firm may comply with FINRA Rule 3110(b)(2) by acknowledging in its supervisory procedures that it does not engage in any such transactions and that it must have supervisory policies and procedures in place before doing so.

## 2. Correspondence and Internal Communications Review

FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) generally incorporates the substance of NASD Rule 3010(d)(2) (Review of Correspondence) and requires a firm to have supervisory procedures, which are appropriate for the firm's business, size, structure and customers, to review incoming and outgoing written (including electronic) correspondence and internal communications relating to its investment banking or securities business.<sup>10</sup> In particular, the supervisory procedures must require the firm's review of (1) incoming and outgoing written (including electronic) correspondence to properly identify and handle in accordance with firm procedures, customer complaints, instructions, funds and securities and communications that are of a subject matter that require review under FINRA rules and federal securities laws; and (2) internal communications to properly identify communications that are of a subject matter that require review under FINRA rules and federal securities laws.<sup>11</sup>

The rule also requires that reviews of correspondence and internal communications be conducted by a registered principal and be evidenced in writing, either electronically or on paper.

### (i) Risk-based Review

FINRA Rule 3110.06 (Risk-based Review of Correspondence and Internal Communications) reflects existing guidance regarding a firm's ability to use risk-based principles to review its correspondence and internal communications.<sup>12</sup> Specifically, a firm, by employing risk-based principles, must decide the extent to which additional policies and procedures for the review of incoming and outgoing written (including electronic) correspondence that fall outside of the subject matters listed in FINRA Rule 3110(b)(4) are necessary for its business and structure. If a firm's procedures do not require that all correspondence be reviewed before use or distribution, the procedures must provide for:

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

In addition, with respect to internal communications, FINRA Rule 3110.06 requires a firm, by employing risk-based principles, to decide the extent to which additional policies and procedures for the review of these internal communications that are not of a subject matter that require review under FINRA rules and federal securities laws are necessary for its business and structure. Consistent with the guidance, FINRA Rules 3110(b)(4) and 3110.06 do not require that a firm review every internal communication.<sup>13</sup> For instance, if a firm does not engage in any activities that are of a subject matter that require review, a firm would not be required to review its internal communications for references to those activities, provided that its supervisory procedures acknowledged that factor as part of the firm's determination that its procedures were reasonably designed to achieve compliance with applicable federal securities laws and FINRA rules.

(ii) *Evidence of Review*

FINRA Rule 3110.07 (Evidence of Review of Correspondence and Internal Communications) codifies existing guidance that a firm must identify what communication was reviewed, the identity of the reviewer, the date of review and the firm's actions taken as a result of any significant regulatory issues identified during the review. Merely opening a communication is not sufficient review.<sup>14</sup>

FINRA Rule 3110.07 permits the use of lexicon-based screening tools or systems; however, as noted in *Regulatory Notice 07-59*, firms using automated tools or systems in the course of their supervisory review of electronic communications must have an understanding of the limitations of those tools or systems and should consider what, if any, further supervisory review is necessary in light of those limitations. Furthermore, the use of electronic surveillance tools to review communications represents a direct exercise of supervision by the supervisor (including any use of such tools by the supervisor's delegate to review communications). The supervisor remains responsible for the discharge of supervisory responsibilities in compliance with the rule and also is responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed.<sup>15</sup>

With respect to communications reviewed by electronic surveillance tools that are not selected for further review, a firm may demonstrate compliance with FINRA Rule 3110.07 if the electronic surveillance system has a means of electronically recording evidence that those communications have been reviewed by that system. With respect to communications that do not generate alerts, a firm may use an electronic surveillance or reviewing tool that only captures the specified information fields to the extent necessary to comply with applicable FINRA and SEC rules.<sup>16</sup>

(iii) *Delegation of Review*

FINRA Rule 3110.08 (Delegation of Correspondence and Internal Communication Review Functions) codifies guidance that a supervisor or principal may delegate review functions to an unregistered person; however, the provision also codifies the principle noted above, that the supervisor or principal remains ultimately responsible for the performance of all necessary supervisory reviews.<sup>17</sup>

(iv) *Retention of Communications*

FINRA Rule 3110.09 (Retention of Correspondence and Internal Communications) requires a firm to retain its internal communications and correspondence of associated persons relating to the firm's investment banking or securities business for the period of time and accessibility specified in SEA Rule 17a-4(b).<sup>18</sup> The names of the persons who prepared outgoing correspondence and who reviewed the correspondence must be ascertainable from the retained records, and the retained records must be readily available to FINRA upon request.

