FINANCIAL SERVICES INSTITUTE

VOICE OF INDEPENDENT BROKER-DEALERS
AND INDEPENDENT FINANCIAL ADVISORS

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VIA ELECTRONIC MAIL

July 20, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549- 1090

RE: SR-FINRA-2011-028 – Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook

Dear Ms. Murphy:

On May 14, 2008, the Financial Industry Regulatory Authority, Inc. (FINRA) published Regulatory Notice 08-24 (RN 08-24).[1] The proposal, titled Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls, sought to make significant changes to National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE) rules related to supervision and supervisory controls rules in the FINRA Rulebook Consolidation process. On June 13, 2008, the Financial Services Institute (FSI)[2] submitted a comment letter in response to RN 08-24.[3] On June 10, 2011, FINRA filed with the SEC its second iteration of the proposed rule changes to NASD and NYSE supervisory rules as part of the FINRA Rulebook Consolidation process (Proposed Rules).[4] On June 29, 2011, the SEC published the Proposed Rules in the Federal Register for comment.[5]

The Proposed Rules set forth FINRA's plan to:

> (1) adopt FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) to replace NASD Rules 3010 (Supervision) and 3012 (Supervisory Control System), respectively;
> (2) incorporate into FINRA Rule 3110 and its supplementary material the requirements of NASD IM-1000-4 (Branch Offices and Offices of Supervisory Jurisdiction), NASD IM-3010-1 (Standards for Reasonable Review), Incorporated NYSE Rule 401A (Customer Complaints), and Incorporated NYSE Rule 342.21 (Trade Review and Investigation);

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[1] Regulatory Notice 08-24, Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038506.pdf

[2] The Financial Services Institute is an advocacy organization for the financial services industry – the only one of its kind. FSI is the voice of independent broker-dealers and independent financial advisors in Washington, D.C. Established in January 2004, FSI's mission is to create a healthier regulatory environment for their members through aggressive and effective advocacy, education and public awareness. FSI represents more than 125 independent broker-dealers and more than 16,000 independent financial advisors, reaching more than 15 million households. FSI is headquartered in Atlanta, GA with an office in Washington, D.C.

[3] Letter from the Financial Services Institute to Marcia E. Asquith (June 13, 2008), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p038772.pdf

[4] Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules (June 10, 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123779.pdf

[5] Notice of Filing of Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, 76 Fed. Reg. 38245 (June 29, 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123841.pdf

(3) replace NASD Rule 3010(b)(2) (often referred to as the "Taping Rule") with new FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms);
(4) replace NASD Rule 3010(e) (Qualifications Investigated) with new FINRA Rule 1260 (Responsibility of Member to Investigate Applicants for Registration);
(5) replace NASD Rule 3110(i) (Holding of Customer Mail) with new FINRA Rule 3150 (Holding of Customer Mail); and
(6) delete the following NASD and Incorporated NYSE Rules and NYSE Rule Interpretations: (i) NASD Rule 3010(f) (Applicant's Responsibility); (ii) NYSE Rule 342 (Offices—Approval, Supervision and Control) and related NYSE Rule Interpretations; (iii) NYSE Rule 343 (Offices—Sole Tenancy, and Hours) and related NYSE Rule Interpretations; (iv) NYSE Rule 351(e) (Reporting Requirements) and NYSE Rule Interpretation 351(e)/01 (Reports of Investigation); (v) NYSE Rule 354 (Reports to Control Persons); and (vi) NYSE Rule 401 (Business Conduct).

FSI welcomes this opportunity to comment on the Proposed Rules. As indicated in our comment letter in response to RN 08-24, we support FINRA's efforts to reorganize, update, and streamline FINRA's Rulebook. We applaud and compliment FINRA on addressing many of the concerns we raised in our earlier comment letter in response to RN 08-24. However, we continue to have significant concerns with many aspects of the Proposed Rules. Specifically, we have concerns related to FINRA's:

- Attempt to expand member supervision requirements beyond securities activities;
- Restrictions on one person office of supervisory jurisdiction (OSJ) locations;
- Requirements for oversight of OSJ locations;
- Effort to expand the scope of the supervisory procedures to be created by a firm;
- Requirements for firms to review internal communications;
- Rules addressing potential conflicts of interest between an associated person and a supervisory principal;
- Expanded reporting requirements for firms with $150 million or more in gross revenue;
- Definition of the term investment banking; and
- Review of Securities Transactions.

