

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-69902; File No. SR-FINRA-2013-025)

July 1, 2013

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 21, 2013, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to adopt the consolidated FINRA supervision rules. Specifically, the proposed rule change would (1) adopt FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) to largely 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); (3) replace NASD

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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 3110(i) (Holding of Customer Mail) with new FINRA Rule 3150 (Holding of Customer Mail); and (5) delete the following Incorporated NYSE Rules and NYSE Rule Interpretations: (i) NYSE Rule 342 (Offices—Approval, Supervision and Control) and related NYSE Rule Interpretations; (ii) NYSE Rule 343 (Offices—Sole Tenancy, and Hours) and related NYSE Rule Interpretations; (iii) NYSE Rule 351(e) (Reporting Requirements) and NYSE Rule Interpretation 351(e)/01 (Reports of Investigation); (iv) NYSE Rule 354 (Reports to Control Persons); and (v) NYSE Rule 401 (Business Conduct).

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

As part of the process of developing a new consolidated rulebook (“Consolidated

FINRA Rulebook”),<sup>3</sup> FINRA is proposing to adopt new FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) and to delete NASD Rule 3010 (Supervision) (with the exception of 3010(e) (Qualifications Investigated) and 3010(f) (Applicant's Responsibility)) and NASD Rule 3012 (Supervisory Control System), on which they are largely based. The proposed rule change also would delete Incorporated NYSE Rule 342 and much of its supplementary material and interpretations as they are, in main part, either duplicative of, or do not align with, the proposed supervision requirements. The proposed rule change, however, would incorporate – on a tiered basis – provisions from Incorporated NYSE Rule 342. The details of the proposed rule change are described below.

(1) Proposed FINRA Rule 3110 (Supervision)

Proposed FINRA Rule 3110 is based primarily on existing requirements in NASD Rule 3010 and Incorporated NYSE Rule 342 relating to, among other things, supervisory systems, written procedures, internal inspections, and review of correspondence. Proposed FINRA Rule 3110 also would incorporate provisions in other NASD rules that pertain to supervision, including NASD Rule 3012.

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<sup>3</sup> The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from the NYSE (“Incorporated NYSE Rules”) (together, the NASD Rules and Incorporated NYSE Rules are referred to as the “Transitional Rulebook”). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE (“Dual Members”). The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, see Information Notice, March 12, 2008 (Rulebook Consolidation Process).

(A) Proposed FINRA Rule 3110(a) (Supervisory System)

Proposed FINRA Rule 3110(a) would require a member to have a supervisory system for the activities of its associated persons that is reasonably designed to achieve compliance with the applicable securities laws and regulations and FINRA and Municipal Securities Rulemaking Board (“MSRB”) rules. The proposed rule provision is substantially similar to NASD Rule 3010(a) except for two revisions. First, proposed FINRA Rule 3110(a) would refer only to associated persons instead of the current reference in NASD Rule 3010(a) to each “registered representative, registered principal, and other associated person.” Second, proposed FINRA Rule 3110(a) would require a member’s supervisory system to be reasonably designed to achieve compliance with MSRB rules, which NASD Rule 3010(a) does not explicitly reference.<sup>4</sup>

(i) Proposed FINRA Rule 3110(a)(1): Establishment and Maintenance of Written Procedures

Proposed FINRA Rule 3110(a)(1), which is identical to NASD Rule 3010(a)(1), would require a member’s supervisory system to include the establishment and maintenance of written procedures.

(ii) Proposed FINRA Rule 3110(a)(2): Designated Principal

Proposed FINRA Rule 3110(a)(2), which is identical to NASD Rule 3010(a)(2), would require a member’s supervisory system to include the designation of an

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<sup>4</sup> In this regard, SEC staff has confirmed FINRA staff’s view that a violation of the MSRB rules also would be a violation of the federal securities laws, as it would constitute a violation of SEA Section 15B(c)(1). See [Letter from James L. Eastman, Chief Counsel and Associate Director, Division of Trading and Markets, SEC, to Patrice M. Gliniecki, Senior Vice President and Deputy General Counsel, FINRA \(March 17, 2009\)](#).

appropriately registered principal(s) with authority to carry out the supervisory responsibilities for each type of business in which the member engages for which registration as a broker-dealer is required.

(iii) Proposed FINRA Rule 3110(a)(3) and Proposed Supplementary Material .01-.02

Proposed FINRA Rule 3110(a)(3) would require the registration and designation as a branch office or an office of supervisory jurisdiction (“OSJ”) of each location, including the main office, as those terms are defined in the proposed rule. Proposed FINRA Rule 3110(a)(3) is based on similar provisions in NASD Rule 3010(a)(3). In addition, the proposed rule provision and proposed Supplementary Material .01 (Registration of Main Office) incorporate the requirement in NASD IM-1000-4 (Branch Offices and Offices of Supervisory Jurisdiction) that all branch offices and OSJs must be registered as either a branch office or OSJ, respectively. FINRA is deleting NASD IM-1000-4 as part of this proposed rule change.

In addition, the proposed rule change moves, with no substantive changes, the provisions in NASD Rule 3010(a)(3) setting forth factors a member should consider in designating additional locations as OSJs into proposed Supplementary Material .02 (Designation of Additional OSJs).

(iv) Proposed FINRA Rule 3110(a)(4) and Proposed Supplementary Material .03-.04

Proposed FINRA Rule 3110(a)(4) would require a member to designate 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. This proposed provision would replace the nearly identical provision in NASD Rule 3010(a)(4) with a minor editorial change to delete the phrase “including the main office,” from the rule text.

Supplementary Material .03 (One-Person OSJs) codifies existing guidance on the supervision of one-person OSJs. Specifically, the proposed supplementary material would clarify the core concept that the registered principal designated to carry out supervisory responsibilities assigned to such an OSJ (“on-site principal”) cannot supervise his or her own activities if such principal is authorized to engage in business activities other than the supervision of associated persons or other offices as enumerated in proposed FINRA Rule 3110(e)(1)(D) through (G). Proposed Supplementary Material .03 also would provide that, in such instances, the on-site principal must be under the effective supervision and control of another appropriately registered principal (“senior principal”). The senior principal is responsible for supervising the activities of the on-site principal at such office and must conduct on-site supervision of such OSJ on a regular periodic schedule determined by the member. The proposed supplementary material would require a member to consider, among other factors, the nature and complexity of the securities activities for which the location is responsible, the nature and extent of contact with customers, and the disciplinary history of the on-site principal in determining this schedule.

Proposed Supplementary Material .04 (Supervision of Multiple OSJs by a Single Principal) would clarify the requirement in proposed Rule 3110(a)(4) to designate an on-site principal in each OSJ with authority to carry out the supervisory responsibilities

assigned to that office. Such on-site principal must have a physical presence, on a regular and routine basis, at the OSJ for which the principal has supervisory responsibilities. The proposed supplementary material would establish a general presumption that a principal will not be assigned to supervise more than one OSJ. If a member determines it is necessary to designate and assign a single appropriately registered principal to supervise more than one OSJ, the proposed supplementary material would require the member to take into consideration, among others, the following factors:

- whether the principal is qualified by virtue of experience and training to supervise the activities and associated persons in each location;
- whether the principal has the capacity and time to supervise the activities and associated persons in each location;
- whether the principal is a producing registered representative;
- 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
- 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.

Where a member determines to assign one principal to supervise more than one OSJ, the member must document the factors it 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 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 proposed supplementary material would provide that such determination will be subject to greater scrutiny, and the member will have a greater burden to evidence the reasonableness of such structure.

(v) Proposed FINRA Rule 3110(a)(5) through (7) and  
Proposed Supplementary Material .05

Proposed FINRA Rule 3110(a)(5) would require that each registered person be assigned to an appropriately registered representative(s) or principal(s) who is responsible for supervising that person's activities. Proposed FINRA Rule 3110(a)(6) would require a member to use reasonable efforts to determine that all supervisory personnel have the necessary experience or training to be qualified to carry out their assigned responsibilities. Proposed FINRA Rule 3110(a)(7) would require each registered representative and registered principal to participate, at least once each year, in an interview or meeting at which compliance matters relevant to the particular representative or principal are discussed. These proposed provisions would replace the nearly identical provisions in NASD Rule 3010(a)(5) through (7) with only minor editorial changes.

Proposed Supplementary Material .05 (Annual Compliance Meeting) would codify existing guidance that a member is not required to conduct in-person meetings with each registered person or groups of registered persons to comply with the annual compliance meetings required by proposed FINRA Rule 3110(a)(7).<sup>5</sup> However, a

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<sup>5</sup> See Notices to Members 99-45 (June 1999) and 05-44 (June 2005); see also Letter from Afshin Atabaki, FINRA, to Evan Charkes, Citigroup Global Markets, Inc., dated November 30, 2006 (members may use on-demand webcast technology to satisfy the annual compliance meeting requirement, subject to specified safeguards and

member that chooses to conduct meetings using other methods (e.g., on-demand webcast or course, video conference, interactive classroom setting, telephone, or other electronic means) must ensure, at a minimum, that each registered person attends the entire meeting (e.g., an on-demand annual compliance webcast would require each registered person to use a unique user ID and password to gain access and use a technology platform to track the time spent on the webcast, provide click-as-you-go confirmation, and have an attestation of completion at the end of a webcast) and is able to ask questions regarding the presentation and receive answers in a timely fashion (e.g., an on-demand annual compliance webcast that allows registered persons to ask questions via an email to a presenter or a centralized address or via a telephone hotline and receive timely responses directly or view such responses on the member's intranet site).

(B) Proposed FINRA Rule 3110(b) (Written Procedures)

FINRA proposes to consolidate various provisions and rules that currently require written procedures into proposed FINRA Rule 3110(b), including provisions from NASD Rule 3010(d) relating to the supervision and review of registered representatives' transactions and correspondence and Incorporated NYSE Rule 401A (Customer Complaints) relating to the review of customer complaints. In addition, proposed supplementary material, which is discussed in detail below, would codify and expand guidance in these areas.

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conditions); letter from Afshin Atabaki, FINRA, to S. Kendrick Dunn, Pacific Select Distributors, Inc., dated February 5, 2013 (members may use on-demand course without voice narration to satisfy annual compliance meeting requirement, subject to specified safeguards and conditions).

(i) Proposed FINRA Rule 3110(b)(1) (General Requirements)

Proposed FINRA Rule 3110(b)(1) would require a 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 that are reasonably designed to achieve compliance with applicable securities laws and regulations, FINRA rules, and MSRB rules. The proposed rule provision is substantially similar to NASD Rule 3010(b)(1) except for two revisions that mirror changes in proposed FINRA Rule 3110(a). First, proposed FINRA Rule 3110(b)(1) would refer only to associated persons instead of the current reference in NASD Rule 3010(b)(1) to “registered representatives, registered principals, and other associated persons.” Second, FINRA Rule 3110(b)(1) would require a member’s written supervisory procedures to be reasonably designed to achieve compliance with MSRB rules, which NASD Rule 3010(b)(1) does not explicitly reference.<sup>6</sup>

(ii) Proposed FINRA Rule 3110(b)(2) (Review of Member’s Investment Banking and Securities Business) and Proposed Supplementary Material .06

FINRA is retaining the provision in NASD Rule 3010(d)(1) requiring principal review, evidenced in writing, of all transactions, but is relocating the provision to proposed FINRA Rule 3110(b)(2). FINRA is also proposing to amend the provision to clarify that such review would include all transactions relating to the member’s investment banking or securities business. Proposed Supplementary Material .06 (Risk-based Review of Member’s Investment Banking and Securities Business) would permit a member to use a risk-based system to review these transactions.

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<sup>6</sup> See supra note 3.

(iii) Proposed FINRA Rule 3110(b)(3)

FINRA is preserving this provision for future rulemaking.<sup>7</sup>

(iv) Proposed FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) and Proposed Supplementary Material .07-.10

Proposed FINRA Rule 3110(b)(4) would generally incorporate the substance of NASD Rule 3010(d)(2) (Review of Correspondence) requiring members to have supervisory procedures for the review of correspondence. In addition, the proposed provision and proposed related supplementary material would incorporate existing guidance regarding the supervision of electronic communications in Regulatory Notice 07-59 (December 2007).

Specifically, proposed FINRA Rule 3110(b)(4) would require that a member have supervisory procedures for the review of the member's incoming and outgoing written (including electronic) correspondence with the public and internal communications that relate to its investment banking or securities business. In particular, the proposed rule would require a member to have supervisory procedures requiring the member's review of incoming and outgoing written (including electronic) correspondence with the public to properly identify and handle in accordance with firm procedures, customer complaints, instructions, funds and securities, and communications that are of a subject matter that

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<sup>7</sup> As noted in Regulatory Notice 08-24 (May 2008), FINRA proposed to delete NASD Rule 3040 (Private Securities Transactions of an Associated Person) and replace it with FINRA Rule 3110(b)(3) (Supervision of Outside Securities Activities) and proposed Supplementary Material .07 (Reliance on Bank or Affiliated Entity to Supervise Dual Employees). FINRA, however, has determined to address NASD Rule 3040 as a separate proposal.

require review under FINRA and MSRB rules and federal securities laws. In addition, proposed FINRA Rule 3110(b)(4) would require a member to have supervisory procedures to review internal communications to properly identify communications that are of a subject matter that require review under FINRA and MSRB rules and federal securities laws. Those communications include (without limitation):

- communications between non-research and research departments concerning a research report's contents (NASD Rule 2711(b)(3) and Incorporated NYSE Rule 472(b)(3));
- certain communications with the public that require a principal's pre-approval (FINRA Rule 2210);<sup>8</sup>
- the identification and reporting to FINRA of customer complaints (FINRA Rule 4530);<sup>9</sup> and
- the identification and prior written approval of changes in account name(s) (including related accounts) or designation(s) (including error accounts) regarding customer orders (FINRA Rule 4515).

