Financial and Operational Effective Practices (Small Firm Focus)
Tuesday, May 22
11:15 a.m. – 12:15 p.m.

Join FINRA staff and industry practitioners for an interactive discussion on recent financial and operational rulemaking activities affecting small firms. Panelists discuss effective practices regarding onboarding of new products, compare and contrast approaches compliance professionals take to ensure coverage of financial and operational risks, and discuss managing vendor and outsourcing relationships, including part-time FINOPs.

Moderator: Erin Vocke
Vice President and District Director
FINRA Dallas and New Orleans District Offices

Panelists: Amber Crouch
Senior Compliance Officer and Regulatory Counsel
Crews & Associates, Inc.

Jeffrey Fortune
Examination Director
FINRA Member Regulation, Office of Risk Oversight and Operational Regulation

Linde Murphy
Chief Operating Officer and Chief Compliance Officer
M.E. Allison & Co., Inc.

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Financial and Operational Effective Practices (Small Firm Focus) Panelist Bios:

Moderator:

Erin C. Vocke is Vice President and District Director of the FINRA Dallas and New Orleans District Offices. Ms. Vocke began her career in 1995 as an examiner in the New Orleans District Office. During this time, she conducted numerous routine and cause examinations of member firms and focused examinations in the areas of variable products and mutual funds. In January 2004, Ms. Vocke became Supervisor of Examiners, where she performed supervisory functions, including reviewing examinations and providing guidance to examiners on case development. In August 2004, she relocated to the Florida District Office. At this time, she assumed responsibilities for supervising Continuing Membership Applications and financial surveillance of member firms, in addition to routine and cause examinations. In June 2007, Ms. Vocke transferred to the Dallas District Office as the Associate Director. In this position, she was responsible for overseeing the District Cycle, Cause, Financial Surveillance and Membership Application Programs. In February 2010, she assumed the role of District Director of the Dallas Office. In February 2014, she assumed the role of District Director in the New Orleans Office. Ms. Vocke completed the Accelerated Development Program in 2007 and the Certified Regulatory and Compliance Professional™ (CRCP™) designation in 2003. She received a bachelor's degree in accounting from the University of New Orleans.

Panelists:

Amber Crouch joined Crews & Associates, Inc., as the Senior Compliance Officer and Regulatory Counsel in May 2016. Founded in 1979, Crews is a full-service broker-dealer based in Little Rock, Arkansas, and specializing in fixed-income products. Ms. Crouch's immediate past position prior to Crews was as an enforcement attorney for five and a half years with the Arkansas Securities Department. While a state regulator, Ms. Crouch was a member of and the 2016 co-chair of the North American Securities Administrators Association (NASAA) Broker-Dealer Operations Project Group, which coordinated an annual training available to all states' securities regulatory staff members in the area of broker-dealer regulation. Ms. Crouch attended the University of Arkansas at Fayetteville where she received a Bachelor of Arts in Psychology, and obtained her law degree, with honors, from the University of Arkansas at Little Rock School of Law. Prior to law school, Ms. Crouch worked for former U.S. Senator Blanche L. Lincoln of Arkansas for five years on her personal Senate staff and campaign staff in both her Washington, D.C., and Little Rock offices. Ms. Crouch is a current member of the National Association of Bond Lawyers and serves on the FINRA Fixed Income Committee.

Jeffrey Fortune is Examination Director in FINRA Member Regulation, responsible for managing the Alternative Net Capital and IT examination programs. Prior to his current role, Mr. Fortune was a Surveillance Director within Member Regulation and served as Risk Lead for the Operational and Customer Protection risks. Prior to his tenure at FINRA, Mr. Fortune worked in the Regulatory Reporting areas at both Lehman Brothers and Merrill Lynch, performing the Net Capital and Reserve Formula computations. At Lehman Brothers, Mr. Fortune also served as Vice President of Operations Control, primary responsible for the firm's compliance with Possession & Control. Mr. Fortune holds a bachelor's degree in Accounting from St. Peter's College.

Linde Murphy currently serves as compliance advisor to M.E. Allison & Co., Inc., a full-service broker/dealer and Texas registered investment adviser. Founded in 1946, the firm also provides municipalities with advisory and underwriting services. In 2012, Ms. Murphy joined Presidio Financial Services as they began the CMA process to join M.E. Allison & Co., Inc. Ms. Murphy started her career in investments on a trading desk in Chicago in 1999 and has held positions in compliance, sales, business development and management. In addition to the pertinent industry licenses, Ms. Murphy obtained the CRCP™ designation in 2014 after attending the FINRA Institute at Wharton on the FINRA Small Firm scholarship. She currently serves on the FINRA Small Firm Advisory Committee and the District 6 Committee. Ms. Murphy served on the FINRA Fixed Income Committee as well as the FINRA Regulatory Advisory Committee.

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2018 FINRA Annual Conference

May 21 – 23, 2018 • Washington, DC

Financial and Operational Effective Practices (Small Firm Focus)

Panelists

- **Moderator**
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- **Panelists**
  - Amber Crouch, Senior Compliance Officer and Regulatory Counsel, Crews & Associates, Inc.
  - Jeffrey Fortune, Examination Director, FINRA Member Regulation, Office of Risk Oversight and Operational Regulation
  - Linde Murphy, Chief Operating Officer and Chief Compliance Officer, M.E. Allison & Co., Inc.

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Agenda

- Recent Financial and Operational Rulemaking Activity
- Current Financial and Operational Issues at Firms
- Product Onboarding
- Outsourcing
- Business Continuity Planning

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Financial and Operational Rulemaking Activity

- Effective practices for identifying rules that impact the firm
- Ensuring stakeholders are informed
- SEC No Action Letters
  - Revenue from Contracts with Customers under Rule 15c3-1
  - Treatment of Operating Leases under Rule 15c3-1

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Current Financial and Operational Issues

- Common Examination Findings
- Governance Framework
- Controls related to Manual versus Automated Systems
- Expense Sharing Agreements
- E & O Insurance
- Series 99

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Product Onboarding

- Effective Practices
- Committee versus Individual Departments
- Identified Stakeholders

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Outsourcing

- What to Outsource?
- Supervision and Due Diligence Process
- Reliance on Vendors
- Offsite FINOP

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Business Continuity Planning

- Observed Effective Practices and Lessons Learned
- Annual Testing

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Wrap-Up

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Resources

Securities and Exchange Commission (SEC) Resources

- No Action Letter Relating to Capitalized Expenses

  www.sec.gov/divisions/marketreg/mr-noaction/2018/sifma-treatment-of-revenue-15c3-1.pdf

- Operating Lease Letter

  www.sec.gov/divisions/marketreg/mr-noaction/2016/sifma-111016-15c3.pdf

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Regulatory Notice 13-25

Business Continuity Planning

FINRA, the SEC and CFTC Issue Joint Advisory on Business Continuity Planning

August 2013

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Operations
- Senior Management

Key Topics
- Business Continuity Planning

Referenced Rules & Notices
- FINRA Rule 4370

Executive Summary

Following Hurricane Sandy, which caused widespread damage on the northeast coast of the United States in October 2012, FINRA, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations and the Commodity Futures Trading Commission's (CFTC) Division of Swap Dealers and Intermediary Oversight jointly reviewed firms' business continuity and disaster recovery planning. FINRA, the SEC and CFTC are issuing the attached Business Continuity Planning advisory to encourage firms to review their business continuity plans and to provide best practices to help improve responses to, and to reduce recovery time after, significant large-scale events.

Questions concerning this *Notice* may be directed to your firm's Regulatory Coordinator.

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Business Continuity Planning

Hurricane Sandy caused significant and wide-ranging damage across the northeast coast of the United States on October 28 and October 29, 2012, which led to the closure of the equities and options markets on October 29 and October 30, 2012. These events prompted the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("SEC"), the Financial Industry Regulatory Authority ("FINRA"), and the Commodity Futures Trading Commission's Division of Swap Dealers and Intermediary Oversight ("CFTC") to jointly review the business continuity and disaster recovery planning of firms.

The SEC, FINRA and CFTC contacted firms with a significant market presence to gain an understanding of how the firms were impacted by the events surrounding Hurricane Sandy; specific emphasis was given to firms' implementation of their business continuity plans ("BCPs") and disaster recovery procedures. The SEC, FINRA and CFTC communicated with several firms regarding the impact of Hurricane Sandy on trading, customer relations, financial and regulatory obligations, and technology, among other topics. As a result, the SEC, FINRA and CFTC compiled the following best practices and lessons learned.

