

Broker-Dealer and Investment Adviser Supervisory Requirements and Related Services

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Proskauer advises broker-dealers and investment advisers on compliance with their supervisory duties under federal and state securities laws and self-regulatory organization (“SRO”) rules.

A rationally designed supervisory system can effectively prevent violations, demonstrate the absence of willful or reckless misconduct, and avoid or mitigate supervisory or derivative liability for employee offenses. It is a mitigating factor in U.S. Department of Justice, Securities and Exchange Commission (“SEC”) and SRO enforcement guidelines.

We help financial services clients build their supervisory systems, respond to changes in supervisory obligations and best practices, and continue to meet their obligations.

I. THE SYSTEM OF SUPERVISION REQUIRED UNDER FEDERAL LAWS, SRO RULES & INDUSTRY STANDARDS

Section 15(b)(4)(E) of the Securities Exchange Act of 1934 (the “Exchange Act”) and Section 203(e)(6) of the Investment Advisers Act of 1940 (the “Advisers Act”) make broker-dealers and investment advisers liable for the failure to supervise their employees and others who violate federal securities laws. Each firm is expected to develop, implement, and maintain policies and procedures reasonably designed to prevent and detect violations. The Financial Industry Regulatory Authority (“FINRA”) and other SROs have rules imposing specific supervisory requirements on their members. Rule 206(4)-7 under the Advisers Act requires registered investment advisers to implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules. Other provisions of the Exchange Act and the Advisers Act require policies and procedures designed to prevent the misuse of material, non-public information and other specified practices.

FINRA Rule 3110, in particular, requires members to develop a comprehensive system of supervision to ensure compliance with federal securities laws and FINRA rules. Each member must designate a senior officer with overall responsibility to develop, implement, and maintain the supervisory system. At a minimum, the system must (1) identify each business unit within the organization, (2) designate one or more persons with authority to supervise each unit, and (3) describe the duties to be performed by each supervisor. Rules 3120 and 3130 require members to examine the effectiveness their supervisory systems annually, to report the results to the firm’s chief executive officer, senior management and board of directors, and to certify that the system is adequate.

State blue sky laws also impose supervisory requirements on broker-dealers and investment advisers, and laws of corporate governance require comprehensive systems to report, investigate and respond to potential securities law violations and other instances of possible wrongdoing.

Proskauer assists company management in building a comprehensive supervisory system that complies with securities laws, SRO rules and industry standards. Our services include: organization of the supervisory system; written supervisory procedures; surveillance systems, audit modules, and inquiry responses; supervisory system reviews, analyses and reports; and training and education programs.