Proposed Supplementary Material .07 (Risk-based Review of Correspondence and Internal Communications), however, would require a member, by employing risk-

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<sup>8</sup> See Securities Exchange Act Release No. 66681 (March 29, 2012), 77 FR 20452 (April 4, 2012) (Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval of SR-FINRA-2011-035); see also Regulatory Notice 12-29 (June 2012) (SEC Approves New Rules Governing Communications With the Public – Effective Date: February 4, 2013).

<sup>9</sup> With respect to customer complaints, as detailed further below, proposed FINRA Rule 3110(b)(5) also would affirmatively require members to capture, acknowledge, and respond to all written (including electronic) customer complaints.

based principles, to decide the extent to which additional policies and procedures for the review of incoming and outgoing written (including electronic) correspondence with the public that fall outside of the subject matters listed in proposed FINRA Rule 3110(b)(4) are necessary for its business and structure. If a member's procedures do not require that all correspondence be reviewed before use or distribution, the procedures must provide for:

- the education and training of associated persons regarding the firm's procedures governing correspondence;
- the documentation of such education and training; and
- surveillance and follow-up to ensure that such procedures are implemented and followed.

In addition, proposed Supplementary Material .07 would require a member, by employing risk-based principles, to decide the extent to which additional policies and procedures for the review of internal communications that are not of a subject matter that require review under FINRA and MSRB rules and federal securities laws are necessary for its business and structure.

Proposed FINRA Rule 3110(b)(4) also would require that a registered principal review correspondence with the public and internal communications and evidence those reviews in writing (either electronically or on paper). Proposed Supplementary Material .09 (Delegation of Correspondence and Internal Communication Review Functions) would allow a supervisor/principal to delegate review functions to an unregistered person; however, the supervisor/principal remains ultimately responsible for the performance of all necessary supervisory reviews.

Proposed Supplementary Material .08 (Evidence of Review of Correspondence and Internal Communications) would codify existing FINRA guidance that merely opening a communication is not sufficient review.<sup>10</sup> Instead, a member must identify what communication was reviewed, the identity of the reviewer, the date of review, and the actions taken by the member as a result of any significant regulatory issues identified during the review.

Finally, proposed Supplementary Material .10 (Retention of Correspondence and Internal Communications), which is largely based on the requirements in NASD Rule 3010(d)(3) (Retention of Correspondence), would require a member to retain its internal communications and correspondence of associated persons relating to the member's investment banking or securities business in accordance with SEA Rule 17a-4(b)<sup>11</sup> and make those records available to FINRA upon request.

(v) Proposed FINRA Rule 3110(b)(5) (Review of Customer Complaints)

Incorporated NYSE Rule 401A (Customer Complaints) requires firms to acknowledge and respond to all customer complaints subject to the reporting requirements of Incorporated NYSE Rule 351(d) (Reporting Requirements). Previously, this meant that firms had to acknowledge and respond to both written and oral customer complaints. However, as part of the effort to harmonize the NASD and NYSE rules in the interim period before completion of the Consolidated FINRA Rulebook, Incorporated NYSE Rule 351(d) was amended to limit the definition of "customer complaint" to

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<sup>10</sup> See Regulatory Notice 07-59 (December 2007).

<sup>11</sup> 17 CFR 240.17a-4(b).

include only written complaints, thereby making the definition substantially similar to that in NASD Rule 3070(c) (Reporting Requirements).<sup>12</sup>

Proposed FINRA Rule 3110(b)(5), which would require a member's supervisory procedures to include procedures to capture, acknowledge, and respond to all written (including electronic) customer complaints, essentially incorporates the customer complaint requirement in Incorporated NYSE Rule 401A, including the limitation on including only written (including electronic) customer complaints. FINRA believes that oral complaints are difficult to capture and assess, and they raise competing views as to the substance of the complaint being alleged. Consequently, oral complaints do not lend themselves as effectively to a review program as written complaints, which are more readily documented and retained. However, FINRA reminds members that the failure to address any customer complaint, written or oral, may be a violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).

(vi) Proposed FINRA Rule 3110(b)(6) (Documentation and Supervision of Supervisory Personnel) and Proposed Supplementary Material .11

Proposed FINRA Rule 3110(b)(6) is based largely on existing provisions in NASD Rule 3010(b)(3) requiring a member's supervisory procedures to set forth the member's supervisory system and to include a record of the member's supervisory

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<sup>12</sup> FINRA adopted FINRA Rule 4530 (Reporting Requirements) to replace NASD Rule 3070 and comparable provisions in Incorporated NYSE Rule 351. See Securities Exchange Act Release No. 63260 (November 5, 2010), 75 FR 69508 (November 12, 2010) (Notice of Filing of Amendments No. 1 and 2 and Order Granting Accelerated Approval of File No. SR-FINRA-2010-034). FINRA Rule 4530 became effective on July 1, 2011. See Regulatory Notice 11-06 (February 2011).

personnel with such details as titles, registration status, locations, and responsibilities.

The proposed rule also would include a new provision, proposed FINRA Rule 3110(b)(6)(C), that would address potential abuses in connection with the supervision of supervisors. This provision would replace NASD Rule 3012(a)(2) concerning the supervision of a producing manager's customer account activity and the requirement to impose heightened supervision when any producing manager's revenues rise above a specific threshold.

Specifically, the proposed provision would require members to have procedures prohibiting associated persons who perform a supervisory function from:

- supervising their own activities; and
- reporting to, or having their compensation or continued employment determined by, someone they are supervising.

The proposal, however, would create an exception for a member that determines, with respect to any of its supervisory personnel, that compliance with either of these conditions is not possible because of the member's size or a supervisory personnel's position within the firm. A member relying on this exception must document the factors the member used to reach such determination and how the supervisory arrangement with respect to such supervisory personnel otherwise comports with proposed FINRA Rule 3110(a). Proposed Supplementary Material .11 (Supervision of Supervisory Personnel) would explain that a member generally will need to rely on this exception only because it is a sole proprietor in a single-person firm or where a supervisor holds a very senior executive position within the firm. Members relying on this exception would not be required to notify FINRA of their reliance.

Proposed FINRA Rule 3110(b)(6)(D) would require a member 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 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. There is no exception from this provision.

(vii) Proposed FINRA Rule 3110(b)(7) (Maintenance of Written Supervisory Procedures) and Proposed Supplementary Material .12

Proposed FINRA Rule 3110(b)(7), which would replace similar requirements in NASD Rule 3010(b)(4), would require a member to keep and maintain a copy of the member's written supervisory procedures, or the relevant portions thereof, at each OSJ and at each location where supervisory activities are conducted on behalf of the member. The member must also promptly amend its written supervisory procedures to reflect changes in applicable securities laws or regulations, including FINRA and MSRB rules, and as changes occur in its supervisory system. In addition, each member must promptly communicate its written supervisory procedures and amendments to all associated persons to whom such written supervisory procedures and amendments are relevant based on their activities and responsibilities.

Proposed Supplementary Material .12 (Use of Electronic Media to Communicate Written Supervisory Procedures) would permit a member to satisfy its obligation to communicate its written supervisory procedures, and any amendments thereto, using

electronic media, provided that: (1) the written supervisory procedures have been promptly communicated to, and are readily accessible by, all associated persons to whom such supervisory procedures apply based on their activities and responsibilities through, for example, the member's intranet system; (2) all amendments to the written supervisory procedures are promptly posted to the member's electronic media; (3) associated persons are notified that amendments relevant to their activities and responsibilities have been made to the written supervisory procedures; (4) the member has reasonable procedures to monitor and maintain the security of the material posted to ensure that it cannot be altered by unauthorized persons; and (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-4(e)(7).<sup>13</sup>

(C) Proposed FINRA Rule 3110(c) (Internal Inspections) and Proposed Supplementary Material .13-.15

Proposed FINRA Rule 3110(c)(1), based largely on NASD Rule 3010(c)(1), would retain the existing requirements for each member to review, at least annually, the businesses in which it engages and inspect each office on a specified schedule. That inspection schedule would require that OSJs and supervisory branch offices be inspected at least annually, non-supervisory branch offices be inspected at least every three years, and non-branch locations be inspected on a regular periodic schedule. The proposed rule provision also would clarify that the term "annually," as used in proposed FINRA Rule 3110(c), means on a calendar-year basis.

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<sup>13</sup> 17 CFR 240.17a-4(e)(7).

Proposed Supplementary Material .14 (General Presumption of Three-Year Limit for Periodic Inspection Schedules) would provide a general presumption that a non-branch location will be inspected at least every three years, even in the absence of any indicators of irregularities or misconduct (i.e., “red flags”). If a member establishes a periodic inspection schedule longer than three years, the member must document in its written supervisory and inspection procedures the factors used in determining that a longer periodic inspection cycle is appropriate. As with NASD Rule 3010(c), proposed FINRA Rule 3110(c) would require a member to retain a written record of each review and inspection, reduce a location’s inspection to a written report, and keep each inspection report on file either for a minimum of three years or, if the location’s inspection schedule is longer than three years, until the next inspection report has been written.

The proposal revises NASD Rule 3010(c)(3)’s provisions prohibiting certain persons from conducting office inspections to make the provisions less prescriptive. To that end, the proposed rule would eliminate the heightened office inspection requirements members must implement if the person conducting the office inspection either reports to the branch office manager’s supervisor or works in an office supervised by the branch manager’s supervisor, and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager’s supervisor. The proposal would replace these requirements with provisions requiring a member to:

- prevent the inspection standards required pursuant to proposed FINRA Rule 3110(c)(1) from being reduced in any manner due to any conflicts of interest that

may be present, including but not limited to, economic, commercial, or financial interests in the associated persons and businesses being inspected; and

- ensure that the person conducting an inspection pursuant to proposed FINRA Rule 3110(c)(1) is not an associated person assigned to the location or is not directly or indirectly supervised by, or otherwise reporting to, an associated person assigned to the location.

A member that determines it cannot comply with this last condition due to its size or business model must document in the inspection report both the factors the member used to make its determination and how the inspection otherwise comports with proposed FINRA Rule 3110(c)(1). Proposed Supplementary Material .15 (Exception to Persons Prohibited from Conducting Inspections) would provide that such a determination generally will arise only in instances where the member has only one office or the member has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager. The proposal also generally would retain as Supplementary Material .13 (Standards for Reasonable Review) the content of NASD IM-3010-1 (Standards for Reasonable Review) relating to standards for the reasonable review of offices.<sup>14</sup>

In addition, the proposal would relocate into proposed FINRA Rule 3110(c)(2) provisions in NASD Rule 3012 regarding the review and monitoring of specified activities, such as transmittals of funds and securities and customer changes of address and investment objectives. Specifically, proposed FINRA Rule 3110(c)(2)(A) would require a member to test and verify a location's procedures for: (1) safeguarding of

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<sup>14</sup> See also Incorporated NYSE Rule 342.10 (Definition of Branch Office).

customer funds and securities; (2) maintaining books and records; (3) supervision of supervisory personnel; (4) transmittals of funds (e.g., wires or checks, etc.) or securities from customers to third party accounts, from customer accounts to outside entities (e.g., banks, investment companies, etc.), from customer accounts to locations other than a customer's primary residence (e.g., post office box, "in care of" accounts, alternate address, etc.), and between customers and registered representatives, including the hand-delivery of checks; and (5) changes of customer account information, including address and investment objective changes and validation of such changes. With respect to the transmittal of funds or securities from customers to third party accounts, the proposal would eliminate NASD Rule 3012's parenthetical text ("i.e., a transmittal that would result in a change in beneficial ownership)" to clarify that all transmittals to an account where a customer on the original account is not a named account holder are included.

Proposed FINRA Rule 3110(c)(2)(B) would require for transmittals of funds or securities a means or method of customer confirmation, notification, or follow-up that can be documented but would make clear that members may use risk-based methods to determine the authenticity of the transmittal instructions. Proposed FINRA Rule 3110(c)(2)(C) also would require for changes of customer account information a means or method of customer confirmation, notification or follow-up that can be documented and that complies with SEA Rules 17a-3(a)(17)(i)(B)(2)<sup>15</sup> and 17a-3(a)(17)(i)(B)(3).<sup>16</sup> Finally, proposed FINRA Rule 3110(c)(2)(D) would make clear that if a location being

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<sup>15</sup> 17 CFR 240.17a-3(a)(17)(i)(B)(2) (changes in the name or address of customer or owner).

<sup>16</sup> 17 CFR 240.17a-3(a)(17)(i)(B)(3) (changes in an account's investment objectives).

inspected does not engage in all of the activities listed above, the member must identify those activities in the location's written inspection report and document in the report that supervisory policies and procedures must be in place at that location before the location can engage in them.

(D) Proposed FINRA Rule 3110(d) (Transaction Review and Investigation)

Section 15(g) of the Act,<sup>17</sup> adopted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"),<sup>18</sup> requires every registered broker or dealer to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the broker or dealer or any associated person of the broker or dealer. Incorporated NYSE Rule 342.21 sets forth specific supervisory procedures for compliance with ITSFEA by requiring firms to review trades in NYSE-listed securities and related financial instruments that are effected for the member's account or for the accounts of the member's employees and family members. Incorporated NYSE Rule 342.21 also requires members to promptly conduct an internal investigation into any trade the firm identifies that may have violated insider trading laws or rules.

FINRA is proposing FINRA Rule 3110(d) to incorporate into the Consolidated FINRA Rulebook the provisions of Incorporated NYSE Rule 342.21, with some modifications, and extend the requirement beyond NYSE-listed securities and related

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<sup>17</sup> 15 U.S.C. 78q(g).

<sup>18</sup> See Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.

financial instruments to cover all securities. Specifically, proposed FINRA Rule 3110(d)(1) would require a member to have supervisory procedures for the review of securities transactions that are effected for the account(s) of the member or associated persons of the member as well as any other “covered account”<sup>19</sup> to identify trades that may violate the provisions of the Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices. The proposed rule change also would require members to promptly conduct an internal investigation into any identified trades to determine whether a violation of those laws or rules has occurred.

