SIFMA
Securities Industry and Financial Markets Association

June 13, 2008

BY EMAIL TO: pubcom@finra.org

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1500

Re: FINRA Regulatory Notice 08-24,
Supervision and Supervisory Controls Amendments

Dear Ms. Asquith:

The Self-Regulation and Supervisory Practices Committee of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the above-referenced FINRA Regulatory Notice, which proposes new rules governing supervision and supervisory controls. Specifically, FINRA is proposing to adopt new Rules 3110 and 3120 for the new FINRA consolidated rulebook, based in part on existing NASD Rules 3010 and 3012, and NYSE Rule 342.

SIFMA commends and greatly appreciates FINRA's efforts to develop a consolidated rulebook that not only seeks to harmonize and streamline existing rules, but also gives consideration to the diversity of firms subject to FINRA regulation. As you know, SIFMA has long supported regulatory consolidation and a single set of rules adapted to firms of different sizes and business models.

SIFMA fully supports rewriting the existing supervision and supervisory control rules to reflect more flexible, principles-based regulation while preserving FINRA's core mission of investor protection and market integrity. Overall, SIFMA believes that the proposed amendments are a positive first step toward that end. We respectfully suggest, however, that several provisions require further consideration and modification to fully achieve the goals of the consolidated rulebook.

In particular, SIFMA notes that in a number of instances FINRA has proposed changes that primarily involve adoption of rules with seemingly minor variances from existing NYSE or NASD rule language. In some instances, however, that language includes the substitution of key defined terms with established meaning. In all instances, absent a

[1] SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

specific explanation from FINRA as to the reason for the variation, SIFMA viewed it as prudent to assume that there was some intent to change the meaning or scope of the affected provision where prior language has been modified. SIFMA thus has commented on certain changes – sometimes considering alternative potential meanings – where we were uncertain as to FINRA's intent. This has necessarily lengthened the commentary, but SIFMA's approach is intended to facilitate an efficient exchange of views on these important amendments.

Finally, SIFMA would like to thank the FINRA staff for their continued diligence in the expeditious and sensible development of a FINRA rulebook. We understand the magnitude of this undertaking and the considerable time pressures under which the FINRA staff is operating. With that said, SIFMA cannot overstate the importance of affording interested parties ample time to analyze and comment upon significant rule changes like the one at hand. As legal and compliance professionals with subject matter expertise, we are pleased to offer comments on this critical industry rule change and we hope that FINRA will give due consideration to our comments. If helpful, we welcome the opportunity to meet with FINRA staff to discuss any of the proposed rule changes and any points raised in this letter. Our specific comments are as follows.[2]

I. Supervisory Systems: Proposed Rule 3110(a)

FINRA proposes to adopt new Rule 3110(a), which addresses a member firm's supervisory systems and would replace NASD Rule 3010(a). Specifically, Rule 3110(a) states:

> Each member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA and [MSRB] rules.

Notably, FINRA deletes the references to "registered representative, registered principal" in the introductory paragraph, relying instead on the broader term "associated person."[3] Although this proposed change may appear non-substantive, due to the ambiguity and potential breadth of the definition of "associated person"[4] within FINRA's By-Laws, this proposed language change raises several questions about the scope of the supervisory rules.

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[2] For ease of reference, SIFMA's comments are set forth in the order of the corresponding proposed rule sections.

[3] FINRA made the same language change to proposed Rule 3110(b)(1) where it similarly eliminates the words "registered representatives, registered principals and other" from the text. SIFMA therefore incorporates by reference the same comments made herein to proposed Rule 3110(b)(1).

[4] Article I of the By Laws , subsection (rr), states that a "person associated with a member" or "associated person of a member" means: (1) a natural person who is registered or has applied for registration under the Rules of the Corporation; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing a similar function, *or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member*, [emphasis added] whether or not any such person is registered or exempt from registration with the Corporation under the By-Laws or the Rules of the Corporation . . ." We note that existing NASD Rule 1011(b) also defines "associated person" and is intended for persons who are registered with the member firm.

It is unclear, for example, to what extent the new supervisory rules are now intended to apply to all associated persons of the member firm, regardless of the person's functional responsibilities or employment location within the global organization. This is of significance with respect to individuals who are (i) permissive registrants;[5] or (ii) subject to the control of a member firm but who are not directly engaged in the "investment banking or securities business" As FINRA is aware, SIFMA has long held concerns about the collateral consequences of a broad application of the associated person definition to these types of individuals, and the extension of SRO rules beyond traditional jurisdictional limits to affiliated entities that are already subject to oversight and supervision of other U.S. or non-U.S regulators. Especially for large global financial services firms, a broad application of the proposed rules would be extremely burdensome and could potentially export FINRA rules overseas.

In keeping with the adoption of a more principles-based regulation and risk-based approach to supervision, SIFMA respectfully requests that FINRA clarify that, in developing their supervisory procedures for individuals not engaged in the member firm's securities and investment banking business, including permissive registrants, firms may take into account the limited, or even nonexistent scope of individual's securities business on behalf of the member firm. In such instances, we suggest that supervision could be limited to such matters as maintenance of current licenses, continuing education, and the like.

II. Designation of a Registered Principal over Each Type of Business: Proposed Rule 3110(a)(2)

In Proposed Rule 3110(a)(2), FINRA seeks to amend the terms of existing NASD Rule 3010 to require firms to designate an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages *regardless of whether registration as a broker-dealer is required.* Although FINRA justifies the proposal as "consistent" with the current rule, the Rule Proposal is significantly broader as it appears to apply to activities outside the direct securities business of the member firm.

Currently, NASD Rule 3010(b) is limited in scope to those types of businesses where registration as a broker-dealer is required. Indeed, the existing FINRA license scheme, where certain principal licenses are required for specific types of activity[6], is designed to meet the objectives of NASD Rule 3010(a)(2) – namely, that a supervisor has a demonstrable level of knowledge in a particular subject matter in order to supervise related activity.

For firms that conduct numerous business activities that do not require registration as a broker-dealer, the proposed amendment would represent a significant expansion of the current rule that implicates several practical and jurisdictional concerns. For example,

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[5] As referred to herein, "permissive registrants" are individuals permitted to obtain and maintain registrations pursuant to NASD Rules 1021(a) and 1031(a) and who do not otherwise engage in a securities or investment banking business on behalf of the member firm. In the case of employees of a member, these rules permit persons who perform legal, compliance, internal audit, back-office operations, and similar responsibilities for the member to be licensed. Individuals engaged in the investment banking or securities business of a foreign securities affiliate or subsidiary of a member may also hold permissive licenses.