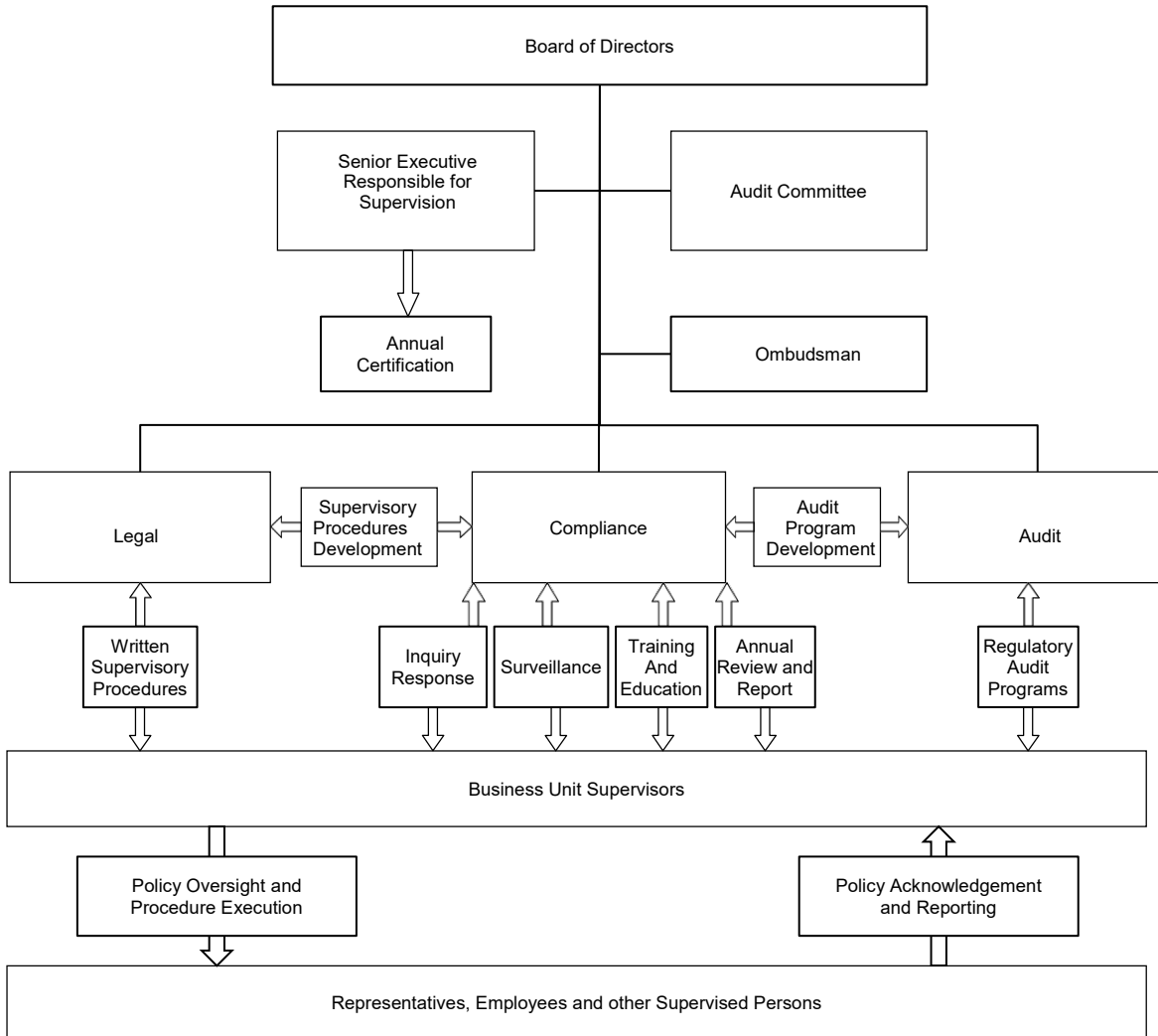
SECTIONS 15(b)(4)(E), 15(g) OF THE SECURITIES EXCHANGE ACT	FINRA RULES 3110, 3120 and 3130	SECTIONS 204A, 206(4), AND RULE 206(4)-7 OF THE ADVISERS ACT
<ul style="list-style-type: none"> > Reasonable Supervisory Procedures > Written Procedures to Prevent the Misuse of Material, Non-Public Information 	<ul style="list-style-type: none"> > Offices of Supervisory Jurisdiction > Qualified Supervisors > Written Supervisory Policies and Procedures > Designation of Chief Compliance Officer(s) > One or more Principals Responsible for Reviewing the Supervisory System > Annual Compliance Meetings > Annual Inspections > Annual Compliance Testing, Verification, Updating and Reporting > Annual CEO Certification 	<ul style="list-style-type: none"> > Written Supervisory Policies and Procedures > Annual Review of Policies and Procedures > Designation of Chief Compliance Officer

II. ORGANIZATION OF THE SUPERVISORY SYSTEM

Proskauer’s lawyers assist in reviewing the company’s current organization and business activities, help to identify risks and conflicts that arise within and across business lines, and align supervisory functions with underlying business activities.

We help identify the appropriate persons to supervise each business unit, advise on licenses required for each supervisor, and assist in developing and documenting supervisory relationships and responsibilities.

Example: Supervisory System Architecture



III. GOVERNANCE

BOARD OF DIRECTORS

- > Appoints Senior Executive Officer and Establishes Committees Responsible for Oversight

SENIOR EXECUTIVE

- > Responsible for Implementing SEC and SRO Rules of Supervision by Delegated/Delegating Authority
- > Reports Annually to the Audit Committee on the Supervisory System
- > Receives, Reviews, and Evaluates Annual Compliance Program Review Report
- > Responsible for the Annual CEO Certification

LEGAL

- > Advise on Regulatory Requirements
- > Advise on Firm Policies and Supervisory Procedures
- > Coordinate with Compliance and Internal Audit

COMPLIANCE

- > Perform General Surveillance and Provide Technical Support to Supervisors
- > Develop Training and Education Programs
- > Respond to Regulatory Inquiries
- > Advise on Specific Supervisory Procedures
- > Advise on Audit Procedures
- > Test and Verify the Supervisory Procedures, Prepare Annual Report of Findings to Senior Management.

