FINRA Proposes Registration of Operations Personnel

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On May 26, 2010, FINRA proposed for comment new rules to require registration of certain “back-office” operations personnel, including examination and continuing education requirements. The rules would expand the universe of personnel requiring registration and impact firms in a number of significant ways.

According to FINRA, these new requirements are needed to help ensure that investor protection mechanisms are in place in all areas of firms’ businesses that could harm a customer, a firm, the integrity of the marketplace or the public. FINRA appears to be responding to Madoff and recent scandals involving back-office shortfalls. It is following the trend of expanding regulatory focus beyond the front-office by heightening scrutiny over supervisory systems and oversight related to operational functions (e.g., custody, record-keeping, accounting, account maintenance, prospectus delivery, valuation and stock loan).

The comment period expires on July 12, 2010.

Who Would Be Covered?

The requirements would not apply to all operations personnel but, rather, only to persons with decision-making or oversight authority. In other words, operations personnel directly responsible for ensuring that covered functions are performed correctly and in accordance with industry rules, firm protocol and policies and procedures, or personnel who are charged with protecting the functional and control integrity of the covered functions of the firm. More specifically, the new registration would apply to the following three categories of persons:

- Senior management with responsibility over covered functions (as that term is explained below);
- Supervisors, managers or others responsible for approving or authorizing work in furtherance of covered functions; or
- Persons with authority or discretion to commit a firm’s capital to, or commit the firm to a contract in furtherance of, a covered function.

Persons who merely perform covered functions without the type of supervisory or decision-making authority set out above, or who engage solely in clerical or ministerial activities or perform ancillary functions (e.g., internal audit, legal or compliance), would not be covered. Notably, however, persons employed by an affiliate or third party but performing these functions on behalf of the firm would be covered and therefore be subject to all FINRA rules applicable to associated persons irrespective of their employing entity.

What Are the Covered Functions?

FINRA listed the following 15 specific back-office functions:

- Development and approval of pricing models used for valuations;
• Trade confirmation, account statements, settlement or margin;
• Stock loan/securities lending;
• Prime brokerage;
• Client on-boarding (customer account data and document maintenance);
• Capturing of business requirements for sales and trading systems and any other systems related to the covered functions, and validation that these systems meet such business requirements;
• Defining and approving business security requirements and policies for information technology related to covered functions;
• Defining information entitlement policy in connection with covered functions;
• Financial Controller (including general ledger);
• Collection, maintenance, re-investment (i.e., sweeps) and disbursement of funds;
• Bank, custody, depository and firm account management and reconciliation;
• Segregation, possession and control, fail control or buy-ins;
• Receipt and delivery of securities and funds or account transfers;
• Financial regulatory reporting; and
• Posting entries to the books and records of a firm in connection with covered functions.

How Would a Person Qualify?

In order to register, a person would need to pass a new FINRA qualifying examination, unless he or she satisfied an exemption from that requirement. The proposal states that the intention is not for this to be a competency examination, but rather a test for general securities and industry knowledge, regulatory requirements and the importance of escalating red flags. In addition to the examination, the person would be subject to continuing education requirements related to the covered functions.

Who Would Be Exempt from the Examination and Education Requirements?

Even if required to register, a person would be exempt from the examination requirements if he or she currently holds one of the broad range of other representative or supervisory licenses (e.g., Series 7, 24 or 27) or reactivates a registration held during the prior two years. Such persons would need to request registration via Form U4 and, if they had no other deficiencies, would be approved automatically. If a person qualifies for this exemption, he or she would also be exempt from the continuing education requirements to the extent that continuing education requirements for the other registration are satisfied.

How Much Time Will Staff Have To Qualify?

FINRA proposed a transition period of six to nine months for existing personnel to register and pass the qualifying examination or satisfy an exemption. Importantly, this transition period would not apply to persons hired after the effective date of the new requirement or to existing associated persons whose responsibilities change. These people would need to qualify prior to engaging in any covered functions without the benefit of any transition period.

How Might These New Requirements Impact Firms?
Historically, regulators have required registration only for individuals engaged in or supervising securities or investment banking business - so-called "front-office" personnel with direct client-facing roles. The proposal would, for the first time, create a registration category specific to the back-office. FINRA seems intent on bringing about a transformation in the way firms view, control and supervise operations staff and the authority that regulators have over them.

When the regulators introduced new examination requirements for research analysts and certain supervisors (e.g., the Series 86 and 87 examinations), the burdens on individuals and firms were not insignificant. The burdens here will be even more substantial because - unlike research personnel who in most cases already had Series 7 or 16 licenses - the majority of back-office staff have no current registrations. FINRA did note in the proposal that only those operational personnel currently acting in a supervisory position would be subject to the new requirements and, therefore, many will likely already hold one of the eligible registrations.

In addition to the initial and on-going costs of carrying an individual's registration, firms will be required to treat registered staff as "associated persons." This subjects them to the full range of FINRA rules and means that firms must review and update their policies and provide a supervisory structure for this new category of registration. All of this brings the back-office more directly and squarely within the jurisdiction and control of both FINRA and the SEC.

If a person has disciplinary history, he or she may be statutorily disqualified from becoming an associated person, even if such history currently permits him or her to be employed by the firm and perform covered functions.

The proposal states that persons employed by affiliates or third parties performing covered functions in a supervisory capacity on behalf of firms are subject to the new requirements. Consequently, firms will need to treat them as associated persons. For example, if an employee of the firm's parent company had supervision over the pricing model used for valuations of the firm's securities positions or an employee of the firm's vendor was responsible for approving the firm's business security requirements for information technology, that non-employee of the firm would need to become an associated person of the firm and would become subject to FINRA rules and jurisdiction and would need to follow the firm's policies and be part of its supervisory structure.

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