6 e.g., Series 4/options; Series 9/10 or 24 for branch office management.

member firms may engage in investment advisory, foreign exchange, commodities, insurance, real estate or transfer agent businesses. Typically, such businesses would not be subject to regulatory oversight by FINRA,[7] but would fall under the jurisdiction of other regulatory authorities (e.g., OCC, SEC, CFTC, state regulators and state insurance commissioners) – each of which has its own rules, requirements and examinations governing those activities. Thus, if the intent of the proposed language change is to apply the supervisory rules, and in turn FINRA oversight, to these types of activities, then the Rule Proposal would be overreaching, unworkable, and would create needless regulatory redundancy contrary to current governmental and regulatory efforts to modernize the regulatory structure and eliminate costly duplication.[8]

Indeed, it is unclear which "principal" license would be required to supervise the types of businesses described above. Because the Series 24, 9/10 and 4 are designed for broker-dealer professionals, it would be inappropriate to require a principal of non-regulated businesses to qualify and obtain a license under the current supervisory principal regime that is largely irrelevant to his or her business activities. Management over such businesses is best left to the determination by firms as to the requisite experience and qualifications. In light of the foregoing, SIFMA respectfully requests that the language contained in existing NASD Rule 3010(a)(2) should carry forward without amendment to the FINRA rulebook. [9]

III. Assignment of Associated Persons To A Designated Registered Principal: Proposed FINRA Rule 3110(a)(5)

SIFMA also respectfully requests that FINRA address and refine several outstanding registration issues relating to Proposed Rule 3110. These include (i) supervisory structure requirement with respect to permissive registrants; and (ii) application of the branch office definition to a member's affiliate locations.

a. Supervisory Requirements Under 3110(a)(5)

Proposed FINRA Rule 3110 would leave existing NASD Rule 3010(a)(5) unchanged. The current Rule requires that a supervisory system must provide for:

> The assignment of each registered person to an appropriately registered representative(s) and/or supervisory principal(s) who shall be responsible for supervising that person's activities.

The existing NASD Rule 3010(a)(5) fails to draw any distinction between persons whose activities *require* registration and those whose job function or activities *permit* registration. These respective categories of registration are mutually exclusive. By definition, an employee who qualifies for registration under the current "permissive" criteria

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[7] The application of FINRA's designated principal obligations to these non broker-dealer activities would allow FINRA to examine and test the adequacy of written supervisory procedures and the discharge of supervisory obligations by a "designated principal" against laws and regulations that today FINRA does not currently oversee.

[8] *See*, The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure. United States Department of the Treasury. March, 2008. http://www.treas.gov/press/releases/reports/Blueprint.pdf.

[9] We note that to the extent FINRA decides to proceed with the amendment, it would need to address NASD Rule 1021(a), which currently prohibits firms from maintaining principal registrations for individuals who are not engaged in the member firm's "investment banking or securities business".

is not engaged in investment banking or securities business activities that require registration. In this context, it serves no purpose to require that a "permissive" representative be assigned and supervised by an individual with a registration qualification.

SIFMA requests that FINRA revise Rule 3110(a)(5) to clarify that the requirement shall only apply to registered persons who are *required* to be registered because they are engaged in the investment banking or securities business of the member firm. In order to take advantage of this distinction, member firms should be obligated to keep appropriate records that indicate each registered person's registration classification as either "Required" or "Permitted" (although in the long run, SIFMA believes that the CRD should be updated to incorporate these separate categories).

b. Branch Office Definition

As with the provisions governing assignment of a registered supervisor, the proposed new Rule 3110 incorporates without modification the current definition of "branch office" as contained in NASD 3010(g)(2)(A). Here too, the issue of permissive registrants is of significance. Specifically, member firms have long been concerned that the branch office definition may inadvertently capture, and require member firms to register as branch offices of the member certain non-U.S. office locations established and maintained by the member firm's non-U.S. affiliates.[10]

Under NASD 3010(g)(2)(A), a "branch office" is generally defined as "any location where one or more associated persons of a member regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security, or is held out as such."[11] As noted above, the phrase "associated persons" is ambiguous in nature and potentially could capture employees of foreign affiliates of a U.S. broker-dealer who are permissive registrants or employees of foreign affiliates who may otherwise be deemed to be "controlled" by the U.S. entity due to the particular facts and circumstances.

Requiring such branch office registration in a non-U.S. jurisdiction may have a number of significant, adverse consequences for the member firm. For example, registration as a branch office may require that branch office to register as a broker-dealer in the local jurisdiction and, indeed, may subject the entire member firm to local securities regulation and registration requirements. In addition, the member firm may be viewed as having created a "permanent establishment" in the local jurisdiction, which could subject the firm to adverse tax consequences with respect to any income attributable to that permanent establishment. We also note that the need to comply with a myriad of different (and sometimes conflicting) regulatory schemes and legal requirements would not only be prohibitively costly, but would likely create more, rather than less, investor confusion.

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[10] These affiliates referenced herein are separately organized, individually capitalized entities that are registered and regulated in their home jurisdictions.

[11] Prior to the effective date of the New Branch Office Definition, the term "branch office" was generally understood to encompass locations that were "held out as" or otherwise identified by any means to the public or customers as a location from which the member conducted an investment banking or securities business.

Clearly, investor protection dictates that member firms and their personnel must be adequately regulated in the local markets where they conduct their businesses. Requiring member firms, however, to register as "branch offices" the non-U.S.-locations of affiliated entities does not serve any legitimate investor protection or prudential mandate and indeed may result in significant adverse consequences for member firms. Accordingly, SIFMA respectfully asks that FINRA clarify that branch office registration is not required for the non-U.S. locations described herein.[12]

IV. Review of Member's Investment Banking and Securities Business: Proposed Rule 3110(b)(2)

FINRA states in the Regulatory Notice that proposed Rule 3110(b)(2) seeks "to retain the requirement in NASD Rule 3010(d)(1) requiring principal review" and at the same time "clarify that such review shall include all transactions relating to the investment banking and securities business of the member firm."[13] Under the proposal:

> The supervisory procedures required by this paragraph (b) shall include procedures by a registered principal, evidenced in writing, of all transactions relating to the investment banking or securities business of the member.

a. Incorporate Risk-Based Language within Text of Rule

SIFMA strongly supports the flexibility to utilize a "risk-based" approach to the review of securities and investment banking transactions as set forth in Supplementary Material .06. We understand that the intent of proposed Rule 3110(a) and (b) is that no business line is to be excluded from having supervisory procedures reasonably designed to achieve compliance with applicable securities laws and regulations. However, as drafted, the Rule appears to suggest that a registered principal would have to review all transactions for every business engaged in investment banking or securities activities, a result that appears inconsistent with the risk-based approach outlined in the Supplementary Material. We therefore respectfully suggest that FINRA insert the "risk-based" language within the text of the rule and eliminate the word "all" in order to avoid potential confusion regarding the scope of the transactional review of procedures that firms must implement.

b. Investment Banking Transactions

SIFMA also believes that FINRA should reconsider requiring the written supervisory review of investment banking transactions, even if done on a risk-based basis. We believe that such a review would be duplicative of existing supervisory systems applicable to the investment banking business. Securities and investment banking businesses are inherently different. Any supervisory review for these businesses should therefore not be subject to a one-size-fits-all approach. The investment banking business tends to consist of discrete transactions involving a team of bankers, capital markets professionals, internal and/or

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[12] Notably, FINRA previously addressed the issue of the application of the associated person definition to matrix reporting in its Business Entertainment rule filing wherein it recognized that persons in a non-member affiliate do not become "associated persons" merely by being supervised by a manager in a global business who is an "associated person." See SR-NASD-2006-044 (April 17, 2007, at pp. 18-19).

