July 20, 2011

By Electronic Mail (rule-comments@sec.gov)

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: SR-FINRA-2011-028

Dear Ms. Murphy:

The Compliance and Regulatory Policy Committee of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the proposed consolidated Financial Industry Regulatory Authority ("FINRA") rules governing supervision and supervisory controls.[2] Specifically, FINRA is proposing to adopt new FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) for the new FINRA consolidated rulebook, based in part on existing NASD Rules 3010 and 3012, and NYSE Rule 342.

I. Introduction

SIFMA supports FINRA's continued efforts to establish a consolidated rulebook, to eliminate duplicative rules and interpretations and to enhance and modernize self-regulation. In particular, SIFMA endorses FINRA's effort to memorialize in its consolidated rulebook the

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA"). More information about SIFMA is available at http://www.sifma.org.

[2] Notice of Filing of Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook; Release No. 34-64736 (June 23, 2011), 76 FR 38245 (June 29, 2011).

concepts of principles- and risk-based regulation upon which many members rely today. SIFMA firmly believes that implementing such methodologies fosters effective supervision and enables all FINRA members, regardless of their size or the nature of their businesses, to reasonably design a supervisory system that is tailored to each member's needs.

FINRA initially published this rule proposal in Regulatory Notice 08-24. SIFMA commends FINRA for addressing many of the comments submitted by SIFMA and others in connection with the initial proposal. The rule proposal in 2008, and as now amended, reflects several important improvements over FINRA, NASD and NYSE rules currently in effect, including:

- As initially proposed in 2008, the requirement in proposed FINRA Rule 3110(a)(2) that an appropriately registered principal be designated to supervise each type of business in which the member is engaged was not limited to activities requiring broker-dealer registration. The initial proposal was a departure from NASD Rule 3010(a)(2), which is designed for business activities that are subject to broker-dealer registration. At the request of SIFMA and other commenters, FINRA has reinserted this important language.

- SIFMA strongly supports FINRA's elimination of (i) the requirement of NASD Rule 3012(a)(2) to rotate the independent reviewers of producing managers every two years, and (ii) the "heightened supervision" requirement for producing managers who meet a total revenue generated or income threshold test relative to their supervisors.

- SIFMA also supports proposed Supplementary Material .13, which formally provides members with the flexibility to disseminate their written supervisory procedures electronically. We do, however, still have certain concerns about the language of that provision, which we address in Part IV., below.

- SIFMA also supports FINRA's inclusion, in proposed Supplementary Material .06, of relief previously given regarding annual compliance meetings required by proposed FINRA Rule 3110(a)(7) to specifically permit such meetings to be conducted via on-demand webcast, video conference and other means not involving an in-person meeting.

- SIFMA also supports proposed Supplementary Material .10 which allows a supervisor/principal to delegate the review of correspondence and internal communications to an unregistered person, but retain ultimate responsibility for the performance of all necessary supervisory reviews. We do ask that this important concept be incorporated in proposed FINRA Rule 3110(b)(4) itself.

While the amended rule proposal reflects an important step forward to a consolidated rulebook, we appreciate the opportunity to provide additional comments on certain aspects of the proposal, including potential concerns around interpretation, as well as a broader jurisdictional concern related to certain aspects of the rule proposal and its supplementary material.

As always, we welcome the opportunity to discuss with FINRA or the Securities and Exchange Commission ("SEC") any of our comments to the proposed rule changes. Our specific comments are as follows.

II. Proposed FINRA Rule 3110(a) and Proposed Supplementary Material .01

The potential scope of proposed FINRA Rule 3110(a)(1) and proposed Supplementary Material .01 appear to extend FINRA's rulemaking beyond its statutory authority, and raises the question of whether the SEC has the authority to approve FINRA rules that may reach beyond its statutory mandate under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Proposed FINRA Rule 3110(a) requires members to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA and MSRB rules. Proposed Supplementary Material .01 makes clear that the supervisory requirement in the proposed rule extends beyond those business activities for which broker-dealer registration is required. According to proposed Supplementary Material .01, the member's supervisory system "must include supervision for all of the member's business lines irrespective of whether they require broker-dealer registration."

FINRA is familiar with business models of its member firms in which certain business activities of the member do not themselves require registration as a broker-dealer. Such business activities involve, among other things, foreign exchange, commodities, insurance, banking products, estate planning and real estate. Most of these business activities fall under the jurisdiction of, and are subject to examination by, other regulatory and self-regulatory authorities—such as, for example, the SEC, Commodity Futures Trading Commission, Federal Reserve Board, Office of the Comptroller of the Currency, Department of Labor, and state insurance and banking regulators—whose specific mandate is to regulate these very business activities. Such regulatory and self-regulatory authorities have extensive knowledge and experience regarding the non-securities products and services they oversee.