These concerns are outlined in greater detail below.

Background on FSI Members

FSI represents independent broker-dealers (IBD) and the independent financial advisors that affiliate with them. The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees, of

their affiliated broker-dealer firm.[6] These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[7] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's mission is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Comments on the Proposed Rule

As stated above, FSI welcomes this opportunity to comment on the Proposed Rules. We appreciate FINRA's efforts to address many of the concerns we raised in our earlier comment letter offered in response to RN 08-24. However, we continue to have significant concerns with many aspects of the Proposed Rules. These concerns are addressed in more detail below.

- **Expansion of Supervision Requirement Beyond Securities Activities – Proposed FINRA Rule 3110(a)(2) and Supplementary Material .01 -** In our comment letter in response RN 08-24, we argued that we believe that requiring the appointment of a principal to oversee each supervisory responsibility of the member for each type of business in which it engages is overly broad, and seeks to expand FINRA's jurisdiction into areas that are currently overseen by other regulators. We also noted that this expansion of a firm's supervisory obligations would significantly expand the potential liability exposure of an independent broker-dealer whose financial advisors engage in numerous outside activities. We added that this expansion is without a corresponding benefit to investors and concluded by recommending that FINRA amend this section of the Proposed Rule by keeping the status quo, which requires a firm to appoint a principal for "each type of business in which it engages for which registration as a broker/dealer is required."

  In response to these comments, FINRA asserts the following:

  > "The proposed rule change was intended to explicitly address the fact that a member is responsible for having a supervisory system

[6] Cerulli Associates at http://www.cerulli.com/.
[7] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

> that encompasses all of its business lines. Thus, if a member chooses to engage in a business that does not require registration as a broker-dealer, the member is nonetheless responsible for supervising that business. To avoid further confusion, FINRA has proposed to retain the language in NASD Rule 3010(a) and adopt supplementary material explaining this requirement. Consequently, proposed Supplementary Material .01 (Business Lines) provides that for a member's supervisory system required by proposed FINRA Rule 3110(a) to be reasonably designed to achieve compliance with FINRA Rule 2010, it must include supervision for all of the member's business lines irrespective of whether they require broker-dealer registration.
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> As FINRA noted in Regulatory Notice 08-24, the requirement that a member supervise all of its business lines is consistent with NASD Rule 3010(b)(1) (and proposed FINRA Rule 3110(b)(1)), which currently requires a member to have supervisory procedures for all business activities in which it engages. Additionally, a member's responsibility for appropriate supervision for all of its business activities is consistent with a member's obligation under FINRA Rule 2010 to observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business. These general ethical standards protect investors and the securities industry from dishonest practices that are unfair to investors or hinder the functioning of a free and open market, regardless of whether those practices occur in business lines that do not require broker-dealer registration or are not illegal or violate a specific rule, law, or regulation. The proposal merely codifies, under proposed FINRA Rule 3110, a member's duty required by FINRA Rule 2010 to supervise all business activities, irrespective of whether they are part of a member's investment banking or securities business."[8]

In the current version of the Proposed Rules, FINRA offers proposed FINRA Rule 3110(a)(2) which provides that a member's supervisory system shall provide, at a minimum, for the "… designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker-dealer is required."[9] Additionally, Supplementary Material .01 (Business Lines) provides that "[f]or a member's supervisory system required by Rule 3110(a) to be reasonably designed to achieve compliance with Rule 2010, it must include supervision for **all of the member's business lines irrespective of whether they require broker-dealer registration**"[10] (emphasis added). If the Proposed Rules were adopted as written, we understand that these provisions would require all broker-dealers to appoint a principal to oversee all securities business lines that flows through a firm, but would not require the appointment of a principal to oversee non-securities business lines. However, insurance business,

[8] Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules, 33 - 34, (June 10, 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123779.pdf
[9] Id. at 376.
[10] Id. at 391.

investment advisory activity, and other outside business activity that result in compensation flowing through a broker-dealer's payment grid would require a firm to supervise this activity.