Proposed FINRA Rule 3110(d)(2) would require any member that engages in “investment banking services,”<sup>20</sup> to provide reports to FINRA regarding such investigations. These members would be required to make written reports to FINRA within ten business days of the end of each calendar quarter describing each internal investigation initiated in the previous calendar quarter, including the member’s identity,

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<sup>19</sup> Proposed FINRA Rule 3110(d)(3)(A) defines the term “covered account” to include (i) any account held by the spouse, domestic partner, child, parent, sibling, son-in-law, daughter-in-law, father-in-law, or mother-in-law of a person associated with the member where such account is introduced or carried by the member; (ii) any account introduced or carried by the member in which a person associated with the member has a beneficial interest; (iii) any account introduced or carried by the member over which a person associated with the member has the authority to make investment decisions; and (iv) any account of a person associated with a member that is disclosed to the member pursuant to NASD Rule 3050 or NYSE Rule 407, as applicable.

<sup>20</sup> 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. This proposed definition is the same definition as in proposed FINRA Rule 2240(a)(4) (Research Analysts and Research Reports). See Regulatory Notice 08-55 (October 2008).

the commencement date of each internal investigation, the status of each open internal investigation, the resolution of any internal investigation reached during the previous calendar quarter, and with respect to each internal investigation, the identity of the security, trades, accounts, member's associated persons or family members of such associated person holding a covered account, under review, and a copy of the member's policies and procedures required by proposed FINRA Rule 3110(d)(1)(A). If a member subject to this requirement did not have an open internal investigation or either initiate or complete an internal investigation during a particular calendar quarter, the member would not be required to submit a report for that quarter.

In addition, the proposed rule would require a written report within five business days of completion of such internal investigation in which it was determined that a violation of the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices had occurred. The report must detail the completion of the investigation, including the results of the investigation, any internal disciplinary action taken, and any referral of the matter to FINRA, another self-regulatory organization ("SRO"), the SEC, or any other federal, state, or international regulatory authority.

(E) Proposed FINRA Rule 3110(e) (Definitions)

Proposed FINRA Rule 3110(e) would retain the definitions of "branch office," "office of supervisory jurisdiction," and "business day" in NASD Rule 3010(g). The branch office definition already has been harmonized with the definition of "branch office" in Incorporated NYSE Rule 342.10.

(2) Proposed FINRA Rule 3120 (Supervisory Control System)

FINRA is proposing to replace NASD Rule 3012 (Supervisory Control System) with FINRA Rule 3120. Proposed FINRA Rule 3120(a) would retain NASD Rule 3012(a)(1)'s testing and verification requirements for the member's supervisory procedures, including the requirement to prepare and submit to the member's senior management a report at least annually summarizing the test results and any necessary amendments to those procedures.

Proposed FINRA Rule 3120(b) would require a member that reported \$200 million or more in gross revenue (total revenue less, if applicable, commodities revenue) on its FOCUS reports in the prior calendar year to include in the report it submits to senior management:

- a tabulation of the reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year; and
- a discussion of the preceding year's compliance efforts, including procedures and educational programs, in each of the following areas:
  - trading and market activities;
  - investment banking activities;
  - antifraud and sales practices;
  - finance and operations;
  - supervision; and
  - anti-money laundering.

The categories listed above are incorporated from the annual report content requirements of Incorporated NYSE Rule 342.30 (Annual Report and Certification).

(3) Proposed FINRA Rule 3150 (Holding of Customer Mail)

The proposed rule change would replace NASD Rule 3110(i) (Holding of Customer Mail) with proposed FINRA Rule 3150, a more general rule that would eliminate the strict time limits in NASD Rule 3110(i) and generally would allow a member to hold a customer's mail for a specific time period in accordance with the customer's written instructions if the member meets specified conditions. Specifically, proposed FINRA Rule 3150(a) would provide that a member may hold mail for a customer who will not be receiving mail at his or her usual address, provided that the member:

- receives written instructions from the customer that include the time period during which the member is requested to hold the customer's mail. If the time period included in the customer's instructions is longer than three consecutive months (including any aggregation of time periods from prior requests), the customer's instructions must include an acceptable reason for the request (e.g., safety or security concerns). Convenience is not an acceptable reason for holding mail longer than three months;
- informs the customer in writing of any alternate methods, such as email or access through the member's website, that the customer may use to receive or monitor account activity and information and obtains the customer's confirmation of the receipt of such information; and
- verifies at reasonable intervals that the instructions still apply.

In addition, proposed FINRA Rule 3150(b) would require that the member be able to communicate, as necessary, with the customer in a timely manner during the time

the member is holding the customer's mail to provide important account information (e.g., privacy notices, the SIPC information disclosures required by FINRA Rule 2266 (SIPC Information)).

Finally, proposed FINRA Rule 3150(c) would require a member holding a customer's mail to take actions reasonably designed to ensure that the customer's mail is not tampered with, held without the customer's consent, or used by an associated person of the member in any manner that would violate FINRA rules, MSRB rules, or the federal securities laws.

(4) Proposed FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms)

FINRA proposes to reconstitute NASD Rule 3010(b)(2) (Tape Recording of Conversations) without any substantive changes as new FINRA Rule 3170. The only proposed changes to the rule text are minor editorial changes to assist with readability, changes to the definition of disciplinary history to reflect the adoption of the enumerated NASD rules as FINRA rules, and a definition clarifying that the term "tape recording" would include without limitation, any electronic or digital recording that meets the requirements of proposed FINRA Rule 3170.

(5) Proposal to Eliminate NYSE Rules

As stated previously, the proposed rule change would delete corresponding provisions in the Incorporated NYSE Rules and Interpretations that are, in main part, either duplicative of, or do not align with, the proposed supervision requirements discussed above. Specifically, the proposed deleted rule provisions are:

- Incorporated NYSE Rule 342;

- Incorporated NYSE Rule Interpretations 342(a)(b)/01 through 342(a)(b)/03, 342(b)/01 through 342(b)/02, 342(c)/02, 342(e)/01, 342.10/01, 342.13/01, 342.15/01 through 342.15/05, 342.16/01 through 342.16/03;
- Incorporated NYSE Rules 343, 343.10 and NYSE Rule Interpretation 343(a)/01;
- Incorporated NYSE Rule 351(e) and NYSE Rule Interpretation 351(e)/01;
- Incorporated NYSE Rule 354; and
- Incorporated NYSE Rule 401.

FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 90 days following Commission approval. The effective date will be no later than 365 days following Commission approval.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>21</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA also believes that the proposed rule change would clarify and streamline the supervision and supervisory rules for adoption as FINRA Rules in the Consolidated FINRA Rulebook.

### B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the

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<sup>21</sup> 15 U.S.C. 78o-3(b)(6).

Act. The proposed rule change's risk-based approach for specified aspects of a member's supervisory procedures is intended to allow firms the flexibility to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concerns may be warranted. For example, proposed FINRA Rule 3110's provisions requiring supervisory procedures for the risk-based review of all transactions relating to a member's investment banking or securities business and review of a member's correspondence and internal communications that are not of a subject matter that require review under FINRA and MSRB rules would alleviate compliance costs by providing members with greater flexibility to tailor their supervisory and supervisory control procedures to reflect their business, size, and organizational structure.

In addition, FINRA believes that the proposed rule change is tailored to minimize the membership's burden and cost of complying with the consolidated supervision rules by providing exceptions, based on a member's size, resources, and business model, to specified supervisory and inspection requirements in proposed FINRA Rule 3110. Specifically, the proposed rule change provides an exception from proposed FINRA Rule 3110's provisions prohibiting a member's supervisory personnel from supervising their own activities and from reporting to, or having their compensation or continued employment determined by, a person or persons they are supervising, where a member determines that compliance with either of these conditions is not possible because of the member's size or supervisory personnel's position within the firm. The proposed rule change also provides an exception from proposed FINRA Rule 3110's requirement that the person conducting a location inspection not be an associated person assigned to the

location or is not directly or indirectly supervised by, or otherwise reporting to, an associated person assigned to that location, where the member determines that compliance with this requirement is not possible either because of the member's size or business model. These exceptions are designed in particular to provide relief to smaller-sized members, such as sole proprietors or members with only one office, as well as members with a business model where small or single person offices report directly to an OSJ manager who is also considered the office's branch office manager. At the same time, the proposed rule change is designed to protect against concerns that a member relying on the exceptions would be unable to comply with its supervisory and inspection obligations by requiring the member to document both the factors the member used to reach the determination that it needs to rely on the exceptions and how the member's reliance on the exception otherwise comports with the applicable standards set forth in proposed FINRA Rule 3110.

The proposed rule change also seeks to mitigate compliance costs and burdens with respect to proposed FINRA Rule 3120's annual reporting requirements by requiring that only members reporting \$200 million or more in gross revenues in the preceding year (increased from the \$150 million threshold originally proposed in the Initial Filing)<sup>22</sup> include in their annual reports supplemental information from Incorporated NYSE Rule 342.30's annual report content requirements. FINRA believes that the revised threshold strikes the appropriate balance as it encompasses larger dual member firms, members engaged in significant underwriting activities (including variable annuity principal underwriting and fund distributions) and substantial trading activities or market making

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<sup>22</sup> See infra note 22.

business, and members with extensive sales platforms – approximately 160 member firms in total. The additional content requirements applicable to such firms would provide a valuable resource in the context of understanding and examining those firms and their activities, which can generally be more complex or sizeable than smaller firms’ activities. FINRA also considered that most members meeting the proposed threshold currently are subject to Incorporated NYSE Rule 342.30’s reporting requirement. Further, the metric is easily determined by reference to the member’s FOCUS reports in the calendar year prior to the annual report.

In addition, FINRA has modified proposed FINRA Rule 3110(d)’s reporting obligations for internal investigation reports to FINRA regarding suspected ITSFEA violations in response to commenters’ concerns regarding potential burdens and compliance costs. The modifications eliminate the requirement to file with FINRA an initial report of an internal investigation within ten business days of its commencement and replace it with a quarterly reporting requirement. In addition, FINRA has replaced the proposed requirement to report the completion of each internal investigation within five business days of its completion with a more focused requirement that is limited to investigations that resulted in a finding of violation.

C. Self-Regulatory Organization’s Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

FINRA published the proposed consolidated FINRA supervision rules in Regulatory Notice 08-24 (May 2008) requesting comment from interested parties. FINRA received 47 comment letters in response to Regulatory Notice 08-24. On June 10, 2011, FINRA filed with the SEC SR-FINRA-2011-028 (the “Initial Filing”), a proposed rule change to

adopt the consolidated FINRA supervision rules, which addressed the comments received in response to Regulatory Notice 08-24.<sup>23</sup>

On June 29, 2011, the Initial Filing was published for comment in the Federal Register,<sup>24</sup> and the SEC received 12 comment letters in response to the proposal.<sup>25</sup>

FINRA withdrew the Initial Filing on September 27, 2011 prior to filing a response to comments.<sup>26</sup> Accordingly, the comments to the Initial Filing and FINRA's responses are discussed below.

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<sup>23</sup> See Securities Exchange Act Release No. 64736 (June 23, 2011), 76 FR 38245 (June 29, 2011) (Notice of Filing of File No. SR-FINRA-2011-028).

<sup>24</sup> See supra note 22.

<sup>25</sup> Letters from David T. Bellaire, Esq., General Counsel and Director of Government Affairs, Financial Services Institute, to Elizabeth M. Murphy, Secretary, SEC, dated July 14, 2011 and July 20, 2011 ("FSI"); letters from Clifford Kirsch and Eric A. Arnold, Sutherland Asbill and Brennan, LLP, on behalf of the Committee of Annuity Insurers, to Elizabeth M. Murphy, Secretary, SEC, dated July 12, 2011, July 20, 2011, and August 4, 2011 ("CAI"); letter from Stephanie L. Brown, Managing Director and General Counsel, LPL Financial, to Elizabeth M. Murphy, Secretary, SEC, dated July 20, 2011 ("LPL"); letter from Scott Cook, Senior Vice President Compliance, Charles Schwab & Co., Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 20, 2011 ("Schwab"); letter from Joan Hinchman, Executive Director, President and CEO, National Society of Compliance Professionals Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 20, 2011 ("NSCP"); letter from Sarah McCafferty, Vice President and Chief Compliance Officer, T. Rowe Price Investment Services, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 20, 2011 ("T. Rowe Price"); letter from Peter J. Mougey, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, SEC, dated July 20, 2011 ("PIABA"); letter from John Polanin and Claire Santaniello, Co-Chairs, Compliance and Regulatory Policy Committee 2011, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, SEC, dated July 20, 2011 ("SIFMA"); and letter from Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated July 20, 2011 ("ICI"). The comment letters are available on the SEC's [website](#).

<sup>26</sup> See Securities Exchange Act Release No. 65477 (October 4, 2011), 76 FR 62890 (October 11, 2011) (Notice of Withdrawal of File No. SR-FINRA-2011-028).

(a) General Comments

Several commenters to the Initial Filing expressed overall support for the proposed rule change, as well as expressing support for specific aspects of the proposal, such as the principles-based requirements for supervising supervisory personnel and codification of existing guidance regarding supervision of electronic communications and the use of electronic media to conduct required annual compliance meetings.<sup>27</sup> However, one commenter opposed the flexibility within the proposed rules, especially the proposed risk-based or principles-based review standards for certain obligations, such as the approval of securities transactions and the review of certain correspondence, stating that such flexibility would result in reduced or diminished supervisory requirements that would not achieve the purpose of protecting the investing public.<sup>28</sup>

In response, FINRA notes that the proposed rules' risk-based approach for specified aspects of a member's supervisory procedures is intended to increase, not diminish, investor protection by allowing firms the flexibility to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concern may be warranted. In addition, as FINRA noted in the Initial Filing, the proposed rules further protect investors by retaining certain specific prescriptive requirements of NASD Rules 3010 and 3012, such as mandatory inspection cycles, prohibitions on who can conduct location inspections, and procedures for the monitoring of certain enumerated activities, while providing additional prescriptive requirements where necessary, including special supervision for supervisory

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<sup>27</sup> SIFMA, FSI, CAI, Schwab, T. Rowe Price.