### 3. Review of Customer Complaints

FINRA Rule 3110(b)(5) (Review of Customer Complaints) requires a firm to have supervisory procedures to capture, acknowledge and respond to all written (including electronic) customer complaints.<sup>19</sup> The rule does not include oral complaints because they are difficult to capture and assess and may raise competing views as to the substance of the complaint being alleged. However, FINRA encourages firms to provide customers with a form or other format that will allow customers to communicate their complaints in writing. FINRA also reminds firms that the failure to address any customer complaint, written or oral, may be a violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).<sup>20</sup>

### 4. Supervision of Supervisory Personnel

FINRA Rule 3110(b)(6) (Documentation and Supervision of Supervisory Personnel) eliminates NASD Rule 3012's provisions specifying the supervision of a producing manager's customer account activity and heightened supervision when any producing manager's revenues rise above a specific threshold. Instead, a firm must have procedures to prohibit its supervisory personnel from (1) supervising their own activities; and (2) reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising.<sup>21</sup> FINRA Rule 3110(b)(6) addresses potential abuses in connection with the supervision of all supervisory personnel, rather than addressing only the supervision of a subset of supervisory personnel and their customer account activity. FINRA believes that addressing the supervision of all supervisory personnel, rather than just producing managers, is better designed to prevent supervisory situations from occurring that would not lead to effective supervision.

#### *(i) Limited Exception*

FINRA Rule 3110(b)(6) provides an exception for a firm that determines, with respect to any of its supervisory personnel, that compliance with either of the prohibitions outlined above is not possible because of the firm's size or a supervisory personnel's position within the firm.<sup>22</sup> A firm relying on the exception must document the factors the firm used to reach its determination and how the supervisory arrangement with respect to such supervisory personnel otherwise complies with FINRA Rule 3110(a).<sup>23</sup> FINRA Rule 3110.10 (Supervision of Supervisory Personnel) reflects FINRA's expectation that this exception will be used primarily by a sole proprietor in a single-person firm or where a supervisor holds a very senior executive position within the firm. However, FINRA Rule 3110.10's list of situations is non-exclusive, and a firm may still rely on the exception in other instances where it cannot comply because of its size or the supervisory personnel's position within the firm, provided the firm complies with FINRA Rule 3110(b)(6)'s documentation requirements. A firm is not required to notify FINRA of its reliance on the exception.<sup>24</sup>

(ii) *Conflicts of Interest*

FINRA Rule 3110(b)(6) also requires a firm to have procedures reasonably designed to prevent the standards of supervision required pursuant to FINRA Rule 3110(a) from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, such as the supervised person's position, the amount of revenue such person generates for the firm or any compensation that the supervisor may derive from the associated person being supervised.<sup>25</sup> This provision does not impose a strict liability obligation to eliminate all conflicts of interest, but rather requires that the supervisory procedures be reasonably designed despite the firm's conflicts of interest.

5. Maintenance of Written Supervisory Procedures

FINRA Rule 3110(b)(7) (Maintenance of Written Supervisory Procedures), based on NASD Rule 3010(b)(4), requires a firm to retain and keep current a copy of the firm's written supervisory procedures at each OSJ and at each location where supervisory activities are conducted on the firm's behalf. A firm also must amend its written supervisory procedures to reflect changes in applicable securities laws or regulations and FINRA rules, and as changes occur in its supervisory system. Each firm must promptly communicate its written supervisory procedures and amendments to all associated persons to whom such written supervisory procedures and amendments are relevant based on their activities and responsibilities.

FINRA Rule 3110.11 (Use of Electronic Media to Communicate Written Supervisory Procedures) permits a firm to satisfy its obligation to communicate its written supervisory procedures (and any amendments) using electronic media, provided that the firm complies with specific conditions, including that the written supervisory procedures have been promptly communicated to, and are readily accessible by, all associated persons to whom such supervisory procedures apply based on their activities and responsibilities.<sup>26</sup>

FINRA Rules 3110(b)(7) and 3110.11 reflect FINRA's continued belief that it is important for all associated persons to have knowledge of the supervisory procedures relevant to their activities.<sup>27</sup> However, the rule provisions do not prohibit a firm from providing only its supervisory personnel with the written supervisory procedures' parameters detailing how a firm monitors or reviews its associated persons' activities to detect and prevent potential violative conduct (e.g., parameters detailing how a firm reviews an associated person's correspondence or trading).

