FINRA
Financial Industry Regulatory Authority

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Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

**Re: File No. SR-FINRA-2009-057 – Response to Comments**

Dear Ms. Morris:

This letter responds to comments received by the Securities and Exchange Commission ("SEC" or "Commission") to the above-referenced rule filing, a proposal to change Section 1(c) of Schedule A to the FINRA By-Laws to amend the Personnel Assessment ("PA") and Gross Income Assessment ("GIA") paid by each FINRA member. As noted in the rule filing, the proposal is intended to achieve a more consistent and predictable funding stream for FINRA to carry out its regulatory mandate. The proposed rule change was published for comment in the Federal Register on September 11, 2009.[1]

The Commission received 743 comments in response to the proposal.[2] Of those, the Commission characterizes four as conforming to form Letter Type "A" and 672 as fitting form Letter Type "B". Each of the commenters objects to the proposal, typically on one or more of the following grounds: (1) FINRA should have anticipated the market downturn and budgeted accordingly; (2) the proposed assessment increases are unreasonable in light of the difficult economic times for the industry and fee increases imposed by other entities, including regulators and market operators; (3) the percentage increase of the PA is too steep and out of step with inflation; and (4) the proposed increases will disproportionately impact small and independent broker-dealers that were not responsible for FINRA's revenue shortfalls. In addition, several commenters – including some sympathetic to FINRA's goal to reduce its revenue volatility – urge FINRA to delay or phase-in implementation of the proposal or cap any annual rate increases.

1 Exchange Act Release No. 60624 (September 3, 2009), 74 FR 46828 (September 11, 2009).

2 The names of commenters can be found at: http://www.sec.gov/comments/sr-finra-2009-057/finra2009057.shtml

FINRA disagrees with the comments and believes that the proposed fee changes are necessary, reasonable and equitably allocated among the firms regulated by FINRA. While FINRA is sensitive to the distress firms have experienced during the financial crisis, FINRA's paramount responsibility is to protect the investing public by administering an effective and sustainable regulatory program. That statutory obligation persists in good times and bad, and the resources needed for FINRA to effectively carry out its responsibilities are not less in difficult financial and market environments.

As set forth in more detail below, the proposal will allow FINRA to continue to effectively discharge its regulatory obligations in a fiscally prudent way, while reducing its vulnerability to another market downturn. FINRA seeks to avert the fiscal situation occasioned in years 2008 and 2009, where it experienced operating losses due to funding shortfalls without any attempt to recoup such losses from member firms. Significantly, the proposed rule change is just one component of FINRA's overall strategy to address its shortfall in operating cash flows. FINRA has minimized the fee increase sought through an ongoing comprehensive cost-cutting program that so far has reduced expenses that do not directly impact its regulatory programs by more than $70 million from prior year. FINRA also supplements, where possible, member fees and assessments with the income yield from its balance sheet portfolio, which has been reallocated to a lower risk asset allocation. As such, FINRA has reduced performance volatility while creating a more reliable income stream to subsidize fees. However, these actions alone have been insufficient to make up the funding deficits FINRA has experienced over the prior two years. The proposed rule change is intended to remedy ongoing deficits and ameliorate vulnerability to future revenue shortfalls. FINRA believes that any delay in implementation of the proposal will only necessitate future fee increases of much greater magnitude.

**Background**

At the outset, FINRA notes that it has a large and diverse membership of differing sizes and business models. It is impossible for FINRA to develop a pricing scheme that accounts for the particulars of every firm, but FINRA believes its current pricing structure is reasonable, achieves general equity across its membership and correlates the fees assessed to the regulatory services provided. FINRA's current regulatory pricing structure is comprised primarily of the PA, GIA and Trading Activity Fee and Branch Office Assessment ("regulatory revenues"). The Commission has previously found the PA and GIA pricing structures to be consistent with the provisions of Section 15A(b)(5) of the Exchange Act[3] at their current levels.[4] The Trading Activity Fee and Branch Office Assessment fee changes were implemented in an immediately effective filing with the Commission, and the Commission did not abrogate the filing under Section 19 of the Exchange Act.[5] FINRA does not believe proposed changes to the PA and GIA alter FINRA's pricing scheme as to make it no longer reasonable or equitable.