<sup>28</sup> PIABA.

personnel rather than just the existing special supervision for producing managers, specific procedures to detect and investigate potential insider trading violations, and additional content requirements for specified firms' annual reports.

(b) Comments on Proposed FINRA Rule 3110(a)

(1) Suggested Amendment to FINRA Rule 3110(a)

Proposed FINRA Rule 3110(a) (Supervisory System) would require a member to have a supervisory system for the activities of its associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA and MSRB rules. One commenter to the Initial Filing suggested that FINRA amend proposed FINRA Rule 3110(a) to require a supervisory system for the “securities activities” of a member’s associated persons, as FINRA’s rulemaking and examination authority does not extend to non-securities activities.<sup>29</sup> The commenter further contended that the suggested amendment would make the provision consistent with proposed FINRA Rule 3110(a)(2), which would require a member to designate an appropriately registered principal to be responsible for each type of a firm’s business for which registration as a broker-dealer is required. As noted above and in the Initial Filing, proposed FINRA Rule 3110(a) is transferring existing rule text in NASD Rule 3010(a) with only minor changes (i.e., including an express reference to the MSRB rules, referring only to associated persons instead of the current reference in NASD Rule 3010(a) to each “registered representative, registered principal, and other associated person”). FINRA continues to believe that proposed FINRA Rule 3110(a) would set forth the appropriate standard for members’ supervisory systems, i.e., that a member’s

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<sup>29</sup> SIFMA.

supervisory system for the activities of its associated persons be reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA and MSRB rules. In this regard, FINRA notes that Exchange Act Section 15A(b)(6) mandates, among other things, that FINRA’s rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. Proposed FINRA Rule 3110(a) also is consistent with proposed FINRA Rule 3110(b)(1), which would require a member to have supervisory procedures for the types of business in which it engages and the activities of its associated persons.<sup>30</sup> Accordingly, FINRA declines to make the suggested change.

(2) Outside Business Activities

Commenters requested that FINRA clarify that outside business activities of registered persons would be subject to FINRA Rule 3270 (Outside Business Activities of Registered Persons) rather than to proposed FINRA Rule 3110.<sup>31</sup> FINRA Rule 3270 generally pertains to outside business activities that are not within the scope of the registered representative’s relationship with the member, and members must comply with the rule’s requirements with respect to covered outside business activities. However, a

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<sup>30</sup> As noted above, proposed FINRA Rule 3110(b)(1) is substantially similar to NASD Rule 3010(b)(1)’s requirements to 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 but includes minor language revisions to mirror changes in proposed FINRA Rule 3110(a). Specifically, proposed FINRA Rule 3110(b)(1) refers only to associated persons instead of the current reference in NASD Rule 3010(b)(1) to “registered representatives, registered principals, and other associated persons” and references the MSRB rules, which NASD Rule 3010(b)(1) does not explicitly reference.

<sup>31</sup> CAI, FSI.

member's supervisory system required by proposed FINRA Rule 3110 must include supervisory procedures that are reasonably designed to ensure compliance with FINRA Rule 3270, including the member's obligation pursuant to FINRA Rule 3270 to evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity. If a member's evaluation revealed that the proposed activity was within the scope of the representative's relationship with the member, then that activity would be subject to the requirements of proposed FINRA Rule 3110.<sup>32</sup>

(3) Deleted Supplementary Material

In the Initial Filing, proposed FINRA Rule 3110 included Supplementary Material .01 (Business Lines) providing 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 (Standards of Commercial Honor and Principles of Trade), it must include supervision for all of the member's business lines irrespective of whether they require broker-dealer registration. A number of commenters provided comments on this proposed supplementary material. FINRA, however, has decided that the best course is to eliminate the proposed supplementary material from the proposed rule<sup>33</sup> and will

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<sup>32</sup> FINRA also considers this reply to be responsive to FSI's request that FINRA clarify whether proposed FINRA Rule 3110(b)(1), which would require a member to establish, maintain, and enforce written supervisory procedures for its supervisory system, would apply to outside business activities of registered persons.

<sup>33</sup> The deletion of this proposed supplementary material has resulted in a change in numbering of the remaining supplementary material to proposed FINRA Rule 3110. For ease of reference, the proposed rule change employs the new proposed numbers in all instances.

continue to apply FINRA Rule 2010's standards to non-securities activities of members and their associated persons consistent with existing case law.<sup>34</sup>

(c) Comments on Proposed Supplementary Material. 03

As stated above, proposed Supplementary Material .03 (One-Person OSJs) would codify existing guidance on the designation and supervision of one-person OSJs and would clarify that the registered principal assigned to such an OSJ (“on-site principal”) cannot supervise his or her own sales activities and must be under the effective supervision and control of another appropriately registered principal (“senior principal”). The senior principal is responsible for supervising the activities of the on-site principal at such OSJ and must conduct on-site supervision of the OSJ on a regular periodic schedule to be determined by the member.

(1) Clarification of “Close Supervision and Control” Requirement

As proposed in the Initial Filing, Supplementary Material .03 would have required that the on-site principal be under the senior principal’s “close supervision and control.” Although one commenter to the Initial Filing supported proposed Supplementary

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<sup>34</sup> See, e.g., Ialeggio v. SEC, No. 98-70854, 1999 U.S. App. LEXIS 10362, at \*4-5 (9th Cir. May 20, 1999) (“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” (citations omitted)); see also Vail v. SEC, 101 F.3d 37, 39 (5th Cir. 1996) (registered representative, who was serving as treasurer for a political-affiliation club, violated just and equitable principles of trade when he misappropriated funds from the club); In re John M.E. Saad, Securities Exchange Act Release No. 62178, 2010 SEC LEXIS 1761, at \*13-14 (May 26, 2010) (registered representative’s falsification of receipts and submission on a fraudulent expense report violated just and equitable principles of trade), remanded on other grounds, No. 10-1195, 2013 U.S. App. LEXIS 11691 (D.C. Cir. June 11, 2013).

Material .03,<sup>35</sup> another commenter requested that FINRA clarify the term “close supervision and control,” stating that such term could be subject to a variety of interpretations.<sup>36</sup> In response, FINRA has amended “close supervision and control” to read “effective supervision and control,” which should provide members with greater clarity. While the senior principal is not required to be physically present, full-time at the one-person OSJ, the member must be able to demonstrate “effective supervision and control” of the activities of the on-site principal at such OSJ.

(2) Consideration of Independent Broker-Dealer Business Model

Two commenters expressed concern that the proposed supplementary material does not take into account the business and supervisory structure of independent broker-dealer firms.<sup>37</sup> Specifically, one commenter supported the notion that self-supervision of one’s own securities activities may be problematic and agreed that the designation of a senior principal to oversee the activity of the on-site principal may be necessary, but suggested that firms should have the flexibility to address self-supervision, and any conflicts such self-supervision may present, in their own manner.<sup>38</sup> The commenter also stated that the requirement of “periodic on-site supervision” by a senior principal may not create the appropriate efficiencies or enhance the overall supervisory structure as intended, and moreover ignores the long established business practices of conducting supervision remotely.

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<sup>35</sup> PIABA.

<sup>36</sup> FSI.

<sup>37</sup> LPL, FSI.

<sup>38</sup> LPL.

FINRA believes proposed Supplementary Material .03 strikes the correct balance between the flexibility firms need to establish a supervisory structure best suited to their business models by allowing firms to establish one-person OSJs, with the need for effective supervision by clarifying that a reasonable supervisory structure cannot permit a principal to supervise his or her own sales activities due to the conflict of interest such situation presents.<sup>39</sup> Accordingly, FINRA believes that the requirement in proposed Supplementary Material .03 to have a senior principal regularly supervise the activities of an on-site producing principal is necessary to ensure that the on-site principal's activities are appropriately supervised.

The second commenter expressed concern that proposed Supplementary Material .03 would prohibit a "field OSJ" supervisory structure used by many independent broker-dealer firms. According to the commenter, a "field OSJ" supervisory structure uses field OSJ principals to supervise branch offices (e.g., approving client accounts, reviewing simple requests, and performing other low-level compliance functions). The "field OSJ" principals are then supervised by a firm's home office principals. Specifically, the commenter was concerned that a "field office" supervisory structure would be prohibited by proposed Supplementary Material .03 because such structure would allow a "field

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<sup>39</sup> See SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004) (reminding broker-dealers that small, remote offices require vigilant supervision and specifically noting that "[n]o individual can supervise themselves"); NASD Regulatory & Compliance Alert, Volume 11, Number 2 (June 1997) (cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves); see also In re Stuart K. Patrick, 51 S.E.C. 419, 422 (May 17, 1993) ("[s]upervision, by its very nature, cannot be performed by the employee himself") (SEC order sustaining application of the New York Stock Exchange's supervisory rule – also cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves).

OSJ” principal to engage in certain basic compliance tasks related to his own business, and may not meet the previous “close supervision and control” standard.<sup>40</sup> The commenter requested more latitude to create effective compliance supervision systems and an explanation to justify the “disparate impact on IBD firms.”

As noted above, proposed Supplementary Material .03 would require effective supervision and control of the sales activities of the on-site principal at the one-person OSJ by a senior principal. The proposed supplementary material does not prohibit the on-site principal at the one-person OSJ from supervising the activities of other associated persons or other offices (e.g., acting as a field principal for other associated persons or offices).

### (3) Use of Technological Supervisory Tools

Both commenters also stated that the proposal “ignore[s] the nature of business in today’s high technology environment” and that technology can effectively assist with supervision.<sup>41</sup> Moreover, one commenter stated that the proposal disregards the substantial costs that would be incurred by independent broker-dealers that have long-established business practices of conducting supervision remotely.<sup>42</sup> FINRA recognizes that technological supervisory tools may augment a senior principal’s supervision. However, FINRA believes technology cannot replace the need for a senior principal who is responsible for supervising the sales activities of the on-site principal; conducting regular periodic on-site supervision of a producing principal is necessary to ensure

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<sup>40</sup> FSI.

<sup>41</sup> LPL, FSI.

<sup>42</sup> LPL.

effective supervision. In addition, FINRA notes that the proposed supplementary material does not specify an exact time frame for such on-site supervision. Rather, proposed Supplementary Material .03 would provide members with the flexibility to establish a regular periodic schedule for such on-site supervision by the senior principal based on a variety of factors, including the nature and complexity of the securities activities for which the one-person OSJ is responsible, the nature and extent of contact with customers, and the disciplinary history of the on-site principal.

(d) Comments on Proposed Supplementary Material. 04

As detailed above, proposed Supplementary Material .04 (Supervision of Multiple OSJs by a Single Principal) would establish a general presumption that a principal will not be assigned to supervise more than one OSJ. The proposed supplementary material would set forth factors a member should consider if assigning a principal to two or more OSJs. There is a further general presumption that a principal supervising more than two OSJs is unreasonable and such determination will be subject to greater scrutiny, and the member will have a greater burden to evidence the reasonableness of such structure.

One commenter to the Initial Filing supported proposed Supplementary Material .04,<sup>43</sup> but three commenters raised concerns regarding aspects of the proposed supplementary material.<sup>44</sup> Specifically, one commenter objected that the proposed

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<sup>43</sup> PIABA.

<sup>44</sup> Schwab, SIFMA, FSI. FSI also stated that proposed Supplementary Material .04 and proposed FINRA Rule 3110(a)(4) should clearly state that firms have discretion to create supervisory systems that are reasonably designed to achieve compliance with applicable FINRA rules and MSRB rules. FINRA notes that proposed FINRA Rule 3110(a) already provides the overarching standard that supervisory systems be reasonably designed to achieve compliance with the enumerated laws and rules.

supplementary material was “unnecessarily restrictive” by depriving members of the flexibility to determine how to supervise their OSJs.<sup>45</sup> The same commenter also argued that the requirement of a “physical presence, on a regular and routine basis” was overly burdensome and unnecessary in light of effective electronic supervisory methods and suggested that FINRA either remove it or provide additional clarification on the phrase.<sup>46</sup> All three commenters objected to the proposed presumption that one principal supervising more than two OSJs is unreasonable,<sup>47</sup> with one commenter also objecting to the presumption that a principal will not be assigned to supervise more than one OSJ.<sup>48</sup> That particular commenter stated that such negative presumptions were inappropriate and could limit the development and design of more effective supervisory models.<sup>49</sup> Finally, one commenter stated that proposed Supplementary Material .04 interchangeably uses the

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<sup>45</sup> SIFMA. SIFMA also stated in footnote 14 of its comment letter, that it assumes “that proposed Supplementary Material [.04] 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.” It is difficult to interpret the specific nature of the commenter’s concerns from this assertion. However, in the context of the commenter’s municipal securities example, FINRA believes that proposed Supplementary Material .04 does not conflict with the specific requirements in MSRB Rule G-27 (Supervision) regarding the obligation of one or more appropriate principals designated under Rule G-27 to supervise the municipal securities activity of the dealer and the dealer’s associated persons to ensure compliance with the rules of the MSRB.

<sup>46</sup> SIFMA raised a similar comment on Regulatory Notice 08-24 that the proposed supplementary material’s requirement of a “physical presence” on a regular and routine basis was overly burdensome. As discussed in the Initial Filing, FINRA declined to make a change to the provision. See Exhibit 2b, page 240.

<sup>47</sup> Schwab, SIFMA, FSI.

<sup>48</sup> Schwab.