## C. Inspection Requirements

### 1. Mandatory Inspection Cycles

FINRA Rule 3110(c)(1), based on NASD Rule 3010(c)(1), requires a firm to review, at least annually, the businesses in which it engages.<sup>28</sup> The review must be reasonably designed to assist the firm in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA rules. FINRA Rule 3110(c)(1) also retains NASD Rule 3010(c)(1)'s requirement that a firm review the activities of each office, including the periodic examination of customer accounts to detect and prevent irregularities or abuses. Each firm must retain a written record of the date upon which each review and inspection is conducted. The rule requires a firm to inspect OSJs and supervisory branch offices at least annually (on a calendar-year basis), non-supervisory branch offices at least every three years and non-branch locations on a regular periodic schedule.<sup>29</sup>

There is a general presumption that a non-branch location will be inspected at least every three years, even in the absence of any indicator of irregularities or misconduct (i.e., "red flags").<sup>30</sup> If a firm establishes a periodic inspection schedule longer than three years, the firm must document in its written supervisory and inspection procedures the factors used in determining that a longer periodic inspection cycle is appropriate. A firm also must retain a written record of each review and inspection, reduce a location's inspection to a written report and keep each inspection report on file either for a minimum of three years or, if the location's inspection schedule is longer than three years, until the next inspection report has been written.<sup>31</sup>

As FINRA has previously recognized, a general practice exists where a firm may inspect non-supervisory branch offices on a more frequent cycle than every three years but target only specified areas of the offices' activities during a particular examination.<sup>32</sup> Consistent with NASD Rule 3010(c)(1), FINRA Rule 3110(c)(1) requires that a firm engaging in this practice must inspect all of the required areas listed in FINRA Rule 3110(c)(2) within the three-year cycle, regardless of the number of times within that cycle a non-supervisory branch office is inspected. Also a firm must set forth in its written supervisory and inspection procedures the manner in which it will inspect those areas within the three-year cycle.

### 2. Inspection Report Content Requirements

FINRA Rule 3110(c)(2) relocates NASD Rule 3012's requirements regarding the review and monitoring of specified activities, such as transmittals of funds and securities and customer changes of address and investment objectives. Specifically, a firm must test and verify a location's supervisory policies and procedures for:

- ▶ safeguarding of customer funds and securities;
- ▶ maintaining books and records;
- ▶ supervision of supervisory personnel;

- ▶ transmittals of funds or securities from customers to third party accounts; from customer accounts to outside entities; from customer accounts to locations other than a customer's primary residence; and between customers and registered representatives, including the hand-delivery of checks; and
- ▶ changes of customer account information, including address and investment objectives changes, and validation of such changes.<sup>33</sup>

A firm's policies and procedures for transmittals of funds or securities must include a means or method of customer confirmation, notification or follow-up that can be documented. However, a firm may use reasonable risk-based criteria to determine the authenticity of the transmittal instructions.<sup>34</sup>

In addition, a firm's policies and procedures for changes of customer account information must include a means or method of customer confirmation, notification or follow-up that can be documented and that complies with SEA Rules 17a-3(a)(17)(i)(B)(2) and 17a-3(a)(17)(i)(B)(3).<sup>35</sup>

With respect to the transmittal of funds or securities from customers to third party accounts, FINRA Rule 3110(c)(2) does not include NASD Rule 3012's parenthetical text ("i.e., a transmittal that would result in a change in beneficial ownership") to clarify that all transmittals to an account where a customer on the original account is not a named account holder are subject to the rule. The rule's follow-up procedures provide an important investor protection function by verifying that the customer was aware of the transfer.

Similarly, with respect to changes of customer account information, a firm must have procedures to monitor all changes of customer account information and not only address and investment objective changes.<sup>36</sup> Examples of other changes to customer account information would include, without limitation, changes to a customer's name, marital status, telephone, email or other contact information. A firm may delegate reviews of such changes to an appropriately qualified person who is not a principal, unless another FINRA or SEC rule would require principal review (e.g., FINRA Rule 4515 (Approval and Documentation of Changes in Account Name or Designation) prohibiting an account name or designation change unless authorized by a qualified and registered principal designated by the firm).

If a location being inspected does not engage in all of the activities listed above, the firm must identify those activities and document that supervisory policies and procedures must be in place at that location. Firms have the flexibility to provide this information in either their written supervisory procedures or a location's written inspection report.<sup>37</sup>

### 3. Associated Persons Conducting Inspections

FINRA Rule 3110(c)(3) replaces NASD Rule 3010(c)(3)'s provision prohibiting branch office managers and supervisors and the persons they directly or indirectly supervise from conducting office inspections. FINRA Rule 3110(c)(3) generally prohibits an associated person from conducting a location's inspection if the person either is assigned to that location or is directly or indirectly supervised by, or otherwise reports to, someone assigned to that location.<sup>38</sup> This restriction does not prohibit firms from using compliance personnel assigned to a firm's separate compliance department and supervised solely by the compliance department to conduct a location's inspections. Such an arrangement helps to protect against the potential conflicts of interest the provision is designed to address.