The regulators encourage firms to review their business continuity plans and consider implementing these best practices and lessons learned as appropriate to help improve responses to, and to reduce recovery time after, significant large scale events.

Widespread Disruption Considerations

- Firms should consider the possibility of widespread lack of telecommunications, transportation, electricity, office space, fuel and water in their BCPs. Consideration should be given to multiple, redundant services and the proximity of vendors to the potential disaster area.
- Remote access is an important component of business continuity planning. Firms should consider their employees' ability to work from home during a crisis and determine what steps can be taken to ensure adequate staffing during a crisis event. Firms should also consider enhancing the capabilities of staff that work from home by identifying technology and communications products and services that could increase efficiency. Since the use of remote access relies heavily on fully functional telephone and internet service, firms should consider alternatives to telework in their BCPs, particularly for key control functions such as compliance, risk management, back office operations and financial and regulatory reporting.

Alternative Locations Considerations

- When considering alternative locations (i.e., back-up data centers, back-up sites for operations, remote locations, etc.) firms should consider the implications of a region wide

disruption. Firms are encouraged to consider geographic diversity when determining the physical location of alternative sites. An alternative site, particularly a system back-up location, in close proximity to the primary site may not sufficiently protect the firm from the effects of a region wide event. Firms should consider whether their primary site and alternative sites rely on the same critical utility services, such as electricity, transportation and telecommunications.

- Firms should consider the accessibility of alternative sites and the ability of staff to travel to the site in the event of a transit shutdown or closure of major roadways. Consideration should be given to staff ability to travel to remote locations, the methods of transportation to move staff to the site and living and lodging expenses related to relocating staff. Firms should further consider establishing pre-arranged contracts with shuttle service providers to facilitate the staff's transport to the work location. Also, familiarizing staff of the transportation alternatives prior to a contingency event may facilitate the process and help ensure that the transportation alternatives are efficiently used.

- Firms should consider the appropriate number of staff necessary at any alternative site to perform critical activities, including risk functions, control functions, finance and treasury activities, and ensure that adequate space is available. Firms should also consider including designations of key operations and supervisory staff to oversee activities.

- Firms should consider the generator capacity at the alternative site (i.e., Does it restore partial or full power?) and whether appropriate capacity is allocated to critical users, activities and systems in advance. Firms are also encouraged to explore the expansion of surplus generator capacity and fuel prior to a contingency event to support expanded business functionality.

- Firms should consider whether their alternate location site has adequate resources. Firms are encouraged to consider whether the site has sufficient staff workspace (e.g., desks, chairs, telephones, etc.), equipment (e.g., computers, printers, network connectivity, etc.) and supplies (e.g., paper, toner, etc.) to accommodate the staff and to carry on operations. In addition, firms should consider keeping their BCPs, contact lists and other necessary documents, procedures and manuals at the alternative site, ideally in paper form in the event that electronic files cannot be accessed.

- Firms should consider making pre-arrangements for reserving space at remote locations such as hotels or other office space and contemplate moving staff to the alternative location in advance of a significant BCP event.

Vendor Relationships

- Firms should consider critical vendor relationships. Firms should consider examining whether vendors that provide critical services such as clearance and settlement, banking and finance, trading support, fuel, telecommunications, electricity and other utilities also have adequate BCPs. Firms should also consider taking into account that many of these providers could be impacted by the same communication, transportation and electricity challenges facing the firm.

- Firms should also consider categorizing vendors (low-risk, high-risk, etc.) and evaluate the risk in BCP plans. Firms should contemplate having pre-arranged contracts in place with multiple fuel suppliers and schedule deliveries in advance of an event.

Telecommunications Services and Technology Considerations

- Reliance on a single telecommunications service provider may lead to significant communications disruptions when that service provider is unable to operate. Firms should consider contracting with multiple telecommunications carriers to provide a failover to a different carrier to maintain fax, voice mail, and landline and VoIP services. Firms should also consider evaluating how a telecommunication provider's contingency plans will affect the firm's ability to operate. Firms should consider using multiple telecommunication providers, secondary phone lines, cloud technology, temporary phone lines, mobile telecom units and Wi-Fi for staff without power, as well as back-up mobile phone services with different carriers. Firms are encouraged to provide customers, trading counterparties and regulators with updated contact information should alternate telephone lines be used.

- Firms should consider multiple alternative staffing scenarios including remote access, staff relocation or staffing at alternative sites. Firms should consider enhancing their telecommunications infrastructure to ensure that staff remains fully functional while working from home during brief and extended periods of time.

Communication Plans

Communications with Customers and Other External Third Parties

- Firms should consider a plan for providing customers and trading counterparties with contact information so that business can continue. Firms should consider taking measures to ensure that their website is kept up-to-date with information about the firm's operational status and general contact information during a disruption event. Introducing firms should consider publishing contact information for clearing firms on their websites to enable customers to execute liquidating orders or wire transfers through their clearing firms should the firm be inoperable. Clearing firms are encouraged to be in a position to authenticate the validity of customer requests.

- Firms should consider whether to establish relationships with multiple broker-dealers to facilitate alternative market entry points.

- Firms should consider implementing a communication plan that allows firms to better communicate and coordinate with regulators, exchanges, emergency officials and other firms. Such coordination should reduce the likelihood of inconsistent communications. Firms are encouraged to participate in industry groups and task forces that may assist firms in strengthening their communication plans.

Communications with Staff

- Firms should consider establishing a centralized process for accounting for all staff members rather than relying on each business unit to contact staff individually. Firms should also update emergency contact lists frequently (e.g., as staff members are added or removed) so staff can be contacted with firm updates.

- Firms should consider adopting more diverse methods of communication with employees including allowing staff, particularly critical staff, to carry multiple communications devices on multiple carriers (e.g., multiple mobile phones, softphones and T-1 lines).

Regulatory and Compliance Considerations

- Firms should consider time-sensitive regulatory requirements, since a crisis event can occur at any time. For example, some firms put a lower prioritization on month-end financial processes, which increased challenges due to the storm's proximity to month end, and caused delays in firms' production of certain month end data for regulatory computations and financial reporting.

- Firms should regularly update their BCPs to include new regulatory and SRO requirements. Firms run the risk of failing to comply with new regulatory and SRO requirements when their BCP is not regularly updated. For example, the Chicago Mercantile Exchange and National Futures Association enacted new requirements for the daily reporting of financial data in 2012. It appeared that this new requirement may not have been included in some firms' BCP processes and therefore may not have been properly prioritized.

Review and Testing

- Firms should consider conducting full BCP tests and participating in industry testing, at least annually, but more frequently if changes are made. Firms should consider full staff BCP tests to evaluate whether all day-to-day functions, including trade processing, can be performed regardless of staff location. In addition, firms are encouraged to keep their BCPs up to date and to amend their BCPs to incorporate testing results.

- Regarding business continuity training, firms should consider conducting annual or more frequent training on their BCPs to familiarize all personnel with the plan and their critical pre-established roles.

- In addition, firms should consider incorporating stress tests into their BCPs. For example, firms could perform a stress test on their liquidity position and review the level of excess customer reserves. Based on this analysis, firms may be better prepared to adjust liquidity or excess reserves (e.g., term repos versus overnight, ability to liquidate money market funds, ability to meet margin calls in a potentially volatile market, adding excess segregation reserves) prior to an event.

Notice to Members

MAY 2006

SUGGESTED ROUTING

Legal & Compliance

Regulatory

Senior Management

KEY TOPICS

Financial and Operations Principal (FINOPs)

NASD Rule 1022

SEC Rule 15c3-1 (Net Capital Rule)

GUIDANCE

Financial and Operations Principals (FINOPs)

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

Executive Summary

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

Questions/Further Information

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

06-23

Background

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

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

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

Discussion

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

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

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

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

On-Site Visits

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

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

On-Site Visit Documentation

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

Access to Books and Records

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

Establish Procedures Regarding FINOP's Duties

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

Ongoing Capabilities Assessments

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

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

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

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

Endnotes

1 A person holding this registration category must have taken and passed the Series 27 Financial and Operations Principal Qualification Examination.

2 A person holding this registration category must have taken and passed the Series 28 Introducing Broker/Dealer Financial and Operations Principal Qualification Examination.

3 *See* Rule 1022(b)(2)(A) through (G) and (c)(2)(A) through (G).

