Recent FINRA Proposal Impacts Bank Securities Activities
Wednesday, June 11, 2008

As part of its ongoing process to consolidate former NASD and NYSE rules, FINRA has recently requested comment on proposals relating to its supervision and supervisory control rules (see FINRA Regulatory Notice 08-24). Although the primary objective of the proposed rules is to provide member firms with greater flexibility to tailor their supervisory procedures to their actual business, size and organizational structure, there are several provisions that will significantly impact existing bank securities practices, including those securities activities permitted by the recently enacted Regulation R under the Gramm-Leach-Bliley Act (GLBA).

Among other things, the proposed FINRA Rule 3110 seeks to amend existing NASD Rule 3040 regarding the supervision of outside securities activities of registered representatives. Under Rule 3040 (the so-called "selling-away" rule), brokerage firms must comply with certain notice, approval, record retention and supervision requirements with respect to securities transactions conducted by their registered representatives outside of their employment with the firm. The rule was designed to preclude "private securities transactions" by representatives that are conducted away from the firm. Proposed Rule 3110 would require a registered representative to obtain the firm's prior written approval before engaging in any outside securities business, even those for which approval would not be required under existing Rule 3040. The brokerage firm would then be required to supervise such activities.

Issue: As proposed, Rule 3110 appears to be much broader in scope than its predecessor in several important respects. First, the rule would require dually registered representatives of investment advisors to obtain the brokerage firm's prior approval for all of their investment advisory activities. Many non-discretionary investment advisory firms delegate all investment discretion to third party managers and do not participate in any underlying securities transaction. Under existing FINRA guidance, such arrangements would not be subject to brokerage firm approval and supervision. The proposed rule would now require the brokerage firm to approve and supervise such activities.

Proposed Rule 3110 would, however, exclude bank-related securities activities conducted by dual employees (i.e., bank employees that are registered representatives of the brokerage firm) pursuant to an exemption from broker-dealer registration (including those found in Regulation R). Under this exclusion, the broker must still approve such securities activities. Prior to any such approval, the broker must receive written assurance that the bank, or a "supervised bank affiliate" (i.e., an affiliate subject to consolidated supervision by a federal banking regulator): (a) will have a comprehensive view of the dual employees securities activities, (b) employs policies and procedures reasonably designed to achieve compliance with the anti-fraud provisions of the securities laws and (c) will promptly notify the brokerage firm of any violation of the policies and procedures by the dual employee. Firms are specifically required to re-evaluate their reliance on a bank's anti-fraud policies after receiving notice that a dual employee has

TEL 724.935.6789 CELL 412.760.6246 FAX 724.935.6790 DIRECT 724.935.2700
vdb@vmdlegal.com
4500 Brooktree Road, Suite 103 Wexford, Pennsylvania 15090
www.vmdlegal.com

violated these policies. Following such re-evaluation, the firm must revoke its approval if it cannot assure itself
that the bank's anti-fraud procedures are sufficient.

The exclusion for bank-related securities activities specifically responds to a letter submitted in 2001 by the ABA Securities Association seeking affirmation that NASD Rule 3040 does not apply to dual employees. Many banking organizations who require their trust officers to become securities licensed were concerned that permissible bank securities activities conducted by such dual employees in the trust department would be regulated by FINRA. As proposed, Rule 3110 would now require firm approval (but not supervision) for all permitted activities under the GLBA and Regulation R. This form of regulatory encroachment appears to be inconsistent with the concept of functional regulation embraced by Congress in the GLBA and by the Fed and SEC in Regulation R. The proposal also is inconsistent with long-standing FINRA guidance applicable to dually registered representatives of investment advisors. Both banking organizations and investment advisors should further scrutinize their dual employee arrangements and compliance programs in light of this proposal.

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