In considering the comments, it is important to understand FINRA's fiscal policy and the impact of the recent market downturn on FINRA's revenues from regulatory fees. FINRA strives to operate on a cash flow neutral basis and it budgets accordingly. Yet FINRA has generally had an asymmetric response in the event of a surplus or deficit: it has consistently issued discretionary rebates to firms in years where cash flow is positive relative to budget but has absorbed the shortfall in deficit years. Since 2001, FINRA has issued a discretionary rebate every year, which in the aggregate amounts to more than $200 million, except for 2007, in which year members received a combined $178 million special rebate in connection with the consolidation of the member regulation operations of NASD and the NYSE. FINRA intends to continue discretionary rebates in the future as practicable in accordance with financial operating results. In addition, FINRA has rebated $1,200 to every firm since 2008 as part of the current GIA structure[6] and will continue these rebates at least through 2012, as previously communicated.

In contrast, FINRA is not seeking an increase in fees or supplemental assessments in 2009 when it will absorb an approximate $100 million GIA shortfall. While this shortfall has not hindered FINRA's ability to fulfill its regulatory mission, this type of revenue loss cannot be sustained in the future. This significant decline in the GIA is the result of member firms' ability to offset assessable revenue with investment losses that have no nexus to regulatory efforts.

Some commenters assert that FINRA should tap its balance sheet reserves to cover any operating cash flow deficit. In fact, the income from these reserves is used to offset a part of the cost of the regulatory program required each year, and consequently that funding stream is in lieu of a more substantial fee increase on members. FINRA expects such income to offset regulatory costs by approximately $50 million in 2010. Moreover, FINRA delayed seeking any fee increase for 2008 and 2009 by utilizing the principal of its reserves. However, it wouldn't be prudent for FINRA to continue to exhaust its reserves to cover all future operating deficits.

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3 15 U.S.C. 78o–3(b)(5).

4 *See e.g.*, Exchange Act Release No. 57474 (March 11, 2008), 73 FR 14517 (March 18, 2008); Exchange Act Release No. 47106 (December 30, 2002), 68 FR 819 (January 7, 2003).

5 *See* Exchange Act Release No. 46416 (August 23, 2002), 67 FR 55901 (August 30, 2002).

6 *See* Exchange Act Release No. 57474 (March 11, 2008), 73 FR 14517 (March 18, 2008).

Not only is such practice unsustainable, but it also would inevitably result in a much more substantial fee increase in the future – and bring that future ever closer.

The proposed rule change therefore seeks to protect FINRA against future downturns and to smooth out the volatility inherent in the GIA by shifting some of FINRA's revenue generation to the more consistent PA revenue stream. To that end, FINRA's recent revenue history is illuminating:

For 2008, FINRA received $454 million in regulatory revenues. Of that amount, the GIA constituted $261 million and the PA, $44 million. In 2009, FINRA's regulatory revenues dropped 16% to $383 million driven primarily by the GIA which fell 36% to $166 million. The PA remained essentially flat at $44 million.

These figures illustrate FINRA's vulnerability to the current volatile GIA, particularly relative to the more predictable PA. For 2010, FINRA projects that if the modified GIA proposal is in effect, GIA revenue will be approximately $197 million (44% of projected total regulatory revenue of $449 million) and the PA will be approximately $86 million (19%). Thus, the new proposed pricing structure would achieve its goal to reduce exposure to the GIA and produce a more consistent and reliable foundation to fund FINRA's regulatory operations.

**Comments**

Within this factual environment, FINRA believes that many of the specific comments that contend the proposed rule change is unreasonable and unfairly allocated are incorrect.

Reasonableness of Fees

Many commenters assert that FINRA should have predicted the market downturn and taken unspecified budgetary steps to account for it. Typical of the comments: "FINRA's failure to properly prepare for the inevitable market downturn is the root cause of their [sic] operating cash flow concerns."[7] FINRA strongly disputes this contention.

FINRA is a regulator, and as such has no special insight into market performance. But even if FINRA possessed any unique market prescience, the comments misapprehend the dynamics of market performance and FINRA funding. While FINRA actually planned for a decline in GIA as evidenced in the 2009 budget decline compared to 2008 GIA, in a market downturn, each element of FINRA's funding source is vulnerable. Gross income either declines or is offset by certain member charges, trading activity may decline and so too the number of registered persons. There is no way for FINRA to account for those changes because

7 *See* Letter Type B.

assessments are, for the most part, FINRA's only means of meeting regulatory costs. Members cannot support rebates in times of cash flow positive operating results and contend at the same time that perhaps more income should have been retained during times of better market condition. Moreover, to the extent the comments are directed at balance sheet investments, they are also misplaced. The balance sheet is used to augment FINRA's funding and thereby decrease the full cost of regulation assessed to FINRA's member firms; its value does not impact the relationship of operating costs and cash flow except to the extent of the subsidy it provides. As a regulator, FINRA does not have the luxury of cutting its lines of operation during leaner market periods, indeed such times make greater demands on regulatory resources. In sum, FINRA has very limited ability to respond to market downturns with the exception of realizing as many efficiencies as practicable during such times without curtailing its operations and, as noted at the outset, this is exactly what FINRA has done.

