

International Implications of New FINRA Registration Rules for Securities Back Office Personnel

On October 17, 2011, the Financial Industry Regulatory Authority's (FINRA) Rule 1230(b) (6) regarding "Operations Professionals" will take effect, imposing registration, qualification, and continuing education requirements on a wide range of people involved in the clearing and settling of securities transactions.¹ The registration requirements apply not just to a FINRA member's direct employees or associated persons, but also to the employees of companies to whom FINRA members outsource these operations. Thus, Rule 1230(b) (6) has implications for many financial services entities who are exempted from FINRA registration themselves, such as foreign dealers providing execution and clearance and other services involving foreign securities pursuant to Rule 15a-6 under the Securities Exchange Act of 1934 (the Exchange Act), but who provide the rule's covered services to FINRA members.

When it was originally adopted on June 16, 2011, the new rule had very broad extraterritorial application to clearance and settlement activities involving foreign securities in foreign markets. This was problematic for many non-US securities firms and governmental officials since these non-US activities are already subject to foreign regulation. The rule did not take into account these extraterritorial effects or the potential inconsistency with the SEC's exemption for foreign brokers and dealers provided by Rule 15a-6 under the Exchange Act.

As noted in Part III below, however, after the rule's adoption, efforts to secure a limited and conditional exemption for institutional transactions involving foreign securities in foreign markets resulted in clarification of the FINRA rule's application to these transactions.

Discussions between the Securities and Exchange Commission (SEC), FINRA and non-US securities firms, and their representatives, regarding the preservation of safe and efficient cross-border clearance and settlement arrangements for the institutional marketplace are also continuing. The existing practices used by US-registered broker-dealers affiliated with foreign firms have been the subject of increasing scrutiny by FINRA during the last year.

¹ FINRA, *SEC Approves Operations Professional Registration Category and Consolidated FINRA Continuing Education Rule*, Regulatory Notice 11-33 (July 2011).

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Arnold & Porter LLP, together with the Canadian securities industry represented by the Investment Industry Association of Canada, has worked over several months through various initiatives to achieve the referenced carve-out from FINRA Rule 1230(b)(6) for cross-border institutional transactions,² and obtain SEC clarification on the existing clearing and settlement arrangements. The clarification efforts are continuing. We would be pleased to discuss how we can be of assistance to other financial services firms seeking to address their cross-border clearance and settlement activities and related services in compliance with US requirements.

I. Rule 1230(b)(6)'s Scope

Rule 1230(b)(6) requires registration for each individual person who is an "Operations Professional." Under the rule, an "Operations Professional" is a "covered person" engaged in one or more "covered functions."

A. Covered Persons

Rule 1230(b)(6) defines the following as "covered persons":

- Senior management with responsibility over the covered functions;
- Supervisors, managers, or other persons responsible for approving or authorizing work, including work of other persons, in direct furtherance of the covered functions; and
- Persons with the authority or discretion materially to commit a member's capital in direct furtherance of the covered functions or to commit a member to any material contract or agreement—written or oral—in direct furtherance of the covered functions.³

Rule 1230(b)(6) does not cover employees working below this level of responsibility. Thus, employees who perform solely clerical activities in a covered function do not need to register. Similarly, FINRA has stated that Rule 1230(b)(6) will not cover audit, legal, or compliance personnel who review the performance of covered functions because they do not have primary responsibility for the function. It is up to the

individual FINRA member on whose behalf these functions are performed to identify who should be registered.

Significantly, the covered person need not be employed directly by the FINRA member or be associated with it through employment by an affiliated entity to be required to register. Instead, if a person working at any entity is a "covered person" under Rule 1230(b)(6), then that person must be registered. Therefore, if a FINRA member outsources these operations, the employees performing the functions at the external company are considered "associated persons" of a FINRA member and subject to all FINRA rules applicable to associated persons and registered persons.⁴

B. Covered Functions

Rule 1230(b)(6) defines sixteen different "covered functions" that a "covered person" may do to trigger mandatory registration. These covered functions are:

1. Client on-boarding (customer account data and document maintenance);
2. Collection, maintenance, re-investment (i.e., sweeps), and disbursement of funds;
3. Receipt and delivery of securities and funds, account transfers;
4. Bank, custody, depository, and firm account management and reconciliation;
5. Settlement, fail control, buy ins, segregation, possession, and control;
6. Trade confirmation and account statements;
7. Margin;
8. Stock loan/securities lending;
9. Prime brokerage (services to other broker-dealers and financial institutions);
10. Approval of pricing models used for valuations;
11. Financial control, including general ledger and treasury;

² FINRA Rule 1230(b)(6), Supplementary Material .06.