[13] FINRA Notice 08-24 at page 5. Existing NASD Rule 3010(d)(1) requires a "… review and endorsement by a registered principal in writing, on an internal record, of all transactions …"

external counsel and other specialists all involved in the consummation or execution of a transaction. This is vastly different from the execution of a securities transaction.

Moreover, the requirement to have a written record documenting the supervisory review of an investment banking "transaction" is unnecessarily bureaucratic, requiring resources to be dedicated to a process that already exists in another area. As FINRA is aware, many member firms have adopted a supervisory structure consisting of one or more committees or groups that review and approve all investment banking transactions or certain kinds of transactions, depending upon the nature of the deal. For example, a firm may have a "commitments committee" review and approve all initial public offerings, common stock underwritings, and high-yield debt underwritings, while employing a more streamlined review process for other transactions such as high-grade corporate debt shelf underwritings or Rule 144A offerings. As we read it, the proposal fails to take into account a member's existing supervisory structure under Rule 3010(a) to conduct, review and approve investment banking transactions, and would add an unnecessary and duplicative supervisory sign-off. SIFMA respectfully requests that FINRA specifically exclude investment banking transactions from proposed Rule 3110(b)(3). At a minimum, we request that FINRA acknowledge that the documentation requirement under the Rule may be satisfied by other existing supervisory processes.

V. Supervision of Outside Securities Activities: Proposed Rule 3110(b)(3)

FINRA proposes to delete existing NASD Rule 3040 and replace it with Proposed Rule 3110(b)(3), which provides that: [14]

> Unless a member provides prior written approval, no associated person may conduct any investment banking or securities business outside the scope of the member's business. If the member gives such approval, such activity is within the scope of the member's business and shall be supervised in accordance with this Rule, subject to the exceptions set forth in subparagraph (B) ["Dual Employees"].

SIFMA supports FINRA's efforts to simplify and make less prescriptive existing NASD Rule 3040. Unfortunately, as drafted, the current proposal is much broader than NASD 3040, and unless modified, could have wide-ranging adverse consequences to broker-dealers. SIFMA's comments and suggested modifications are as follows:

a. Clarify that Passive Investments Are Covered by the Rule

As proposed, the rule's use of the word "conduct" may be construed to exclude an associated person's passive investment in an outside private securities transaction. SIFMA believes that the interests of investors and member firms are better served if associated persons notify and seek approval from their firms for passive investments in outside private securities transactions (e.g., hedge funds, private equity funds). SIFMA, therefore, respectfully requests that FINRA modify this language to clarify that passive investments

[14] SIFMA notes that FINRA has not stated what it intends to do with NYSE Rule 407(b), which is the comparable – but not identical – rule governing outside private securities transactions. This is significant since NYSE Rule 407(b) has been incorporated within the FINRA Transitional Rulebook.

continue to be covered by the rule but are not subject to the more comprehensive on-going supervision discussed below.

b. Distinction Between Passive Investment and Selling Away

Second, SIFMA does not believe it is necessary for a firm, once it has notice of, and gives approval for, outside private securities transactions, to subject passive investments to the full panoply of supervisory rules set forth in Proposed Rule 3110. In the case of passive investments, FINRA should permit member firms to design their own policies and procedures relating to prior approval, potential conflicts of interest, and other potential sales practices issues, which would not need to satisfy the full scope of requirements under Proposed Rule 3110. Similarly, under long-established interpretation, FINRA has not required full supervision by firms as their "business as such" for outside fee-based advisory services where the member approves the activity in writing and actively monitors it. We do agree with FINRA that such supervision is required where the representative conducts an outside securities or investment banking transaction and receives compensation for such a transaction.[15]

Moreover, in light of Proposed Rule 3110(b)(3), SIFMA requests that FINRA clarify the status of existing NASD Rule 3030 (Outside Business Activities of Associated Persons). We believe that outside business activities such as serving on the board of directors of a for-profit or not-for-profit corporation is not an "outside private securities transaction" since it is not the conducting of "investment banking and securities activities" and thus would not be within the ambit of proposed Rule 3110(b)(3). SIFMA also would like to confirm whether FINRA intends to adopt NASD Rule 3030 within the new consolidated rulebook. Firms have developed policies and procedures relating to outside business activities and will need to determine how Proposed Rule 3110(b)(3) affects, if at all, existing NASD Rule 3030. We hope that FINRA does not intend to incorporate the requirements of that rule within the supervisory obligations under proposed new rule 3110, as such a modification would likely result in a prohibition of all outside business activities. In that regard we ask that FINRA to clarify that the supervisory obligations under proposed new rule 3110 would not apply to approved outside business activities that neither involve the conduct of investment banking nor securities activities.

c. Dual Employees: Proposed Rule 3110(b)(3)(B)

With respect to proposed Rule 3110(b)(3)(B), we believe FINRA's approach to bank-related securities activities of dual employees is sensible and appropriate, recognizing that the approach is predicated on an otherwise associated bank employee engaging in securities activities that are nonetheless exempt from registration as a broker-dealer. The proposal would not require a member to consider such activities within the scope of its business for supervisory purposes, provided the specified written assurances are obtained.

SIFMA believes that this approach should serve as a model for, and the concept extended to, employees of the broker-dealer who are dually employed by and engaged in business activities on behalf of any financial services affiliate (domestic and foreign) when such activities either *do not require registration* as a broker-dealer, or are included within

[15] SIFMA also seeks confirmation that Proposed Rule 3110 is not intended to change FINRA's position regarding trailing commissions under NASD IM 2420-2.

any of the statutory or regulatory exemptions from registration as a broker or dealer, or are subject to jurisdiction of non-U.S. regulators (e.g. the Financial Services Authority). Assuming the member firm receives written assurances (as is the case with bank-related securities activities) that the affiliate is overseeing activities performed by dually-employed persons, we believe that it is unnecessary to require the member firm to supervise such activities that are subject to the applicable alternative regulation.

As drafted, the current proposal creates significant ambiguities because it could be read to suggest that member firms have ongoing supervisory responsibility over dual employees who are engaged in activities at an affiliated entity, even though these registered persons have no direct participation in securities transactions.

For independent contractor broker-dealers that have Registered Investment Advisers ("RIAs"), this proposal also presents numerous challenges and unnecessarily burdensome requirements. For those firms, it is not unusual for persons associated with the member to own an entity that is registered as an RIA. Any securities transactions for the RIA's clients, may or may not be conducted through the member. Under interpretations to current Rule 3040, the member is required to conduct a suitability review of the securities transactions away from the member, but only when the associated person "participated" in them. Under Proposed FINRA Rule 3110(b)(3), the outside RIA itself could be construed as part of the member's "business" and therefore subject to the member firm's policies and procedures. RIAs are subject to a different regulatory scheme and an alternative supervisory structure. Customers of the RIA may not be customers of the member. To impose FINRA regulation on these activities would be an unwarranted expansion of jurisdiction and would submit the entity to duplicative, possibly conflicting regulation.