While we appreciate FINRA's effort to respond to our initial comments, and the comments of others related to this provision of the proposal, we do not believe that FINRA has adequately addressed our concerns. We continue to believe that requiring a firm to supervise all business lines in which the member engages is overly broad, and seeks to expand FINRA's jurisdiction into areas that are currently overseen by other regulators. We continue to believe that this expansion of a firm's supervisory obligations would have a disparate impact on independent broker-dealers whose financial advisors engage in numerous outside activities. For example, several IBDs are affiliated with insurance companies and many sell the products of the insurance company as part of a fully disclosed outside business activity. Under the Proposed Rules, a broker-dealer would be required to supervise this activity despite the fact that it is already subject to supervision by the insurance company parent, which has the knowledge, expertise and regulatory obligation supervise. As a result, the Proposed Rules require duplicative and inferior supervision efforts by the broker-dealer. We believe this result is nonsensical.

Moreover, we disagree with FINRA's interpretation of the case law that it introduces to support its position that it has jurisdiction over certain business activities, even if that activity does not involve a security. It appears that FINRA is adopting an overly expansive interpretation of the decision in *Ialeggio v. SEC*.[11] FINRA provides one quote from this case to support its assertion: "NASD's disciplinary authority is broad enough to encompass business-related conduct that is inconsistent with just and equitable principles of trade, even if that activity does not involve a security." However, FINRA does not provide any further analysis of the court's decision. We believe a fair interpretation of the case law and subsequent enforcement actions is that there must be a violation of criminal law, or existing regulations, for FINRA to be successful in an enforcement action related to an NASD Rule 2010 violation that does not involve securities related activity. For example, when a registered person misappropriates funds of a political organization, FINRA has been able to successfully bring an enforcement action under violation of NASD Rule 2010.[12] Additionally, FINRA was able to bring a successful enforcement action under NASD Rule 2010 when a registered person violated Regulation S-P by emailing customer information to his home email address in an attempt to take customer information in contravention to the firm's privacy policy.[13] In both of these matters, FINRA was able to apply an NASD Rule 2010 violation over non-securities related activity because there was criminal activity, or clear regulatory violation, by the registered person. In accordance with the precedent established by these cases, we urge the SEC to prevent FINRA from expanding its jurisdiction to non-securities business lines, except where there is a violation of criminal law or existing regulation.

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[11] See Ialeggio v. SEC, No. 98-70854, 1999 U.S. App. LEXIS 10362, at 4-5 (9th Cir. May 20, 1999), Footnote 34 of the Proposed Rules.

[12] Vail v. SEC, 101 F. 3d 37, 39 (5th Cir. 1996)

[13] In Re Department of Enforcement v. DiFrancesco, 2010 WL 5176694 (N.A.S.D.R.) (In this case the hearing panel initially found that the registered representative had also violated Rule 2010 because his actions resulted in a breach of contract with his employer. On appeal, however, the decision regarding the breach of contract serving as a basis for violation of Rule 2010 was overturned, with the NAC holding that violation of Regulation S-P was the sole basis for finding a violation of Rule 2010.)

Additionally, we urge the SEC to direct FINRA to amend this section of the Proposed Rule by requiring a firm to supervise "each type of business in which it engages for which registration as a broker/dealer is required" rather than expanding this requirement into new areas over which FINRA does not have jurisdiction. Alternately, we urge the SEC to direct FINRA to expressly exempt disclosed and reported outside business activities from the supervision requirements of the Proposed Rule.

- **One Person OSJ Locations - Proposed FINRA Rule 3110(a)(4) and Supplementary Material .04 -** Proposed FINRA Rule 3110(a)(4) provides that a member's supervisory system shall provide, at a minimum, for "[t]he designation of one or more appropriately registered principals in each OSJ and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member."[14]

  Proposed Supplementary Material .04 (One-Person OSJs) provides that "[a] location with only one registered person that either meets the definition of OSJ in Rule 3110(e) or that the member has selected as an additional OSJ pursuant to [Supplementary Material].03 above, must be registered and designated as an OSJ. The registered person must be an appropriately registered principal and designated, pursuant to Rule 3110(a)(4), to carry out supervisory responsibilities assigned to that office ("on-site principal"). If the on-site principal is authorized to engage in business activities other than the supervision of associated persons or other offices as enumerated in Rule 3110(e)(1)(D) through (G), **the principal cannot supervise his or her own activities.** Such one-person OSJ location must be under the **close supervision and control** of another appropriately registered principal ("senior principal"). The senior principal will be responsible for supervising the activities of the on-site principal at such office…"[15] (emphasis added).