<sup>49</sup> Schwab.

terms “on-site supervisor” and “designated principal” and requested that FINRA clarify that the terms are not intended to encompass a member’s “up-the-chain” reporting structure.<sup>50</sup>

In response, FINRA notes that the presumptions are consistent with the long-standing requirement (and cornerstone of a member’s supervisory structure) in NASD Rule 3010(a)(4) for members to have an on-site principal in each OSJ location, which is being transferred virtually unchanged as proposed FINRA Rule 3110(a)(4). Thus, the physical presence, on a regular basis, of a principal already is required at each OSJ. FINRA believes the term “physical presence, on a regular basis,” supports the general requirement in NASD Rule 3010(a)(4) to have a principal in each OSJ.

Proposed Supplementary Material .04 would provide members with greater flexibility than currently exists under NASD Rule 3010. In recognition of today’s evolving business models, the proposed supplementary material would allow members the flexibility to designate and assign one principal to supervise more than one OSJ if the member determines that such supervision is reasonable and effective. However, FINRA expressly included the general presumption to make clear its view that effective supervision by one principal at more than two OSJs presents unique supervisory challenges and should be carefully considered and evidenced by a member. The proposed supplementary material would require a member that is assigning a principal to supervise more than one OSJ to consider, among other things, whether the OSJ locations are sufficiently close in proximity to ensure that the principal is physically present at each location on a regular and routine basis. In addition, as discussed above, while a member

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<sup>50</sup> SIFMA.

has the flexibility to use appropriate technology as part of its supervisory systems, FINRA does not believe that such technology can replace the effectiveness of on-site supervision. Thus, FINRA declines to remove this requirement.

In response to the comment to clarify the use of the terms “on-site supervisor” and “designated principal” in Supplementary Material .04 to make it clear that the terms are not intended to encompass a member’s “up-the-chain” reporting structure, FINRA clarifies that, for purposes of this provision, the two terms refer to one person – the on-site principal assigned and designated to supervise the OSJ pursuant to proposed FINRA Rule 3110(a)(4).<sup>51</sup>

(e) Comments on Proposed FINRA Rule 3110(b)(2) and Supplementary Material .06

As stated above, proposed FINRA Rule 3110(b)(2) would require that a member have supervisory procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the member’s investment banking or securities business. Proposed Supplementary Material .06 (Risk-based Review of Member’s Investment Banking and Securities Business) would permit a member to use a risk-based system to review these transactions.

Two commenters to the Initial Filing requested that FINRA clarify in the body of FINRA Rule 3110(b)(2) that members may use risk-based reviews of their investment

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<sup>51</sup> FINRA also noted in the Initial Filing that, in response to comments, it had modified the proposed supplementary material 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.

banking and securities transactions.<sup>52</sup> Alternatively, one commenter requested that FINRA eliminate the word “all” in proposed FINRA Rule 3110(b)(2) to clarify that the rule language is modified by proposed Supplementary Material .06.<sup>53</sup>

FINRA declines to make the suggested changes. Proposed FINRA Rule 3110(b)(2) would transfer into the Consolidated FINRA Rulebook a member’s fundamental obligation regarding principal review of all transactions relating to its investment banking and securities business, while at the same time providing supplementary material that would permit, but does not require, a member to conduct risk-based reviews of such transactions. Also, as FINRA noted in the Initial Filing, supplementary material is part of the rule, and FINRA believes that locating the risk-based discussion in Supplementary Material .06 improves the readability of the rule without affecting the weight or significance of the provision.

In addition, as FINRA stated in the Initial Filing the term “risk-based,” which the proposed rule uses in several places, describes the type of methodology a member may use to identify and prioritize for review those areas that pose the greatest risk of potential securities laws and SRO rule violations. FINRA acknowledges that members may need to prioritize their review processes due to the volume of information that must be reviewed by using a review methodology based on a reasonable sampling of information in which the sample is designed to discern the degree of overall compliance, the areas that pose the greatest numbers and risks of violation, and any possibly needed changes to firm policies and procedures. FINRA believes that allowing risk-based review in limited

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<sup>52</sup> SIFMA, NSCP.

<sup>53</sup> SIFMA.

circumstances improves investor protection by ensuring that those areas that pose the greatest potential for investor harm are reviewed more quickly to uncover potential violations.

(f) Comments on Proposed FINRA Rule 3110(b)(4) and Supplementary Materials .07-.10

(1) Review of Internal Communications

As proposed in the Initial Filing, FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) would require a member to have procedures to review incoming and outgoing written (including electronic) correspondence and internal communications relating to its investment banking or securities business. The supervisory procedures must ensure that the member properly identifies and handles in accordance with firm procedures, customer complaints, instructions, funds and securities, and communications that are of a subject matter requiring review under FINRA or MSRB rules and the federal securities laws. Also as originally proposed, Supplementary Material .07 (Risk-based Review of Correspondence and Internal Communications) would permit a member to use risk-based principles to decide the extent to which additional policies and procedures for the review of incoming and outgoing written (including electronic) correspondence with the public and internal communications that fall outside of the subject matters listed in proposed FINRA Rule 3110(b)(4) are appropriate for its business and structure.

A number of commenters to the Initial Filing suggested that proposed FINRA Rule 3110(b)(4) and proposed Supplementary Material .07 could be read to create a new affirmative obligation to supervise all written (including electronic) internal

communications relating to investment banking and securities activities.<sup>54</sup> Commenters requested that FINRA either revise these provisions to reflect the guidance in Regulatory Notice 07-59 (December 2007) regarding the review of internal communications<sup>55</sup> or that FINRA remove the review requirements for internal communications (including the use of a risk-based review standard) from the provisions.<sup>56</sup>

In response to the commenters' concerns, FINRA has modified proposed FINRA Rule 3110(b)(4) and Supplementary Material .07 to more precisely reflect the guidance in Regulatory Notice 07-59 that a member must have supervisory procedures to provide for the member's review of its internal communications to properly identify communications that are of a subject matter that require review under FINRA or MSRB rules and the federal securities laws and that, by employing risk-based principles, the member must decide the extent to which additional policies and procedures for the review of additional internal communications are necessary for its business and structure. These modifications reflect FINRA's intent, as noted in the Initial Filing, to codify Regulatory Notice 07-59's guidance regarding the supervision of electronic communications.<sup>57</sup>

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<sup>54</sup> CAI, ICI, T. Rowe Price, Schwab, FSI, SIFMA.

<sup>55</sup> CAI, ICI, T. Rowe Price, SIFMA.

<sup>56</sup> FSI, Schwab.

<sup>57</sup> One commenter, ICI, also questioned the meaning of the phrase "and funds and securities" in proposed FINRA Rule 3110(b)(4)'s language stating that a member's supervisory procedures must "ensure that the member properly identifies 'and handle[s] 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.'" The word "and" before "funds and securities" was a typographical error. As corrected, the provision requires that a member's supervisory procedures "must ensure that the member properly identifies and handles in accordance with firm procedures, customer complaints, instructions,

(2) Evidence of Review

Proposed Supplementary Material .08 (Evidence of Review of Correspondence and Internal Communications) would clarify that merely opening a communication is not sufficient review. Instead, a member must identify what communication was reviewed, the identity of the reviewer, the date of review, and the actions taken by the member as a result of any significant regulatory issues identified during the review.

One commenter requested that FINRA delete the provision stating that merely opening a communication is not sufficient review.<sup>58</sup> FINRA addressed this issue in the Initial Filing and declined to make the suggested change. As noted in the Initial Filing, proposed Supplementary Material .08 would codify existing guidance that FINRA believes remains appropriate, especially as it is unclear how an opened communication, by itself, would be sufficient to demonstrate actual review of the communication.<sup>59</sup> For this reason, FINRA declines to delete the provision.

The same commenter also requested that FINRA clarify what other evidence of review is necessary if an email does not raise any issues that warrant follow-up. FINRA does not believe further clarification is necessary as proposed Supplementary Material .08 specifies the required evidence of review. As noted above, the proposed supplementary material would require a member to identify what communication was

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funds and securities, and communications that are of a subject matter that require review under FINRA and MSRB rules.”

<sup>58</sup> SIFMA.

<sup>59</sup> See also Regulatory Notice 07-59 (December 2007) (“Members should remind their reviewers that merely opening the communication will not be deemed a sufficient review.”).

reviewed, the identity of the reviewer, the date of review, and the actions taken by the member as a result of any significant regulatory issues identified during the review.

Where review has not identified any such issues, this last requirement would not apply.

The commenter also suggests that FINRA assist members' management of recordkeeping costs by clarifying that a member does not have to retain the specified information fields required by Supplementary Material .08 for communications that are reviewed through electronic review systems or lexicon-based screening tools if those messages do not generate review alerts. FINRA declines to accept this suggestion; the required documentation is necessary to demonstrate that the communication was actually reviewed. In addition, failing to record and retain such information, such as the identity of the reviewer, could be contrary to a member's record retention obligations required under both FINRA and SEC rules.<sup>60</sup>

### (3) Delegation of Review Functions

Proposed Supplementary Material .09 (Delegation of Correspondence and Internal Communication Review Functions) would permit a supervisor/principal to delegate certain review functions, while remaining ultimately responsible for the performance of all necessary supervisory reviews.

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<sup>60</sup> See NASD Rule 3010(d)(3) (Retention of Correspondence) (to be replaced by proposed Supplementary Material .10) (both provisions require that, among other things, the person who reviewed correspondence be ascertainable from the member's retained records); see also SEA Rule 17a-4(b)(4) (requiring, among other things, that a broker-dealer's retained communications records include any approvals of communications sent).

One commenter to the Initial Filing suggested that the proposed supplementary material be included in the body of proposed FINRA Rule 3110(b)(4).<sup>61</sup> FINRA declines to make the suggested change. As stated above, supplementary material is part of the rule, and FINRA believes that locating this provision in Supplementary Material .09 improves the readability of the rule without affecting the weight or significance of the provision.

(4) Retention of Correspondence and Internal Communications

Proposed Supplementary Material .10 (Retention of Correspondence and Internal Communications) would require, among other things, that a member retain internal communications and correspondence of associated persons relating to the member's investment banking or securities business for the period of time and accessibility specified in SEA Rule 17a-4(b) (not less than three years, the first two years in an easily accessible place).<sup>62</sup>

One commenter to the Initial Filing requested that FINRA expand the record retention period in proposed Supplementary Material .10 to six years to match the eligibility provisions for customer arbitration disputes in FINRA Rule 12206 (Time Limits).<sup>63</sup> FINRA declines to make the suggested change. As noted in the Initial Filing, the proposed rule purposefully aligns the record retention period for communications

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<sup>61</sup> SIFMA.

<sup>62</sup> 17 CFR 240.17a-4(b).

<sup>63</sup> PIABA. PIABA also requested that FINRA propose a rule requiring that records pertaining to correspondence and internal communications as well as any other customer-related documents, be made available upon request to customers and former customers within a reasonable time and at no charge. FINRA considers the comment to be outside the scope of the proposed rule change.

with the SEC's record retention period for the same types of communications to achieve consistent regulation in this area.

(g) Comments on Proposed FINRA Rule 3110(b)(5)

Proposed FINRA Rule 3110(b)(5) (Review of Customer Complaints) would require members to have supervisory procedures to capture, acknowledge, and respond to all written (including electronic) customer complaints.

(1) New Requirement for Certain Members

One commenter to the Initial Filing noted that the requirement to “acknowledge” customer complaints would be a new requirement for firms currently required to comply only with NASD rules.<sup>64</sup> FINRA previously addressed this comment in the Initial Filing and acknowledged that this requirement would be a new requirement for many FINRA members. Nevertheless, FINRA believes that the investor protection that this provision would provide outweighs any potential compliance burdens because requiring members to acknowledge customer complaints would help to ensure that customers are timely notified that their complaints have been received and recorded, and that they can expect the issues raised in their complaints to be addressed within a reasonable period. In addition, the records of acknowledgements should provide supervisory personnel with another tool for confirming that the issues raised in complaints are ultimately addressed through timely responses. The acknowledgment requirement also should help to focus members' attention on specific situations where investor harm may be occurring, as well as to alert members to more general problems customers may be having with their registered representatives, products, or services. In this regard, the acknowledgement

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<sup>64</sup> Schwab.

requirement may serve to strengthen members' risk assessment capabilities. Further, the absence in the proposed rule of a specific time period in which members must acknowledge their receipt of customer complaints provides members a certain amount of flexibility in designing their supervisory procedures to address this new responsibility. As noted in the Initial Filing, however, members would be expected to explain the reasonableness of a period in excess of 30 days.

(2) Exclusion of Oral Complaints

One commenter supported the decision to include only written customer complaints in proposed FINRA Rule 3110(b)(5).<sup>65</sup> Another commenter, however, stated that members should be required to reduce an oral complaint to writing or to provide the customer with a form.<sup>66</sup> As FINRA noted in the Initial Filing, FINRA declined to include oral complaints because they are difficult to capture and assess, whereas members can more readily capture and assess written complaints. For these reasons, FINRA continues to believe that proposed FINRA Rule 3110(b)(5) should include only written customer complaints. However, as FINRA stated in the Initial Filing, FINRA encourages members to provide customers with a form or other format that will allow customers to detail their complaints in writing.<sup>67</sup> In addition, FINRA continues to remind members that the failure to address any customer complaint, written or oral, may be a violation of FINRA Rule 2010.

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<sup>65</sup> T. Rowe Price.

<sup>66</sup> PIABA.

<sup>67</sup> See Exhibit 2b, page 249.

### (3) Guidance on Certain Types of Customer Complaints

One commenter asked how FINRA Rule 3110(b)(5)'s proposed requirements would apply to repetitious, threatening, or anonymous complaints received by members. Specifically, the commenter asked whether a member could address repeated complaints from the same person on the same issue by responding only once to the issue and informing the complainant that no further responses would be forthcoming. The commenter also requested that FINRA amend proposed FINRA Rule 3110(b)(5) to recognize that members cannot respond to anonymous customer complaints.<sup>68</sup> In addition, the commenter asked whether an oral response to a complaint would be appropriate, as long as the member maintained sufficient records to document the response.

