

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-70612; File No. SR-FINRA-2013-025)

October 4, 2013

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as modified by Amendment No. 1, to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook

I. Introduction

On June 21, 2013, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to adopt consolidated FINRA supervision rules.<sup>3</sup> The proposed rule change was published for comment in the Federal Register on July 8, 2013.<sup>4</sup> The Commission received seventeen (17) individual comment letters in response to the proposed rule change and five hundred fifty five (555) submissions of a form comment letter (“Letter Type A”).<sup>5</sup> On August 22, 2013, FINRA extended the time period in which the Commission must

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

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

<sup>3</sup> On June 10, 2011, FINRA filed with the SEC a proposed rule change to adopt the consolidated FINRA supervision rules (“Initial Filing”), which addressed the comments received in response to FINRA’s Regulatory Notice 08-24. See Securities Exchange Act Release No. 64736 (June 23, 2011), 76 FR 38245 (June 29, 2011) (File No. SR-FINRA-2011-028). FINRA withdrew the Initial Filing on September 27, 2011. 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).

<sup>4</sup> See Exchange Act Release No. 69902 (July 1, 2013), 78 FR 40792 (July 8, 2013) (Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook) (“Notice of Filing”). The comment period closed on July 29, 2013.

<sup>5</sup> Letters from Steven B. Caruso, Esq., Maddox Hargett Caruso, P.C., to Elizabeth M. Murphy, Secretary, SEC, dated July 12, 2013 (“Caruso”); Norman B. Arnoff, Esq., to Elizabeth M. Murphy, Secretary, SEC, dated July 19, 2013 (“Arnoff”); J.S.

approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to October 4, 2013. On October 2, 2013, FINRA responded to the comments<sup>6</sup> and filed Amendment No. 1 to the proposed rule change. The Commission is publishing this notice and order to solicit

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Brandenburger, Registered Principal, FSC Securities Corporation, to Elizabeth M. Murphy, Secretary, SEC, dated July 25, 2013 (“Brandenburger”); Steve Putnam, Financial Advisor, Raymond James Financial Services, to Elizabeth M. Murphy, Secretary, SEC, dated July 25, 2013 (“Putnam”); Nina Schloesser McKenna, General Counsel, Cetera Financial Group, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“Cetera”); Scott Cook, Senior Vice President, Chief Compliance Officer, Charles Schwab & Co., Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“Schwab”); Clifford Kirsch and Eric A. Arnold, Sutherland Asbill & Brennan LLP, on behalf of the Committee of Annuity Insurers, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“CAI”); David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“FSI”); Howard Spindel, Senior Managing Director, and Cassondra E. Joseph, Managing Director, Integrated Management Solutions USA, LLC, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“IMS”); Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“ICI”); Susanne Denby, Chief Compliance Officer, NFP Securities, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“NFP”); A. Heath Abshire, President and Arkansas Securities Commissioner, North American Securities Administrators Association, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated August 6, 2013 (“NASAA”); Scott C. Ilgenfritz, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“PIABA”); Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“SIFMA”); Pamela Albanese, Legal Intern, and Christine Lazaro, Esq., Acting Director, Securities Arbitration Clinic of St. John's University School of Law, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“St. John’s”); Brian P. Sweeney, Law Office of Brian P. Sweeney, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“Sweeney”); Robert J. McCarthy, Director of Regulatory Policy, Wells Fargo Advisors, LLC, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“Wells Fargo”); see also Memorandum from the Division of Trading and Markets, SEC, dated August 29, 2013 (memorializing an August 5, 2013 conference call between SEC staff and Gary Goldsholle and Michael Post of the Municipal Securities Rulemaking Board (“MSRB”) (“MSRB Memo”) to discuss FINRA’s recently proposed rule change to adopt the proposed consolidated supervision rules).

<sup>6</sup> See Letter from Patricia Albrecht, Assistant General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, Commission, dated October 2, 2013 (“Response”).

comments on Amendment No. 1 from interested persons and to institute proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>7</sup> to determine whether to approve or disapprove the proposed rule change, as modified by Amendment No. 1.

Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to the proposed rule change, nor does it mean that the Commission will ultimately disapprove the proposed rule change. Rather, as discussed below, the Commission seeks additional input from interested parties on the changes to the proposed rule change, as set forth in Amendment No. 1.

## II. Description of the Proposed Rule Change and Summary of Comments

As further described in the Notice of Filing, FINRA proposes to adopt consolidated FINRA broker-dealer supervision rules. As part of the process of developing a new consolidated rulebook (“Consolidated FINRA Rulebook”),<sup>8</sup> 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

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<sup>7</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>8</sup> The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from the New York Stock Exchange (“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. 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).

NYSE Rule 342.21 (Trade Review and Investigation); (3) replace NASD Rule 3010(b)(2) (often referred to as the “Taping Rule”) with new FINRA Rule 3170 (Tape Recording of Registered Persons by Certain Firms); (4) replace NASD Rule 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).

In general, the commenters to the Notice of Filing supported the proposal. Commenters, however, raised concerns regarding various aspects of the proposed rules, including, among others:

- references to MSRB rules;<sup>9</sup>
- the scope of the definition of the term “covered accounts”;<sup>10</sup>
- application of a risk-based approach;<sup>11</sup>
- the conditions for establishing a one person office of supervisory jurisdiction (“OSJ”);<sup>12</sup>
- the requirements and presumptions relating to a single principal supervising multiple OSJs;<sup>13</sup>

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<sup>9</sup> ICI. See also MSRB Memo.

<sup>10</sup> Brandenburger, CAI, FSI, ICI, IMS, Letter Type A, Putnam, SIFMA.

<sup>11</sup> Cetera, ICI, IMS, SIFMA.

<sup>12</sup> Brandenburger, Cetera, IMS, Letter Type A, Putnam.

- the documentation requirements relating to written and oral complaints;<sup>14</sup> and
- the lack of a cost benefit analysis.<sup>15</sup>

FINRA addressed many of these comments by modifying the proposed rules in Amendment No. 1, as described below. Additionally, FINRA responded to these and other comments in its Response.<sup>16</sup>

### III. Description of Amendment No. 1

FINRA's proposed changes in response to comments, as set forth in Amendment No. 1 are summarized below.

First, FINRA is proposing to delete the references to MSRB rules in proposed FINRA Rules 3110(a), (b)(1), (b)(4), (b)(6), (b)(7), (c)(1), 3110.06, 3110.12, 3120(a)(1), 3150(c), and 3170(b)(3) in light of a member's separate obligation to comply with MSRB Rule G-27 (Supervision).

Second, FINRA is proposing to delete proposed FINRA Rule 3110.03 (One-Person OSJs), which expressly provided that the registered principal at a one-person OSJ ("on-site principal") must be under the effective supervision and control of another appropriately registered principal (referred to as a "senior principal") who would be responsible for conducting on-site supervision of the one-person OSJ on a regular periodic schedule to be determined by the

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<sup>13</sup> CAI, Cetera, FSI, IMS, Wells Fargo.

<sup>14</sup> Caruso, NASAA, PIABA, St John's.

<sup>15</sup> Brandenburger, FSI, IMS, Letter Type A, Putnam.

<sup>16</sup> See supra, note 6.

member.<sup>17</sup> The proposed supplementary material required that the designated senior principal be responsible for supervising the activities of the on-site principal at the one-person OSJ and conduct on-site supervision of the one-person OSJ on a regular periodic schedule to be determined by the member. FINRA believes that OSJs conduct critical functions and one-person OSJs present unique supervisory challenges. However, FINRA has decided the best course is to eliminate the proposed supplementary material from the proposed rule. Importantly, FINRA believes that one-person OSJ locations where the on-site principal engages in sales-related activities that trigger OSJ designation should be subject to scrutiny, and firms should conduct focused reviews of such locations because of the possible conflicts of interest that may arise.