4 NASD Regulatory & Compliance Alert, Volume 13, Number 4, Winter 1999 (pages 15-16).

5 *Id.*

6 Approximately 11 percent of NASD designated firms use the services of a part-time FINOP.

7 SEC Rule 15c3-1.

8 *See* NASD *Notice to Members 03-63* (SEC Issues Guidance in the Recording of Expenses and Liabilities by Broker/Dealers) and the attached letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, SEC, to Elaine Michitsch, NYSE, and Susan DeMando, NASD (July 11, 2003).

9 For example, a firm with a net capital requirement of $50,000 may receive customer securities, but must promptly forward those securities or be subject to a net capital requirement of $250,000. *See* SEC Rule 15c3-1(a)(2)(i) and (iv). An introducing firm otherwise subject to a net capital requirement of only $5,000 that routinely accepts checks in its own name would be subject to a $250,000 net capital requirement. *See* SEC Rule 15c3-1(a)(2)(i) and (vi).

10 *See Fox & Co., Inv.,* Exchange Act Release No. 52697, 2005 SEC LEXIS 2822 (Oct. 28, 2005) (SEC sustained NASD disciplinary action against a firm and the person who was the firm's primary owner, president and FINOP and upheld the bar against the person from associating with any member firm as a FINOP) at *www.sec.gov/litigation/opinions/34-52697.pdf.* FINOPs and firms that violate the Net Capital Rule also may face SEC disciplinary action. *See Harrison Sec. Inc.,* Exchange Act Release No. 50614, 2004 SEC LEXIS 2477 (Oct. 29, 2004) (SEC administrative proceeding against a firm, the firm's CEO and the firm's FINOP for violations of the Exchange Act's net capital, books and records and reporting provisions) at *www.sec.gov/litigation/aljdec/id256jtk.htm*.

11 NASD Sanctions Guidelines (online edition available at *www.nasd.com/sanctionguidelines).*

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Notice to Members

JULY 2005

SUGGESTED ROUTING

Legal and Compliance

Operations

Senior Management

KEY TOPICS

Due Diligence

Outsourcing

Supervisory Responsibilities

Third-Party Service Providers

GUIDANCE

Outsourcing

Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers

Executive Summary

NASD is aware that members are increasingly contracting with third-party service providers to perform certain activities and functions related to their business operations and regulatory responsibilities that members would otherwise perform themselves—a practice commonly referred to as outsourcing. NASD is issuing this *Notice* to remind members that, in general, any parties conducting activities or functions that require registration under NASD rules will be considered associated persons of the member, absent the service provider separately being registered as a broker-dealer and such arrangements being contemplated by NASD rules (such as in the case of clearing arrangements), MSRB rules, or applicable federal securities laws or regulations. In addition, outsourcing an activity or function to a third party does not relieve members of their ultimate responsibility for compliance with all applicable federal securities laws and regulations and NASD and MSRB rules regarding the outsourced activity or function. As such, members may need to adjust their supervisory structure to ensure that an appropriately qualified person monitors the arrangement. This includes conducting a due diligence analysis of the third-party service provider.

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Patricia Albrecht, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8026.

05-48

Background

The practice of contracting with third-party service providers/vendors to perform certain activities and functions on a continuing basis (outsourcing) is not new to the securities industry. For example, NASD Rule 3230 (Clearing Agreements) has long permitted members that are introducing broker-dealers to enter into contracts with registered clearing broker-dealers that allocate certain functions and responsibilities, such as providing execution services, custody, and margin; maintaining books and records; and receiving, delivering, and safeguarding funds. Over the years, however, members' outsourcing activities have grown beyond the use of clearing agreements. Now, members regularly enter into outsourcing arrangements with entities other than broker-dealers. These entities may be unregulated, such as providers of data services, or regulated, such as transfer agents. Additionally, members increasingly are outsourcing activities other than those traditionally performed pursuant to clearing agreements.

To better understand their members' outsourcing activities, NASD and the New York Stock Exchange (NYSE) conducted a joint survey in October 2004 of a select number of broker-dealers. The survey sought to determine whether broker-dealers had procedures in place to determine the proficiency of service providers, whether outsourced business functions were properly monitored, and whether broker-dealers were in compliance with applicable regulations pertaining to the privacy of customer information in connection with such outsourcing arrangements. The survey found that, in many instances, there was a lack of written procedures to monitor the outsourcing of services, a lack of business continuity plans on the part of service providers and members with respect to outsourced services, and a lack of formalized due diligence processes to screen service providers for proficiency. However, while not always in the form of written procedures, most participants reported that they did have methods that they used to monitor and assess a third-party vendor's own procedures and performance and the accuracy and quality of the work product produced on a continuing basis. These methods included (1) using programmatic checks through business operations; (2) including the procedures in the contracts with the vendors; (3) requiring status reports and periodic meetings; and (4) testing and reviewing the third parties' procedures.

The survey results also provided a snapshot of the type and range of activities being outsourced and the nature of the third-party service providers being used. Survey participants frequently outsourced functions associated with accounting/finance (payroll, expense account reporting, etc.), legal and compliance, information technology (IT), operations functions (*e.g.*, statement production, disaster recovery services, etc.), and administration functions (*e.g.*, human resources, internal audits, etc.). Approximately two-thirds of the third-party vendors used by survey participants were regulated entities, subject to the jurisdiction of the Securities and Exchange Commission, NASD, NYSE, the Board of Governors of the Federal Reserve System, and/or the Office of the Comptroller of the Currency. The remaining third-party vendors were unregulated entities—both foreign and domestic. Survey participants indicated that they used foreign third-party vendors most often when outsourcing IT and communications activities.[1]

Discussion

Given the growing trend among members to outsource an increasing number of activities and functions to outside entities—both regulated and unregulated—and the lack of uniformity in members' procedures regarding members' use of outsourcing, NASD is issuing this *Notice* to provide guidance on requirements that pertain to the outsourcing of activities and functions that, if performed directly by members, would be required to be the subject of a supervisory system and written supervisory procedures pursuant to Rule 3010 (covered activities).[2] In addition, members are reminded that, in the absence of specific NASD rules, MSRB rules, or federal securities laws or regulations that contemplate an arrangement between members and other registered broker-dealers with respect to such activities or functions (*e.g.*, clearing agreements executed pursuant to NASD Rule 3230), any third-party service providers conducting activities or functions that require registration and qualification under NASD rules will generally be considered associated persons of the member and be required to have all necessary registrations and qualifications.

I. Accountability and Supervisory Responsibility for Outsourced Functions

Rule 3010 requires NASD members to design a supervisory system and corresponding written supervisory procedures that are appropriately tailored to each member's business structure.[3] If a member, as part of its business structure, outsources covered activities, the member's supervisory system and written supervisory procedures must include procedures regarding its outsourcing practices to ensure compliance with applicable securities laws and regulations and NASD rules. The procedures should include, without limitation, a due diligence analysis of all of its current or prospective third-party service providers to determine whether they are capable of performing the outsourced activities.[4]

After the member has selected a third-party service provider, the member has a continuing responsibility to oversee, supervise, and monitor the service provider's performance of covered activities. This requires the member to have in place specific policies and procedures that will monitor the service providers' compliance with the terms of any agreements and assess the service provider's continued fitness and ability to perform the covered activities being outsourced. Additionally, the member should ensure that NASD and all other applicable regulators have the same complete access to the service provider's work product for the member, as would be the case if the covered activities had been performed directly by the member.

Members should also include specific policies and procedures to determine whether any covered activities that the member is contemplating outsourcing are appropriate for outsourcing. To determine the appropriateness of outsourcing a particular activity, firms may want to consider certain factors, such as the financial, reputational, and operational impact on the member firm if the third-party service provider fails to perform; the potential impact of outsourcing on the member's provision of adequate services to its customers; and the impact of outsourcing the activity on the ability and capacity of the member to conform with regulatory requirements and changes in requirements.[5] These factors, however, are not meant to illustrate all of the factors a member may want to consider and are not meant to be an exclusive or exhaustive list of factors a member may need to consider.

In addition, members are reminded that outsourcing covered activities in no way diminishes a member's responsibility for either its performance or its full compliance with all applicable federal securities laws and regulations, and NASD and MSRB rules.