### 4. Limited Exception

FINRA Rule 3110(c)(3) retains, with modifications, NASD Rule 3010(c)(3)'s exception for firms with limited size and resources from the general prohibitions regarding who can conduct a location's inspection. Specifically, if a firm determines that it cannot comply with FINRA Rule 3110(c)(3)'s general prohibitions, the firm must document in the inspection report both the factors the firm used to make its determination and how the inspection otherwise complies with FINRA Rule 3110(c)(1).<sup>39</sup> A firm will generally rely on the exception in instances where the firm has only one office or has a business model where small or single person offices report directly to an OSJ manager who is also considered the offices' branch office manager (e.g., independent contractor business model).<sup>40</sup> However, a firm may still rely on the exception in other instances, provided the firm documents the factors used in making its determination that it needs to rely on the exception.

FINRA Rule 3110(c)(3) does not include NASD Rule 3010(c)(3)'s restriction that a firm relying on the exception must have a principal who has the requisite knowledge to conduct the inspection. Eliminating this restriction provides a firm with flexibility to assign the most appropriate person who has the requisite knowledge, regardless of registration status, to conduct a location's inspection, taking into consideration the requirement under FINRA Rule 3110(c)(1) that a firm's review of its businesses be reasonably designed to assist the firm in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA rules.

### 5. Conflicts of Interest

FINRA Rule 3110(c)(3) eliminates NASD Rule 3010(c)(3)'s heightened office inspection requirements firms must implement if the person conducting the office inspection either reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20 percent or more of the revenue of the business units supervised by the branch office manager's supervisor. Instead, firms must have procedures reasonably designed to prevent the effectiveness of the inspections from being compromised due to the conflicts of interest that may be present with respect to the location being inspected, including but not limited to, economic, commercial or financial interests in the associated person and businesses being inspected.<sup>41</sup>

A firm is not required to eliminate all conflicts of interest with respect to a location's inspections. As stated above, however, a firm's review of its businesses must be reasonably designed to assist the firm in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA rules. To that end, firms should be diligent in identifying potential conflicts of interest and the manner in which they will be addressed to prevent a location's inspection from being compromised.

#### F. Transaction Review and Reporting

Section 15(g) of the Exchange Act,<sup>42</sup> adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA),<sup>43</sup> requires every registered broker or dealer to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the broker or dealer or any associated person of the broker or dealer. To help firms comply with ITSFEA, NYSE Rule 342.21 required firms to review trades in NYSE-listed securities and related financial instruments effected for the firm's account or for the accounts of the firm's employees and family members and to promptly conduct an internal investigation into any trade the firm identified that may have violated insider trading laws or rules. FINRA Rule 3110(d) extends the requirement beyond NYSE-listed securities and related financial instruments to cover all securities.

In particular, FINRA Rule 3110(d) requires a firm to include in its supervisory procedures a process for reviewing securities transactions that is reasonably designed to identify trades that may violate the provisions of the Exchange Act, its regulations or FINRA rules prohibiting insider trading and manipulative and deceptive devices that are effected for:

- ▶ accounts of the firm;
- ▶ accounts introduced or carried by the firm in which a person associated with the firm has a beneficial interest or the authority to make investment decisions;
- ▶ accounts of a person associated with the firm that are disclosed to the firm pursuant to NASD Rule 3050 or NYSE Rule 407, as applicable; and
- ▶ covered accounts (as defined below).<sup>44</sup>

Firms may take a risk-based approach to monitoring transactions that take into account their specific business models, and firms are encouraged to tailor their policies and procedures to their specific business models. There is no implied obligation on firms as to how best to conduct the reviews.<sup>45</sup> For instance, some firms may determine that only specific departments or employees pose a greater risk and examine trading in those accounts accordingly.

## 1. Covered Accounts

FINRA Rule 3110(d) defines the term “covered account” to include any account introduced or carried by the firm that is held by (1) the spouse of a person associated with the firm; (2) a child of the person associated with the firm or such person’s spouse, provided that the child resides in the same household as or is financially dependent upon the person associated with the firm; (3) any other related individual over whose account the person associated with the firm has control; or (4) any other individual over whose account the associated person of the firm has control and to whose financial support such person materially contributes.<sup>46</sup> Once a firm has identified a potentially violative trade, the firm must conduct promptly an internal investigation into the trade to determine whether a violation of the relevant laws or rules has occurred.<sup>47</sup>