By statute, FINRA is a securities regulator. Its mandate is to regulate its broker-dealer members and their securities-related activities. Subjecting non-securities activities to FINRA oversight could therefore result in confusion and duplication, which is not consistent with the purpose of the consolidated rulebook. Whether it takes formal disciplinary action or not, proposed FINRA Rule 3110(a) would allow FINRA to impose its rules, related guidance and standards over business activities that are already regulated by other established regulatory and self-regulatory authorities. For example, we do not believe that the laws and rules of state insurance regulators mirror those of FINRA, nor would we expect the standards of supervision to be analogous.

For all of the above reasons, FINRA should not extend its rulemaking over business activities that do not require registration as a broker-dealer. Indeed, SIFMA believes there are legal questions as to whether such an extension would exceed FINRA's mandate under the

Exchange Act. Section 15A(b)(6) of the Exchange Act, which circumscribes the authority of national securities associations, makes clear that a national securities association cannot adopt rules designed "to regulate by virtue of any authority conferred by this Act matters not related to the purposes of this Act." Business activities that do not involve securities, and that do not require registration as a broker-dealer under Section 15 of the Exchange Act, are not addressed in the Exchange Act, are not relevant to securities or securities SROs, and are generally beyond FINRA's jurisdictional mandate. [3]

The limits of FINRA's jurisdiction were specifically acknowledged in the Report of the 2009 Special Review Committee on FINRA's Examination Program (the "Special Review Committee Report"). Although the Special Review Committee found that FINRA has broad authority to take *enforcement* action for unlawful or unethical activities, the Special Review Committee made clear that FINRA's jurisdiction in other matters extends only to the "securities activity" by a member or associated person.[4] This means that FINRA's rulemaking and examination authority does not extend into non-securities lines of business of its member firms.

As stated above, even beyond the jurisdictional question, SIFMA believes that it could be confusing for member firms, and could also result in conflicting standards if FINRA were to assert its regulatory priorities, objectives, standards and judgment to business activities currently overseen by other regulatory and self-regulatory authorities.

FINRA should remedy this jurisdictional issue by modifying the text of proposed FINRA Rule 3110(a)—as it modified the text of proposed FINRA Rule 3110(a)(2)—so that its regulatory authority is limited to business activities for which registration as a broker-dealer is required. SIFMA proposes the first sentence to read as follows:

> Each member shall establish and maintain a system to supervise the securities activities of each associated person that is reasonably designed to achieve compliance with applicable FINRA and Municipal Securities Rulemaking Board (MSRB) rules.

In the event that FINRA declines to limit the text of proposed FINRA Rule 3110(a) to securities activities, FINRA should make clear in proposed Supplementary Material .01 that its jurisdiction over areas that do not implicate securities will be limited only to addressing unlawful or unethical activities,[5] and that it will defer to the laws, rules, regulations and interpretations of the regulatory or self-regulatory authority whose specific mandate it is to regulate those non-securities business activities.

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[3] SIFMA recognizes that courts have accorded FINRA more latitude solely in the context of enforcement actions against members and associated persons for unlawful and unethical activities. *See, e.g., In the Matter of Thomas E. Jackson*, 45 SEC 771 (June 16, 1975) (insurance applications); *In the Matter of Daniel C. Adams*, 47 SEC 919 (June 27, 1983) (tax shelters); and *In the Matter of Daniel D. Manoff*, SEC Release No. 34-46708 (October 23, 2002) (improper use of a co-worker's credit card).

[4] *See* Special Committee Review Committee Report, at 65-66.

[5] *See id*.

III. Proposed FINRA Rule 3110(b)(6)(D) and Proposed FINRA Rule 3110(c)(3)(A)

Proposed FINRA Rule 3110(b)(6)(D) and proposed FINRA Rule 3110(c)(3)(A) require members to establish procedures to prevent supervision and inspection standards from being "reduced in any manner due to conflicts of interest that may be present." The proposed rules are well-intended proposals that are meant to minimize the impact of conflicts of interest in this context. SIFMA fully supports these objectives. The proposed rules eliminate, moreover, the prescriptive supervisory requirements of NASD Rule 3012(a)(2)(A) and (C). Those inflexible requirements—which require members to rotate "independent reviewers" of producing managers, and to impose "heightened supervision" over producing managers responsible for more than 20% of the revenue of the relevant business unit—hinder members from implementing risk-based supervisory systems and controls tailored to their business activities. SIFMA commends FINRA for eliminating these prescriptive requirements.

