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Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2013-025 – Response to Comments

Dear Ms. Murphy:

This letter responds to comments submitted to the Securities and Exchange Commission (“SEC” or “Commission”) regarding the above-referenced rule filing,¹ a proposed rule change to adopt the consolidated FINRA supervision rules. The Commission received 572 comment letters in response to the Proposing Release, with 555 commenters using a form comment letter (“Letter Type A”), and 17 other commenters filing individual letters.²

¹ See Securities Exchange Act Release No. 69902 (July 1, 2013), 78 FR 40792 (July 8, 2013) (Notice of Filing of File No. SR-FINRA-2013-025) (the “Proposing Release”).

² 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. 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”); 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”); Brian P. Sweeney, Law Office of Brian P. Sweeney, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“Sweeney”); Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“ICI”); Robert J. McCarthy, Director of Regulatory Policy, Wells Fargo Advisors, LLC, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“Wells Fargo”); Susanne Denby, Chief Compliance Officer, NFP Securities, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“NFP”); Clifford Kirsch and Eric A. Arnold, Sutherland Asbill & Brennan LLP, on behalf of the Committee of Annuity

The proposed rule change would, in main part, adopt new FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) and delete NASD Rules 3010 (Supervision) and 3012 (Supervisory Control System), on which they are largely based. The proposed rule change also would delete Incorporated NYSE Rule 342 (Offices – Approval, Supervision and Control) and much of its supplementary material and interpretations as they are, in main part, either duplicative of, or do not align with, the proposed supervision requirements. The proposed rule change, however, would incorporate, on a tiered basis, specific provisions from Incorporated NYSE Rule 342. The proposed rule change also would 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) and replace NASD Rule 3110(i) (Holding of Customer Mail) with new FINRA Rule 3150 (Holding of Customer Mail).

The comments received by the Commission on the consolidated supervision rules proposal and FINRA’s responses to the comments are discussed in detail below.

A. General Comments

1. Support for Proposal

Several commenters expressed overall support for the proposed rule change³ and specific changes FINRA made in response to comments on SR-FINRA-2011-028 (the “Initial Filing”),⁴

Insurers, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“CAI”); Scott C. Ilgenfritz, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“PIABA”); David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“FSI”); 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”); 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 and Chief Compliance Officer, Charles Schwab & Co., Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (“Schwab”); 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”); A. Heath Abshure, President and Arkansas Securities Commissioner, North American Securities Administrators Association, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated August 6, 2013 (“NASAA”); *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 MSRB to discuss FINRA’s recently proposed rule change to adopt the proposed consolidated supervision rules).

³ SIFMA, Schwab, Sweeney, St. John’s, NFP, Cetera.

including requiring that supervisory procedures and corresponding amendments be communicated to relevant associated persons rather than throughout the organization; eliminating the requirement that associated persons verify annually that they have reviewed their firm's written supervisory procedures; eliminating risk management from the additional content requirements under proposed FINRA Rule 3120; and clarifying that supplementary material is part of the rule and the location of language within the supplementary material does not affect the weight or significance of a provision.⁵ Commenters also expressed support for FINRA's efforts to consolidate the existing NASD and Incorporated NYSE rules into the FINRA rulebook.⁶

2. Opposition to Risk-Based Review Principles

Two commenters opposed the proposed rules' flexibility permitting members to rely on risk-based or principles-based review standards for specific obligations, such as the review of securities transactions and correspondence, arguing that such flexibility would result in reduced or diminished supervisory requirements that would not achieve the purpose of protecting the investing public.⁷

As noted in the Proposing Release, the proposed rules' risk-based approach for certain aspects of a member's supervisory procedures is intended to further strengthen, not diminish, investor protection by allowing firms the flexibility to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concern may be warranted. In addition, the proposed rules further protect investors by retaining specific prescriptive requirements of NASD Rules 3010 and 3012, such as mandatory inspection cycles, prohibitions on who can conduct location inspections, and procedures for the monitoring of enumerated activities. The proposed rules also provide additional prescriptive requirements where necessary, including special supervision for supervisory personnel rather than just the existing special supervision for producing managers, specific procedures to detect and investigate potential insider trading violations, and additional content requirements for specific firms' annual reports. FINRA, however, understands concerns that additional guidance may be needed and intends to provide such guidance as circumstances warrant.