  FSI has serious concerns with these provisions. Specifically, we believe that these provisions are not business model neutral and will have a substantial and unnecessary negative impact on the supervisory structure utilized by many IBD firms. Many IBDs use a Field OSJ Structure. This effective supervisory system uses OSJ principals in the field to supervise branch offices. Field OSJ Principals may be charged with approving client accounts, reviewing simple advertising requests, and other low-level compliance functions. These Field OSJ Principals are then supervised by Home Office Principals. The Home Office Principals, who are also trained compliance professionals, double check the work of the Field OSJs, add another layer of review and supervision, and are aided in their efforts by sophisticated electronic surveillance systems and the support of the firm's entire compliance department.

  IBD firms are concerned that such a Field OSJ Structure would be prohibited by the Proposed Rules because it: (a) allows a Field OSJ principal to engage in certain basic compliance tasks related to his own business, and (b) may not meet the undefined "close supervision and control" standard. We believe that FINRA should provide broker-dealer firms with latitude to create effective compliance supervision systems or be required to explain the specific rational for this requirement and justify the Proposed Rules' disparate impact on IBD firms. Absent such a change, the net result of this section of the Proposed Rule will be a reduction in the quality of supervision at firms utilizing a Field OSJ

[14] Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules at 377, (June 10, 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123779.pdf.
[15] Id. at 392.

Structure due to the reduction in the number of registered principals engaging in the oversight.

Moreover, in an age where electronic means have been developed to assist firms with supervision, we seek additional guidance from FINRA on the meaning of the phrase "close supervision and control" in Supplementary Material .04. Specifically, we believe that reasonable people could disagree on meaning of "close supervision and control," and that this term can be subject to a variety of interpretations. Accordingly, we urge the SEC to require FINRA to provide guidance on the meaning of the phrase "close supervision and control."

- **Oversight of OSJ Locations - Proposed FINRA Rule 3110(a)(4) and Supplementary Material .05 –** As noted above, Proposed FINRA Rule 3110(a)(4) provides that a member's supervisory system shall provide, at a minimum, for the " … designation of one or more appropriately registered principals in each OSJ, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member."[16]

  Supplementary Material .05 (Supervision of Multiple OSJs by a Single Principal) provides that:

  > "Rule 3110(a)(4) requires a member to designate one or more appropriately registered principals in each OSJ with the authority to carry out the supervisory responsibilities assigned to that office. The designated principal for each OSJ must have a **physical presence, on a regular and routine basis**, at each OSJ for which the principal has supervisory responsibilities. **Consequently, there is a general presumption that a principal will not be designated and assigned to be the on-site supervisor pursuant to Rule 3110(a)(4) to supervise more than one OSJ.** If a member determines it is necessary to designate and assign one appropriately registered principal to be the on-site supervisor pursuant to Rule 3110(a)(4) to supervise two or more OSJs, the member must take into consideration, among others, the following factors:
  >
  > (a) whether the principal is qualified by virtue of experience and training to supervise the activities and associated persons in each location;
  > (b) whether the principal has the capacity and time to supervise the activities and associated persons in each location;
  > (c) whether the principal is a producing registered representative;
  > (d) whether the OSJ locations are in sufficiently close proximity to ensure that the principal is **physically present at each location on a regular and routine basis**; and
  > (e) the nature of activities at each location, including size and number of associated persons, scope of business activities, nature and complexity of products and services offered, volume of business done, the disciplinary history of persons assigned to such locations, and any other indicators of irregularities or misconduct.

[16] Id. at 377.

> The member must establish, maintain, and enforce written supervisory procedures regarding the supervision of all OSJs. In all cases where a member designates and assigns one principal to supervise more than one OSJ, the member must document in the member's written supervisory and inspection procedures the factors used to determine why the member considers such supervisory structure to be reasonable. **There is a further general presumption that a determination by a member to designate and assign one principal to supervise more than two OSJs is unreasonable.** If a member determines to designate and assign one principal to supervise more than two OSJs, the member's determination will be subject to greater scrutiny, and the member will have a greater burden to evidence the reasonableness of such structure." [17](emphasis added)

In our comment letter in response to RN 08-24, we indicated that we believe that subsection 3110(a)(4) and Supplementary Material .04 (which is now Supplementary Material .05 in the Proposed Rules) should be revised to allow a registered principal to be assigned the responsibility of supervising more than one OSJ and/or non-OSJ branch office. We also indicated that the requirement of a "physical presence, on a regular and routine basis" is overly burdensome, unnecessary, and should be removed.