II. Activities and Functions that are Prohibited from being Outsourced

A. Activities and Functions Requiring Registration and Qualification

It is NASD's view that the performance of covered activities, which require qualification and registration, cannot be deemed to have been outsourced because the person performing the activity is an associated person of the member irrespective of whether such person is registered with the member. An exception would be where a third-party service provider is separately registered as a broker-dealer and the contracted arrangement between the member and the service provider is contemplated by NASD rules, MSRB rules, or applicable federal securities laws or regulations.[6] An example of such an exception would be a clearing agreement executed pursuant to NASD Rule 3230 between a member and a clearing broker-dealer.[7]

B. Supervisory and Compliance Activities

NASD has noted in previous guidance that the ultimate responsibility for supervision lies with the member.[8] Accordingly, a member may never contract its supervisory and compliance activities away from its direct control. This prohibition, however, does not preclude a member from outsourcing certain activities that support the performance of its supervisory and compliance responsibilities. For example, a member may implement a supervisory system designed by another party, which could include a computer software program that detects excessive trading in customer accounts. However, if a member chooses to implement such a system, it must make its own determination that the system implemented is current and reasonably designed to achieve compliance as required under Rule 3010. This may include, for example, monitoring the system to ensure that it functions as designed and that such design is of an adequate nature and breadth.[9]

Endnotes

1 A February 2005 joint report by the Joint Forum of the Basel Committee on Banking Supervision found similar trends in the use of outsourcing by financial firms. *See Outsourcing in Financial Services*, The Joint Forum of the Basel Committee on Banking Supervision (February 2005). The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (Basel Committee), the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) to address issues common to the banking, securities, and insurance sectors, including the regulation of financial conglomerates. The Joint Forum is composed of an equal number of senior bank, insurance, and securities supervisors representing each supervisory constituency.

2 Examples of covered activities include, without limitation, order taking, handling of customer funds and securities, and supervisory responsibilities under Rules 3010 and 3012.

3 *See* Rule 3010(a) and (b); *Notice to Members (NTM) 99-45* (June 1999).

4 Rule 3012 also requires a member firm to have a written supervisory control system that will, among other things, test and verify that the member's supervisory policies and procedures are reasonably designed to achieve compliance with the applicable securities laws and regulations and NASD rules. Members are reminded that this requirement includes the testing and verification of their supervisory procedures regarding their outsourcing practices, including testing and verifying that any due diligence procedures meet the "reasonably designed to achieve compliance" standard. *See NTM 99-45* (June 1999) (providing guidance on the meaning of the term "reasonably designed to achieve compliance"). Such testing and verifying will help firms to ensure that their due diligence analyses of third-party service providers remain current and relevant.

5 Members may also want to consult a February 2005 IOSCO report for more factors that they should consider in connection with outsourcing. *See Principles of Outsourcing of Financial Services for Market Intermediaries*, IOSCO Technical Committee (February 2005). Another resource members may want to consider is the previously mentioned report by the Joint Forum of the Basel Committee on Banking Supervision. *Outsourcing in Financial Services, supra* note 1.

6 NASD does not view a third-party vendor as an associated person of the member if it solely provides services such as a trade execution and reporting system or automated data services in connection with back-office functions that, in turn, are utilized by registered or other associated persons of the member.

7 *See* Rule 3230(a)(1). Some members also enter into secondary or sub-clearing (sometimes referred to as "piggyback clearing") arrangements for clearing services with an intermediary firm that has an existing contract with a clearing firm instead of contracting directly with the clearing firm. Because intermediary firms do not always identify to clearing firms which accounts belong to the piggybacking firms, NASD has filed with the SEC a proposed rule change to Rule 3230 and Rule 3150 (Reporting Requirements for Clearing Firms) that would require intermediary firms to identify the accounts belonging to the piggybacking firms and that would require clearing firms to distinguish the data belonging to intermediary firms from the data belonging to the piggybacking firms.

8 *See NTM 99-45* (June 1999).

9 *See id.*

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Notice to Members

OCTOBER 2003

SUGGESTED ROUTING

Accounting
Executive Representatives
Internal Audit
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Expense-Sharing Agreements
Net Capital
Recordkeeping
SEC Rule 15c3-1
SEC Rules 17a-3, 17a-4, and 17a-5

ACTION REQUIRED

Expense-Sharing Agreements

SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers

Executive Summary

On July 11, 2003, the Securities and Exchange Commission (SEC) Division of Market Regulation (DMR) issued a letter (the "Letter") to clarify its position under SEC Rules 15c3-1, 17a-3, 17a-4, and 17a-5 (collectively, the "financial responsibility rules") regarding the treatment of broker/dealer expenses and liabilities. The Letter addresses situations in which another party has agreed to pay expenses related to the business of the broker/dealer. The Letter's requirements became effective when it was issued; however, the DMR and NASD recognize that some firms may need time to revise existing agreements and to obtain required documentation. NASD members must be able to demonstrate compliance with the requirements stated in the Letter (a copy of which is attached) by no later than December 1, 2003.

Questions/Further Information

Questions concerning this *Notice to Members* may be directed to NASD's Financial Operations Department at (202) 728-8221.

03-63

Background

Both NASD and the New York Stock Exchange (NYSE) (collectively, the self-regulatory organizations or the SROs) have become increasingly concerned that some broker/dealers are using expense-sharing agreements as a basis for not recording expenses and liabilities on the broker/dealer's books and records.[1] In such circumstances, the books and records of the broker/dealer may not accurately reflect its operating performance and financial condition and may appear to artificially inflate its profitability and, ultimately, cause it to appear to be in capital compliance when it is not. Further, such firms may continue to conduct a securities business when not in capital compliance, which is a violation of the SEC's Net Capital Rule, as well as a violation of NASD Rule 2110. In addition, as the party paying the expenses of the broker/dealer is usually not a member of an SRO, obtaining books and records related to the broker/dealer's operations can be problematic. As a result, the SROs requested guidance from the DMR concerning the application of the financial responsibility rules when a third party, which may include a parent, holding company, or affiliate of a broker/dealer, agrees to assume responsibility for payment of the broker/dealer's expenses.

Recording Certain Broker/Dealer Expenses and Liabilities

The Letter addresses nine items/requirements based on how a broker/dealer incorporates an expense-sharing agreement into its operations. For clarification, the nine requirements are repeated below with additional information provided by NASD to explain the requirements of the letter.[2]

1. Pursuant to Exchange Act Rule 17a-3(a)(1) and (a)(2), a broker-dealer must make a record reflecting each expense incurred relating to its business and any corresponding liability, regardless of whether the liability is joint or several with any person and regardless of whether a third party has agreed to assume the expense or liability. A broker-dealer must make a record of each expense incurred relating to its business, including the value of any goods or services used in its business, when a third party has furnished the goods or services or has paid or has agreed to pay the expense or liability, whether or not the recording of the expense is required by GAAP and whether or not any liability relating to the expense is considered a liability of the broker-dealer for net capital purposes. One proper method is to record the expense in an amount that is determined according to an allocation made by the third party on a reasonable basis.

> *For purposes of this Letter, expenses include all costs for which a broker/dealer would derive direct or indirect benefit and/or for which a broker/dealer would be responsible if another entity had not agreed to pay for it. This would certainly include, but not be limited to, rent, telephone, copy services, etc. A broker/dealer's business is to be understood broadly. It includes the existence of the legal entity that is registered as a broker/dealer (even when not conducting a securities business) and all of that entity's activities (whether or not the activities are securities-related).*

The last sentence of this item indicates that a broker/dealer meets the requirements of the Letter if it records its expenses as incurred in amounts determined according to a reasonable allocation, applied on a consistent basis, of the costs assumed by the third party. A reasonable allocation is one that attempts to equate the proportional cost of a service or product to the proportional use of or benefit derived from the service or product. The broker/dealer must be prepared to provide the SROs with evidence of the reasonableness of the expenses.

Members are advised that to the extent a third party pays certain expenses of a broker/dealer, particularly those costs related to compensation of its registered personnel, the third party may be required to register with the Securities and Exchange Commission as a broker/dealer in accordance with Section 15 of the Exchange Act.

Further, members are cautioned that an arbitration award rendered against the broker/dealer is a liability of the broker/dealer until it is satisfied in an appropriate manner. See Notice to Members 00-63. *NASD will consider any attempt to move the obligations associated with an unsatisfied arbitration award to a third party as a violation of NASD Rule 2110, and the firm may be subject to severe disciplinary action.*

Examples:

Fact Patterns 1 and 2:

1. *An expense agreement provides that the broker/dealer will pay a certain monthly fee to an affiliated company "in consideration of the mutual covenants and agreements to be kept and performed on the part of the parties."*
2. *An expense agreement states that the broker/dealer will pay its parent $25,000 per month for "management services and other administrative services" that the parent provides. The written agreement does not further define the services. The broker/dealer does not record any expenses such as rent, utilities, telephone, etc., and management says that all such expenses are included in the $25,000 per month fee.*

Analysis: In the computations of net capital, each broker/dealer in Fact Patterns 1 and 2 must reduce net worth by its actual expenses as if there were no expense agreement. An expense agreement must enumerate the services or products being provided to the broker/dealer, with a reasonable cost assigned to each.