³ Rule 1230(b)(6)(A).

⁴ FINRA, *SEC Approves Operations Professional Registration Category and Consolidated FINRA Continuing Education Rule*, Regulatory Notice 11-33 (July 2011), at 3.

12. Contributing to the process of preparing and filing financial regulatory reports;
13. Defining and approving 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;
14. Defining and approving business security requirements and policies for information technology, including, but not limited to, systems and data, in connection with the covered functions;
15. Defining and approving information entitlement policies in connection with the covered functions; and
16. Posting entries to a member's books and records in connection with the covered functions to ensure integrity and compliance with the federal securities laws and regulations and FINRA rules.⁵

Additionally, while Rule 1230(b)(6) covers such personnel, FINRA intends to introduce a separate category for covered persons who conduct or supervise stock loan or securities lending activities.

C. Rule 1230(b)(6)'s Requirements

1. Operations Professional Examination Requirement

A person whose employment falls within the scope of Rule 1230(b)(6) must pass a qualifying examination to continue with the covered functions. The examination will cover professional conduct and ethical considerations, essential product and market knowledge, and knowledge associated with operations activities.

There are some exceptions to the examination requirement. If a person holds an "eligible registration," then that person may opt-in to the Operations Professional Registration. The eligible registrations fall into two categories: Representative-level registration, and principal-level registration. Thus, employees who have representative registration, such as the Series 7 registration, or those who have UK Securities Representative status (Series 16) or Canada Securities Representative status (Series 37 or 38) would be eligible to

opt-in without taking the FINRA examination. Additionally, employees in principal-level categories such as Compliance Officers or Financial and Operations Principals would also be able to opt into the registration requirement without taking the examination.

2. Continuing Education Requirement

Operations Professionals must also complete continuing education requirements. NASD Rule 1120, on Continuing Education Requirements, has been adopted as FINRA Rule 1250. Rule 1250 will have two educational elements: The Regulatory Element and a Firm Element. The Regulatory Element consists of periodic computer-based training on regulatory, compliance, ethical, supervisory, and sales practices standards. A newly registered person must complete FINRA's designated Regulatory Element within 120 days of registration, and thereafter every three years. Failure to do so deactivates that person's registration and bars them from conducting any covered functions until the Regulatory Element is completed. The Firm Element is designed by the individual FINRA member for whom the employee performs the covered functions. This component educates the employee on the products and services offered by the member, and any regulatory developments.

II. Rule 1230(b)(6)'s Exception: Foreign Operations Personnel

On August 11, 2011, the SEC approved supplementary material proposed by FINRA to 1230(b)(6), which exempts from registration certain foreign employees of foreign broker-dealers.⁶ This interpretation applies to an employee of a foreign broker-dealer who, for transactions in foreign securities on behalf of a customer of a FINRA member, facilitates the clearance and the settlement of the applicable transactions. Registration is not required only if two additional conditions are fulfilled. One, the FINRA member sending the order to the foreign broker-dealer is not a direct participant of the applicable foreign clearing system. Two,

⁵ Rule 1230(b)(6)(B).

⁶ *Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Amend the Supplementary Material to FINRA Rule 1230(b)(6) (Operations Professional)*, Release No. 34-65137.

the foreign broker-dealer accepts the FINRA member's customer's instructions to settle the transaction on a DVP/RVP basis and settles directly with a custodian for the customer. The SEC made clear that it considered only this specific fact pattern to fit the exemption.⁷

III. Rule 1230(b)(6)'s Implementation

Rule 1230(b)(6) will take effect on October 17, 2011. FINRA members must identify all persons who, on October 17, 2011, meet the criteria for both covered persons and covered functions. FINRA calls these people "Day One Professionals." There will be a sixty-day period starting October 17, 2011, in which FINRA members must identify all Day One Professionals. Those people must register during that period, but may act as Operations Professionals without passing the Operations Professional Examination until October 16, 2012. Clients should consider taking steps now to identify those personnel who must register and, for each person, if the examination requirement may be waived.

Any person who does not meet the criteria as of October 17, 2011 must first register and pass the examination before acting as an Operations Professional. Those persons have a 120-day grace period between registration and their required passing of the examination; in that 120 days the person may act as an Operations Professional.

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⁷ The comment period for this amendment ends on September 9, 2011. The SEC approved the new material on an accelerated basis so that Rule 1230(b)(6) can come into effect on October 17, 2011, as planned.

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