⁴ On June 10, 2011, FINRA filed with the SEC the Initial Filing, a proposed rule change to adopt the consolidated FINRA supervision rules, which addressed the comments received in response to *Regulatory Notice* 08-24 (May 2008). See Securities Exchange Act Release No. 64736 (June 23, 2011), 76 FR 38245 (June 29, 2011) (Notice of Filing of File No. SR-FINRA-2011-028). 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).

⁵ SIFMA, Schwab.

⁶ Wells Fargo, PIABA, NASAA.

⁷ PIABA, NASAA.

3. Reconsider Previously Proposed Supplementary Material

One commenter suggested that FINRA reconsider its decision to delete supplementary material previously proposed in the Initial Filing providing that for a member's supervisory system to be reasonably designed to achieve compliance with FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade), it must include supervision of all of a member's business lines irrespective of whether they require broker-dealer registration.⁸ FINRA continues to believe that it was the best course to eliminate the proposed supplementary material from the proposed rule, because of potential differences with the supervision requirements otherwise applicable to those business lines. As noted in the Proposing Release, FINRA will continue to apply FINRA Rule 2010's standards to non-securities activities of members and their associated persons consistent with existing case law.

4. Cost Benefit Analysis

One commenter stated its belief that the proposal's compliance costs would be minimal and outweighed by the benefits.⁹ Other commenters suggested that the proposal lacked a sufficient cost benefit analysis,¹⁰ with some commenters stating that FINRA had not provided any specific performance objectives or identified other metrics to which it may later refer to assess the effectiveness of the proposed changes.¹¹ One commenter acknowledged that it was not possible for FINRA to perform a thorough cost benefit analysis when the proposal was filed, but suggested that FINRA revisit the proposed rules within five years of their adoption to ensure they are achieving their stated purpose while avoiding unnecessary costs.¹²

The proposed rule change strives to minimize the membership's burden and cost of complying with the consolidated supervision rules, as consistent with their purposes. At the outset, FINRA notes that the consolidated supervision rules transfer much of the existing requirements in NASD Rules 3010 and 3012 relating to, among other things, supervisory systems, written procedures, internal inspections, review of correspondence, and supervisory controls. Thus, transferring these existing requirements does not raise additional costs or burdens for firms, because firms have already developed the necessary procedures and supporting systems to comply with those requirements. The proposed rule change also would delete Incorporated NYSE Rule 342 and much of its supplementary material and interpretations as they are, in main part, either duplicative of, or do not align with, the proposed supervision requirements, thereby reducing potential costs to firms that are members of both FINRA and the NYSE.

⁸ NASAA (referring to previously proposed FINRA Rule 3110.01 (Business Lines)).

⁹ St. John's.

¹⁰ FSI, Letter Type A, Brandenburger, IMS, Putnam.

¹¹ FSI, Letter Type A, Brandenburger, IMS.

¹² FSI.

As noted in the Proposing Release, FINRA also has applied a risk-based approach or similar flexibility for specified aspects of a member's supervisory procedures that is intended to allow firms the ability to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concerns may be warranted. Those aspects include:

- Permitting risk-based review of all transactions relating to a member's investment banking or securities business;¹³
- Permitting risk-based review of a member's correspondence and internal communications that fall outside of the subject matters listed in proposed FINRA Rule 3110(b)(4);¹⁴
- Providing exceptions, based on a member's size, resources, and business model, from proposed FINRA Rule 3110's provisions regarding the supervision of a member's supervisory personnel and the persons prohibited from conducting a location's inspections;¹⁵
- Requiring that only members reporting \$200 million or more in gross revenues in the preceding year (increased from the \$150 million threshold originally proposed in the Initial Filing) include in the annual report required by FINRA Rule 3120 supplemental information from Incorporated NYSE Rule 342.30's annual report content requirements;¹⁶
- Aligning proposed FINRA Rule 3110(d)'s definition of "covered account" with respect to detecting and investigating potential insider trading violations with existing NYSE guidance in response to commenters' concerns regarding compliance costs and burdens;¹⁷
- Replacing NASD Rule 3110(i) (Holding of Customer Mail) and its strict time limits for holding customer mail with proposed FINRA Rule 3150 (Holding of Customer Mail), which generally allows a member to hold a customer's mail for a specific time period in accordance with the customer's written instructions if the member meets specified conditions;¹⁸ and

¹³ See proposed FINRA Rule 3110(b)(2) and FINRA Rule 3110.05; *see also* Section E, page 12 of FINRA's response to comments.