## 2. Internal Investigation Reporting

Although all firms must include in their supervisory procedures a process for reviewing transactions that is reasonably designed to identify trades for insider trading, only firms engaging in investment banking services must file with FINRA written reports (signed by a senior officer) regarding their internal investigations.<sup>48</sup> A firm engages in “investment banking services” if it, without limitation, acts as an underwriter; participates in a selling group in an offering for the issuer or otherwise acts in furtherance of a public offering of the issuer; acts as a financial adviser in a merger or acquisition; or provides venture capital or equity lines of credit or serves as placement agent for the issuer or otherwise acts in furtherance of a private offering of the issuer.<sup>49</sup>

Although firms engaged in investment banking services may have special access to information that increases the risk of insider trading by individuals at the firm, FINRA understands that some types of “investment banking services” may present less risk of insider trading than others, and firms should take these risks into account when developing their policies and procedures. As part of implementing a firm’s risk-based approach to these requirements, a firm’s procedures should include establishing guidelines or criteria for taking reasonable follow-up steps to determine which trades are potentially violative trades and, therefore, merit further review via an internal investigation. FINRA does not expect that every trade highlighted in an exception or other report would require a firm to conduct an internal investigation; however, firms that use such reports should maintain additional written procedures that set forth guidelines or criteria for reasonable follow-up steps for determining which trades initially highlighted merit further review.

### *(i) Quarterly Reporting*

FINRA Rule 3110(d) requires firms engaging in investment banking services to make written reports to FINRA within ten business days of the end of each calendar quarter describing each internal investigation initiated in the previous calendar quarter, including the firm’s identity, the commencement date of each internal investigation, the status of each open internal investigation, the resolution of any internal investigation reached

during the previous calendar quarter, and, with respect to each internal investigation, the identity of the security, trades, accounts, firm's associated persons or family members of such associated person holding a covered account, under review, and a copy of the firm's insider trading review policies and procedures.<sup>50</sup> If a firm did not have an open internal investigation, or either initiate or complete an internal investigation during a particular calendar quarter, the firm is not required to submit a report for that quarter.

*(ii) Reporting Insider Trading Violations*

In addition, if a firm determines after an internal investigation that a trade has violated provisions of the Exchange Act, its regulations or FINRA rules prohibiting insider trading and manipulative and deceptive devices, the firm must, within five business days of the internal investigation's completion, file a written report with FINRA. The report must detail the completion of the investigation, including the results of the investigation, any internal disciplinary action taken, and any referral of the matter to FINRA, another SRO, the SEC or any other federal, state or international regulatory authority.<sup>51</sup>

*(iii) Filing Written Reports with FINRA*

Firms required to file a written report with FINRA under FINRA Rule 3110(d) must provide the report, either in hard copy or electronically, to their Regulatory Coordinator. FINRA is considering alternative methods for filing such reports and will announce any changes to the filing procedures in a future *Regulatory Notice* (or similar communication).

**E. Branch Office and OSJ Definitions**

FINRA Rule 3110(e) retains NASD Rule 3010(g)'s definitions of "branch office" and "office of supervisory jurisdiction," as well as the definition of "business day."

## II. FINRA Rule 3120 (Supervisory Control System)

### A. Testing and Verifying a Firm's Supervisory Procedures

FINRA Rule 3120(a), based on NASD Rule 3012(a)(1), requires each firm to designate and identify to FINRA one or more principals who must establish, maintain and enforce a system of supervisory control policies and procedures that (1) test and verify that the firm's supervisory procedures are reasonably designed with respect to the firm's and its associated persons' activities to achieve compliance with applicable securities laws and regulations and FINRA rules, and (2) where necessary, create additional or amended supervisory procedures. The designated principals must also prepare and submit to the firm's senior management a report at least annually summarizing the test results and any necessary amendments to those procedures.

### B. Additional Content Requirements—FINRA Rule 3120(b)

FINRA Rule 3120(b) requires a firm that reported \$200 million or more in gross revenue (total revenue less, if applicable, commodities revenue) on its FOCUS report in the prior calendar year to include, to the extent applicable to the firm's business, a:

- ▶ tabulation of the reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year; and
- ▶ a discussion of the preceding year's compliance efforts, including procedures and educational programs, in each of the following areas:
  - ▶ trading and market activities;
  - ▶ investment banking activities;
  - ▶ antifraud and sales practices;
  - ▶ finance and operations;
  - ▶ supervision; and
  - ▶ anti-money laundering.

The additional content requirements, which are drawn from NYSE Rule 342.30 (Annual Report and Certification), provide valuable information for FINRA's regulatory program and will be valuable compliance information for a firm's senior management. In addition, some content requirements relate to regulatory obligations, such as supervision and anti-money laundering, that apply to all firms, regardless of their business activities. However, because all the content requirements are not relevant to every firm, FINRA Rule 3120 provides that a firm's report must include the additional content only to the extent applicable to the firm's business.