SIFMA therefore requests that FINRA expand the bank-related exemption to employees of the broker-dealer who are dually employed by and engaged in business activities on behalf of any financial services affiliate when such activities either (i) do not require registration as a broker-dealer, or (ii) are included within any of the statutory or regulatory exemptions from registration as a broker or dealer.[16]

VI. Review of Correspondence and Internal Communications: FINRA Rule 3110(b)(4)

Proposed FINRA Rule 3110(b)(4) and accompanying Supplementary Materials .09 through .12 would require appropriate procedures for the review of correspondence and internal communications. Although FINRA states that the proposal is intended to incorporate the substance of NASD Rule 3010(d), by combining external correspondence with internal communications, the proposal appears to impose potentially new and confusing requirements on the review of internal communications. In addition, certain language in Supplementary Material .09 creates ambiguity around the well-established practice of risk-based review of communications.

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[16] SIFMA notes that some broker-dealers enter into Dual Registration Agreements that clearly delineate supervisory obligations among the member firms for dually registered employees. In such cases, the member firms agree in writing to the dual registration of their employees and the allocation of supervisory responsibilities for dually registered representatives in connection with securities business conducted under the broker-dealer registration. We presume that the Rule Proposal would not impact these types of arrangements, and respectfully requests that FINRA will specifically address this in its written guidance."

a. Proposed Rule 3110 (b)(4): Review of Correspondence and Internal Communications

Existing NASD rules and recent guidance generally distinguish between the review of incoming and outgoing correspondence with the public and internal communications. For example, FINRA Regulatory Notice 07-59 (Electronic Communications Guidance), sets forth different standards for the review of external and internal electronic communications.

By combining external correspondence with internal communications, Proposed Rule 3110(b)(4) unnecessarily confuses the established separate standards of review for these communications. The proposal seems to state that supervisory procedures for all communications must ensure that the member properly handles customer complaints, customer instructions, and various other customer-related procedures – all of which are more appropriately addressed in the review of customer, rather than internal, communications. SIFMA submits that communications with the public and internal communications present very different levels and types of risk, which should be reflected in any risk-based approach to supervision. In addition, firms satisfy the risk-based standards for external and internal communications in different ways. Internal e-mail, for example, may be reviewed in the course of internal inspections, rather than by supervisors.

SIFMA therefore recommends that FINRA move the provisions of the Proposed Rule concerning internal communications to a separate rule or a separate section of Proposed Rule 3110. SIFMA also requests that FINRA explicitly recognize the guidance in Regulatory Notice 07-59, which established clear and accepted industry practices for the review and supervision of electronic communications.

b. Supplementary Material .09

Although the Proposed Rule contemplates a risk-based approach to the review of correspondence and internal communications, it is unclear what is intended by the highlighted language in the following sentence: "a member may decide the extent to which *additional* policies and procedures for the review of…correspondence with the public and internal communications *that fall outside of the subject matters listed in Rule 3110(b)(4)* are appropriate for its business and structure (emphasis added)."

Because a risk-based approach contemplates that each member firm will address additional subject matters that pose unique risks to that firm in accordance with the supervision of its business, this language creates unnecessary ambiguity. Moreover, the Supplementary Material does not affirmatively state that a risk-based approach would be permissible in such circumstances (even though this does appear to be the intent of the Rule).

SIFMA therefore recommends that FINRA place the risk-based review standard in the proposed rule itself. Alternatively, SIFMA suggests that FINRA *replace* the first sentence of Supplementary Material .09 with an affirmative statement that firms may take a risk-based approach to the review of communications. FINRA could adopt some of the language from the Electronic Communication Guidance, as follows:

> Members generally may decide by employing risk-based principles the extent to which the review of [electronic] communications, both internal and external, is necessary in accordance with the supervision of their business. However, members must have policies and procedures for the

> review by a supervisor of employees' incoming and outgoing [electronic] communications that are of a subject matter that require review under SRO rules and federal securities laws. . .

c. Supplementary Material .10

Supplementary Material .10 expressly states that merely opening a communication is not sufficient evidence of review. Although this language is established guidance and SIFMA does not dispute the point, FINRA's guidance in this section does not appear to be consistent with the broader goal of principles-based regulation, particularly when the guidance is placed in a section on evidence of review. In other areas, FINRA has not prescribed a specific required level of review. For example, while supervisors sign off on trade runs and order tickets, firms have latitude to determine how to evidence their review. SIFMA therefore recommends that FINRA delete this sentence.

d. Supplementary Material .11

SIFMA strongly supports the modifications permitting the delegation of correspondence and internal communication review functions to non-registered personnel, provided that appropriate controls are in place to ensure non-registered personnel have sufficient knowledge, experience and training to perform the reviews.

SIFMA is concerned, however, that Supplementary Material .11 could be interpreted to require a supervisor/principal to evidence the review of all delegated functions in order to demonstrate overall supervisory control. More specifically, in cases where member firms have chosen to implement a structure that results in the centralized review of electronic communications, what are the expectations in this regard where there are potentially vast numbers of supervisory principals? Shall they each make a periodic and independent inquiry of the central review team? This prospect would seem highly inefficient. Member firms should be able to use a testing program established pursuant to current NASD Rule 3012 as means of achieving reasonable comfort that controls are functioning as intended.

We also believe a distinction ought to be made between cases where a supervisor arranges for a one-off specific delegation to an individual and where the member has adopted a model of central review. SIFMA recommends that FINRA clarify the reasonable and appropriate standards for demonstrating overall supervisory control with respect to delegated functions, while considering that there are varying forms of delegation.

VII. Review of Customer Complaints: Proposed Rule 3110(b)(5)

Proposed Rule 3110(b)(5) incorporates the NYSE Rule 401A requirement that firms capture, acknowledge and respond to complaints. SIFMA fully supports limiting the requirement to written complaints and echoes FINRA's rationale that "oral complaints are more difficult to capture and assess, and raise competing views as to the substance of the complaint being alleged; consequently, oral complaints do not lend themselves as effectively to an examination program as written complaints."