In response to these comments, FINRA indicated that "[t]he one-principal-per-OSJ presumption in proposed Supplementary Material .05 … does not limit a member's ability to have more than one principal in the supervisory chain for an OSJ. Rather, FINRA believes that the presumption is consistent with the long-standing requirement in NASD Rule 3010(a)(4) for members to have an on-site principal in each OSJ location, which is a cornerstone of a member's supervisory structure. Moreover, FINRA believes that physical presence, on a regular and routine basis, by a supervisor at a location that engages in significant activities is necessary for effective oversight. The presumption ensures that such an on-site principal has sufficient time and resources to engage in meaningful supervision. However, in response to the comments, FINRA has modified proposed Supplementary Material .05 to make it clear that the presumption applies only to the designation of the on-site principal supervisor required for FINRA Rule 3110(a)(4) purposes in each OSJ location."[18]

While we appreciate FINRA's clarification that the one-principal-per-OSJ presumption applies only to OSJs, and not other branch offices, we believe that FINRA has not gone far enough with revisions to this section. Each broker-dealer and its registered principals should determine the appropriate number of offices assigned to each OSJ manager because they are in the best position to judge the effectiveness of the chosen supervisory system. The Proposed Rules and Supplementary Material should clearly state that firms have discretion to create supervisory systems that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA and MSRB Rules.

More specifically, we believe that FINRA should not create a rebuttable presumption as it relates to the appropriate number of OSJs a principal can oversee and supervise. While we appreciate FINRA providing a clear list of items it would like a firm to consider if and/or when it decides to designate and assign one registered principal to be the on-site

[17] Id. at 393-394.
[17] Id. at 38 – 39.

supervisor for two or more OSJs, we believe it is inappropriate for FINRA to create this rebuttable presumption as firms have devised effective ways to properly supervise their associated persons via electronic methods supplemented by periodic onsite inspections. As a result, we continue to believe that Rule Proposal subsection 3110(a)(4) and Supplementary Material .05 should be revised to remove FINRA's bias against a registered principal being assigned the responsibility of supervising more than one OSJ.

Moreover, we believe the requirement of a "physical presence, on a regular and routine basis" is overly burdensome and unnecessary, as electronic supervisory methods are prevalent and effective in current supervisory systems. Accordingly, we urge the SEC to require that FINRA strike this language from Supplementary Material .05. To the extent that the phrase "physical presence, on a regular and routine basis" is left in the Proposed Rule, we would like additional guidance as to the exact meaning on this phrase. We believe that reasonable people could disagree on what "regular and routine" means and, therefore, greater clarity is necessary

- **Scope of Supervisory Procedures – Proposed FINRA Rule 3110(b)(1) –** Proposed FINRA Rule 3110(b)(1) provides that "[e]ach member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA and MSRB rules." [19]

  As provided for in our comment letter in response to RN 08-24, and in line with our comments in response to Proposed FINRA Rule 3110(a)(2) above, we believe that the language of Proposed FINRA Rule 3110(b)(1) is overly broad and represents a significant expansion of a broker-dealer's supervisory responsibilities and FINRA's jurisdiction.

  In response to our comments on this issue to RN 08-24, FINRA provides that "NASD Rule 3010(b)(1) currently requires a member to have supervisory procedures to supervise all types of business in which it engages. Proposed FINRA Rule 3010(b)(1) merely retains this existing requirement." FINRA goes on to explain that "a member's supervisory system must include appropriate supervision for all of its business activities in order to comply with its obligations under FINRA Rule 2010 to protect investors and the securities industry from dishonest practices that are unfair to investors or hinder the functioning of a free and open market."[20]

  The entire text of NASD Rule 3010(b)(1) provides as follows – "Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD."[21]

  We disagree with FINRA's interpretation of a firm's obligation to supervise all of its business activities in order to comply with its obligations under FINRA Rule 2010. As noted above, we disagree with FINRA's interpretation of the case law that it introduces to support its position that it has authority over certain business lines, even if that activity

[19] Id. at 378.
[20] Id. at 41.
[21] Available at http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=3717&print=1

does not involve a security. We believe a fair interpretation of the case law and subsequent enforcement actions is that there must be a violation of criminal law, or existing regulations, for FINRA to be successful in an enforcement action related to an NASD Rule 2010 violation that does not involve securities related activity. As a result, we urge the SEC to prevent FINRA from expanding its jurisdiction to non-securities business lines, except where there is a violation of criminal law or existing regulation. More specifically, we recommend that the Proposed FINRA Rule 3110(b)(1) be revised to provide that "[e]ach member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages **for which registration as a broker/dealer is required** and the activities of its associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA and MSRB rules."