FINRA has proposed a new standard in these two proposed rules, however, that is ambiguous, and, importantly, in its application may be inconsistent with the well-established standards of proposed FINRA Rule 3110(a). First, in proposed FINRA Rule 3110(b)(6)(D), FINRA requires members to establish written supervisory procedures that prevent the standards of supervision "from being reduced in any manner, due to any conflicts of interest that may be present with respect to the associated person being supervised." Taken literally, members cannot reasonably be expected to guarantee through their supervisory procedures to end any and all conflicts of interest. Indeed, integrated firms have conflicts of interest that must be identified, mitigated, disclosed and otherwise carefully monitored and managed, but which can never be eliminated in their entirety. Written supervisory procedures should be reasonably designed to protect the independence and authority of supervisors, but members should not be subject to disciplinary proceedings because they have failed to eliminate any and all conflicts of interest that could impact supervision, no matter how slight. With the benefit of hindsight, FINRA's enforcement staff would almost always be in a position to argue that there was *some* conflict that led to *some* reduction of supervisory standards. No supervisory system can prevent every conflict that might conceivable impact supervision. As drafted, this standard cannot reasonably be achieved.

SIFMA urges FINRA to delete the language in proposed FINRA Rule 3110(b)(6)(D) that requires members to establish procedures to prevent supervision standards from being "reduced in any manner due to conflicts of interest that may be present." FINRA should replace its proposed standard with one that requires members to establish supervisory procedures that are "reasonably designed to prevent conflicts of interest from impeding effective supervision." This is a fair and reasonable standard that meets what we understand to be FINRA’s goal of fostering the independence and authority of the supervisor of the associated person and is likewise consistent with the well-established standards of supervision in proposed FINRA Rule 3110(a) and proposed Rule 3110(b)(6).

With respect to internal inspections, proposed FINRA Rule 3110(c)(3)(A), likewise, requires members to establish procedures that prevent inspection standards "from being reduced

in any manner due to any conflicts of interest that may be present." Here again, it appears that FINRA is subjecting its members to a standard that requires members, in the context of an internal inspection, to eliminate any conflicts of interest, no matter how slight. Consistent with the standards of proposed FINRA Rule 3110(a), members should be required to establish procedures that are reasonably designed to achieve compliance with applicable laws and rules. Members should not be later subject to disciplinary proceedings when their internal inspection standards did not eradicate every conceivable conflict of interest.

SIFMA therefore urges FINRA to replace its proposed standard with one that requires members to establish inspection procedures that are "reasonably designed to prevent conflicts of interest from impeding effective inspections." This, too, is a fair and reasonable standard that is consistent with proposed FINRA Rule 3110(a).

IV. Proposed Supplementary Material .13

Proposed Supplementary Material .13 is a welcome step forward and contains helpful provisions that enable members to maintain and disseminate their written supervisory procedures more efficiently. Proposed Supplementary Material .13 does contain, however, certain inconsistencies that should be changed: (1) to clarify that written supervisory procedures must be distributed to relevant supervisory personnel; (2) to clarify that a member must ensure that written supervisory procedures have been communicated to, and are accessible by, all relevant supervisory personnel; and (3) to eliminate the use of certain ambiguous terms.

First, it is important to note that there is a clear difference between compliance procedures and supervisory procedures. This well-established distinction was specifically addressed by the NASD in Notice to Members 99-45 (the "Notice"). In the Notice, the NASD defined “compliance procedures” as those that "generally set forth the applicable rules and policies that must be adhered to and describe specific practices that are prohibited." Supervisory procedures, on the other hand, "document the supervisory system that has been established to ensure that compliance guidelines are being followed and to prevent and detect prohibited practices." As explained in the Notice, the compliance guideline may, for example, discuss the suitability of an options transactions for customers by providing the elements of the rule and other information to its associated persons while supervisory procedures would "instruct the supervisor" on the steps necessary to determine whether an options transaction was suitable for a customer.

Because compliance and supervisory procedures have different purposes, they may be distributed to different audiences. Compliance procedures may apply to *all* associated persons and are therefore distributed broadly to such persons when appropriate. By contrast, written supervisory procedures are distributed to supervisors to fulfill their oversight obligations in accordance with such procedures. To reduce the potential for confusion resulting from receipt of irrelevant information, written supervisory procedures that are specific to a particular business line or function should not be required to be distributed to supervisors other than those responsible for that particular business line or function. Accordingly, proposed Supplementary Material .13 should be amended to reflect the more limited and targeted distribution of

supervisory procedures.