### III. FINRA Rule 3150 (Holding of Customer Mail)

FINRA Rule 3150, which replaces NASD Rule 3110(i) (Holding of Customer Mail), eliminates the strict time limits in NASD Rule 3110(i) and generally allows a firm to hold a customer's mail for a specific time period in accordance with the customer's written instructions if the firm meets several conditions. Specifically, a firm may hold mail for a customer who will not be receiving mail at his or her usual address, provided that the firm:

- ▶ receives written instructions from the customer that include the time period during which the firm is requested to hold the customer's mail. If the time period included in the customer's instructions is longer than three consecutive months (including any aggregation of time periods from prior requests), the customer's instructions must include an acceptable reason for the request (*e.g.*, safety or security concerns). Convenience is not an acceptable reason for holding mail longer than three months;
- ▶ informs the customer in writing of any alternate methods, such as email or access through the firm's website, that the customer may use to receive or monitor account activity and information and obtains the customer's confirmation of the receipt of such information; and
- ▶ verifies at reasonable intervals that the customer's instructions still apply.

In addition, the firm must be able to communicate, as necessary, with the customer in a timely manner during the time the firm is holding the customer's mail to provide important account information (*e.g.*, privacy notices, the SIPC information disclosures required by FINRA Rule 2266 (SIPC Information)). A firm holding a customer's mail also must take actions reasonably designed to ensure that the customer's mail is not tampered with, held without the customer's consent, or used by a firm's associated persons in any manner that would violate FINRA rules or the federal securities laws.

### IV. FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms)

FINRA Rule 3170 reconstitutes NASD Rule 3010(b)(2) (Tape Recording of Conversations) without any substantive changes and includes a definition clarifying that the term "tape recording" includes without limitation, any electronic or digital recording that meets the rule's requirements. Specifically, the rule requires a firm to establish, enforce and maintain special written procedures supervising the telemarketing activities of all of its registered persons, including the tape recording of conversations, if the firm has hired more than a specified percentage of registered persons from firms that meet FINRA Rule 3170's definition of "disciplined firm." To assist firms in complying with FINRA Rule 3170, FINRA provides a "Disciplined Firms List" identifying those firms that meet the definition of "disciplined firm."<sup>52</sup>

## Endnotes

1. See Securities Exchange Act Release No. 71179 (December 23, 2013), 78 FR 79542 (December 30, 2013) (Order Approving Proposed Rule Change as Modified by Amendment No. 1); File No. SR-FINRA-2013-025; see also *Regulatory Notice 08-24* (May 2008) (Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls).
2. The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE (Incorporated NYSE Rules) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the "Transitional Rulebook"). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those member firms of FINRA that are also members of the NYSE. The FINRA Rules apply to all FINRA member firms, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see *Information Notice 03/12/03* (Rulebook Consolidation Process).
3. Effective December 1, 2014, the following NYSE Rules and Interpretations will be deleted from the Transitional Rulebook: (1) NYSE Rule 342 (Offices-Approval, Supervision and Control) and NYSE Rule Interpretations 342(a)(b)/01 through 342(a)(b)/03, 342(b)/01 through 342(b)/02, 342(c)/02, 342(e)/01, 342.10/01, 342.13/01, 342.15/01 through 342.15/05, 342.16/01 through 342.16/03; (2) NYSE Rules 343 (Offices-Sole Tenancy, and Hours), 343.10 and NYSE Rule Interpretation 343(a)/01; (3) NYSE Rule 351(e) (Reporting Requirements) and NYSE Rule Interpretation 351(e)/01 (Reports of Investigation); (4) Incorporated NYSE Rule 354 (Reports to Control Persons); and (5) NYSE Rule 401 (Business Conduct); and (6) NYSE Rule 401A (Customer Complaints).
4. This standard, which requires that a firm's supervisory system be reasonably designed to achieve compliance with applicable federal securities laws and regulations and FINRA rules recognizes that a supervisory system cannot guarantee firm-wide compliance with all applicable laws and regulation and FINRA rules. See *Notice to Members 99-45* (June 1999) (noting that NASD Rule 3010's "reasonably designed" standard "recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations" but that the "reasonably designed" standard requires that the system "be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business").
5. FINRA Rule 3110.02 specifies that, in addition to the locations that meet the definition of OSJ in Rule 3110(e), each firm must also register and designate other offices as OSJs as is necessary to supervise its associated persons in accordance with the standards set forth in Rule 3110. In making a determination as to whether to designate a location as an OSJ, the firm should consider the following factors:
  - (a) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;
  - (b) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;
  - (c) whether the location is geographically distant from another OSJ of the firm;
  - (d) whether the firm's registered persons are geographically dispersed; and
  - (e) whether the securities activities at such location are diverse or complex.