Proposed FINRA Rule 3110(b)(5) was drafted in a manner to provide members with the flexibility to design supervisory procedures that would be appropriate for each member's size, business model, and the volume and type of complaints received. Accordingly, the proposed provision does not set forth prescriptive requirements a member must use to acknowledge and respond to a written complaint or how a firm must handle repetitious, threatening, or anonymous complaints. For many customer complaints, a member may evidence both its acknowledgement and response in one communication. For complaints raising multiple or complicated issues, members may

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<sup>68</sup> T. Rowe Price. The commenter also requested that FINRA clarify that anonymous complaints do not need to be considered complaints for purposes of FINRA Rule 4530 (Reporting Requirements). FINRA considers the commenter's request for clarification regarding FINRA Rule 4530 to be outside the scope of the proposed rule change, though FINRA notes that the FINRA Rule 4530 reporting system instructs members regarding how to report anonymous complaints for purposes of the rule.

choose first to acknowledge the complaint and send a following response after completing a review of the issues raised. With respect to repetitious complaints from the same individual that raise no new issues, a member may choose to provide a response only once. A member may also consider whether to include a notation on the response that the member will not provide additional responses to subsequent complaints from that individual raising the same issues. For complaints containing threats, in addition to acknowledging and responding to the complaint, the member may wish to adopt procedures to review such complaints in light of the potential seriousness of the threat and decide on appropriate action, up to, and including, contacting the appropriate law enforcement authority, if deemed necessary. FINRA also notes that, while members would not be able to acknowledge or respond to truly anonymous complaints, a member would still have an obligation to capture and review the complaint to determine whether it contains a legitimate grievance.

(h) Comments on Proposed FINRA Rule 3110(b)(6) and Supplementary Material .11

Proposed FINRA Rule 3110(b)(6) (Documentation and Supervision of Supervisory Personnel) is based largely on existing provisions in NASD Rule 3010(b)(3) requiring a member's supervisory procedures to set forth the member's supervisory system and to include a record of the member's supervisory personnel with such details as titles, registration status, locations, and responsibilities. The proposed rule also would include two new provisions:

- proposed FINRA Rule 3110(b)(6)(C) requiring a member to have procedures prohibiting its supervisory personnel from supervising their own activities and

reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising (the provision also would provide a limited size and resources exception to this general requirement); and

- proposed FINRA Rule 3110(b)(6)(D) requiring a member 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 revenue such person generates for the firm, or any compensation that the supervisor may derive from the associated person being supervised.

Proposed Supplementary Material .11 (Supervision of Supervisory Personnel) would provide that a member generally will need to rely on the exception provided in proposed FINRA Rule 3110(b)(6)(C) only because it is a sole proprietor in a single-person firm or where a supervisor holds a very senior executive position within the firm.

(1) Commission Overrides

One commenter requested that FINRA add rule language explaining that the prohibition against supervisors having their compensation determined by a person who is supervised, does not include a supervisor receiving commission overrides.<sup>69</sup> FINRA addressed this comment in the Initial Filing and declined to make the suggested change. FINRA noted in the Initial Filing that, although a supervised person may affect his or her supervisor's compensation (through overrides or in other ways), proposed FINRA Rule 3110(b)(6) concerns only those situations where a supervised person directly controls a

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<sup>69</sup> FSI.

supervisor's compensation or continued employment. In the commission override context, however, the member would still need to address this conflict in its procedures; that is, the override may not be a factor in reducing the standard of supervision in any manner. For these reasons, FINRA declines to make the suggested change. In addition, FINRA notes that the commenter expressly agreed with FINRA's statements on this point in the Initial Filing and has not provided additional information to support adding the suggested rule language.

(2) Conflicts of Interest

Some commenters expressed concern that requiring members to have procedures to prevent the supervision standards from being reduced in any manner due to any conflicts of interest that may be present creates a strict liability standard that would require members to eliminate any and all conflicts of interest that could be inconsistent with existing supervisory roles, no matter how slight.<sup>70</sup> Commenters suggested that FINRA either eliminate the provision or amend the provision to include a reasonableness standard.<sup>71</sup>

FINRA disagrees with this strict liability argument and declines to eliminate the provision. The reasonably designed standard that applies to the supervisory procedures required throughout proposed FINRA Rule 3110(b) does not recognize a strict liability obligation requiring identification and elimination of all conflicts of interest. Rather, the

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<sup>70</sup> Schwab, SIFMA, FSI. As part of its argument, FSI noted that the Initial Filing's discussion of examples of potential conflicts of interest included "any other factor that would present a conflict" and asked that FINRA clarify that this language would apply only to conflicts of interest that are known, or should reasonably be known, to the firm.

<sup>71</sup> Schwab, SIFMA.

reasonably designed standard recognizes that while a supervisory system cannot guarantee strict compliance, the system must be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business.<sup>72</sup> Accordingly, a member's conflict of interest procedures should reflect a member's sound, common sense identification of potential conflicts of interest, based on factors unique to the member's business, and address how the member will prevent these conflicts from reducing in any manner the standards of supervision for its supervisory personnel.

FINRA also declines the suggestion to include a reasonableness standard. As FINRA noted in the Initial Filing, amending the proposed conflict of interest requirement in this manner would have the effect of altering the standards within the rule that describe the outcome the procedures should try to achieve, resulting in an impermissible relaxation of the standard around which the rule is designed.

(3) Limited Exception

One commenter stated, without additional detail, that there were "potentially limitless" situations where a member would need to rely on the proposed exception from the general supervisory requirements and requested that FINRA amend proposed Supplementary Material .11 to provide only illustrative examples of when a member could rely on the exception.<sup>73</sup> FINRA declines to make the suggested change. The proposed exception is specifically based on a member's inability to comply with the general supervisory requirements because of the member's size or supervisory

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<sup>72</sup> See Notice to Members 99-45 (June 1999).

<sup>73</sup> CAI.

personnel's position within the firm, and proposed Supplementary Material .11 reflects FINRA's belief that a member will generally need to rely on the exception only because it is a sole proprietor in a single-person firm or where a supervisor holds a very senior executive position within the firm. However, a member may still rely on the exception in other instances where it cannot comply because of its size or supervisory personnel's position within the firm, provided the member documents the factors used to reach its determination and how the supervisory arrangement with respect to the supervisory personnel otherwise comports with proposed FINRA Rule 3110(a).

(i) Comments on Proposed FINRA Rule 3110(b)(7) and Supplementary Material .12

FINRA Rule 3110(b)(7) (Maintenance of Written Supervisory Procedures) would require a member to retain and keep current, a copy of the member's written supervisory procedures at each OSJ and at each location where supervisory activities are conducted on behalf of the member. As proposed in the Initial Filing, the member would also have to communicate any amendments to its written supervisory procedures throughout its organization. Proposed Supplementary Material .12 (Use of Electronic Media to Communicate Written Supervisory Procedures) would permit a member to satisfy its obligation to communicate its written supervisory procedures, and any amendments thereto, using electronic media, provided that the member complies with certain conditions.

(1) Communicating Written Supervisory Procedures

Several commenters to the Initial Filing requested that FINRA revise proposed FINRA Rule 3110(b)(7) and Supplementary Material .12 to require that members

communicate such material only to relevant associated persons and/or supervisory personnel rather than to all associated persons.<sup>74</sup> The commenters suggested it would be inappropriate to communicate written supervisory procedures and amendments throughout a firm if those procedures or amendments are relevant only to a limited business line or set of associated persons. In response to these concerns, FINRA has revised proposed FINRA Rule 3110(b)(7) and Supplementary Material .12 to clarify that a member is responsible for promptly communicating its written supervisory procedures and amendments to all associated persons to whom such written supervisory procedures and amendments are relevant based on their activities and responsibilities. FINRA declines to adopt the suggestion to limit the requirement to distribute written supervisory procedures and amendments to “supervisory personnel.” As noted further below, all associated persons are deemed to have knowledge of and are subject to a member’s supervisory procedures and amendments. Requiring a member to communicate to all associated persons, and not just “supervisory personnel,” the written supervisory procedures and amendment relevant to their activities helps ensure that the member’s associated persons have this requisite knowledge.

(2) Accessibility of Written Supervisory Procedures

As proposed in the Initial Filing, Supplementary Material .12 required that a member using electronic media to communicate its written supervisory procedures make its procedures “quickly and easily accessible” to associated persons through, for example, the member’s intranet system. One commenter requested that the term “quickly and

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<sup>74</sup> SIFMA, T. Rowe Price, NSCP (requesting changes to Supplementary Material .12), Schwab (requesting changes to FINRA Rule 3110(b)(7)).

easily accessible” be modified to “readily accessible,” which the commenter contended is a term regularly used in FINRA and SEC rules.<sup>75</sup> In response, FINRA has modified proposed Supplementary Material .12 to use this term.

(3) Use of “Promptly”

The same commenter also requested that FINRA delete the term “promptly” from proposed Supplementary Material .12’s requirement that members promptly post all written supervisory procedures amendments to the electronic media. Instead, the commenter requested that FINRA require that the written supervisory procedures be “timely communicated.” FINRA, however, declines to make this change as it views “promptly” and “timely” as having the same meaning in the context of updating and distributing written supervisory procedures amendments. In addition, FINRA has amended proposed FINRA Rule 3110(b)(7) to clarify that each member must promptly amend its written supervisory procedures to reflect changes in applicable securities laws or regulations, including FINRA and MSRB rules, and as changes occur in its supervisory system and has included in the proposed rule a member’s general obligation to promptly communicate its written supervisory procedures and amendments. FINRA clarifies that, for purposes of distributing a member’s written supervisory procedures amendments, “promptly” means prior to the effective date of any changes (or as expeditiously as possible following any immediately effective changes) in the securities laws or regulations or FINRA and MSRB rules necessitating the amendments.

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<sup>75</sup> SIFMA.

(4) Notification of “Substantive” Amendments

In addition, the commenter requested that FINRA revise the proposed supplementary material’s requirement to notify associated persons of amendments to a member’s written supervisory procedures to require notification of only “substantive” amendments. FINRA declines to make the suggested change, especially as it is unclear what standard members could use to consistently identify a “substantive” amendment for these purposes. FINRA, however, has amended this provision to require that associated persons be notified that amendments relevant to their activities and responsibilities have been made to the written supervisory procedures.

(5) Verifying Associated Persons’ Review of Amendments

As proposed in the Initial Filing, Supplementary Material .12 required that a member using electronic media to communicate its written supervisory procedures be able to verify, at least once each calendar year through electronic tracking, written certifications, or other means that associated persons have reviewed the written supervisory procedures. Commenters requested that FINRA eliminate the verification requirement or revise the provision to apply only to supervisory personnel.<sup>76</sup> As one commenter noted, proposed FINRA Rule 3110(b)(7) does not contain a similar requirement for the dissemination of hard copies of written supervisory procedures.<sup>77</sup> In response, FINRA has deleted this requirement from proposed Supplementary Material .12. FINRA views such annual verification process as unnecessary in light of the fact that all associated persons are deemed to have knowledge of and are subject to a

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<sup>76</sup> SIFMA, Schwab (eliminate), NSCP (revise).

<sup>77</sup> SIFMA.

member's supervisory procedures and amendments irrespective of whether members verify that their associated persons have reviewed such procedures.

(j) Comments on Proposed FINRA Rule 3110(c) and Supplementary Materials .14-.15

Proposed FINRA Rule 3110(c)(1) (Internal Inspections), based largely on NASD Rule 3010(c)(1), would retain the existing requirements for each member to review, at least annually, the businesses in which it engages and inspect each office on a specified schedule. The provision also would retain the existing requirement that the member's annual review must be reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA and MSRB rules.

Proposed FINRA Rule 3110(c)(3)(A) would require members to prevent the inspection standards required pursuant to proposed FINRA Rule 3110(c)(1) from being reduced in any manner due to any conflicts of interest that may be present, including but not limited to, economic, commercial, or financial interests in the associated persons and businesses being inspected.

Proposed FINRA Rule 3110(c)(3)(B) would generally prohibit an associated person from conducting a location's inspection if the person is either assigned to that location or is directly or indirectly supervised by someone assigned to that location. Proposed FINRA Rule 3110(c)(3)(C) would provide an exception from these general prohibitions, while proposed Supplementary Material .15 (Exception to Persons Prohibited from Conducting Inspections) would set forth the general presumption that

only a member with one office or an independent contractor business model will need to rely upon the exception.

Proposed Supplementary Material .14 (General Presumption of Three-Year Limit for Periodic Inspection Schedules) would set forth a general presumption of a three-year limit for periodic non-branch location inspection schedules.

(1) Reference to Inspection Standards

One commenter objected to proposed FINRA Rule 3110(c)(3)(A)'s reference to FINRA Rule 3110(c)(1) on the basis that this subparagraph does not contain any inspection standards.<sup>78</sup> However, as noted above, proposed FINRA Rule 3110(c)(1) would retain the requirement that a member's annual review of its business (which would include location inspections conducted during that review) must be reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and with applicable FINRA and MSRB rules.<sup>79</sup>

(2) Conflicts of Interest

Some commenters suggested that proposed FINRA Rule 3110(c)(3)(A) would create a strict liability standard that would require a firm to identify and eliminate any conflicts of interest, no matter how slight, that would prevent a location's inspection standards from being reduced in any manner and suggested that the provision be

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<sup>78</sup> NSCP.

<sup>79</sup> NSCP also asks that FINRA clarify that the term "reduced in any manner" means that the frequency of internal inspections should not be reduced because of any conflicts of interest. FINRA notes that the term "reduced in any manner" does not have a fixed interpretation, but rather should be considered within the context of proposed FINRA Rule 3110(c)(1)'s reasonably designed inspection standards discussed above.

amended to include a reasonableness standard.<sup>80</sup> FINRA disagrees with commenters' strict liability argument. The standard does not require identification and elimination of all possible conflicts of interest. Rather, the proposed provision is intended to address conflicts of interest that would cause diminished inspection standards for a location that, in turn, could result in a failure to detect violative conduct committed at that location. FINRA also does not believe proposed FINRA Rule 3110(c)(3)(A) should include a reasonableness standard. As FINRA noted in the Initial Filing, this proposed requirement does not pertain to a member's supervisory procedures, which a member must "reasonably design" to achieve compliance with applicable federal laws and regulations and SRO rules, but instead defines a standard around which inspections must be conducted.