In addition, the requirement that a member verify actual review of written supervisory procedures is a departure from the current requirement under NASD Rule 3010(b)(4) (and proposed FINRA Rule 3110(b)(7)), which requires only that a member "be responsible for communicating amendments throughout its organization." As drafted, proposed Supplementary Material .13 goes much further, requiring members that distribute their written supervisory procedures by electronic means to confirm the actual review of the procedures. While SIFMA completely agrees that it is important that a member's supervisors be adequately advised of their supervisory responsibilities, there is no apparent reason for distinguishing between written supervisory procedures delivered in hard copy versus electronically. This difference may have the unintended consequence of dissuading firms from utilizing electronic delivery of written supervisory procedures.

Finally, there are a number of ambiguities in proposed Supplementary Material .13 that SIFMA believes are easily resolved by amendments to the text. Among other things, SIFMA suggests that the phrase "quickly and easily accessible" be replaced with "readily accessible." "Quickly and easily accessible" is a vague and subjective standard, while "readily accessible (or available)," is a commonly used term of art used in both FINRA Rules and the Exchange Act.[6] Further, we suggest that the word "promptly" be removed and replaced with "timely." We believe that "timely" more reasonably suggests that written supervisory procedures must be communicated and accessible at the time the procedures become effective. SIFMA recommends the following alternative language for proposed Supplementary Material .13:

> **.13 Use of Electronic Media to Communicate Written Supervisory Procedures**. A member may satisfy its obligation to communicate its written supervisory procedures, and any amendment thereto, throughout its organization pursuant to Rule 3110(b)(7) by use of electronic media, provided that: (1) the written supervisory procedures [are quickly and easily accessible to all associated persons of the member] have been timely communicated to, and are readily accessible by, all relevant supervisory personnel through, for example, the member's intranet system; (2) all amendments to the written supervisory procedures are [promptly] posted to the electronic media; (3) [associated persons] relevant supervisory personnel are notified that substantive amendments have been made to the written supervisory procedures; [(4) the member can verify at least once each calendar year through electronic tracking, written certifications, or other means that associated persons have reviewed the member's written supervisory procedures; (5)] (4) the member has reasonable procedures to monitor and maintain the security of the document posted to ensure that it cannot be altered by unauthorized persons; and [(6)] (5) the member retains current and prior versions of its written supervisory procedures in compliance with the applicable record retention requirements of SEA Rule 17a-(e)(7).

[6] *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(61)(A), 78o-3(i)(1)(B),78o-7(a)(3); FINRA Rules 2360(b)(17)(B), 2370(b)(17)(B), 9242(a)(5).

V. Proposed FINRA Rule 3110(b)(2) and Proposed Supplementary Material .07

Proposed FINRA Rule 3110(b)(2) provides that the written supervisory procedures required in proposed FINRA Rule 3110(b)(1) "shall include procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the investment banking or securities business of the member." Proposed FINRA Rule 3110(b)(2) thus requires a principal review of *all* transactions relating to the investment banking and securities business of the member. Proposed Supplementary Material .07, on the other hand, does not. It provides that a member is permitted to "use a risk-based review system to comply with Rule 3110(b)(2)."

We fully endorse the Supplementary Material because it recognizes that requiring a registered principal to review each and every transaction relating to the investment banking or securities business,[7] no matter how ordinary or insignificant, would be impractical and worse, could impede meaningful supervisory review of transactions that potentially raise greater risks.

FINRA should resolve the apparent inconsistency between the proposed Rule and the proposed Supplementary Material by amending the text of proposed FINRA Rule 3110(b)(2). SIFMA proposes the following language:

> The supervisory procedures required by the paragraph (b) shall include procedures for the review by a registered principal, evidenced in writing, of [all] transactions relating to the investment banking or securities business of the member. Such supervisory procedures may be risk-based to allow for the review of selected transactions.

In the alternative, and at the very least, FINRA should delete the word "all" from the text of the proposed Rule so that it is clear that the rule language is modified by the proposed Supplementary Material. Proposed FINRA Rule 3110(b)(2) and proposed Supplementary Material .07 should both recognize that risk-based review systems are appropriate in this context.