In addition, we would like additional clarity related to the Proposed Rules applicability to the outside business activities of a registered representatives, registered principals, or other associated persons. It is not clear from the language of the Proposed Rule - "the types of business in which it engages and the activities of its associated persons" – if this requires a firm to create written supervisory procedures to oversee outside business activities of the firms' registered representatives, registered principals, or other associated persons. We do not anticipate that it would, but request additional clarity on this point.

- **Review of Internal Communications – Proposed FINRA Rule 3110(b)(4) -** Proposed FINRA Rule 3110(b)(4) provides that "[t]he supervisory procedures required by this paragraph (b) shall include procedures for the review of incoming and outgoing written (including electronic) correspondence with the public and internal communications relating to the member's investment banking or securities business."[22] This provision of the Proposed Rule goes on to add that "[t]he supervisory procedures must be appropriate for the member's business, size, structure, and customers. The supervisory procedures must ensure that the member properly identifies and handles in accordance with firm procedures, customer complaints, instructions, and funds and securities, and communications that are of a subject matter that require review under FINRA and MSRB rules and federal securities laws."[23] It concludes with the position that the review of the public and internal communications must be conducted by "a registered principal and must be evidenced in writing, either electronically or on paper."[24]

  This represents a significant change in broker-dealer's communication review obligations. Currently, NASD Rule 3010(d)(2) requires a member firm to supervise incoming and outgoing written correspondence with the public, and to establish procedures to do the same. This section also requires a member firm to retain the correspondence of registered representatives relating to its investment banking or securities business. However, the current rules do not call for the review of internal communications.

  We have concerns with the addition of the internal communications review requirements contained in Proposed FINRA Rule 3110(b)(4). Specifically, we do not believe that the benefits of supervision of "internal communications relating to the member's investment banking or securities business" outweigh the excessive burdens created by such a requirement. While we compliment FINRA on the inclusion of Supplementary Material

[22] Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules at 378-79, (June 10, 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123779.pdf.
[23] Id. at 379.
[24] Id.

.08 and .10 (Supplementary Material .08 allows for the use of a risk based review of public and internal communications, and Supplementary Material .10 allows a principal to delegate this review to an unregistered person)), we believe that firms are in the best position to determine whether review of some or all of their internal communications would be reasonable in light of the burdens created by this practice. Furthermore, we believe most firms will conclude that the supervision of internal communication will not lead to the discovery of matters of compliance concern with sufficient frequency to justify this burdensome supervision requirement. As a result, we urge the SEC to require FINRA to remove the requirement for a broker-dealer to supervise internal communications from the Proposed Rules. If this request is not granted, we argue in the alternative that the SEC should require FINRA to: (a) make the review of internal communications a suggested practice, rather than a mandatory requirement; and (b) require that FINRA more specifically define "internal communications" rather than stating that internal communication is simply "…any [internal] communications relating to the member's investment banking or securities business." This overly broad definition would require the supervision of ALL communications as the broker-dealer exists for the sole purpose of furthering the investment banking and securities business of the firm.

- **Conflicts of Interest between Associated Persons and Supervisory Principals – Proposed FINRA Rule 3110(b)(6)(D) -** Proposed FINRA Rule 3110(b)(6)(D) provides that a firm's supervisory procedures shall set forth a procedure to address "any conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the firm, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised."[25] FINRA's comment related to this provision in the FINRA-SR-2011-028 provides, in pertinent part, that this rule requires members to have procedures to prevent the standards of supervision required pursuant to proposed FINRA Rule 3110(a) from being reduced in any manner due to any conflicts of interest that may be present with respect to the associated person being supervised, such as "the person's position, the amount of the revenue generated by such person, or any other factor that would present a conflict."[26]

  We generally support this section of the Proposed Rules, and believe that firms will be able to properly manage conflicts of interest that are known, or should reasonably be known to the firm. However, we have concerns related to FINRA's position that this provision should be read to include "any" conflict of interest. We also have concerns related to FINRA's vague statement that firm's are obligated to identify "any other factor that would present a conflict."[27] While we realize that this guidance is contained in the release, and is not contained in the Proposed Rule or Supplementary Material, we have concerns that this may be used by FINRA in enforcement actions to expand the scope of the Proposed Rule. Accordingly, we urge the SEC to require that FINRA provide additional guidance in the Regulatory Notice announcing the final version of the FINRA Supervision Rules that FINRA Rule 3110(b)(D) only applies to conflicts of interest that are known, or should reasonably be known to the firm.