VIII. Supervision of Supervisory Personnel: Proposed Rule 3110(b)(6)

Proposed FINRA Rule 3110(b)(6) combines the recordkeeping provisions of NASD Rule 3010(b)(3) with the requirements for supervising associated persons who perform supervisory functions currently contained in NASD Rule 3012(A)(2). The new requirements adopt two clearly-stated prohibitions that would apply to the supervision of any associated person in a supervisory role, not only to supervisors who conduct customer account activity. As a resut, the proposed rule is considerably broader than the current NASD rules, reflecting FINRA's encouraging efforts to de-emphasize specific compliance mandates in favor of principles-based regulation. As discussed below, however, the proposed language set forth in paragraph (D) creates a standard for written supervisory procedures that is not sufficiently clear to enable firms to implement it, and will require further clarification from FINRA.

a. Prohibition Against Self-Supervision and Other Improper Supervisory Relationships Under Rule 3110(b)(6)(C),

SIFMA supports the approach taken by Proposed FINRA Rule 3110(b)(6)(C), which would eliminate the array of prescriptive requirements for supervising "producing managers" contained in NASD Rule 3012(a)(2)(A) and (C). SIFMA particularly commends FINRA for eliminating (i) the requirement to rotate the "independent" reviewers of producing managers every two years, and (ii) the "heightened supervision" requirement for producing managers who meet total revenue generated or income threshold relative to their supervisors.[17]

SIFMA strongly supports Paragraph (C) of the Proposed Rule because it gives members flexibility in establishing policies and procedures to supervise its supervisors, while setting forth clear minimum standards designed to foster oversight and accountability at all levels of a member organization. SIFMA also supports the exception procedure set forth in the Proposed Rule to allow firms to craft an alternative supervisory arrangement when the minimum requirements cannot be met due to a firm's size or a supervisor's role in the firm.

b. Rule 3110(b)(6)(D) – Conflicts of Interest

Paragraph (D) of the Proposed Rule, on the other hand, raises a number of issues. Though clearly well-intended, this proposed new language would significantly expand the standards regarding conflicts of interest set forth in Paragraph (C) by requiring firms to implement procedures to "prevent" the effective supervision of supervisors from being "lessened in any manner" by "any conflicts of interest that may be present" with respect to any supervisor. For the reasons stated below, SIFMA respectfully requests that FINRA withdraw Paragraph (D) from the Proposed Rule, or alternatively modify the language as recommended herein.

As a threshold matter, the rule proposal would create an unrealistic standard in that it would require firms to develop written supervisory procedures that "prevent" a particular circumstance from occurring, including one that relates to the supervision of a conflict of interest. In addition, this broadly-stated mandate, presented without further guidance, uses

[17] SIFMA understands that Incorporated Rule NYSE 342.19, including its 10% threshold for a reviewing manager's gross income derived from a producing manager, will be eliminated from FINRA's rulebook when this proposal is approved.

ambiguous language – "lessened in any manner" – which we believe will impede a member's ability to establish and test written supervisory procedures. The preamble to Regulatory Notice 08-24 uses similarly unhelpful language in requiring firms to "prevent[] the diminution of supervision . . . to detect non-compliant conduct due to conflicts of interest." We are concerned that such ambiguous language could lead to second-guessing by FINRA after a supervisory breakdown occurs, without giving members the guidance they need to prevent violations from occurring in the first place.

Indeed, in light of existing NASD Rules 3010(a) and (b) and their proposed equivalents, SIFMA questions whether Paragraph (D) is necessary at all. Proposed FINRA Rule 3110(a) maintains the current NASD requirement for members to establish and maintain a supervisory system that is reasonably designed to achieve compliance with all applicable laws, rules and regulations. Proposed FINRA Rule 3110(b)(1) requires that this system be maintained and enforced with written supervisory procedures. Together, these requirements already impose an obligation upon members that would include a process to identify and mitigate potential conflicts of interest. In an effort to meet these obligations, SIFMA's members have implemented a variety of controls and corporate governance mechanisms to minimize the presence of conflicts in their supervisory systems and to identify and effectively address these conflicts when they inevitably occur. Finally, we believe that Proposed Rule 3110(b)(6)(3)(C), as stated above, speaks directly to conflicts of interest in supervision.

SIFMA fully supports FINRA's continued efforts to enhance its members' conflicts of interest policies and procedures. However, for the reasons stated above, we believe the proposed language is problematic and should be deleted. Alternatively, SIFMA recommends FINRA modify the language to clarify that firms' policies and procedures must be reasonably designed to prevent effective supervision of supervisors from being impeded by conflicts.

IX. Transaction Review and Investigation: Supplementary Material .08

FINRA also proposes to adopt Supplementary Material .08, which would incorporate with some modification the NYSE Rule 342.21 requirement that member firms' insider trading procedures specifically include a review of trades affected in firm proprietary accounts, or for accounts of employees or family members for potential insider trading violations.[18] The Supplementary Material would also require member firms to promptly conduct internal investigation into transactions the firm identifies as having violated insider trading regulations.

Additionally, and perhaps most significantly, the Supplementary Material would also require member firms that engage in "investment banking services" as that term is defined in the consolidated research analyst rules, to provide FINRA with various written "reports" regarding such investigations. These include: (i) a written report within 10 business days of initiation of an internal investigation disclosing, among other things, the securities trading activity of employees and employee family members under review; (ii) a quarterly report

[18] As noted by FINRA, "the ITSFEA requires every broker-dealer to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the broker-dealer or any associated person of the broker-dealer." *Regulatory Notice at p. 9, citing* Exchange Act Section 15(f). SIFMA believes this language is helpful to understanding the scope of the requirement and should be carried over to the supplementary material.

addressing the progress of each open investigation; and (iii) a written report within five business days of completion of internal investigation disclosing the results of the investigation, including any internal disciplinary actions and regulatory referrals.

SIFMA is generally supportive of incorporating within the FINRA consolidated rulebook the current NYSE Rule 342.21 and Rule 351(e) quarterly reporting requirements.

SIFMA strongly opposes, however, requiring firms to provide FINRA with additional reports during a quarter to reflect the commencement of individual internal investigations. This proposed requirement expands the NYSE's current requirement in which firms may make a single consolidated quarterly filing that includes both investigations commenced during the preceding quarter and progress reports on ongoing investigations (commenced and initially reported) during preceding quarters. These additional reports are unnecessary and unduly burdensome to member firms in light of the quarterly reporting requirement. This is particularly true for small firms with limited resources and would constitute a new requirement for formerly NASD-only firms. Further, we note that NYSE's Risk Assessment Unit reviewed industry practice and issued comprehensive guidance in NYSE Information Memo 06-06 that, among other things, reaffirmed the timetable for reporting Rule 342.21(b) internal investigations that had been in place since the inception of the requirement. SIFMA believes that the guidance reflected therein is sufficient and should serve as the benchmark for the Supplementary Material.

Finally, and more generally, SIFMA believes it would be extremely beneficial for FINRA to articulate the interaction between the Rule Proposal and certain Incorporated NYSE Rules that have been designated as Non-Exclusive Common Rules under the 17d-2 Agreement – rules for which both FINRA and NYSE bear responsibility when performing their respective regulatory functions. Because the 17d-2 Agreement provides for sharing of information between FINRA and NYSE with respect to reports and other documents, we would hope that dual member firms would not be subject to separate reporting requirements regarding internal investigations once the FINRA rulebook is completed.[19]

X. Maintenance of Written Supervisory Procedures: Proposed Rule 3010(b)(7)

Proposed Rule 3010(b)(7) contains non-substantive revisions to current NASD Rule 3010(B)(4). SIFMA believes the requirement to maintain a "copy" of a member's written supervisory procedures in each OSJ and at each location where supervisory activities are conducted is antiquated. For a large number of member firms, written supervisory procedures only exist in electronic form. SIFMA suggests that the first sentence be modified as follows: *"A copy or demonstrated electronic access to the members written supervisory procedures…shall be kept, maintained, or otherwise made available…"*

[19] See Securities Exchange Act Release No. 56148.