COMPLIANCE/AUDIT COMMITTEE

- > Monitors the Supervisory System
- > Receives, Reviews, and Evaluates Annual Compliance Program Review Report

OMBUDSMAN

- > Receives and Directs the Response to Reports of Misconduct

INTERNAL AUDIT

- > Perform Periodic On-site Examinations
- > Report Findings and Makes Recommendations
- > Monitor Resolutions

BUSINESS UNIT SUPERVISORS

- > Perform Supervision

SUPERVISED PERSONS

- > Acknowledge Firm Policies
- > Report Misconduct

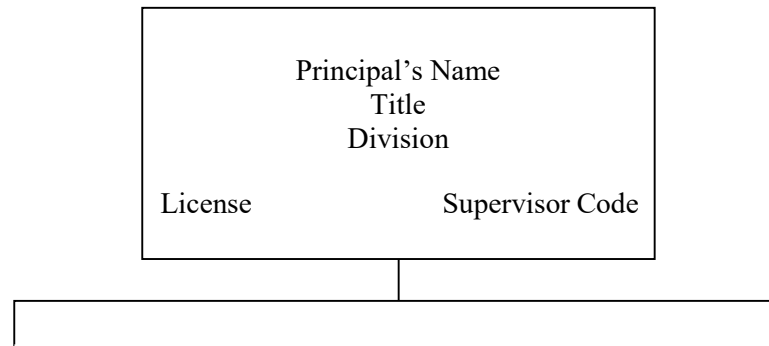
IV. WRITTEN SUPERVISORY PROCEDURES

Proskauer will help the company develop specific policies and procedures tailored to its business, written in plain English.

Policies consist of succinct descriptions of federal and state securities laws, SRO rules and company policies, and a clear discussion of the compliance issues affecting each business unit. We save expense by working with and revising the company's existing policy manuals.

Many companies have supervisory procedures that are not in writing or lack sufficient detail. We identify and document new and existing procedures in a format that is easily accessible for supervisors.

Organization Chart of Supervisors



- > The Organization Chart contains information required by SRO rules for each supervisory principal.
- > Supervisor Codes allow for Supervisory Policies and Procedures Manuals that are tailored to each business group.

Policy Manual Component

- > The policy component of the written supervisory procedures ("Policy Manual") typically would include a discussion of federal and state law provisions, SRO rules, and firm policies.
- > The Policy Manual, or your existing manual(s), can be organized into separate volumes for distinct businesses or subjects such as: (1) underwriting, (2) secondary trading, (3) sales practices, (4) research, (5) investment banking, (6) asset management, (7) MNPI protection, (8) Code of Conduct and other requirements.
- > Volumes describe specific obligations in clear language. Sections are titled, dated, and indexed to one or more business units.
- > Supervisors can reference versions specific to their businesses.

Procedures Manual Component

- > The procedures component of the written supervisory procedures ("Procedures Manual") typically would contain oversight directions for each business activity, describe how and when they should be performed, and how they should be documented (including how exceptions should be investigated and reported).

- > A specific Procedures Manual can be created for each supervisor or business unit.

Example: Supervisory “Policy Manual” Module

Volume 2	Title: Secondary Trading	Page:
Section: 1.20	Subject: Commission/Markup Policy	
Effective Date: []	Instruction: Replace § 1.20, Dated []	
<p>§ 1.20 “FINRA Markup Policy”</p> <p>After receiving a customer order to buy or sell a security as agent, a trader must take reasonable steps to locate the best inter dealer market for the security and execute the order in that market so that the price obtained for the customer is as favorable as possible before the addition of any commission or related charges. See Best Execution Obligation § 1.10. The commission charged must be fairly determined according to the factors described below:</p> <p>When executing a transaction with a customer as principal, the trader must buy or sell at a price – exclusive of a markup or markdown – that is fair, taking into consideration all relevant factors. See Best Execution Obligation § 1.10; New Order Execution Obligations § 1.15.</p> <p>The “FINRA Markup Policy,” Rule 2121, mentions seven factors that should be considered when determining the value of the markup or markdown for a principal transaction or the commission for an agency execution. They are as follows:</p> <ol style="list-style-type: none"> 1. The type of security included (normally bond transactions command a lower percent markup than stock transactions); 2. the availability of the security in the market; 		