VI. Proposed FINRA Rule 3110(b)(4)

Proposed FINRA Rule 3110(b)(4) requires members to conduct principal reviews of correspondence, and to establish written supervisory procedures governing such reviews. SIFMA appreciates that FINRA has generally recognized that a risk-based approach is appropriate for the review of correspondence, given the varying size and complexity of member firms. The proposed rule, however, fails to draw any distinction between internal and external communications. Different review standards should apply to different types of communications based on their content, target audience and other relevant factors. Proposed FINRA Rule

[7] Indeed, the standard is not limited to each and every investment banking or securities transaction (which is itself a very broad standard), but includes transactions that *relate to* the investment banking or securities business of the member. A foreign exchange transaction, for example, is not a securities transaction, but may be construed to relate to a securities transaction when it is effected in connection with a securities transaction.

3110(b)(4) does not recognize these important risk-based differences, conflating the various standards into an unworkable one-size-fits-all standard.

FINRA has previously recognized that internal and external communications involve different levels of risk.[8] External communications—so-called "communications with the public"—pose greater risks to the investing public and are deservedly subject to more supervisory review. Communications with the public trigger concerns relating to, among other things, pre-approval requirements, content standards, customer instructions, anti-money laundering and gifts and gratuities. Internal communications raise altogether different concerns, posing fewer potential risks to the investing public and, given the sheer volume and variety of content, require different types of review.

Creating the same standard for internal and external communications in one rule is confusing at best and at worst could potentially dilute the review of the potentially more risky, and thus important, external communications. Firms' internal message volume is several times the volume of external communication and the overall volume of electronic messaging is increasing every year. Thus, potentially increasing the sampled message volume will result in less time per message for review. Indeed, in Regulatory Notice 07-59 and elsewhere, FINRA has long recognized the differences between internal and external communications, and the need for members to conduct reviews that acknowledge these differences.[9]

Despite its prior regulatory position, FINRA now proposes, in FINRA Rule 3110(b)(4), to treat internal and external communications identically, setting out categories of communications that must be reviewed regardless of whether the communication is internal or external. Some categories make little sense in the context of internal communications. As an example, internal communications relating to "funds and securities" would encompass virtually all of the internal e-mails of a firm's back-office and operations personnel. The review of such internal communications would be an extreme burden for many members and would be unlikely to yield significant compliance benefits. As well, firms use alternative mechanisms to review and supervise funds and securities movements.

For all of these reasons, SIFMA believes that the provisions of proposed FINRA Rule 3110(b)(4) governing internal communications should be moved to a separate sub-section. In accordance with the established guidance of Regulatory Notice 07-59, SIFMA proposes the following language for the review of internal communications:

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[8] *See, e.g.*, Regulatory Notice 07-59 (December 2007).

[9] We note that Supplementary Material .10 provides that the underlying review of internal and external communications may be delegated by a supervisor/principal to an unregistered person, provided that the supervisor/principal remains ultimately responsible for the performance of the review. SIFMA believes that this important concept should be reflected in the proposed rule itself. Reviews of internal communications are frequently conducted by unregistered personnel in the first instance. The proposed rule should make clear that such review practices are acceptable, as long as the supervisor/principal remains ultimately responsible for the performance of the review.

> When developing supervisory procedures required by this paragraph (b), with the exception of areas specifically requiring review by a supervisor under applicable FINRA and MSRB rules, *members may decide, employing risk-based principles, the extent to which review of any internal communications is necessary in accordance with the supervision of their business*.[10] Reviews of internal communications may be conducted by unregistered persons, provided, however, that a registered principal remains ultimately responsible for the performance of the review. The review must be evidenced in writing, either electronically or on paper.

SIFMA's proposed language recognizes the differences between internal and external communications. Proposed FINRA Rule 3110(b)(4) should be amended to acknowledge the important risk-based distinctions between internal and external communications that have evolved over time with increasing supervisory knowledge and experience with new technology.[11]

SIFMA appreciates that FINRA contemplates the risk-based review of correspondence and internal communications, as the title of proposed Supplementary Material .08 suggests. However, the text within the Supplementary Material implies that a member may only employ a risk-based approach to the additional procedures that fall outside of the subject matters listed in proposed FINRA Rule 3110(b)(4). SIFMA believes that firms should have the flexibility to employ risk-based control or supervisory mechanisms relating to the subject matters listed in proposed FINRA Rule 3110(b)(4) (*e.g.*, instructions, or funds and securities movements) that complement, but yet are independent of correspondence and internal communications[12] review processes. By way of example, a member, in processing a fund or asset movement, may already review the correspondence related to the instruction, and because it does so, should not need to duplicate efforts to review every other correspondence or internal communication involving such an instruction. Further, a firm may employ systematic controls when reviewing funds or asset movements based upon risk-based criteria and the member's business model and structure. Such

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[10] Italicized language is taken directly from Regulatory Notice 07-59 at page 9.