Fact Pattern 3:

An expense agreement specifies that the broker/dealer will pay its holding company $1,000 per month for rent and $500 per month for utilities and telephone services. The broker/dealer occupies two floors of a three-story building, while the holding company and another affiliate occupy the third floor; the holding company pays $25,000 per month to rent the building, and pays $15,000 per month for telephones and utilities. Management states that the rent and utilities fees specified in the expense agreement are consistent with the business goals and objectives of both firms, and therefore have been allocated on a reasonable basis.

Analysis: The expenses do not appear to be allocated on a reasonable basis. In its computation of net capital, the broker/dealer must reduce net worth by expenses allocated on a reasonable basis.

2. If the broker-dealer does not record certain expenses on the reports it is required to file with the Commission or with its designated examining authority ("DEA") under the financial responsibility rules, the broker-dealer may satisfy the Exchange Act Rule 17a-3(a)(1) and (a)(2) requirement to make a record of those expenses by making a separate schedule of the expenses.

To the extent a broker/dealer reflects its expenses and liabilities as part of its general ledger, and maintains proper backup documentation relative to the expense, no other documentation would be necessary relative to items 1 and 2 above. Otherwise, the broker/dealer must maintain the "record" as noted. This record must be updated as expenses are incurred similar to those records that support the broker/dealer's financial statements.

3. If a third party agrees or has agreed to assume responsibility for an expense relating to the business of the broker-dealer, and the expense is not recorded on the reports the broker-dealer is required to file with the Commission or with its DEA under the financial responsibility rules, any corresponding liability will be considered a liability of the broker-dealer for net capital purposes unless:

a. If the expense results in payment owed to a vendor or other party, the vendor or other party has agreed in writing that the broker-dealer is not directly or indirectly liable to the vendor or other party for the expense;

b. The third party has agreed in writing that the broker-dealer is not directly or indirectly liable to the third party for the expense;

c. There is no other indication that the broker-dealer is directly or indirectly liable to any person for the expense;

d. The liability is not a liability of the broker-dealer under GAAP; and

e. The broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense.

The Net Capital Rule requires broker/dealers to have sufficient liquid capital to protect the assets of customers and to meet their obligations to other broker/dealers. In calculating net capital, broker/dealers begin with their net worth and then make various positive and negative adjustments. Item 3 refers to the requirement to charge a firm's net worth, in the computation of net capital, for any "liability" noted unless the broker/dealer can comply with all five conditions enumerated in 3(a) through 3(e).

Item 3 indicates that a broker/dealer cannot avoid recording the expenses it incurs as a result of its activities by arranging to have a third party assume responsibility for such expenses, if the third party lacks adequate resources independent of the broker/dealer to pay the costs incurred by the broker/dealer. Further, if the broker/dealer remits funds to such third party, the broker/dealer is viewed as being indirectly liable for the expenses assumed by the third party, and would need to reflect those expenses on the reports it is required to file with the SEC under the financial responsibility rules, as a deduction from net worth in determining net capital.

Upon entering into an expense-sharing agreement and annually thereafter, as of the broker/dealer's fiscal year-end, the broker/dealer has to obtain evidence that the third party has adequate resources independent of the broker/dealer to pay the costs incurred by the broker/dealer.

- *i. If the third party is a reporting company under the Securities Act of 1933 and is current on all financial filings required under that Act, the firm may rely on those filings to determine whether the third party has adequate resources apart from the broker/dealer.*
- *ii. If the third party is not a reporting company under the Securities Act of 1933, the broker/dealer must obtain evidence pursuant to either a. or b. below, at a minimum, as well as further information as requested by NASD:*
  - *a. A signed and dated copy of a complete set of the third party's most recent audited financial statements, but in no event with an as-of date older than 12 months; or a signed and dated copy of the third party's most current required Federal income tax return as it has been filed with the Internal Revenue Service within the last 12 months.*
  - *b. If the shareholders, partners, or other owners of the third party want their abilities to infuse capital into the third party to be accepted as demonstrating adequate resources independent of the broker/dealer, they must, at a minimum, provide copies of their audited financial statements or Federal income tax returns, using the same twelve-month parameters as in a. Other additional evidence may also be required by NASD.*

With respect to the third party's financial statements, if, for example, the broker/dealer and the third party have a December 31st fiscal year-end, the broker/dealer could submit a copy of the third party's financial statements as of December 31st for the year prior. If the third party's fiscal year-end were June 30th, the broker/dealer would need to provide the third party's financial statements as of June 30th for the current year.

Example:

Fact Pattern 4:

A broker/dealer has an expense agreement under which its parent pays the broker/dealer's rent of $10,000 per month, and GAAP (Generally Accepted Accounting Principles) does not require the broker/dealer to record a liability to either the vendor or the parent. The broker/dealer is unable to demonstrate to the SRO that the parent has adequate resources independent of the broker/dealer to pay the liability or expense.

Analysis: In its computation of net capital, the firm must reduce net worth by the actual $10,000 rent expense. The firm must maintain a separate record of the rent expense.

4. Any withdrawal of equity capital, as defined in paragraph (e)(4)(ii) of Exchange Act Rule 15c3-1, from a broker-dealer by a third party, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, within three months before or within one year after the broker-dealer incurs an expense which the third party has paid or agreed to pay, will be presumed for net capital purposes to have been made to repay the third party for the expense of the broker-dealer, unless the broker-dealer's books and records reflect a liability to the third party relating to the expense.

Paragraph (e)(4)(iii) indicates that the notice and limitation provisions on capital withdrawals do not preclude broker/dealers from making required tax payments or paying partners reasonable compensation and that such amounts are not included in the calculation of withdrawals, advances, or loans for the purposes of these provisions.

Item 4 reaffirms the DMR's view that broker/dealers must maintain their financial records using an accrual basis of accounting. Capital withdrawals cannot be used as a means of timing the broker/dealer's recognition of the costs incurred in its operations.

5. For purposes of determining net capital, if the broker-dealer records a capital contribution from a third party that has assumed responsibility for paying an expense of the broker-dealer, and the expense is not recorded on the reports the broker-dealer is required to file with the Commission or with its DEA under the financial responsibility rules, the broker-dealer must be able to demonstrate that the recording of a contribution to capital is appropriate. Among other things, the broker-dealer must be able to demonstrate that the third party has paid the expense or has adequate resources independent of the broker-dealer to pay the expense and that the broker-dealer has no obligation, direct or indirect, to a vendor or other party to pay the expense. For net capital purposes, any equity capital withdrawn by the third party, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, within three months before or one year after the broker-dealer incurs the expense, will be deemed to have been a repayment of the expense to the third party. For net capital purposes, if a contribution to capital is made to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the contributor, the contribution may not be included in the firm's net capital computation

and must be re-characterized as a liability. Any withdrawal of capital as to that contributor within a period of one year, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, shall be presumed to have been contemplated at the time of the contribution.

Item 5 is similar to item 4, and reaffirms the DMR's view that broker/dealers must maintain their financial records using an accrual basis of accounting. The difference in the two items relates to the type of accounting treatment that the broker/dealer uses. Item 5 applies, for example, where the broker/dealer's actual expense to a vendor or service provider was recorded on the broker/dealer's general ledger as an expense and a related liability owed to the third party; the third party then forgave the liability, and the broker/dealer removed (debited) the (forgiven) liability and credited a capital contribution from the third party.

The broker/dealer may not record the capital contribution until it demonstrates that the third party paid the expense, or has the financial wherewithal to pay the expense independent of the broker/dealer, and that the broker/dealer will not be obligated to repay the third party for any portion of the expense. To demonstrate the third party's ability to pay, the broker/dealer would need to provide the evidence discussed in the comments under item 3.

Under items 4 and 5, a firm from which capital is withdrawn as described in those items will be required to recalculate its net capital beginning at the date of the incurrence of the expense which was paid by the third party, and to provide telegraphic notice as required per SEC Rule 17a-11, if necessary, based upon the revised computation.