Example: Supervisory “Procedures Manual” Module

Supp. Principal: _____	Division: High Yield Trading	Page:
Section 2.1.20	Subject: Markups on High Yield Debt Transactions	
Effective Date: []	Instruction: Replace § 2.1.20, Dated []	
<p>§ 2.1.20 Markups on High Yield Debt Transactions (Corporate Policy Reference: Vol. 2, § 1.20)</p> <p>The supervisory principal of the High Yield Trading Department evaluates the execution price of every customer purchase and sale of high yield debt securities to ensure that the price obtained by the customer is fair. The execution price is judged according to the prevailing market price and mark-up evaluation criteria presented in the “FINRA Mark-up Policy” and subsequent releases on the subject. For this purpose, the Compliance Department has developed a computer system which utilizes these criteria to calculate markups that may be excessive. Questionable transactions are presented as exceptions on a report generated by the system. The exceptions are evaluated by the supervisory principal. Executions are brought to the attention of the managing director of the High Yield Trading Department for final disposition based upon all the circumstances of the transaction and the advice of the Compliance Department.</p> <p>A record of the price exception reports and any determinations made by the High Yield Trading Department are maintained by the supervisory principal. The criteria for determining price exceptions generated by the “High Yield Markup Report” are described in the Compliance Department’s operations manual.</p>		

V. SURVEILLANCE SYSTEMS, AUDIT MODULES, AND INQUIRY RESPONSES

The SEC, FINRA and other regulators expect broker-dealers and investment advisers to develop and utilize robust computerized systems and exception reports to prevent and detect violations and enable management to supervise more effectively. SEC and FINRA rules specifically contemplate the use of systems and reports in specific areas.

Proskauer can work with the company and its in-house and outside providers to help configure surveillance systems that capture and analyze activities that can signal potential violations. We can help develop systems and reports specifically tailored to your organization and business activities.

We can also work with you to develop regulatory compliance modules for internal audit programs, and counsel you on findings and resolutions.

REVIEW OF OVERALL SUPERVISORY SYSTEM

FINRA Rule 3120 requires member broker-dealers to develop, maintain and enforce a system (1) to test and verify that the member's supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and FINRA rules, and (2) to create or amend supervisory procedures as needed in response to such testing. The rule also requires members to submit a report annually to the firm's CEO, senior management and board of directors or audit committee that details the system of supervisory controls, summarizes the testing results, and identifies any additional or amended supervisory procedures in response to those results.

FINRA Rule 3130 requires the CEO to certify annually that the member has in place processes to establish, maintain, review, test and modify its supervisory policies and procedures after one or more meetings with the firm's chief compliance officer to discuss the supervisory system.

Rule 206(4)-7(b) of the Advisers Act requires investment advisers to review the adequacy and effectiveness of their supervisory policies and procedures at least once a year.

Proskauer works with clients to develop and maintain their compliance review programs and counsels them on findings and resolutions in specific exams.

COMPLIANCE, TRAINING AND EDUCATION PROGRAMS

FINRA Rule 1240 requires member firms to develop a comprehensive continuing education program for registered persons consisting of a Regulatory Element and a Firm Element. The Regulatory Element affects all registered persons, and the content is prescribed by the SRO. The Firm Element affects registered persons who have direct contact with customers and are engaged in retail sales, trading, and investment banking activities, and their supervisors, and the content is largely set by the member based on a needs assessment analysis.

In addition, FINRA Rule 3110(a)(7) requires that each registered person participate in an annual compliance meeting—*i.e.*, a meeting at which compliance matters relevant to the person(s) particular activities are discussed.

Proskauer works with clients to develop the Firm Element of continuing education programs and Compliance Meeting agendas. These include preparation and delivery of materials on topics such as the Anti-Money Laundering (AML) obligations, Information Barrier Procedures, Code of Conduct, as well as specific modules relating to retail sales, institutional sales and trading, research, investment banking activities and other business operation.

We evaluate and prioritize your training needs, document the program, and provide a written training plan.

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Please contact Benjamin J. Catalano at bcatalano@proskauer.com, or call him at (212) 969-3980, if you would like more information on our broker-dealer and investment adviser supervisory services.

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice, or render a legal opinion.

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