XI. Internal Inspections: Proposed Rule 3110(c)

a. FINRA Should Adopt the Risk-Based Inspection Scheme Permitted under NYSE Rules 342.24 and 342.25

Proposed FINRA Rule 3110(c)(1)(A) would require a member firm to conduct an annual inspection of any location that meets the definition of "office of supervisory jurisdiction" under proposed FINRA Rule 3110(d)(1) or any branch office that supervises one or more non-branch locations. SIFMA supports proposed new FINRA Rule 3110(c). We respectfully request, however, that FINRA incorporate within the consolidated rulebook the risk-based inspection scheme permitted by current NYSE Rules 342.24 and 342.25.

Under these NYSE rules, firms may, upon application to and approval by the NYSE, obtain an exemption from the annual inspection requirement for branch offices if the firm can demonstrate that it has policies and procedures that provide for a systemic risk-based surveillance of its branch offices. In effect, NYSE member firms have been able, since 2006, to forego an annual inspection of every branch office location if they meet the requirements set forth in NYSE Rule 342.24 and .25. Since the regulatory consolidation of NASD and NYSE, FINRA has continued to approve appropriate risk-based inspection programs.

Because the definition of OSJ in proposed Rule 3110(d)(1) is broad enough to cover a number of smaller offices or satellites where one part of the definition is technically met, SIFMA is concerned that that this definition combined with the provisions of proposed Rule 3110(c)(1)(A), would virtually eliminate the risk-based approach to inspections of satellite locations that has been approved by the NYSE specifically, and more generally by the SEC. This would include, for example, locations that have the majority of its supervision occurring through a parent office and that perform no other functions that otherwise would cause it to be considered an OSJ other than approving new accounts. Moreover, because proposed FINRA Rule 3110(c)(1)(A) requires members to designate as an OSJ and therefore annually inspect any office at which "structuring of public offerings or private placements" occurs, the rule would also capture certain investment banking offices.[20]

SIFMA can find no such regulatory rationale for eliminating the risk-based framework currently embodied within NYSE Rules 324.24 and. 25, and we urge FINRA to incorporate those rules within the consolidated rulebook for several reasons. First, in approving NYSE Rules 342.24 and .25 in June 2006,[21] the SEC explicitly endorsed the use of risk-based inspections of branch offices. After the adoption of these rules, NYSE then issued guidance regarding the process for requesting certain offices be exempt from the

[20] While we are mindful that these types of activities carry with them a measure of regulatory significance, SIFMA believes that the conduct of investment banking business as well as the complex supervisory structure firms have developed and implemented over time to oversee that business obviates the need for a mandated annual inspection of each office that engages in it and, instead, supports the adoption of a less rigorous framework that allows the member to decide, using risk-based principles, the appropriate inspection schedule, i.e., annually or at least every three years, for each of its investment banking offices.

[21] *See* Exchange Act Release No. 34-53983 (June 14, 2006), 71 FR 35723 (June 21, 2006) (SR-NYSE-2005-60) ("NYSE Rule 342.24 and 342.25 Approval Order").

annual inspection requirement and the factors that the NYSE will consider in reviewing the application.[22]

A number of NYSE member firms have applied for, and received approval from, NYSE and FINRA to conduct risk-based inspections of their branch offices. These firms have already revised their branch office inspection programs in line with the NYSE approval. Reversing such approval will necessarily expand firms' annual inspection programs, resulting in higher costs in the form of increased headcount, commensurate staff training and a dramatic rise in travel and related expenses.[23] In today's challenging economic environment, and with travel costs rising exponentially, we urge FINRA staff to consider carefully the sizeable negative financial impact to firms unless FINRA incorporates this program within the rule, especially in light of the recognized benefits and reasonableness of the program.

Second, permitting a risk-based inspection program for locations that meet the definition of supervisory branch offices or OSJs is consistent with FINRA's approach to risk-based testing in Rule 3012.[24] FINRA has recognized previously that risk-based testing of policies and procedures is appropriate for its member firms, and this principle should be applied to inspections of supervisory branch offices and OSJs.

Third, the criteria used by the NYSE to approve a risk-based approach to branch office inspections is equally valid for FINRA member firms. NYSE Information Memo 06-47 requires that in making a risk-based assessment to exempt specific branch offices from the annual inspection requirement, a firm review the "business profile" of the office (e.g., size of the office, number of customers, volume of transactions), the regulatory history of the office (e.g., number of customer complaints, reps on special supervision or subject to disciplinary actions), operational factors (e.g., number of errors, account designation changes), the branch office manager, and the history of the branch office. Offices subject to the exemption were also monitored by the member firm for "red flags" on an ongoing basis. In addition to these prudent requirements, we note that NYSE Rule 342.25(c) requires annual inspections for most types of offices that meet FINRA's definition of "OSJ," including offices with 25 or more registered individuals and any branch office designated as exercising supervision over another branch office.

A risk-based inspection rule embodied in NYSE Rule 342.24 and .25 allows firms effectively to direct attention to those regulatory risk areas that need closer investigation during the course of each inspection cycle. Risk-based scheduling allows for better-focused and more productive on-site examination efforts, gives firms flexibility in developing and

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[22] *See* NYSE Info Memo 06-47 (June 27, 2006).

[23] One firm estimates that it would require the inspection of an additional 88 offices this year, which translates into hundreds of thousands of dollars in travel expenses, as well as the hiring of an additional six examiners. Other firms likewise anticipate having to spend thousands of dollars in travel expenses per each additional office that would be required to be inspected annually as well as hiring additional personnel. In addition, some firms have seen a decrease in turnover in branch inspection personnel as a result of the reduced number of offices to be inspected each year, and would expect to see higher rates of turnover if more offices are added back into the program. The turnover rate negatively affects an inspection program because it makes it less efficient and more costly to operate.

[24] *See* NASD NTM 05-29 ("Guidance Regarding Rule 3012(a)(1) Requirement to Test and Verify a Member's Supervisory Policies and Procedures")(April 2005).

modifying their branch office inspection programs and results in time savings and reduction in mandatory field work, and an increase in examiner preparation and training time, all of which leads to more thorough and useful examinations. Indeed, the SEC, in approving the NYSE's rule proposal stated that it, "appropriately balances the need for firms to survey and inspect their branch offices with the need to provide firms with some flexibility to adapt branch office inspections according to changing circumstances."[25]

We also note that the risk-based inspection program adopted by the NYSE contains effective measures specifically tailored to prevent firms from applying the exemption inappropriately.[26] The SEC likewise noted that the NYSE Rules, "contain appropriate limitations on a firm's ability to apply the exemption from the requirement to inspect branch offices every year."[27] Accordingly, we request that FINRA incorporate the risk-based internal office inspection scheme contained in NYSE Rule 342.24 and .25 into the FINRA rulebook.

b. Requiring Firms to Maintain Procedures that Prevent an Inspection from Being "Lessened in any Manner" is Unreasonable

In seeking to make the inspection provisions less prescriptive, FINRA has proposed eliminating the heightened office inspection provisions of NASD Rule 3010(c)(3), which must be implemented where a branch office manager and the person conducting the inspection report to the same person.[28] In its place, FINRA proposes to adopt, through FINRA Rule 3110(c)(3), inspection requirements that would require each member to have procedures that both ensure that each location is inspected by someone who is not an associated person of, or supervised by someone at, that location and "prevent the inspection from being lessened in any manner due to any conflicts of interest."