[11] Accordingly, Rule 3110 (b)(4) would be revised as follows (deletions in brackets/additions underlined): "The 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. The 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. Reviews of correspondence with the public [and internal communications] must be conducted by a registered principal and must be evidenced in writing, either electronically or on paper. Reviews may be conducted by unregistered persons, provided, however, that a registered principal remains ultimately responsible for the performance of the review."

[12] We suggest above that internal communications be treated separately in the rule, but for these purposes comment on the existing rule language.

controls have continued to evolve and improve over time and reduce the need for separate reviews of correspondence related to those instructions.

Lastly, proposed Supplementary Material .08 makes a presumption that a member must have certain procedures if *all* correspondence is not reviewed before use or distribution. Such a presumption is a departure from current practices for which only certain types of communications require prior review. Further, this presumption does not reflect a risk-based approach and may not be practical depending on the member's size and business model, particularly with respect to internal communications.

Accordingly, SIFMA proposes the following language for Supplementary Material .08:

> A member may employ risk-based principles in its review of incoming and outgoing written (including electronic) correspondence with the public that are appropriate for its business and structure. A member must have procedures reflecting its risk-based principles. The procedures should further provide for: (a) the education and training of associated persons regarding the firm's procedures governing correspondence; (b) the documentation of such education and training; and (c) follow-up to ensure that such procedures are implemented and followed.

Proposed Supplementary Material .09 sets forth express requirements for documenting the review of internal and external communications, including certain mandatory fields of information to be retained for each communication reviewed (reviewer, date reviewed, and actions taken). We request that FINRA clarify in the Supplemental Material that the specified fields of information do not need to be retained for communications that are reviewed through electronic review systems or lexicon-based screening tools if those messages do not generate review alerts. This clarification will help members manage the extensive recordkeeping costs associated with conducting such automated reviews.

In addition, we request that FINRA reconsider the following language, particularly in the context of emails: "merely opening a communication is not sufficient review." If an email does not raise any issues that warrant follow up, what other evidence of review is necessary? Given the sheer volume of emails and the fact that not all messages are equally important (e.g., spam), we suggest that reviewers' time would be better spent on emails warranting follow up, rather than emails that require no further follow up.

As a final matter, SIFMA notes that FINRA recently filed with the SEC a rule proposal relating to NASD Rule 2210 and certain other provisions (the "Communications with the Public Proposal").[13] SIFMA intends to comment further on these matters in response to the Communications with the Public Proposal.

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[13] *See* Proposed Rule Change to Adopt FINRA Rules 2210, 2212, 2213, 2214, 2215, and 2216 in the Consolidated FINRA Rulebook, File No. SR-2011-035 (July 14, 2011).

VII. Proposed Supplementary Material .05

Although SIFMA generally supports FINRA's effort to provide further guidance regarding standards for supervision, proposed Supplementary Material .05, which establishes standards for the supervision of offices of supervisory jurisdiction ("OSJs"), does not appear to advance FINRA's goal of moving to principles- and risk-based regulation. As drafted, the Supplementary Material is unnecessarily restrictive as it deprives members of the flexibility to determine how to supervise their OSJs.[14]

Of greatest concern to SIFMA is the negative presumption that, without regard for the facts and circumstances specific to the supervisory structure under review, it is unreasonable for a member to assign a single principal to supervise more than two OSJs. Where a member has assigned a principal to supervise more than two OSJs, the member faces "greater scrutiny" and will have a "greater burden to evidence the reasonableness of such structure." This standard is unreasonable as it does not give sufficient deference to the member's determinations regarding the appropriate supervisory structure for its business. While the member may consider, among other things, the factors identified in proposed Supplementary Material .05(a) through (e) in designing its supervisory structure, its decisions are subject to a presumption of inadequacy when a single principal is designated to supervise more than two OSJs.

A member's supervisory structure, absent some fundamental supervisory failure, should not be evaluated by FINRA under the shadow of a negative presumption. Rather, it should be reviewed by FINRA's Staff on a facts-and-circumstances basis. The negative presumption inappropriately substitutes an inflexible standard for the sound and considered judgment of the member about its own business, for which it already remains fully accountable under current laws and regulations. SIFMA urges FINRA to delete the last paragraph of proposed Supplementary Material .05.