  Moreover, in our comment letter in response to RN 08-24, we requested that additional guidance be added to the Supplementary Material to explain that the receipt of

[25] Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules at 381, (June 10, 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123779.pdf.
[26] Id. at 17.
[27] Id.

commission overrides does not equate to having one's compensation "determined by" a person who is supervised, within the context of Proposed FINRA Rule 3110(b)(6)(D). In response to this comment, FINRA provides that it "does not believe that additional rule language is necessary. Although a supervised person may affect his or her supervisor's compensation (through overrides or in other ways), proposed FINRA Rule 3110(b)(6)(C) concerns only those situations where a supervised person directly controls a supervisor's compensation or continued employment."[28] While we agree with FINRA's position on this issue, we believe that FINRA members will benefit from having this guidance in the final rule or final Supplementary Material. Accordingly, we urge the SEC to require FINRA to include this guidance in the final rule or Supplementary Material.

- **Expanded Reporting Requirements for Firms with $150 million in Gross Revenue – Proposed FINRA Rule 3120(b) -** Proposed FINRA Rule 3120(b) requires firms that report gross revenue of $150 million or more to report to their senior management on the firm's supervisory procedures in the following areas:

    - Customer complaints and internal investigations reported to FINRA
    - The prior year's compliance efforts related to:
        1. Trading and market activities,
        2. Investment banking activities,
        3. Antifraud and sales practices,
        4. Finance and operations,
        5. Supervision,
        6. Anti-money laundering, and
        7. Risk management

  This section of the rule goes on to define "gross revenue" for the purposes of the rule, but it does not provide definitions of the seven areas that must be reported on to senior management. FSI members would benefit from additional clarity concerning the content of the required report. Specifically, we request that FINRA provide definitions and examples of issues that would be reported on within the seven areas of the report. This additional guidance will assist broker-dealer firms in their effort to comply with the requirements of Proposed FINRA Rule 3120(b). As a result, we urge the SEC to require FINRA to provide definitions and examples in each of the seven reporting areas. We would also request an explanation from FINRA on the significance of the $150 million threshold . This figure appears to be arbitrary, without clear justification, and likely to involve a larger number of firms in future years as inflation has its impact.

- **Definition of the Term "Investment Banking Services" - Proposed FINRA Rule 3110(b)(2), 3120(d)(3)(B, and Supplementary Material .07 –** Proposed FINRA Rule 3110(b)(1) requires each member to establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons. These written procedures must be reasonably designed to achieve compliance with applicable securities laws and regulations, and applicable FINRA and MSRB rules.[29] Subsection (2) of this section of the Proposed Rule requires these written procedures to include the review of all transactions relating to the investment banking or securities business of the member.[30] Supplementary Material .07 provides that, "[a] member may use a risk-based review system to comply with Rule 3110(b)(2), which requires the review

[28] Id. at 50.
[29] Id. at 378.
[30] Id.

by a registered principal, as evidenced in writing, of all transactions relating to the investment banking or securities business of the member.[31] Finally, proposed FINRA Rule 3110(d)(3)(B) defines the term "investment banking services" to include, without limitation, **acting as an underwriter, participating in a selling group in an offering for the issuer,** or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital or equity lines of credit or serving as placement agent for the issuer or otherwise acting in furtherance of a private offering of the issuer" (emphasis added).[32]

While we understand FINRA's desire to require member firms who engage in significant investment banking activity to supervise this activity, we believe that the proposed definition of "investment banking" is extremely broad and unintentionally sweeps in many activities that are not, per se, investment banking activities. For example, under the proposed definition of investment banking, a firm may be deemed to be acting as an "underwriter" in the sale of a variable annuity, if that firm is the principal underwriting broker dealer. Moreover, firm's may unintentionally be swept into this definition if they "participate in a selling group in an offering for the issuer" by selling shares of real estate investment trusts, variable annuity contracts, and limited partnerships. While we realize that firms would be obligated to have written procedures to supervise these actives as "securities business of the member," we believe that they should not be considered "investment banking" activities. Accordingly, we urge the SEC to require FINRA to revise the definition of "investment banking services" to narrow its scope and limit any untended consequences that may result from a broad definition of this term.