A number of commenters also complain that the proposal is unfair because it comes at a time when firms are suffering financially and on top of recent fee increases from a variety of other entities, including the SEC, the Securities Investor Protection Corporation, NASDAQ OMX BX, the Municipal Securities Rulemaking Board and certain states. FINRA does not undervalue the financial difficulties and other burdens firms are facing. At the same time, FINRA's regulatory responsibilities have not ebbed – if anything, as noted above, they may have increased. To that end, FINRA cited figures in the rule filing to show that the population of registered representatives has remained fairly constant, even through the recent market turmoil. FINRA must focus on the resources it needs to adequately and consistently carry out its statutory obligations and therefore cannot let fees assessed by other entities dictate or compromise its funding requirements. FINRA is committed to maintaining top-notch regulatory programs irrespective of market conditions, and FINRA believes the proposed rule change is justified to ensure that commitment will be met in the future.

Most of the commenters further assert that the proposed PA increase is too severe. The proposal would adjust the PA for the first time in five years, doubling it from between \$65 and \$75 per registered person to between \$130 and \$150 for each such person, depending on the number of registered persons at the firm. While several commenters acknowledge that some type of PA increase is justified, they and others argue that a 100% increase is out of line when compared to the rate of inflation as measured by the Consumer Price Index over the past five years. FINRA believes this argument is flawed because it examines the fee change in percentage terms relative to an incongruous benchmark. The proposed PA increase is more properly measured in absolute dollars relative to FINRA's regulatory funding needs, which is correlated not to the price of goods and services paid by consumers, but rather by the costs associated with operating its regulatory oversight programs and examination and enforcement responsibilities. As explained above, FINRA's annual funding mechanisms have proven insufficient to sustain its regulatory programs the past two years – a time marked by modest inflation.

Looked at in this more appropriate light, FINRA believes its proposed PA increase is reasonable and will better align FINRA's revenues with its costs. Based on projections that the registered representative population will modulate at a rate consistent with historical trends, FINRA estimates that the proposal would result in a total increase of $42 million in PA fees, an average of approximately $8,600 per firm. FINRA further estimates that the average increase in total PA fees for firms with 100 or fewer registered persons – a population that constitutes 4,074 out of 4,868, or nearly 84%, of FINRA firms – will amount to approximately $1,000 per firm, whereas the largest 100 firms (based on the number of registered persons as of year-end 2008) would see an average increase of approximately $300,000. And these estimates assume that firms do not pass along the PA to the individual registered persons, a practice FINRA understands is done in certain segments of the industry. For firms that do engage in such practice, the impact would shift from the firm to the registered persons. However, FINRA believes a fee of between $130 and $150 per year is reasonable, particularly when compared to other professional licensing fees. Nor can there be any question that the number of registered representatives is a driving factor that impacts FINRA's oversight responsibilities. In 2008, FINRA conducted 4,924 oversight and cause examinations. These examinations, in large part, focus on broker-dealer conduct and activity involving interaction with customers. As result, in that year, FINRA brought 586 formal disciplinary actions against registered representatives and an additional 115 formal actions against member firms for failing to supervise their employees. The increase of the PA creates more stable funding in FINRA's assessments designed to ameliorate the negative fluctuations in GIA due to market conditions. This is particularly important because regulatory demands typically rise in declining markets.

Based on the two quarters of 2009 FOCUS data, FINRA projects that the GIA for the largest 100 firms (based on the amount of GIA assessed for 2008) in 2010 would increase approximately $280,000 per firm due to the artificially lower FOCUS revenues used to calculate the 2009 GIA. Conversely, the remaining firms would experience a negligible rise of less than an average of $1,000 per firm. Thus, taken together, the projected increases in PA and GIA relative to a firms' overall FOCUS revenues are ratably progressive in line with firm revenues, do not disproportionately burden firms in any manner other than to equitably allocate the cost of regulatory funding, and therefore constitute a rational and reasonable funding scheme in light of cash flow operating demands.