If FINRA does not delete the last paragraph of proposed Supplementary Material .05, we ask that FINRA address an ambiguity in the text. The ambiguity relates to the use, in some instances, of the phrase "on-site supervisor" while at other times referring to the OSJ supervisor as the "designated principal" without reference to whether they are "on-site." In particular, in the last paragraph of proposed Supplementary Material .05, FINRA states its presumption that "assign[ing] one principal to supervise more than two OSJs is unreasonable." We believe that the quoted text is intended to refer to the "on-site supervisor" and is not intended to encompass a member's up-the-chain reporting structure such that no principal could be assigned supervisory responsibility for more than two OSJs. At a minimum, we ask that FINRA address this ambiguity by changing "principal" in the quoted text above to "on-site supervisor."

[14] We assume that proposed Supplementary Material .05 is not intended to change existing requirements regarding product-specific principals that can be designated for a firm as a whole as opposed to being designated for a particular office, e.g. a member firm's municipal securities principal. *See* MSRB Rule G-27.

VIII. Proposed FINRA Rule 3110(d)

SIFMA is generally supportive of proposed FINRA Rule 3110(d), but believes that certain elements of the proposed rule, which is intended to incorporate the requirements of NYSE Rules 342.12 and 351(e) into the consolidated rulebook, should be modified to more closely track the requirements of NYSE Rule 351(e). In addition, the definition of "covered account" should be modified to be consistent with the definition of "research analyst account" in NASD Rule 2711. Under the proposed standard, a member may be required to review accounts of their associated persons' adult children or their associated persons' children's spouses even when such individuals are not supported by, or living in the same household with, an associated person. FINRA has not provided any rationale for expanding the scope of this review.

A. Proposed FINRA Rule 3110(d)(2)

SIFMA understands FINRA's desire to impose consistent reporting requirements on all of its members in proposed FINRA Rule 3110(d)(2). Proposed FINRA Rule 3110(d)(2), however, borrows from former NYSE Rule 351(e) but departs from its language in significant ways. These departures result in substantive differences that will result in additional costs and burdens for all members, and that will yield information that will be less useful to FINRA.

Like NYSE Rule 351(e)(ii)(B) and (C), proposed FINRA Rule 3110(d)(2)(B) and (C) require members that engage in investment banking activities to file written reports, signed by a senior officer of the member, relating to (i) open internal investigations relating to certain suspicious trading activity in covered accounts, and (ii) completed internal investigations relating to suspicious trading activity, including the results of the investigation. Proposed FINRA Rule 3110(d)(2)(A), however, is less faithful to the language of NYSE Rule 351(e)(ii)(A). It provides that members must, within ten business days of the initiation of an internal investigation, file a written report "that discloses the identity of the member, the date the internal investigation commenced, and the identity of the security, trades, accounts, associated persons, or associated persons' family members holding a covered account, under review, and that includes a copy of the member's policies and procedures." NYSE Rule 351(e)(ii)(A) has long required more targeted disclosure ("the identity of the trade and the reason why it could not be the subject of a written statement"), and does so on a more reasonable timeframe ("by the 15th day of the month, following the calendar quarter in which the trade occurred").

The proposed changes are costly and burdensome, and do not appear to yield substantial benefits. Over many years, firms have developed robust and detailed procedures for complying with the reporting requirements in NYSE Rule 351(e). Proposed FINRA Rule 3110(d)(2)(A) would require significant modifications to those procedures and more written reports, resulting in significant costs. The benefits, on the other hand, are far less clear. Members do not know whether an internal investigation has viability (much less, merit) ten business days after it is initiated and often know very little until a much later stage. Indeed, many of the internal investigations commenced by members turn out to be "false alarms" and are discontinued. SIFMA believes that requiring the disclosure to FINRA of an internal investigation just ten business days after its commencement will not be useful to FINRA and may even subject

associated persons or their family members to unwarranted regulatory scrutiny. At best, regulatory scrutiny at this early stage is premature.

For all of these reasons, SIFMA urges FINRA to adopt the language in NYSE Rule 351(e)(ii)(A) concerning the disclosure of the commencement of internal investigations. The standards of NYSE Rule 351(e) have worked well for many years, and those standards should not be expanded to require premature and unnecessarily comprehensive disclosure without a demonstration of compelling reasons. SIFMA is not aware of reasons for the expanded requirements of proposed FINRA Rule 3110(d)(2)(A).

B. Proposed FINRA Rule 3110(d)(3)(A), Definition of "Covered Account"

As proposed, the definition of "covered account" differs depending on whether the member introduces or carries the account. We are not aware of any regulatory purpose served by differentiating between accounts that are introduced or carried by the member versus those that are not. Furthermore, for carrying member firms, we do not believe that an account should be subject to review only by virtue of it being introduced by an unaffiliated correspondent broker. We believe that a uniform approach to this definition will maintain good supervisory controls over employee trading and reduce confusion and the possibility for errors.