6. If a third party agrees or has agreed to assume responsibility for an expense of the broker-dealer, the broker-dealer must make, keep current, and preserve the following records pursuant to Exchange Act Rules 17a-3 and 17a-4:

a. If a vendor or other party has agreed that the broker-dealer is not liable directly or indirectly to the vendor or other party for an expense, a written agreement between the broker-dealer and the vendor or other party that clearly states that the broker-dealer has no liability, direct or indirect, to the vendor or other party; and

b. A record of each expense assumed by the third party.

7. A broker-dealer must make, keep current, and preserve a written expense sharing agreement between the broker-dealer and a third party that has paid or agreed to pay an expense of the broker-dealer. The agreement must set out clearly which party is obligated to pay each expense, whether the broker-dealer has any obligation, direct or indirect, to reimburse or otherwise compensate any party for paying the expense, and, when the broker-dealer records the expense in an amount that is determined according to an allocation made by the third party, the method of allocation.

8. Each broker-dealer and broker-dealer applicant must be able to demonstrate to the appropriate authorities that it is in compliance with the financial responsibility rules in connection with any expense-sharing agreement it has entered into, and therefore it may be required to provide these authorities with access to books and records, including those of unregistered entities, relating to the expenses covered by the agreement.

If the broker/dealer does not provide appropriate access to all relevant books and records, including those of a third party with which it has an expense-sharing agreement, an SRO may operate under the rebuttable presumption that the broker/dealer was not in capital compliance for the period covered by the expense-sharing agreement.

If the broker/dealer applicant does not provide appropriate access to all relevant books and records, including those of a party that has agreed to assume responsibility for paying all or a portion of the applicant's costs pursuant to paragraph (a)(7) of Membership and Registration Rule 1014, NASD will not permit the applicant to use an expense-sharing arrangement to demonstrate that it is capable of maintaining sufficient excess net capital to support its intended business operations on a continuing basis.

9. A broker-dealer must notify its DEA if it enters into, or has entered into, an expense sharing agreement and the broker-dealer does not record each of the expenses it incurs relating to its business on the reports it is required to file with the Commission or with its DEA under the financial responsibility rules. The notification must include the date of the agreement and the names of the parties to the agreement. The broker-dealer must provide a copy of the agreement to its DEA upon request.

The notification required in item 9 must be made, in writing, to a firm's assigned District Office for both existing and new expense-sharing agreements.

Endnotes

1 Expense-sharing agreements include any arrangement in which another party bears or pays for all or a portion of the costs incurred by a broker/dealer.

2 The redacted portions of the Letter, which are included in this *Notice to Members,* do not include the footnotes; a copy of the original Letter is attached to this *Notice.* The additional information provided by NASD is in italics.

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

July 11, 2003

Ms. Elaine Michitsch
Member Firm Regulation
New York Stock Exchange, Inc.
20 Broad Street
New York, New York 10005

Ms. Susan Demando
Director, Financial Operations
NASD Regulation, Inc.
1735 K Street, NW
Washington, D.C. 20006-1500

Re: Recording Certain Broker-Dealer Expenses and Liabilities

Dear Ms. Michitsch and Ms. Demando:

You have requested guidance from the Division of Market Regulation ("Division") of the U.S. Securities and Exchange Commission ("Commission") concerning the application of the financial responsibility rules[1] when a third party, which may include a parent, holding company, or affiliate of a broker-dealer, agrees to assume responsibility for payment of the broker-dealer's expenses.[2] You are concerned that some broker-dealers are using these expense-sharing agreements as a basis for not recording expenses and liabilities on the broker-dealer's books and records. In that instance, the books and records of the broker-dealer may not accurately reflect its performance and financial condition, artificially inflating its profitability, causing it to appear to be in capital compliance when it is not, and possibly disguising fraudulent activity. Further, you need access to sufficient records to verify that the broker-dealer is in compliance with the financial responsibility rules.

Under the financial responsibility rules, broker-dealers are required to prepare certain financial statements in accordance with generally accepted accounting principles ("GAAP"). A broker-dealer is also required to make and keep current certain books and

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[1] For purposes of this letter, the financial responsibility rules include the net capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934 ("Exchange Act"), and reporting and record keeping requirements under Exchange Act Rules 17a-3, 17a-4, and 17a-5.

[2] If a third party pays certain expenses of a broker-dealer, that party may be required to register with the Securities and Exchange Commission as a broker-dealer in accordance with Section 15 of the Exchange Act.

records relating to its business, including records "reflecting all assets and liabilities, income and expense and capital accounts."[3] A broker-dealer must also retain copies of all written agreements entered into by the broker-dealer relating to its business.[4]

It is the view of the Division that:

1. Pursuant to Exchange Act Rule 17a-3(a)(1) and (a)(2), a broker-dealer must make a record reflecting each expense incurred relating to its business and any corresponding liability, regardless of whether the liability is joint or several with any person and regardless of whether a third party has agreed to assume the expense or liability. A broker-dealer must make a record of each expense incurred relating to its business, including the value of any goods or services used in its business, when a third party has furnished the goods or services or has paid or has agreed to pay the expense or liability, whether or not the recording of the expense is required by GAAP and whether or not any liability relating to the expense is considered a liability of the broker-dealer for net capital purposes. One proper method is to record the expense in an amount that is determined according to an allocation made by the third party on a reasonable basis.

2. If the broker-dealer does not record certain expenses on the reports it is required to file with the Commission or with its designated examining authority ("DEA") under the financial responsibility rules, the broker-dealer may satisfy the Exchange Act Rule 17a-3(a)(1) and (a)(2) requirement to make a record of those expenses by making a separate schedule of the expenses.

3. If a third party agrees or has agreed to assume responsibility for an expense relating to the business of the broker-dealer, and the expense is not recorded on the reports the broker-dealer is required to file with the Commission or with its DEA under the financial responsibility rules, any corresponding liability will be considered a liability of the broker-dealer for net capital purposes unless:

a. If the expense results in payment owed to a vendor or other party, the vendor or other party has agreed in writing that the broker-dealer is not directly or indirectly liable to the vendor or other party for the expense;[5]

b. The third party has agreed in writing that the broker-dealer is not directly or indirectly liable to the third party for the expense;

c. There is no other indication that the broker-dealer is directly or indirectly liable to any person for the expense;

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[3] Exchange Act Rule 17a-3.
[4] Exchange Act Rule 17a-4.
[5] This requirement does not apply to a fixed term arrangement with a lessor that was in place before the issuance of this letter.

d. The liability is not a liability of the broker-dealer under GAAP; and

e. The broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense.

4. Any withdrawal of equity capital, as defined in paragraph (e)(4)(ii) of Exchange Act Rule 15c3-1, from a broker-dealer by a third party, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, within three months before or within one year after the broker-dealer incurs an expense which the third party has paid or agreed to pay, will be presumed for net capital purposes to have been made to repay the third party for the expense of the broker-dealer, unless the broker-dealer's books and records reflect a liability to the third party relating to the expense.

5. For purposes of determining net capital, if the broker-dealer records a capital contribution from a third party that has assumed responsibility for paying an expense of the broker-dealer, and the expense is not recorded on the reports the broker-dealer is required to file with the Commission or with its DEA under the financial responsibility rules, the broker-dealer must be able to demonstrate that the recording of a contribution to capital is appropriate. Among other things, the broker-dealer must be able to demonstrate that the third party has paid the expense or has adequate resources independent of the broker-dealer to pay the expense and that the broker-dealer has no obligation, direct or indirect, to a vendor or other party to pay the expense. For net capital purposes, any equity capital withdrawn by the third party, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, within three months before or one year after the broker-dealer incurs the expense, will be deemed to have been a repayment of the expense to the third party. For net capital purposes, if a contribution to capital is made to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the contributor, the contribution may not be included in the firm's net capital computation and must be re-characterized as a liability. Any withdrawal of capital as to that contributor within a period of one year, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, shall be presumed to have been contemplated at the time of the contribution.[6]

6. If a third party agrees or has agreed to assume responsibility for an expense of the broker-dealer, the broker-dealer must make, keep current, and preserve the following records pursuant to Exchange Act Rules 17a-3 and 17a-4:

a. If a vendor or other party has agreed that the broker-dealer is not liable directly or

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[6] Letter from Michael A. Macchiaroli, Associate Director, Division of Market Regulation, to Raymond J. Hennessey, Vice President, New York Stock Exchange, and Susan Demando, Vice President, NASD Regulation (February 23, 2000). This letter presumes that a broker-dealer's designated examining authority could recognize an exception to this presumption under appropriate circumstances.

indirectly to the vendor or other party for an expense, a written agreement between the broker-dealer and the vendor or other party that clearly states that the broker-dealer has no liability, direct or indirect, to the vendor or other party; and

b. A record of each expense assumed by the third party.