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6. See SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004) (reminding broker-dealers that small, remote offices require vigilant supervision and specifically noting that “[n]o individual can supervise themselves”); NASD Regulatory & Compliance Alert, Volume 11, Number 2 (June 1997) (cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves); see also *In re Stuart K. Patrick*, 51 S.E.C. 419, 422 (May 17, 1993) (“[s]upervision, by its very nature, cannot be performed by the employee himself”) (SEC order sustaining application of the New York Stock Exchange’s supervisory rule – also cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves).
7. See FINRA Rule 3110.04 (Annual Compliance Meeting) (codifying existing guidance that a firm is not required to conduct in-person meetings with each registered person or groups of registered persons to comply with the annual compliance meetings required by FINRA Rule 3110(a)(7)); see also *Notices to Members 99-45* (June 1999) and *05-44* (June 2005); see also Letter from Afshin Atabaki, FINRA, to Evan Charkes, Citigroup Global Markets, Inc., dated November 30, 2006 (firms may use on-demand webcast technology to satisfy the annual compliance meeting requirement, subject to specified safeguards and conditions); letter from Afshin Atabaki, FINRA, to S. Kendrick Dunn, Pacific Select Distributors, Inc., dated February 5, 2013 (firms may use on-demand course without voice narration to satisfy annual compliance meeting requirement, subject to specified safeguards and conditions).
8. See FINRA Rule 3110(b)(1) (General Requirements).
9. See also *Regulatory Notice 07-53* (November 2007) (Deferred Variable Annuities) (discussing use of automated supervisory systems).
10. FINRA Rule 3110(b)(4) and FINRA Rules 3110.06-.08 refer to “correspondence,” consistent with FINRA Rule 2210’s (Communications with the Public) definition and use of the term “correspondence.”
11. Communications that are of a subject matter that require review under FINRA rules and the federal securities laws include (without limitation):
  - Communications between non-research and research departments concerning a research report’s contents (NASD Rule 2711(b)(3) and NYSE Rule 472(b)(3));
  - Certain communications with the public that require a principal’s pre-approval (FINRA Rule 2210);
  - The identification and reporting to FINRA of customer complaints (FINRA Rule 4530) (as further detailed herein, FINRA Rule 3110(b)(5) also affirmatively requires firms to capture, acknowledge and respond to all written (including electronic) customer complaints); and
  - The identification and prior written approval of changes in account name(s) (including related accounts) or designation(s) (including error accounts) regarding customer orders (FINRA Rule 4515).
12. See *Regulatory Notice 07-59* (December 2007) (FINRA Provides Guidance Regarding the Review and Supervision of Electronic Communications).

13. *See id.* at 3, 9 (“with the exception of the enumerated areas requiring review by a supervisor, members may decide, employing risk-based principles, the extent to which review of any internal communications is necessary in accordance with the supervision of their business”); *see also id.* at 3 (specifically noting that the guidance neither created new supervisory requirements nor required the review of every communication).
14. *See id.*
15. *See Regulatory Notice 07-53* (November 2007) (Deferred Variable Annuities) (discussing use of automated supervisory systems).
16. *See* FINRA Rule 3110.09 (Retention of Correspondence and Internal Communications) and SEA Rule 17a-4(b)(4) (requiring, among other things, that a broker-dealer’s retained communications records include any approvals of communications sent).
17. *See Regulatory Notice 07-59* (December 2007).
18. The rule purposefully aligns the record retention period for communications with the SEC’s record retention period for the same types of communications to achieve consistent regulation in this area.
19. Although NYSE Rule 401A previously required firms to acknowledge and respond to specified customer complaints (both oral and written), to harmonize the NASD and NYSE rules in the interim period before completion of the Consolidated FINRA Rulebook, FINRA amended Incorporated NYSE Rule 351(d) (Reporting Requirements) to limit the definition of “customer complaint” to include only written complaints, thereby making the definition substantially similar to that in NASD Rule 3070(c) (Reporting Requirements). *See* Securities Exchange Act Release No. 58533 (September 12, 2008), 73 FR 54652 (September 22, 2008) (Order Approving File No. SR-FINRA-2008-036). FINRA adopted FINRA Rule 4530 to replace NASD Rule 3070 and comparable provisions in NYSE Rule 351. *See* Securities Exchange Act Release No. 63260 (November 5, 2010), 75 FR 69508 (November 12, 2010) (Notice of Filing of Amendments No. 1 and 2 and Order Granting Accelerated Approval of File No. SR-FINRA-2010-034). FINRA Rule 4530 became effective on July 1, 2011. *See Regulatory Notice 11-06* (February 2011).
20. In addition, FINRA’s investor education literature advises customers to communicate any complaints to their broker-dealer in writing, especially if customers have lost money or there were any unauthorized trades made in the customers’ accounts. *See* FINRA’s pamphlet Investor Complaint Program: What to Do When Problems Arise; *see also* NASD Rule 2340(a) (Customer Account Statements) (requiring a customer account statement to, among other things, advise the customer that any oral communications should be re-confirmed in writing to further protect the customer’s rights, including rights under the Securities Investor Protection Act (SIPA)).
21. FINRA Rule 3110(b)(6)(C)(i) and (ii). FINRA Rule 3110(b)(6) also requires that a firm’s supervisory procedures include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable laws and regulations, and FINRA rules, as well as a record of the names of its designated supervisory personnel and the dates for which such designation is or was effective. FINRA Rule 3110(b)(6)(A) and (B).