Third, FINRA is proposing to revise proposed FINRA Rule 3110.03 (Supervision of Multiple OSJs by a Single Principal) to use the term “on-site principal” consistently throughout the provision. As originally proposed, FINRA Rule 3110.03 used the terms “on-site supervisor” and “designated principal” interchangeably throughout the provision; however, FINRA clarified in the rule filing that the two terms referred to one person. Also, FINRA is proposing to revise proposed FINRA Rule 3110.03 to replace the presumption that assigning one principal to be the on-site principal at more than two OSJs is unreasonable with a general statement that assigning a principal to more than one OSJ will be subject to scrutiny.

Fourth, FINRA is proposing to amend proposed FINRA Rule 3110.05 (Risk-based Review of Member’s Investment Banking and Securities Business) to clarify that a member is not required to conduct detailed reviews of each transaction required to be reviewed pursuant to proposed FINRA Rule 3110(b)(2) (Review of Member’s Investment Banking and Securities

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<sup>17</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 description of the proposed changes in Amendment No. 1 employs the new proposed numbers in all instances.

Business) if a member is using a reasonably designed risk-based review system that provides a member with sufficient information that permits the member to focus on the areas that pose the greatest numbers and risks of violation.

Fifth, FINRA is proposing to replace the term “correspondence with the public” used in proposed FINRA Rules 3110(b)(4) (Review of Correspondence and Internal Communications), 3110.06 (Risk-based Review of Correspondence and Internal Communications), 3110.07 (Evidence of Review of Correspondence and Internal Communications), and 3110.08 (Delegation of Correspondence and Internal Communication Review Functions) with “correspondence” to be consistent with FINRA Rule 2210’s (Communications with the Public) definition and use of the term “correspondence.”

Sixth, FINRA is proposing to revise proposed FINRA Rule 3110(b)(6)(D) to clarify that the provision does not create a strict liability obligation requiring identification and elimination of all conflicts of interest with respect to an associated person being supervised by a member’s supervisory personnel. As revised, proposed FINRA Rule 3110(b)(6)(D) requires that a member have procedures reasonably designed to prevent the supervisory system required pursuant to proposed FINRA Rule 3110(a) from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the firm, or any compensation that a supervisor may derive from an associated person being supervised.

Seventh, FINRA is proposing to revise proposed FINRA Rule 3110(c)(2)(D) to require a member to: (1) identify in its written supervisory procedures *or* in the location’s written inspection report the activities enumerated in FINRA Rule 3110(c)(2)(A) that the member does not engage in at a particular location; and (2) document in its written supervisory procedures *or*

within that location's written inspection report that supervisory policies and procedures must be in place for those enumerated activities at that location before the member can engage in them. As initially proposed, members would have been required to identify such activities in a location's written inspection report; thus, the proposed revisions provide firms with additional flexibility in complying with proposed FINRA Rule 3110(c)(2)(D).

Eighth, FINRA is proposing to revise proposed FINRA Rule 3110(c)(3)(A) to clarify that the provision does not create a strict liability obligation requiring identification and elimination of all conflicts of interest with respect to a location's inspections. As revised, proposed FINRA Rule 3110(c)(3)(A) requires that a member have procedures reasonably designed to prevent the effectiveness of the inspections required pursuant to proposed FINRA Rule 3110(c)(1) from being compromised due to the conflicts of interest that may be present with respect to the location being inspected, including but not limited to, economic, commercial, or financial interests in the associated persons and businesses being inspected.

Ninth, FINRA is proposing to revise proposed FINRA Rules 3110.10 (Supervision of Supervisory Personnel) and 3110.14 (Exception to Persons Prohibited from Conducting Inspections) to delete the term "only" in both supplementary materials, to further clarify that the provisions provide non-exclusive examples of situations where the exceptions generally would apply.