(3) Associated Persons Conducting Inspections

One commenter requested deleting proposed FINRA Rule 3110(c)(3)(B)'s proposed restrictions prohibiting certain associated persons from conducting a location's inspection on the basis that the restrictions would otherwise force firms to remove valuable on-site personnel who routinely conduct inspections and carry out supervisory procedures in the office.<sup>81</sup> As stated in the Initial Filing, FINRA believes that the proposed rule change would provide members with sufficient flexibility to conduct their inspections using only firm personnel. In addition, the proposed rule would provide an exception to the proposed restrictions for those members that cannot comply with the

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<sup>80</sup> Schwab, SIFMA.

<sup>81</sup> CAI.

provision, either because of their size or business model. For these reasons, FINRA declines to make the suggested change.

(4) Reliance on the Limited Size and Resources Exception

One commenter requested that FINRA amend proposed Supplementary Material .15 to include home or administrative office personnel conducting home or administrative office inspections as one of the enumerated situations covered by the presumption.<sup>82</sup>

Another commenter stated that it should not have to document its reasons for relying on the exception from the general inspection restrictions, especially when the documentation will not be in line with the general presumption in proposed Supplementary Material .15. The commenter also requested that FINRA revise the proposed supplementary material to provide only illustrative examples of when a member may rely upon the exception.<sup>83</sup>

FINRA declines to make the suggested changes. Proposed FINRA Rule 3110(c)(3)(B) would require that any reliance on the exception from its general restrictions must be documented. A member's documentation of its reliance on the exception is crucial to understanding whether the member has inspection procedures that are reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable FINRA and MSRB rules.

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<sup>82</sup> CAI.

<sup>83</sup> T. Rowe Price.

(5) Presumption of Three-Year Limit for Periodic Inspection Schedules

One commenter requested that FINRA eliminate proposed Supplementary Material .14 on the basis that it would be problematic for firms to meet the proposed supplementary material’s presumption of a three-year limit for periodic non-branch location inspection schedules when conducting inspections for locations that, despite being used only one-day per calendar year, would be considered non-branch locations.<sup>84</sup> FINRA declines to make the suggested change. As noted in the Initial Filing, proposed Supplementary Material .14 merely establishes a three-year presumption and provides members with the flexibility to use an inspection schedule period that is either shorter or longer than three years. If a member chooses to use a periodic inspection schedule longer than three years, then the proposed supplementary material would require the member to properly document the factors used in determining the appropriateness of the longer schedule.

(k) Comments on Proposed FINRA Rule 3110(d)

(1) General Requirement

Proposed FINRA Rule 3110(d)(1) (Transaction Review and Investigation) would require a member to have supervisory procedures to review securities transactions that are effected for a member’s or its associated persons’ accounts, as well as any other “covered account,” to identify trades that may violate the provisions of the SEA, its regulations, or FINRA rules prohibiting insider trading and manipulative and deceptive devices.

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<sup>84</sup> NSCP.

One commenter suggested that the proposed rule should be limited to identifying insider trading and not require trades to be reviewed for possible violations of rules regarding “manipulative and deceptive devices,” especially as retail brokerages are already obligated under existing rules to review accounts for that type of activity.<sup>85</sup> The commenter noted that SEA Rule 10b5-1(a) states that “manipulative and deceptive devices” includes, among other things, insider trading. The commenter argued that “other things” could reasonably be expected to encompass manipulation of security prices as described in Section 9 of the SEA and asserted that detecting that type of activity could be costly and burdensome, especially for online brokerage services that would be “forced to establish electronic feeds of trading activity in covered accounts held at other member firms to enable the ‘computerized surveillance of account activity’ in those accounts.”

The required review in proposed FINRA Rule 3110(d)(1) for “trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices” is taken from existing obligations in Incorporated NYSE Rule 342.21 (Trade Review and Investigation). FINRA believes that the continued use of this standard is appropriate for many of the same reasons identified by the Commission when it approved NYSE Rule 342.21. In approving NYSE Rule 342.21, the Commission noted that, among other things, the increased surveillance mandated by the rule “should have a positive impact

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<sup>85</sup> NSCP.

upon the compliance efforts of Exchange members and member organizations[.]”<sup>86</sup> In addition, the Commission found that “mandating such a thorough review will not only increase the possibility of detecting illegal trades, but also will have a deterrent effect on insider trading and manipulative and deceptive practices.”<sup>87</sup> FINRA believes that the benefits identified by the Commission, which would continue to be present by adopting the standards of NYSE Rule 342.21 into the Consolidated FINRA Rulebook, would help to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and protect investors, particularly since the provision covers the review of trading activity of the member in addition to its associated persons.

FINRA also notes that there is no obligation on members to establish electronic feeds of trading activity at other firms. As discussed in detail below, FINRA has revised the definition of “covered account” to clarify a member’s obligations regarding which accounts must be reviewed. Under the new definition, members are required to review (1) accounts of an associated person (and certain of his or her family members) that are held at or introduced by the member; and (2) accounts held away from the member if the associated person is required to disclose the account pursuant to FINRA rules (currently, NASD Rule 3050 (Transactions for or by Associated Persons) and Incorporated NYSE Rule 407 (Transactions—Employees of Members, Member Organizations and the Exchange)). Thus, the only outside trading activity members are required to review under this provision is activity in a covered account that is disclosed to the member

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<sup>86</sup> Securities Exchange Act Release No. 25763 (May 27, 1988), 53 FR 20925 (June 7, 1988) (Order Approving File No. SR-NYSE-87-10).

<sup>87</sup> Id.

pursuant to other FINRA rules.<sup>88</sup> In addition, FINRA emphasizes that firms are permitted to take a risk-based approach to monitoring trading activity.

One commenter stated that the Initial Filing “appears to infer that firms may be required to, at a minimum, conduct periodic reviews of trading” and did not agree that this would always be the case for all firm personnel when using a risk-based review, as provided for under Rule 3110(d).<sup>89</sup> In the Initial Filing, FINRA stated that a “member’s procedures should take into consideration the nature of the member’s business, which would include an assessment of the risks presented by different transactions and different departments within a firm. Thus, while some members may need to develop restricted lists and/or watch lists, other members may only need to periodically review employee and proprietary trading. . . . [T]here is no requirement that a member examine every trade of every employee or every proprietary trade.” As noted, the review would be informed by the firm’s business model, and firms may determine that certain departments or employees pose a greater risk and examine trading in those accounts accordingly. There is no implied obligation on firms as to how best to conduct the reviews.

One commenter expressed concerns about a firm’s ability to prevent violations of insider trading or the use of manipulative and deceptive devices, especially when supervising account activity occurring in an account held at another firm in which an associated person has a beneficial interest, where the firm will, at best, receive post

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<sup>88</sup> FINRA notes that NASD Rule 3050(b)(2) requires the firm at which the trading activity is taking place to provide the member with duplicate confirmations, account statements, or other account information upon written request. Incorporated NYSE Rule 407(a) generally requires the member to promptly send duplicate confirmations and account statements.

<sup>89</sup> CAI.

transaction notification through confirmation statements.<sup>90</sup> The commenter asked FINRA to clarify that a firm’s supervisory obligations for brokerage accounts held outside of the member is limited to detecting and reporting indicia of potential insider trading or use of manipulative and deceptive devices.

Section 15(g) of the SEA requires broker-dealers to “establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer.”<sup>91</sup> Transaction review is one tool for firms in meeting this statutory obligation, in addition to steps such as information barriers and restricted lists that broker-dealers may implement to meet this requirement. Reviewing transactions can also help firms spot potential weaknesses in, or violations of, other procedures. Robust transaction review also provides a deterrent effect that can prevent insider trading and other manipulative or deceptive trading activity by associated persons. As noted above, the only account activity outside of the member firm that it must review under this provision is trading activity in certain accounts reported to the firm pursuant to other FINRA rules, and FINRA recognizes that the information firms receive regarding outside accounts may be less timely and less comprehensive than information firms have available with respect to accounts they hold or introduce.

One commenter requested that FINRA provide a substantial implementation period because implementing the new review process would be burdensome and time

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<sup>90</sup> FSI.

<sup>91</sup> 15 U.S.C. 78o(g).

consuming, especially in light of the “covered accounts” definition.<sup>92</sup> FINRA would provide firms with adequate time to develop and establish policies and procedures for complying with new rules and obligations. FINRA notes, however, that the proposed procedures, in large part, help implement existing obligations for broker-dealers pursuant to Section 15(g) of the SEA. Thus, while some firms may need to revise and update procedures to comply with new requirements, FINRA expects that many members will already have some level of policies and procedures in place to meet their existing obligations under Section 15(g) of the SEA.

(2) “Covered Accounts”

As proposed in the Initial Filing, FINRA Rule 3110(d)(3)(A) defined “covered account” to include (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. FINRA, however, has revised the definition as described below in response to comments.

One commenter asserted that the definition of “covered account” was unduly narrow and should include an associated person’s parents, siblings, mother-in-law, and father-in-law, as well as any life partner.<sup>93</sup> Other commenters argued that the definition was too broad. For example, one commenter suggested limiting the scope of (ii) and (iii)

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<sup>92</sup> CAI.

<sup>93</sup> PIABA.

to accounts introduced or carried by the member<sup>94</sup> while another commenter suggested that FINRA use a more uniform definition that does not differentiate between accounts that are introduced or carried by the member versus those that are not.<sup>95</sup> Other commenters stated that the definition of “covered account” should not include accounts of associated persons’ adult children or their spouses.<sup>96</sup> One commenter stated that adult children and their spouses are under no obligation to provide associated persons with information related to their accounts introduced or carried by the member.<sup>97</sup> Another commenter asserted that extending review to this class of accounts will require an unnecessary and burdensome layer of filtering to an already “robust” system of compliance with no added benefit.<sup>98</sup>

In response to these comments, FINRA has revised the definition of “covered account.” As amended, the transaction review requirements in the proposed rule would apply to two types of “covered accounts”: (i) certain accounts held at or introduced by the member and (ii) accounts that are reported to the member pursuant to other FINRA rules. Consequently, firms are under no obligation under this provision to review

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<sup>94</sup> NSCP.

<sup>95</sup> SIFMA. This commenter also stated its belief that, for carrying members, an account should not be subject to review only by virtue of its being introduced by an unaffiliated correspondent broker. FINRA questions whether such accounts would generally be subject to review under the proposed rule because an account held by a carrying firm for an unaffiliated correspondent broker would generally not be an account of the carrying firm or one of its associated persons.

<sup>96</sup> Schwab, T. Rowe Price.

<sup>97</sup> Schwab.

<sup>98</sup> T. Rowe Price.

transaction information in accounts to which they do not have access to confirmations and account statements. In addition, FINRA has amended the definition of “covered account” to add the accounts of parents, siblings, fathers-in-law, mothers-in-law, and domestic partners if the account is held at or introduced by the member. Although some commenters requested that FINRA exclude accounts of adult children and spouses, the primary purpose of the rule is to help firms identify insider trading, and FINRA does not view the accounts of an associated person’s adult children and spouses as presenting less risk for that type of trading activity than other accounts.<sup>99</sup> Thus, for those accounts in the first category above (i.e., those held at or introduced by the member), FINRA has expanded the definition to include additional family members. FINRA has also clarified that the only accounts held away from the member (or the member’s clearing firm) that fall within the definition of “covered account” are those accounts of associated persons disclosed to the member pursuant to other FINRA rules.

(3) Internal Investigation Reporting

As proposed in the Initial Filing, FINRA Rule 3110(d)(2) would have required any member that engages in “investment banking services,” to provide reports to FINRA

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<sup>99</sup> See, e.g., Securities Exchange Act Release No. 43154 (August 15, 2000), 65 FR 51716 (August 24, 2000) (noting that the Commission’s experience “indicates that most instances of insider trading between or among family members involve spouses, parents and children, or siblings”). See also Securities Exchange Act Release No. 42259 (December 20, 1999), 64 FR 72590, 72604 (December 28, 1999) (noting that the inclusion of children in proposed Rule 10b5-2 was not intended to be limited to minor children because the Commission’s “enforcement cases in this area typically involve communications between parents and adult sons or daughters”). For this same reason, FINRA declines to incorporate the definitions in NYSE Information Memo 89-17 (April 4, 1989), which excepted from the covered accounts outlined in NYSE Information Memo 88-21 (July 29, 1988) those accounts held by children of employees and their spouses who do not reside in the same household with or are not financially dependent on the employee. See Schwab, SIFMA.

regarding internal investigations within ten business days of the initiation of an investigation, update the status of all ongoing investigations each quarter, and report to FINRA within five business days of the completion of any internal investigation. As described below, FINRA is retaining the definition of “investment banking services” as proposed but has substantially revised the reporting requirements.