SIFMA supports FINRA's intent to remove the specific heightened inspection requirements and replace them with a more principles-based approach designed to prevent conflicts of interest from harming the effectiveness of internal inspections. However, for reasons similar to those set forth above in Part VIII(b) , we submit that the conflict of interest standard expressed in proposed Rule 3110(c)(3)(B), like that in proposed Rule 3110(b)(6)(C), is vague, overly broad and not reasonable in light of the purpose of FINRA's internal inspection rules.

The inspection provisions, as set forth in current NASD Rule 3010(c)(1) and proposed FINRA Rule 3110(c)(1), require that members conduct reviews that assist in "detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable … rules." SIFMA agrees that this requirement contemplates a member's duty to reasonably safeguard its internal inspection system from

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[25] *See* NYSE Rule 342.24 and 342.25 Approval Order, 71 FR at 37523.

[26] As part of the application to the NYSE, firms were required to detail the risk criteria to be applied, how often the criteria was to be updated, and provide a list of offices the firm was going to visit in the first year of the program.

[27] *See* NYSE Rule 342.24 and 342.25 Approval Order, 71 FR at 37523.

[28] NASD Rule 3010(c)(3) generally requires members to have in place procedures that are reasonably designed to avoid conflicts of interest "that serve to undermine complete and effective inspection because of the economic, commercial or financial interest that the branch office manager's supervisor hold s in the associated persons and the businesses being inspected."

conflicts of interest. However, we are concerned that creating an expectation in the rulebook that members have (and can enforce) procedures that "prevent" any conflict that may "lessen in any manner" the inspection is a standard that is overreaching and too easily susceptible to misinterpretation.

For the above reasons, SIFMA urges FINRA to withdraw section 3110(c)(3)(B) from the Proposed Rule, relocate subparagraph (i) to paragraph (A), and eliminate any remaining references to paragraph (B). Alternatively, SIFMA urges FINRA to adopt language that provides more guidance to firms in implementing procedures reasonably designed to prevent the effectiveness of the inspection from being impeded by conflicts.

c. FINRA Should Eliminate the Negative Presumption in Supplementary Material .15

SIFMA generally supports proposed Rule 3110(c)(1)(C) as an adequate method to provide supervision for non-branch offices as it reasonably permits member firms to establish a "periodic schedule" for inspection of non-branch offices by considering identified relevant factors. Further, the flexibility of the proposed Rule is consistent with a risk-based approach to regulation and recognizes the varied sizes, structures and access to resources of member firms.

SIFMA recommends, however, that FINRA eliminate the related Supplementary Material .15 as we believe that the following language of contained therein runs contrary to the flexibility inherent in proposed Rule 3110(c)(1)(C):

> In establishing a non-branch location inspection schedule, there is 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 implemented, the presumption would effectively *require* member firms to establish a three year non-branch inspection cycle, thereby eviscerating the reasonable discretion otherwise allowed in proposed Rule 3110(c)(1)(C).

For many member firms, the presumption would necessitate allocating valuable resources to non-branch inspections even when the relevant factors do not warrant a 3-year cycle. Non-branch offices, by their definition under proposed Rule 3110 (d)(2)(A)(i)-(iii), are a limited class of offices whose activities generally carry - as compared to branches – less potential for harm to the public investor and less potential risk to the member firms. As such, FINRA should not attempt to create a presumption that will impose *de facto* an inspection cycle on them similar to that imposed on branch offices.

XII. Branch Office and OSJ Definitions and Standards for Review of Offices: Proposed Rule 3110(d) and Supplementary Material .04

FINRA Proposed Rule 3110(d) retains the definitions of "branch office" and "office of supervisory jurisdiction" in existing Rule 3010(g). Proposed Supplementary Material .04, however, goes beyond existing rules in creating: (1) a general presumption that a principal will not be designated and assigned to supervise more than one OSJ; and (2) a general presumption that a determination by a member to designate and assign one principal to supervise more than two OSJs is unreasonable. The latter presumption will subject any

member determination assigning one supervisor to more than two OSJs to "greater scrutiny" and the member will have a "greater burden to evidence the reasonableness of such structure."

SIFMA believes that the introduction of negative presumptions addressing the reasonableness of certain supervisory structures is unnecessary, inappropriate, and should be eliminated. As a threshold matter, such presumptions run counter to the stated objective of the Regulatory Notice to rewrite the supervisory rules "to provide firms with greater flexibility to tailor their supervisory and supervisory control procedures to reflect their business, size and organization structure." The presumptions disregard technology-driven methods of supervision that allow for robust and comprehensive supervision of an OSJ by a designated principal who is not physically present at the location. Enhancements in surveillance, trading and communication systems increasingly allow for effective remote supervision. The presumptions do not consider the varied sizes and resources of member firms that support designated principals in the discharge of their supervisory obligations. These resources may include compliance, control, operations or oversight functions dedicated to supervisory monitoring and support. While the factors outlined in Supplementary Material .04 (a) through (e) are relevant considerations in designating principals to supervise multiple OSJs, a member firm should not be required to overcome negative presumptions and heightened scrutiny to implement an otherwise reasonable supervisory structure. SIFMA therefore recommends that the Supplementary Material be reframed as a statement of factors to be considered in creating a supervisory structure over multiple OSJs, without the negative presumptions.

SIFMA further recommends that FINRA clarify the language within Supplementary Material .04(d) that states that OSJ locations should be "in sufficiently close proximity". Geographic distance, means of travel, and travel time are all variables that could be relevant to a determination of "sufficiently close proximity." SIFMA recommends that FINRA modify section (d) to remove the reference to close proximity and state instead: *" whether the principal is able to be physically present at each OSJ office location on a regular and routine basis; and..."*

XIII. Supervisory Control System: Proposed Rule 3120

Proposed FINRA Rule 3120 retains NASD Rule 3012's testing and verification requirements, including the requirement to prepare and submit to the firm's senior management a report at least annually summarizing the test results, significant identified exceptions, and any additional or amended supervisory procedures. FINRA is also proposing to require firms that report $150 million or more in gross revenue on their FOCUS reports to include certain content requirements (adapted from NYSE Rule 342.30) in the annual report. In addition, FINRA has recommended that NYSE Rule 354 relating to delivery of the annual report to control persons be eliminated.