Tenth, FINRA is proposing to revise the definition of "covered account" in proposed FINRA Rule 3110(d) (Transaction Review and Investigation) to align the definition with existing NYSE guidance. Under the revised definition, "covered account" would include any account introduced or carried by the member that is held by: (1) the spouse of a person associated with the member; (2) a child of the person associated with the member or such person's spouse,

provided that the child resides in the same household as or is financially dependent upon the person associated with the member; (3) any other related individual over whose account the person associated with the member has control; or (4) any other individual over whose account the associated person of the member has control and to whose financial support such person materially contributes. FINRA also is proposing to revise proposed FINRA Rule 3110(d) to include the phrase “reasonably designed” to acknowledge more clearly that firms with different business models may adopt different procedures and practices. As amended, the proposed rule requires each member to “include in its supervisory procedures a process for the review of securities transactions reasonably designed to identify trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices.”

Eleventh, proposed FINRA Rule 3120 (Supervisory Control System) requires a member to test and verify the member’s supervisory procedures and 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. The proposed rule also requires a member that reported \$200 million or more in gross revenue on its FOCUS reports in the prior calendar year to include additional content in the report it submits to senior management. FINRA is proposing to revise proposed FINRA Rule 3120(b) to clarify that a member complying with the additional content requirement must include the additional content in its report only to the extent applicable to the member’s business.

IV. Proceedings to Determine Whether to Approve or Disapprove SR-FINRA-2013-025 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act to determine whether the proposed rule change should be approved or disapproved.<sup>18</sup> Institution of such proceedings appears appropriate at this time in view of the legal and policy issues raised by the proposal. As noted above, institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, the Commission seeks and encourages interested persons to comment on the changes to the proposed rule change as set forth in Amendment No. 1 and provide the Commission with arguments to support the Commission's analysis as to whether to approve or disapprove the proposal, as amended.

Pursuant to Section 19(b)(2)(B) of the Exchange Act,<sup>19</sup> the Commission is providing notice of the grounds for disapproval under consideration. In particular, Section 15A(b)(6) of the Exchange Act<sup>20</sup> 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. In addition, Section 15A(b)(9) of the

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<sup>18</sup> 15 U.S.C. 78s(b)(2). Section 19(b)(2)(B) of the Act provides that proceedings to determine whether to disapprove a proposed rule change must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. The time for conclusion of the proceedings may be extended for up to an additional 60 days if the Commission finds good cause for such extension and publishes its reasons for so finding or if the self-regulatory organization consents to the extension.

<sup>19</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>20</sup> 15 U.S.C. 78o-3(b)(6).

Exchange Act<sup>21</sup> requires that FINRA rules not impose any unnecessary or inappropriate burden on competition.

The Commission believes FINRA's proposed rule change, as amended, raises questions as to whether it is consistent with the requirements of Section 15A(b)(6) and 15A(b)(9) of the Exchange Act.

V. Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the changes to the proposed rule change as set forth in Amendment No. 1, as well as any others they may have identified with the proposed rule change, as amended. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change, as modified by Amendment No. 1, is inconsistent with Section 15A(b)(6) or any other provision of the Exchange Act, or the rules and regulations thereunder.

Although there do not appear to be any issues relevant to approval or disapproval which would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.<sup>22</sup> Interested persons are invited to submit written data, views, and arguments by October 28, 2013 concerning Amendment No. 1 and regarding whether the proposed rule change, as modified by Amendment No. 1, should be approved or disapproved. Any person who wishes to file a rebuttal

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<sup>21</sup> 15 U.S.C. 78o-3(b)(9).

<sup>22</sup> Section 19(b)(2) of the Exchange Act, as amended by the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975), grants the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Acts Amendments of 1975, Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

to any other person's submission must file that rebuttal by November 12, 2013. 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 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principle 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 publicly available.

All submissions should refer to File Number SR-FINRA-2013-025 and should be submitted on or before October 28, 2013. If comments are received, any rebuttal comments should be submitted by November 12, 2013.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>23</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>23</sup> 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(57).