22. FINRA Rule 3110(b)(6)(C)(ii)a.
23. FINRA Rule 3110(b)(6)(C)(ii)a.1 and 2.
24. NASD Rule 3012 requires a firm relying on a similar exception to notify FINRA through an electronic process (or any other process prescribed by FINRA) within 30 days of the date on which the firm first relies on the exception, and annually thereafter. Firms provide this notification through the FINRA Contact System (FCS). Effective December 1, 2014, firms will no longer be required to provide this information, and FINRA intends to disable FCS's notification feature.
25. FINRA Rule 3110(b)(6)(D).
26. Specifically, FINRA Rule 3110.11 provides that a firm may use electronic media to communicate its written supervisory procedures (and amendments) provided that (1) the written supervisory procedures have been promptly communicated to, and are readily accessible by, all associated persons to whom such supervisory procedures apply based on their activities and responsibilities through, for example, the firm's intranet system; (2) all amendments to the written supervisory procedures are promptly posted to the firm's electronic media; (3) associated persons are notified that amendments relevant to their activities and responsibilities have been made to the written supervisory procedures; (4) the firm has reasonable procedures to monitor and maintain the security of the material posted to ensure that it cannot be altered by unauthorized persons; and (5) the firm retains current and prior versions of its written supervisory procedures in compliance with SEA Rule 17a-4(e)(7)'s applicable record retention requirements.
27. *See also Notice to Members 99-45* (June 1999) (distinguishing between a firm's compliance procedures and written supervisory procedures and specifying that "[i]t is crucial that all persons associated with a member be informed of any changes in the supervisory system and applicable written procedures. [NASD Rule 3010(b)(3)], therefore, requires members to inform all associated persons of such changes.>").
28. For purposes of FINRA Rule 3110(c)(1), the term "annually" means on a calendar-year basis.
29. *See* FINRA Rule 3110(c)(1)(A)–(C). In addition, FINRA Rule 3110.12 (Standards for Reasonable Review) retains the content of NASD IM-3010-1 (Standards for Reasonable Review) setting forth the standards for the reasonable review of offices.
30. FINRA Rule 3110.13 (General Presumption of Three-Year Limit for Periodic Inspection Schedules).
31. FINRA Rule 3110(c)(2).
32. *See Notice to Members 04-71* (October 2004).
33. FINRA Rule 3110(c)(2)(A).
34. FINRA Rule 3110(c)(2)(B). *See Regulatory Notice 09-64* (November 2009) (Verification of Instructions to Transmit or Withdraw Assets from Customer Accounts) (guidance on firms' policies and procedures to verify transmittal instructions).
35. FINRA Rule 3110(c)(2)(C).
36. This requirement is consistent with NASD Rule 3010(c)'s requirement that a firm have supervisory policies and procedures for validating changes in customer account information. *See* NASD Rule 3010(c)(2)(F).

37. FINRA Rule 3110(c)(2)(D).
38. FINRA Rule 3110(c)(3)(B).
39. FINRA Rule 3110(c)(3)(C).
40. *See* FINRA Rule 3110.14 (Exception to Persons Prohibited from Conducting Inspections).
41. FINRA Rule 3110(c)(3)(A).
42. 15 U.S.C. 78o(g).
43. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.
44. FINRA Rule 3110(d)(1)(A)-(D).
45. FINRA Rule 3110(d)(1)'s "reasonably designed" standard acknowledges that firms with different business models may adopt different procedures and practices.
46. FINRA Rule 3110(d)(4)(A).
47. FINRA Rule 3110(d)(2).
48. FINRA Rule 3110(d)(3).
49. FINRA Rule 3110(d)(4)(B).
50. FINRA Rule 3110(d)(3)(A).
51. FINRA Rule 3110(d)(3)(B).
52. FINRA previously provided the list to assist firm's supervisory obligations under NASD Rule 3010(b)(2).