Proposed FINRA Rule 3120(b)(1) would require that the report include a tabulation of reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year. Proposed Rule 3120(b)(2) would require a discussion of the preceding year's compliance efforts, including procedures and education programs in the areas specified.

a. Tabulation of Customer Complaints and Internal Investigations: Proposed Rule 3120(b)(1)

The requirement to include a tabulation of customer complaints and investigations appears duplicative and overlaps with proposed FINRA Rules 3110(b)(5), and 4513[29] and with existing NASD Rule 3070, which require each member to report statistical and summary information regarding customer complaints and internal investigations to FINRA. It also overlaps with NYSE Rules 351(a), (e) and 401A[30]. We suggest that the existing and proposed reporting requirements should be sufficient for FINRA's purposes without imposing an additional yearly tabulation requirement through proposed Rule 3120(b)(1) on members.

b. Discussion on Compliance Efforts: Proposed Rule 3120(b)(2)

SIFMA is appreciative that some of the content included in NYSE Rule 342.30 is proposed to be streamlined and reduced, and that the requirement to provide the report to control persons is being removed. Nevertheless, SIFMA strongly believes that the legacy NYSE Rule 342.30 report should have been eliminated in light of subsequent regulatory developments.

Specifically, SIFMA believes that that FINRA's proposal to apply certain content requirements in NYSE Rule 342.30 is redundant with the requirements of NASD Rules 3012 (proposed Rule 3120(a)) and 3013. The wording in the introductory paragraph of proposed Rule 3120(b)(2), for example, is almost identical to the language in NASD IM-3013, which requires one or more meetings between the firm's CEO and CCO to discuss matters pertaining to the certification, the member's compliance efforts, and compliance problems and plans for emerging business areas.

Notably, when NASD Rule 3013 was first proposed, industry representatives recommended that NASD adopt the NYSE annual report requirement in lieu of a certification and yearly meeting. At the time, NASD rejected this approach, reasoning that the CEO certification and CEO meeting of Rule 3013 would "enhance investor protection by ensuring that senior management focuse[d] increased attention on their firm's compliance and supervisory systems, and by fostering regular interaction between business and compliance officers."[31] NASD augmented, however, the requirements relating to the CEO meeting to more "closely parallel" the language in NYSE 342.30[32] by requiring that the discussion cover compliance efforts and identify and address significant compliance problems and plans for emerging business areas.

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[29] See FINRA Regulatory Notice 08-25 proposing FINRA Rule 4513.

[30] NYSE Rule 401A is being consolidated into proposed FINRA Rules 3110(b)(5) and 4513

[31] NASD News Release, September 23, 2004.

[32] See letter to SEC from Phil Shaikun, dated March 8, 2004, which stated that "NASD believes that those mandated meetings present practical and important opportunity to discuss more broadly the quality of compliance, including such areas as resources, risk and deficiencies. Accordingly, NASD is amending the proposal to require that the CEO and CCO also discuss during their meetings the member's compliance efforts to date and that they further identify and address significant compliance problems and plans for emerging business areas. These enumerated topics in the amendment closely parallel the requirements in NYSE Rule 342.30."

We are appreciative of FINRA's efforts to streamline and reduce some of the content included in NYSE Rule 342.30 and eliminate the delivery of the annual report to Control Persons pursuant to NYSE Rule 354. In light of the Rule 3013 requirements and history, SIFMA members are disappointed that FINRA did not choose to eliminate in its entirety the NYSE annual report requirements. In fact, many firms have implemented regular meetings and reviews with business heads – not just the CEO – covering the same topics, namely compliance efforts, significant compliance problems and plans for emerging business areas. For dual member firms, the report requirement is cumbersome and time-consuming, replicating much of the processes implemented under NASD Rules 3012 and 3013. For NASD-only firms meeting the gross revenue threshold that will now be required to prepare an annual report, the proposed rule represents a significant expansion of their current obligations – increasing costs without any substantial additional mitigation of risks. Several large firms estimate that today it takes approximately 160 hours to prepare this report alone. Accordingly, SIFMA respectfully requests that FINRA eliminate the annual report requirement, and rely on existing proposed Rule 3120(a) and NASD Rule 3013.

We also believe that certain areas currently identified in proposed Rule 3120(b)(2) – Finance and Risk Management – are themselves control groups that operate quite independently and do not look to the Compliance Department to provide significant compliance support. Finance departments, generally, have detailed procedures that they have developed to comply with applicable law and regulations, are subject to Sarbanes Oxley requirements, independently audited, and, in general, are not "covered" by Compliance personnel. Risk Management departments tend to operate in a similar fashion and are subject to processes as to which Compliance personnel are not able or expected to provide support. Because of the broad range of processes associated with a firm's Risk Management practices it would be difficult and impractical to incorporate them into the proposed Rule 3120(b) report requirements. Therefore, if proposed Rule 3120(b) is retained, we recommend that the rule should be revised to exclude Finance and Risk Management from the specified areas included in the proposed rule.[33]

XIV. Supplementary Material .05 Annual Compliance Meeting

SIFMA strongly supports this provision, which codifies a no-action letter giving firms the flexibility to conduct the annual compliance meeting using methods other than in-person meetings. This flexibility is critical for geographically dispersed firms. SIFMA submits, however, that FINRA should move the specific examples in the Supplementary Material to a notice or general guidance. Examples provided in rules tend to become prescriptive over time, and there are several alternative ways that firms could meet the standards of the rule (*e.g.*, rather than tracking the time spent on a webcast, which does not measure the effectiveness of training, a firm could offer a quiz or provide another mechanism to evidence attendance). In addition, SIFMA suggests that the reference to "presenter" in Supplementary Material .05 be removed, as many webcasts have audio recordings and

[33] While not stated in Regulatory Notice 08-24, SIFMA assumes that (i) the requirements in NYSE 342.23, which are redundant with proposed Rule 3120(a), and (ii) the requirements in NYSE 342.30 pertaining to the annual report, the CEO certification, CEO meeting and CEO certification report, which are redundant with proposed Rule 3120(b) and existing Rule 3013, will be eliminated.

screens, rather than presenters, and employees with questions may be directed to an email address or group of individuals, rather than to a single presenter.

XV. Proposed Deletion of NYSE Rule 343 (Offices-Branch Office Space-Sharing Arrangements and Main Office of Business Hours)

Regulatory Notice 8-24 states that FINRA is proposing to delete NYSE Rule 343, which SIFMA strongly supports. However, SIFMA requests that FINRA also make corresponding revisions to FINRA's Form BR by eliminating the section of Form BR entitled "NYSE Office Space Sharing Form – Rule 343."

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SIFMA appreciates the opportunity to provide comments on FINRA's proposed new FINRA Rules 3110 and 3120 governing supervision and supervisory control requirements, and looks forward to continuing the dialogue as this initiative develops further. If you have any questions or require further information, please contact Amal Aly, SIFMA Managing Director and Assistant General Counsel at (212) 313-1268.

Sincerely,

Jill Ostergaard
Co-Chair
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CC: Mary Schapiro, Chief Executive Officer
Marc Menchel, Executive Vice President and General Counsel for Regulation
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