- **Review of Securities Transactions – Proposed Rule 3110(d)(1) –** This Proposed Rule was initially included in RN 08-24 as Supplementary Material .08. As initially contained in the Supplementary Material, each member had the obligation to "include in its supervisory procedures a process for the review of securities transactions that are effected for the account(s) of **the member and/or the member's associated persons and their family members** to identify trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices" (emphasis added).[33] We initially commented on this provision stating that we believed the provision should be changed to require review of securities transactions that are affected for the accounts "owned by a registered person directly or through beneficial ownership, interest, or control, including immediate family members."[34]

  In response to this and other comments expressing concern regarding the wording of Supplementary Material .08, FINRA amended the Proposed Rule to include the Supplementary Material in the Rule itself and changed the language. Proposed Rule 3110(d)(1) provides that "[e]ach member shall: (A) include in its supervisory procedures a process for the review of securities transactions that are effected for the account(s) of the member and/or the member's associated persons and any other covered account to

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[31] Id. at 395.
[32] Id. at 389. See also, footnote 18 of the release, which provides that this definition of investment banking is the same definition as in proposed FINRA Rule 2240(a)(4) (Research Analysts and Research Reports). See Regulatory Notice 08-55 (October 2008).
[33] Regulatory Notice 08-24, Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls at 28, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038506.pdf.
[34] Letter from the Financial Services Institute to Marcia E. Asquith at 6 (June 13, 2008), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p038772.pdf.

identify trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices, and (B) conduct promptly an internal investigation into any such trade to determine whether a violation of those laws or rules has occurred."[35] Proposed rule 3110(d)(3) further defines "covered account" to mean: "(i) any account held by the spouse, child, son-in-law, or daughter-in-law of a person associated with the member where such account is introduced or carried by the member; (ii) any account in which a person associated with the member has a beneficial interest; and (iii) any account over which a person associated with the member has the authority to make investment decisions."[36]

Additionally, FINRA states that "[c]onsistent with the requirements of Section 15(g) of the Act and proposed FINRA Rule 3110(b), the procedures adopted by the member would need to be reasonably designed to prevent violations of the Act, the rules thereunder, and FINRA rules prohibiting insider trading and manipulative and deceptive devices."[37] FINRA further states, therefore, that "each member's procedures should take into consideration the nature of the member's business, which includes an assessment of the risks presented by different transactions and different departments within the firm."

We applaud FINRA for responding to our concerns regarding this issue and for further clarifying in its amendment which family members are covered under the Rule. However, we continue to have concerns with the requirements of the Proposed Rules. Specifically, we have concerns about firm's ability to prevent violations of the Act, violations of statutory and regulatory prohibitions on insider trading, or the use of manipulative and deceptive devices. After all, broker-dealers supervising account activity occurring in an account held at another firm in which an associated person has a beneficial interest will, at best, receive post transaction notification of the trade through confirmation statement or data download. At that point, such a violation shall already have occurred. Thus broker-dealer firms can at best detect and promptly report potential violations. As a result, we urge the SEC to require FINRA to provide clarification related to a firm's supervisory obligations for brokerage accounts held outside of the firm . Specifically, we believe this obligation should only be to detecting and reporting indicia of potential insider trading or use of manipulative and deceptive devices.

[35] Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules at 387-88, (June 10, 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123779.pdf.
[36] Id. at 389.
[37] Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules at 61 (June 10, 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p123779.pdf.

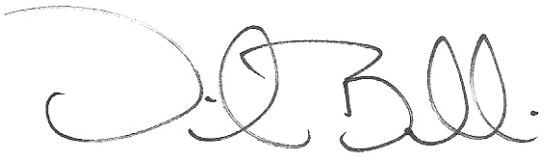
Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to comment on the Proposed Rules. Given the importance of these Proposed Rules, the scope and complexity of the changes included therein, and the short comment period, FSI reserves the right to supplement this comment letter in the event we observe addtional areas of concern.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 770 980-8488.

Respectfully submitted,

Sincerely,



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