(A) “Investment Banking Services”

The reporting requirements in proposed FINRA Rule 3110(d)(2) would apply only to those firms that engage in “investment banking services.” 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.<sup>100</sup>

Several commenters to the Initial Filing requested that FINRA exclude certain activity from the definition of “investment banking services.” One commenter suggested that distribution activities undertaken by firms in connection with investment companies and 529 plans should not fall under this definition as long as a firm engaged in this activity does not also engage in the functions typically seen as traditional underwriting

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<sup>100</sup> One commenter asked that FINRA clarify that this definition only applies to proposed FINRA Rule 3110 and not to other rules. See CAI. Paragraph (d)(3) begins with the language “For purposes of this Rule”; consequently, the proposed definition is solely for purposes of determining those firms subject to the proposed reporting requirement in proposed FINRA Rule 3110(d)(2). FINRA notes, however, that it has proposed to use the same definition for purposes of the proposed research analyst conflict of interest rules. See Regulatory Notice 08-55 (October 2008).

activities, such as those described in the proposal.<sup>101</sup> Other commenters requested that FINRA revise the definition to exclude activities such as serving as a principal underwriter or a selling firm of variable annuities<sup>102</sup> or selling shares of real estate investment trusts, variable annuity contracts, and limited partnerships.<sup>103</sup>

FINRA does not believe that any of the categories of activity identified by the commenters should be categorically excluded from the definition of “investment banking services,” given its limited use for the purposes of proposed FINRA Rule 3110. All members, including those who engage in “investment banking services,” are required to include in their supervisory procedures a process for reviewing securities transactions and promptly conducting an internal investigation into any trade that may violate the provisions of the SEA, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices. The only additional requirement of those firms that engage in “investment banking services” is that they report information regarding their internal investigations to FINRA. Because individuals engaged in investment banking activities may have special access to material, non-public information,<sup>104</sup> which increases the risk of insider trading by those individuals, FINRA believes that this additional reporting requirement is appropriate. To the extent the commenters are correct

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<sup>101</sup> T. Rowe Price.

<sup>102</sup> CAI.

<sup>103</sup> FSI.

<sup>104</sup> See, e.g., United States v. Contorinis, 692 F.3d 136, 144 (2d Cir. 2012) (affirming co-portfolio manager’s conviction for insider trading and securities fraud based on tips received from an investment banker with material, non-public information regarding pending merger discussions).

that certain types of underwriting activities do not present the same risks of insider trading, the instances of reporting obligations on firms that only engage in those activities should not be significant. To the extent such firms do have internal investigative actions to report, FINRA believes that they should be reported.

(B) Reporting Requirements

Several commenters suggested that FINRA eliminate the requirement that members must, within ten business days of the initiation of an internal investigation, file a written report and replace it with more targeted disclosure within a more reasonable time frame, such as that in Incorporated NYSE Rule 351(e) (Reporting Requirements).<sup>105</sup> One commenter stated that firms already have robust and detailed procedures for complying with the reporting requirements in Incorporated NYSE Rule 351(e), and FINRA's proposed changes would be costly and burdensome to implement and would not appear to yield substantial benefits, especially as members cannot know whether an internal investigation has viability or merit within ten business days.<sup>106</sup>

In light of the comments, FINRA has modified the reporting obligations for firms that are engaged in investment banking services in a manner that reduces the potential burden for firms, while also providing necessary information to assist FINRA in preventing and detecting violations of insider trading and use of manipulative and deceptive devices. First, FINRA has eliminated the requirement that firms file an initial report of an internal investigation within ten business days of its commencement and has replaced it with a quarterly reporting requirement. Under the amended provision, within

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<sup>105</sup> SIFMA, T. Rowe Price.

<sup>106</sup> SIFMA.

ten business days of the end of each calendar quarter, a member engaged in investment banking services must file a written report describing each internal investigation initiated in the previous calendar quarter. The report must include the identity of the member, the date each internal investigation commenced, the status of each open internal investigation, the resolution of any internal investigation reached during the previous calendar quarter, and, with respect to each internal investigation, the identity of the security, trades, accounts, associated persons of the member, or associated person of the member's family members holding a covered account, under review, and that includes a copy of the member's policies and procedures required by proposed FINRA Rule 3110(d)(1). Also, as noted above, if a member subject to this requirement did not have an open internal investigation or either initiate or complete an internal investigation during a particular calendar quarter, the member would not be required to submit a report for that quarter. Second, FINRA has replaced the proposed requirement to report the completion of each internal investigation within five business days of its completion with a more focused requirement that is limited to investigations that resulted in a finding of violation. Under the amended provision, members engaged in investment banking services must, within five business days of completion of an internal investigation in which it was determined that a violation of the provisions of the SEA, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices had occurred, file with FINRA a written report detailing the completion of the investigation, including the results of the investigation, any internal disciplinary action taken, and any referral of the matter to FINRA, another SRO, the SEC, or any other federal, state, or international regulatory authority.

One commenter questioned the need to file reports of investigations that did not result in a finding of violation, stating that the Initial Filing, more than the rule text, indicates that reports are required even if violations have not been found during the investigation.<sup>107</sup> The commenter believed that additional reporting is unnecessary and exceeded the reporting requirements in FINRA Rule 4530 (Reporting Requirements). The commenter also asserted that FINRA has not provided any rationale for why firms must still file a report even when violations have not been found during the investigation.

Unlike FINRA Rule 4530, proposed FINRA Rule 3110(d) would require more targeted and detailed reporting. While FINRA Rule 4530(b) requires reporting only where a member concludes or reasonably should have concluded that an associated person of the member or the member itself has violated, among other things, any securities-related law or rule,<sup>108</sup> the proposed reporting requirement in proposed FINRA Rule 3110(d)(2) would require that members engaged in investment banking services report investigations (and results of those investigations) of securities transactions effected for the accounts of the member, the member's associated persons, and any other covered account<sup>109</sup> that may violate the provisions of the Exchange Act, the rules

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<sup>107</sup> T. Rowe Price.

<sup>108</sup> See FINRA Rules 4530(b) and 4530.01.

<sup>109</sup> As noted above, for purposes of proposed FINRA Rule 3110(d), a “covered account” is defined to include: (1) any account held by the spouse, domestic partner, child, parent, sibling, son-in-law, daughter-in-law, father-in-law, or mother-in-law of a person associated with the member where such account is introduced or carried by the member; (2) any account introduced or carried by the member in which a person associated with the member has a beneficial interest; (3) any account introduced or carried by the member over which a person associated with the member has the authority to make investment decisions; and (4) any account of a person associated

thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices, regardless of whether a violation was ultimately discovered. Information regarding internal investigations that do not result in a finding of violation must be included in the quarterly report. FINRA believes that this reporting obligation is necessary to help protect investors and market integrity. As described in the Initial Filing, the rationale for filing a report when no violation has been found by the member is because a fact pattern that may result in a member concluding that no misconduct has occurred could nonetheless prove vital to FINRA in connecting the underlying conduct to other conduct about which the member may not know.

(l) Comments on Proposed FINRA Rule 3120

All of the comments FINRA received regarding proposed FINRA Rule 3120 (Supervisory Control System) addressed the provisions requiring a member that meets a specified gross revenue threshold in the preceding year to include additional content in the proposed rule's annual report to senior management. FINRA originally proposed a gross revenue threshold of \$150 million or more in the Initial Filing; however, as discussed further below, FINRA has revised the threshold to \$200 million or more.

The required additional content includes a tabulation of the reports pertaining to the previous year's customer complaints and internal investigations made to FINRA. Also, the report must include a discussion of the preceding year's compliance efforts, including procedures and educational programs, in each of the following areas: (1)

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with a member that is disclosed to the member pursuant to NASD Rule 3050 or NYSE Rule 407, as applicable.

trading and marketing activities; (2) investment banking activities; (3) antifraud and sales practices; (4) finance and operations; (5) supervision; and (6) anti-money laundering.

(1) Revenue Threshold

One commenter suggested that all members be required to include the supplemental information in the report, not merely those members reporting more than \$150 million in revenue.<sup>110</sup> FINRA addressed this comment in the Initial Filing and declined to make the suggested change. As FINRA noted in that rule filing, FINRA believes that the additional information reported by members meeting the gross revenue threshold, now proposed as \$200 million or more, would prove to be valuable information for FINRA's regulatory program, especially as Incorporated NYSE Rule 342.30's annual report supplemental information was a valuable tool for the NYSE regulatory program.<sup>111</sup> Also, as FINRA noted in the Initial Filing, such information would be valuable compliance information for the senior management of the firm.

FINRA, however, recognizes the burden the additional content requirements could place on FINRA members and, as a result, proposed only requiring certain members to include such additional content in their reports. Although FINRA considered several alternative metrics (e.g., number of registered persons), FINRA decided to use a gross revenue metric. FINRA has further attempted to balance the value of the information with the burden by increasing the gross revenue threshold from the \$150

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<sup>110</sup> PIABA.

<sup>111</sup> See also Regulatory Notice 08-24 (noting that the supplemental information in Incorporated NYSE Rule 342.30's annual report was a valuable tool for the NYSE regulatory program and would also be valuable information for FINRA's regulatory program going forward).

million threshold proposed in the Initial Filing to \$200 million. FINRA believes that the revised threshold strikes the appropriate balance as it encompasses larger dual member firms, members engaged in significant underwriting activities (including variable annuity principal underwriting and fund distributions) and substantial trading activities or market making business, and members with extensive sales platforms – approximately 160 member firms in total, for which the additional content requirements would provide a valuable resource in the context of understanding and examining those firms and their activities, which can generally be more complex or sizeable than smaller firms’ activities. FINRA also took into account the fact that most members meeting that threshold already comply with Incorporated NYSE Rule 342.30’s reporting requirement. Further, the metric is easily determined by reference to the member’s most recent FOCUS reports in the calendar year prior to the annual report. FINRA continues to believe that its rationale supports the gross revenue threshold, as revised to \$200 million, and again declines to make the suggested change.

(2) Additional Content Requirements

One commenter suggested that members should have the flexibility to determine the content of their respective annual reports and requested that the additional content requirements listed above be revised as merely examples of additional report content.<sup>112</sup> Other commenters suggested that the additional content topics were vague and requested that FINRA provide more guidance (e.g., definitions, examples) on the additional content requirements.<sup>113</sup> In particular, one commenter asked whether the tabulation of reports

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<sup>112</sup> T. Rowe Price.

<sup>113</sup> CAI, FSI.

pertaining to customer complaints and internal investigations was the same as the customer complaint data for FINRA Rule 4530.<sup>114</sup>

FINRA disagrees with the commenters' suggestions that the supplementary information topics are vague and require examples or definitions. The topics refer to specific components common to a member's business. In addition, as FINRA noted in the Initial Filing, with the exception of risk management (which is no longer included, as discussed below), the categories listed above are incorporated from the annual report content requirements of Incorporated NYSE Rule 342.30 (Annual Report and Certification) and are familiar to many of the firms that would be required to comply with proposed FINRA Rule 3120's additional content requirements. Also, FINRA made clear in the Initial Filing that the proposed requirement to include a tabulation of information provided to FINRA regarding customer complaints and internal investigations was not duplicative of existing requirements in FINRA Rule 4530, as each rule serves a distinct purpose. Whereas FINRA Rule 4530 requires reporting certain information to FINRA, the requirement in proposed FINRA Rule 3120 covers information required to be provided to a firm's senior management. To that end, however, firms may use the information reported to FINRA pursuant to FINRA Rule 4530, as well as other relevant information reported to FINRA pursuant to other regulatory requirements (e.g., investigation information reported to FINRA pursuant to proposed FINRA Rule 3110(d)), to prepare the tabulation required by proposed FINRA Rule 3120.

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<sup>114</sup> CAI.

(3) Risk Management

As proposed in the Initial Filing, FINRA Rule 3120 would have required that a member meeting the applicable gross revenue threshold must include a discussion of the preceding year's compliance efforts in the area of risk management. At least one commenter suggested that FINRA eliminate this requirement since the term "risk management," as proposed, appears to encompass specific control functions for various types of risk (e.g., market, credit, liquidity, operational). The commenter asserted that, because there are no SEC or FINRA rules relating to "risk management" as there are with finance and operations, the 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. Alternatively, the commenter suggested that FINRA acknowledge that "risk management" relates solely to "compliance risk," which would be covered by the firm's compliance department.<sup>115</sup> Another commenter also stated that the risk management topic appears to fall outside of the responsibilities of many compliance departments and requested that FINRA confirm whether chief compliance officers can rely on such items as certifications and representations from managers of areas not under the purview of, or routinely overseen by, the compliance department in completing and submitting the annual report.<sup>116</sup>

FINRA originally proposed the requirement for the purpose of providing senior management with a narrative specifically reflecting whether a member is effectively

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<sup>115</sup> SIFMA.

<sup>116</sup> NSCP.

supervising and managing its business risks. However, in response to commenters' ongoing concerns regarding the role of compliance departments with respect to risk management activities, FINRA is eliminating risk management from the additional content requirements under proposed FINRA Rule 3120 and will consider whether to address separately members' risk management practices. Based on its examination and enforcement experience, FINRA has found that a strong risk management program mitigates a member's potential compliance problems.<sup>117</sup>

(m) Comments on Proposed FINRA Rule 3170

SIFMA requested that FINRA confirm whether it would continue to maintain and disseminate the "Disciplined Firms List" once new FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms), which replaces NASD Rule 3010(b)(2) (the "Taping Rule"), becomes effective. Currently, FINRA provides a "Disciplined Firms List" identifying those firms that meet NASD Rule 3010(b)(2)'s definition of "disciplined firm." This list assists members that are required to establish special supervisory procedures, including the tape recording of conversations, when they have hired more than a specified percentage of registered persons from firms that meet the Taping Rule's definition of "disciplined firm." FINRA intends to continue to maintain the list to assist members in meeting their supervisory obligations under FINRA Rule 3170.

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<sup>117</sup> See e.g., Regulatory Notice 10-57 (November 2010) (guidance on developing and maintaining robust funding and liquidity risk management practices to prepare for adverse circumstances); Notice to Members 99-92 (November 1999) (SEC, NASD Regulation, and NYSE Issue Joint Statement on Broker/Dealer Risk Management Practices) (emphasizing the importance of maintaining an appropriate risk management system and providing examples of weaknesses and strengths in various broker-dealers' risk management policies and practices).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2013-025 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2013-025. This file number should be included on the subject line if e-mail is used. To help the Commission process

and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You

should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2013-025 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>118</sup>

Elizabeth M. Murphy

Secretary

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<sup>118</sup> 17 CFR 200.30-3(a)(12).