7. A broker-dealer must make, keep current, and preserve a written expense sharing agreement[7] between the broker-dealer and a third party that has paid or agreed to pay an expense of the broker-dealer. The agreement must set out clearly which party is obligated to pay each expense, whether the broker-dealer has any obligation, direct or indirect, to reimburse or otherwise compensate any party for paying the expense, and, when the broker-dealer records the expense in an amount that is determined according to an allocation made by the third party, the method of allocation.

8. Each broker-dealer and broker-dealer applicant must be able to demonstrate to the appropriate authorities that it is in compliance with the financial responsibility rules in connection with any expense-sharing agreement it has entered into, and therefore it may be required to provide these authorities with access to books and records, including those of unregistered entities, relating to the expenses covered by the agreement.

9. A broker-dealer must notify its DEA if it enters into, or has entered into, an expense sharing agreement and the broker-dealer does not record each of the expenses it incurs relating to its business on the reports it is required to file with the Commission or with its DEA under the financial responsibility rules. The notification must include the date of the agreement and the names of the parties to the agreement. The broker-dealer must provide a copy of the agreement to its DEA upon request.

Please contact me if you have any other questions or concerns relating to this matter.

Sincerely yours,

Michael A. Macchiaroli
Associate Director

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[7] Expense sharing agreements include franchising or other agreements relating to the costs of doing business of the broker-dealer.

A REPORT FROM THE
FINANCIAL INDUSTRY REGULATORY AUTHORITY

Report on Conflicts of Interest

OCTOBER 2013

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EXECUTIVE SUMMARY

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

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

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

To assist in these efforts, FINRA launched its conflicts initiative in July 2012[4] to review firms' approaches to conflicts management and to identify effective practices.[5] We used firms' responses to FINRA's conflicts review letter, in-person meetings and a follow-up compensation questionnaire to develop the observations detailed in this report.

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

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

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

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

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

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

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

Conflicts of Interest Framework

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

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

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

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

New Product Conflicts

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

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

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

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

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

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

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

Compensation Practices

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

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

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

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

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

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

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

Questions/Further Information

Inquiries regarding the Report may be directed to Daniel M. Sibears, Executive Vice President, Regulatory Operations/Shared Services, at (202) 728-6911; George Walz, Vice President, Regulatory Programs/Shared Services, at (202) 728-8462, or Steven Polansky, Senior Director, Regulatory Programs/Shared Services, at (202) 728-8331.

ENTERPRISE-LEVEL CONFLICTS GOVERNANCE FRAMEWORK

Introduction

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

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

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

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

Effective Practices Summary: Comprehensive Conflicts Governance Framework

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

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

continued

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

"Tone from the Top," Firm Culture and Conflicts of Interest

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

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

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

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

Conflicts Management Structures

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

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

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

Distributed Model

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

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

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

Centralized Model

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

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

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

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

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

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

No Defined Structure

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

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

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

Committees and Other Ad Hoc Bodies

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

Conflicts Management Policies

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

Code of Conduct

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

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

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

Enterprise-level Conflict Policy

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

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

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

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

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

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

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

continued

- **Employee vs. client conflicts**
  - The compensation arrangements or incentives for the firm or its employees could affect whether employees recommend or offer a particular security or transaction to a client.
  - An employee is engaged in outside business activities with an issuer about which the employee may make a recommendation.
- **Employee vs. firm conflicts**
  - An employee may compete with the firm for the purchase or sale of property, assets, services or other interests.
  - An employee engages in personal trading or outside business activities (including board memberships/directorships) that could conflict with a client or with the firm.
- **Vendor vs. client conflicts**
  - A vendor may misuse, or inadequately protect, confidential customer information.
  - A vendor may fail adequately to protect confidential customer information after its relationship with the firm is terminated.

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

Business Activity and Other Policies

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

Conflicts Management Processes

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

Escalation Procedures

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

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

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

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

Conflicts Inventory Reviews

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

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

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

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

Disclosure

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

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

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

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

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

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

Hiring Practices

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

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

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

Hiring Associated Persons With a Problematic Disciplinary History

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

continued

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

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

Training

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

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

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

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

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

Information Technology

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

Conflicts Clearance and Business Selection

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

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

Structures

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

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

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

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Process

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

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

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

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

NEW BUSINESS AND NEW PRODUCT CONFLICTS REVIEW

Introduction

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

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

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

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

Effective Practices Summary: New Product Conflicts Review

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

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

continued

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

Manufacturing

Conflicts Reviews and New Product Review Committees

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

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

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

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

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

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

Expanding Product Availability

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

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

Reverse Inquiry

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

Know-Your-Distributor Policies and Procedures

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

The following elements of a KYD process reflect effective practices:

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

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

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

Post-launch Product Reviews

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

Embedded Conflicts

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

Structured and Complex Products and Embedded Conflicts

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

continued

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

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

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

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

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

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

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

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

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

Distribution

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

Conflicts Reviews and New Product Review Committees

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

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

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

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

Open Product Architecture and Revenue Sharing

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

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

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

Reverse Inquiry

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

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

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

COMPENSATION AND OVERSIGHT

Introduction

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

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

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

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

Effective Practices Summary: Compensation and Oversight

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

Effective practices include the following:

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

continued

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

Compensation Grids

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

Structure and Mechanics

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

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

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

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

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

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

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

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

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

Other Approaches

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

Compensation and Oversight Structures

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

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

Neutral Grids

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

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

Commission-based vs. Fee-based Accounts

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

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

Compensation for Proprietary or Preferred Provider Products

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

Fee-capping

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

Supervision, Surveillance and Conflicts Management

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

Supervision of Sales Activity Near Compensation Thresholds

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

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

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

Supervision of Sales Activity at Investor Lifecycle Milestone Events

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

Other Effective Supervisory Practices

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

Compensation for Supervisory and Branch Management Staff

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

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

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

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

Deterrents to Poor Conflicts Management

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

Red Flags

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

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

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

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

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

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

Clawbacks

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

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

Scope and Content of Policies

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

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

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

Performance-based

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

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

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

Risk-based

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

Behavior-based

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

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

Review Processes

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

CONCLUSION

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

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

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

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

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

United States

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

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

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

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

continued

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

International Organization of Securities Commissions

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

Australia, Canada and the European Union

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

Best Interest of the Client Standard

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

Conflicts of Interest Policies and Procedures

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

Disclosure of Conflicts of Interest

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

Compensation-related Conflicts of Interest

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

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

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

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

July 2012

Re: Conflicts of Interest

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

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

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

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

APPENDIX III—SUMMARY OF CONFLICTS IDENTIFIED BY FIRMS

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

General Conflicts

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

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

Supervision and Compliance Conflicts

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

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

Research-related Conflicts

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

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

Banking and Capital Markets

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

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

Retail/Private Wealth

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

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

ENDNOTES

1. *See, e.g.*, the Securities Act of 1933, the Securities Exchange Act of 1934, the Glass-Steagal Banking Act of 1933, the Investment Company Act of 1940 and the Investment Advisor Act of 1940.

2. As the SEC noted in a 2005 release, "[b]roker-dealers are subject to extensive oversight by the Commission and one or more self-regulatory organizations under the Exchange Act. The Exchange Act, Commission rules, and SRO rules provide substantial protections for broker-dealer customers that in many cases are more extensive than those provided by the Advisers Act and the rules thereunder." *See* Securities Exchange Act Rel. No. 50980 (January 14, 2005).

3. FINRA rules also impose high ethical obligations on broker-dealers. *See, e.g.*, FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade) and FINRA Rule 2111 (Suitability).

4. *See* Appendix II for a copy of FINRA's letter informing firms of the review and requesting that they provide certain information to FINRA.

5. *See* Appendix III for a summary of conflicts firms identified in their responses to FINRA.

6. All recommendations are, of course, subject to FINRA Rule 2111 (Suitability). This rule requires firms to, among other things, conduct both reasonable basis and customer-specific determinations before recommending a transaction or investment strategy involving a security. A reasonable basis suitability determination is necessary to ensure that a transaction or investment strategy is suitable for at least some investors. The customer-specific suitability determination must be performed on an investor-by-investor basis.