Should FINRA decline to adopt a uniform definition of the term "covered account," it should, at the very least, limit the review for accounts of an associated person's children and their spouses to instances where the child and spouse either reside in the same household, or are financially dependent on, the associated person. In the Proposing Release, FINRA acknowledges that the proposed language is "based, in large part, on the obligations established by the NYSE in Information Memo 88-21." FINRA does not acknowledge, however, that the definition of "covered account" in Information Memo 88-21 was, less than one year later, amended in Information Memo 89-17. That subsequent Information Memo limited the definition of "covered account" to accounts for children and their spouses only when they either live in the household or are financially dependent on the employee. In addition to being identical to the current limitation in the NYSE's rule, this limitation is reasonable and does not unnecessarily dilute the required review. FINRA should not avail itself of the NYSE's definition without also taking into account the NYSE's subsequent modifications to that definition. Adopting the NYSE's definition of "covered accounts" with its subsequent modifications, has the added benefit of easing the compliance burden on NYSE member firms that already have supervisory systems in place to comply with the rule.

IX. Proposed FINRA Rule 3120(b)

Proposed FINRA Rule 3120, formerly FINRA Rule 3012, requires members to designate one or more principals who shall establish, maintain and enforce the member's system of supervisory control policies. Like FINRA Rule 3012, proposed FINRA Rule 3120 requires the designated principal(s) to submit a report to the member's senior management on no less than an annual basis detailing, among other things, the member's system of supervisory controls. Proposed FINRA Rule 3120(b) provides additional reporting obligations for firms that reported

more than $150 million in gross revenue in the prior calendar year. Firms meeting the $150 million gross income threshold must discuss certain enumerated elements in the required report to senior management, including a discussion of, among other things, the member's compliance efforts in the area of risk management.

SIFMA does not believe that proposed FINRA Rule 3120 should be expanded to include "compliance efforts in the area of risk management." As proposed, SIFMA understands "risk management" to encompass specific control functions for market risk, credit risk, liquidity risk and operational risk. Because there are no SEC or FINRA rules relating to "risk management" as there are with finance and operations (for which a Financial and Operations Principal is separately designated), Compliance departments generally do not have programs to assess the performance of that function, and supervisors so designated for purposes of FINRA rules are not therefore charged with supervision of "compliance efforts in the area of risk management." Accordingly, SIFMA asks that FINRA eliminate the reference to "risk management" in proposed FINRA Rule 3120.

In the alternative, and at a minimum, SIFMA asks that FINRA acknowledge that the meaning of this term relates solely to "Compliance risk," which would be covered by the firm's Compliance program.

As a final matter, SIFMA respectfully suggests that FINRA reconsider the "anniversary date" approach that it has adopted in FINRA Rule 3130. SIFMA proposes instead that FINRA restore the April 1 deadline for the CEO certification or, in the alternative, permit members to effect the annual certification no less than three weeks after the anniversary date of the previous year's certification, but in no event later than April 1. SIFMA's proposal satisfies the same policy objectives of the FINRA rule, while providing members with some flexibility in scheduling the certification process.

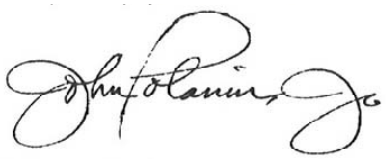
X. Proposed FINRA Rule 3170

If adopted, proposed FINRA Rule 3170 would replace FINRA Rule 3010(b)(2) regarding tape recording of registered persons. Currently, FINRA maintains and disseminates a "Disciplined Firms List" that helps members readily and consistently identify firms required to tape record telephone calls. SIFMA urges FINRA to continue to maintain and disseminate the Disciplined Firms List. SIFMA requests clarification as to whether FINRA intends to maintain and disseminate the Disciplined Firms List once proposed Rule 3170 is effective to continue to aid member firms in their compliance efforts.

* * *

SIFMA appreciates the opportunity to provide comments on proposed consolidated FINRA Rules 3110 and 3120 governing supervision and supervisory control requirements, and looks forward to continuing the dialogue. If you have any questions or require further information, please contact Jim McHale, at (202) 962-7386 (jmchale@sifma.org), or outside counsel David Sieradzki at (202) 828-5826 (david.sieradzki@bgllp.com) or Bob Frenchman at (212) 508-6184 (robert.frenchman@bgllp.com).

Very truly yours,



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