Equitable Allocation of Fees

Many commenters assert that the proposed change to the GIA calculation will fall disproportionately on small firms and independent broker-dealers. However, the facts do not support that assertion.

The figures above demonstrate that the proposed PA increase will not have disparate impact on smaller firms. Similarly, the change to the GIA will not unfairly burden those small firms and independent broker-dealers. Instead, the proposal aligns the fee correction with those largest 100 firms (based on the number of registered persons as of year-end of 2008 for PA and the amount of GIA assessed for 2008 for GIA) that primarily caused the GIA shortfall with substantial write-downs against FOCUS income.

FINRA revenues from the GIA have dropped nearly $100 million since 2008. Of that amount, nearly $95 million resulted from the GIA paid in by the largest 100 GIA-assessed firms. Had the new proposed GIA calculation been in place for the 2009 billing cycle, FINRA projects that approximately $47 million (nearly 49%) of the lost revenues would have been replaced, and those largest 100 firms would have absorbed approximately $44 million, or nearly 94%, of the shortfall. For 2010, FINRA estimates that with the proposed fee structure, the percentage of GIA paid will shift back toward the largest 100 GIA-assessed firms, rising to 63% from 57% in 2009. If the GIA current structure remains in place, those 100 firms are estimated to account for only 59% of GIA in 2010.

For firms with 100 or fewer registered persons, FINRA estimates that if the proposal had been implemented for 2009, it would have resulted in an average increased GIA of $850 in 2009 as compared to the actual amount assessed on those firms. As noted above, every FINRA firm currently receives a rebate of $1,200 against its GIA fee and that rebate will continue until at least 2012. Under the current GIA tiered pricing structure – which is maintained in the proposal – firms with FOCUS revenues of less than $1 million pay a minimum of $1,200. There are 2,237 such firms in 2009. Thus, taking into account the $1,200 rebate, those firms currently effectively pay zero GIA fees to FINRA. Under the proposed modified GIA, those same firms would continue effectively to pay no GIA.

The Financial Services Institute ("FSI") , which represents the interests of independent broker-dealers, asserts that the proposed GIA change will "fall particularly heavily on independent broker-dealer firms . . . ." Similarly, Letter Type B asserts that "the proposed calculation for the GIA will only heighten the disproportionate regulatory cost born by independent broker-dealers, financial advisors, and their clients." However, FINRA's projections show that the proposal, if implemented, will not impact disparately the GIA of FSI firms. For 2009, FSI broker-dealers paid in total $11.63 million in GIA. Under the proposal, that figure is estimated to fall to $11.17 million for 2010. By comparison, the GIA of the largest 100 GIA-assessed firms is projected to rise from $94 million in 2009 to $123.53 million under the proposal. Thus, the increases resulting from the proposed GIA calculation will fall most heavily not on independent broker-dealers but on the largest 100 GIA-assessed firms, which include the several largest firms whose steep income declines primarily account for FINRA's current revenue deficit.

Caps and Implementation

Several commenters suggest that FINRA impose a cap on any year-over-year GIA increases. In addition, certain commenters request that the proposal be phased-in. For example, FSI asks that the GIA changes take effect on January 1, 2012 and that the PA be increased incrementally over the next three years.

FINRA believes it is critical to implement the proposed rule change effective January 2010 and without further limitation. In fact, FINRA has phased-in the need for additional assessed funding by not charging firms in 2008 and 2009 for cash flow shortfalls that are funded out of capital. The GIA will remain subject to an existing cap for 2010[8], but FINRA believes any further caps could leave FINRA facing the same fiscal quandary it currently faces in the event of another crisis or lean year for the industry. For the same reason, FINRA disfavors a phased-in implementation. Perhaps more significantly, FINRA believes that prolonging implementation of these changes will only lead to a geometric future fee increase, as FINRA perpetuates a budget imbalance and depletes its revenue-producing assets.

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FINRA believes that the foregoing responds to the material issues raised by the commenters to this rule filing. If you have any questions, please contact me at (202) 728-8451; email: philip.shaikun@finra.org. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Philip Shaikun
Associate Vice President and
Associate General Counsel

[8] For 2010, any increase or decrease in GIA will be capped at 10% of what a firm would have paid under the prior NASD or NYSE rate structures that it was subject to before FINRA's GIA rate structure was amended in 2008.