7. FINRA believes that the increasing "retailization" of complex products requires increased review of these products by the firms. The inherent conflicts in these products—*e.g.*, use of proprietary indices, certain call or extension features or use of affiliated calculation agents—and their typical complexity raise serious issues for a firm preparing to sell them to retail investors. Given these concerns, some firms impose heightened criteria for eligible customers before a complex product could be recommended. In the retail context, FINRA remains concerned that reliance on disclosure may be an inadequate antidote to conflicts, unless the firm is confident that the customer can effectively evaluate these disclosures and make sound judgments about their potential impact on an investment recommendation.

8. "Compensation grid" refers to the compensation schedule many firms use to pay brokers. Typically, the more commission revenue the registered representative generates, the larger the percentage of that revenue the representative may keep. Compensation grids are discussed in greater detail in the compensation section.

9. The federal securities laws and FINRA rules require broker-dealers to have comprehensive supervisory structures. Under Section 15(b) of the Securities Exchange Act, a firm and its supervisory personnel may be held liable for failing to supervise an individual who engages in bad behavior unless (i) the firm has established supervisory procedures and a system for applying the procedures, and (ii) individuals reasonably discharged their supervisory responsibilities. FINRA also requires comprehensive supervision. NASD Rule 3010 requires each firm, among other things, to establish, maintain and enforce a written supervisory system; designate supervisory personnel; and conduct an annual internal inspection. NASD Rule 3012 details the requirements for a firm's supervisory control system.

10. FINRA Rule 2111 (Suitability) *Frequently Asked Questions* 7.1., page 11.

11. In addition to the anti-fraud provisions discussed here, these also include rules under the Securities Exchange Act, *e.g.*, Rule 10b-10. This rule generally requires a broker-dealer to provide confirmation statements for transactions, which must note, among other information, the firm's compensation and whether it is acting as agent or principal. Rules 15c1-5 and 15c1-6 require a broker-dealer to disclose in writing to the customer if it has any control, affiliation, or interest in a security it is offering or in the issuer of the security.

12. As noted by the SEC staff, when a broker-dealer merely processes a customer's order, but does not recommend securities or solicit the customer, the broker-dealer's obligations are generally limited to information related to the consummation of the transaction. *See* January 2011 SEC Staff Study on Investment Advisers and Broker-Dealers, at 55 (SEC Staff Study).

13. *Id.*

14. *Id.*

15. *In re* El Paso Corp. Shareholder Litigation, 41 A.3d 432 (Del. Ch. 2012) and *In re* Del Monte Foods Co. Shareholder Litigation, 25 A.3d 813 (Del. Ch. 2011).

16. FINRA has stated on a number of occasions that firms must take care to present a fair and balanced picture of the risks, costs and benefits of investing in a product. In promoting the advantages of a product, firms must balance their promotional materials with disclosures concerning the attendant risks. Simply providing a prospectus does not cure unfair or unbalanced sales or promotional materials, whether prepared by the firm or the issuer. *See,* for example, *Regulatory Notice 09-31*, FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds, June 2009; *Regulatory Notice 08-81*, FINRA Reminds Firms of Their Sales Practice Obligations with Regard to the Sale of Securities in a High Yield Environment, December 2008; *Notice to Members 04-30*, NASD Reminds Firms of Sales Practice Obligations In Sale of Bonds and Bond Funds, April 2004; and *Notice to Members 03-71*, Non-Conventional Investments: NASD Reminds Members of Obligations When Selling Non-Conventional Investments, November 2003.

17. See earlier guidance on this issue, for example, *Regulatory Notice 07-55*, Personnel Background Investigations: FINRA Reminds Member Firms of Their Obligations Regarding Background Investigations of Prospective Personnel, November, 2007; *Notice to Members 97-19*, NASD Regulation And New York Stock Exchange Memorandum Discusses Sweep Report And Provides Guidance On Heightened Supervision Recommendations, April 1997; and, with respect to supervisory visits to office with personnel who have disciplinary records, *Notice to Members 98-38*, NASD Reminds Members Of Supervisory And Inspection Obligations, May 1998. *Notice to Members 99-45*, NASD Provides Guidance On Supervisory Responsibilities, June, 1999.

18. Firms need to determine whether a prospective employee is a statutorily “disqualified” person. The term disqualification is defined in Article III, Section 3 of the FINRA By-Laws, and among other things, renders FINRA member firms and their associated persons ineligible for membership, continued membership, association or continued association with FINRA.

19. *See* NASD Rule 3010(e).

20. *See* NASD Rule 3010(e) for greater specificity on the obligations of FINRA member firms and their hiring practices.

21. *See* NASD Rule 3010(b).

22. FINRA recognizes that in many firms a number of committees may review new business initiatives and that some of these may include conflict concerns as part of their remit. Here, FINRA focuses on the dedicated new business initiative review since firms identified this as the primary gateway for identifying and managing conflicts of interest in a new product launch.

23. In *Notice to Members 05-26*, New Products: NASD Recommends Best Practices for Reviewing New Products, April 2005, FINRA identifies a number of good practices that include, but also go beyond, conflicts of interest. In the current report, FINRA focuses on how firms address conflicts of interest in their new product review.

24. *See also Regulatory Notice 12-03*, Complex Products: Heightened Supervision of Complex Products, January 2012, and *Notice to Members 05-59*, Structured Products: NASD Provides Guidance Concerning the Sale of Structured Products, September, 2005.

25. Large firms typically have a variety of committees outside the new business initiative committee where issues, including those related to conflicts, may arise. FINRA’s focus in this section is on the new business initiative committee.

26. Revenue-sharing payments can take many different forms. For example, a fund company may pay a firm additional amounts at year end based on the amount a firm’s customers currently hold in the offeror’s funds, or based on the firm’s total sales of the offeror’s funds in the previous year. They can also take the form of other cash payments, such as an offeror helping to pay the costs of a firm’s annual sales meeting. *See, e.g.,* Securities Act Release No. 8358 (Jan. 24, 2004), 69 FR 6438 (Feb. 10, 2004), at 6441 n.17.

27. There are a number of FINRA rules which address compensation, including: NASD Rule 2440 (Fair Price and Commissions), IM-2440-1 (Mark-Up Policy), IM–2440-2 (Additional Mark-Up Policy For Transactions in Debt Securities, Except Municipal Securities), FINRA Rule 5110 (Underwriting Compensation), FINRA Rule 5250 (Payments for Market-Making), NASD Rule 2830 (Investment Company Securities), FINRA Rules 2310 (Direct Participation Programs), 2320 (Variable Contracts of an Insurance Company) and 5110 (Corporate Financing Rule—Underwriting Terms and Arrangements), and NASD Rule 2830 (Non-Cash Compensation).

28. The Commission has stated that undisclosed markups of more than 10 percent on an equity security are fraudulent, and that a markup of less than 10 percent may be fraudulent depending on the circumstances. Acceptable markups on debt securities are significantly lower.

29. *See* Timothy Edward Daly, FINRA Letter of Acceptance Waiver and Consent (April 27, 2012) for an example of inappropriate behavior with regard to commission-based vs. fee-based accounts.

30. U.S. Government Accountability Office, 401(K) Plans: Labor and IRS Could Improve the Rollover Process for Participants, GAO-13-30, March 7, 2013, p. 10.

31. Not all firms implement performance appraisals of their registered representatives. In addition, legal restrictions may limit firms’ ability to reduce the non-discretionary salary portions of individuals’ compensation.

32. *See*, for example, *Credit Rating Agencies: Internal Controls Designed to Ensure the Integrity of the Credit Rating Process and Procedures to Manage Conflicts of Interest*, Report of the Board of IOSCO, December 2012; *Guidelines for the Regulation of Conflicts of Interest Facing Market Intermediaries*, Report of the Emerging Markets Committee of IOSCO, November 2010; *Private Equity Conflicts of Interest*, Report of the Technical Committee of IOSCO, November 2010; *Market Intermediary Management of Conflicts that Arise in Securities Offerings - Final Report*, Report of the Technical Committee of IOSCO, November 2007; and *IOSCO Statement Of Principles For Addressing Sell-Side Securities Analyst Conflicts Of Interest*, Statement of the Technical Committee of IOSCO, September 2003.

33. Investment Industry Regulatory Organization of Canada, IIROC Rule 42.4 Guidance.

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