¹⁴ See proposed FINRA Rule 3110(b)(4) and FINRA Rule 3110.06; *see also* Section F, page 14 of FINRA's response to comments.

¹⁵ See proposed FINRA Rule 3110(b)(6)(C)(ii) and FINRA Rule 3110(c)(3)(C); *see also* Section H, page 19 and Section K, page 24 of FINRA's response to comments.

¹⁶ See proposed FINRA Rule 3120(b); *see also* Section N, page 34 of FINRA's response to comments.

¹⁷ See proposed FINRA Rule 3110(d)(1)(A) through (D); *see also* Section L, page 29 of FINRA's response to comments.

¹⁸ See proposed FINRA Rule 3150(a) and (b).

- Deleting proposed supplementary material, in response to commenters' concerns regarding compliance costs and burdens, that would have required a senior principal to have a physical presence on a regular periodic schedule at a one-person office of supervisory jurisdiction ("OSJ") where the one-person OSJ principal was conducting sales-related activities.¹⁹

Moreover, FINRA agrees that the proposed consolidated supervision rules should be subject to a retrospective review process following an appropriate period after their implementation to determine whether they are achieving their intended purpose or have become overly burdensome.²⁰ FINRA would seek to consult with the membership, the public, and other stakeholders in analyzing the economic impact of the rules.

5. Include Other Supervisory-Related Requirements

Some commenters requested that FINRA revise the proposal to include provisions addressing other supervisory-related issues.²¹ Such issues include, for example, establishing a minimum ratio of producing representatives to compliance officers,²² requiring heightened supervision for associated persons with a high volume of complaints,²³ identifying and supervising suspicious withdrawal patterns,²⁴ and requiring special supervisory procedures for senior investors and non-English speaking customers.²⁵ At this time, however, FINRA believes

¹⁹ See Section C, page 8 of FINRA's response to comments.

²⁰ On September 19, 2013, FINRA issued a public statement, *Framework Regarding FINRA's Approach to Economic Impact Assessment for Proposed Rulemaking*, outlining the core principles defining FINRA's approach to conducting economic impact assessments for rulemaking. As noted in the public statement, the framework applies specifically to the prospective analysis of rules and rule changes. However, as noted in the framework, FINRA has historically taken into account the costs and burdens of its rulemaking, including the changes proposed in the proposed consolidated supervision rule filing.

²¹ Sweeney, St. John's, PIABA. In addition, IMS suggested that FINRA include in the proposal a specific presumption that a member firm's supervisory procedures would be presumed acceptable to FINRA examiners if the firm's procedures are properly documented and reasonable in light of the scope of its business, the extent of its customer contact, and its disciplinary history. However, as FINRA has noted previously, members retain the responsibility to design and implement supervisory procedures that are appropriate for their specific businesses and structures. *See Notice to Members 99-45* (June 1999).

²² Sweeney.

²³ PIABA.

²⁴ PIABA.

²⁵ St. John's.

that such matters should be considered as part of a member's establishment of a supervisory system and procedures reasonably designed to achieve compliance with the federal securities laws and FINRA rules, and the testing and verification of such procedures under FINRA Rule 3120. In this regard, FINRA has issued guidance addressing areas of concern, including supervision of associated persons with disciplinary history,²⁶ verification of emailed instructions to transmit or withdraw assets,²⁷ and obligations relating to senior investors.²⁸

6. Additional Comments

One commenter suggested that proposed FINRA Rule 3110 would require firms to have compliance departments that operate independently from their sales activity.²⁹ FINRA disagrees with this interpretation of proposed FINRA Rule 3110. Proposed FINRA Rule 3110, which is based primarily on existing requirements in NASD Rule 3010 and Incorporated NYSE Rule 342 relating to, among other things, supervisory systems, written procedures, internal inspections, and review of correspondence, is intended to allow firms the flexibility to establish their supervisory programs in a manner that reflects business, size, and organizational structure. Proposed FINRA Rule 3110 does not require that a member have an independent compliance department.

Another commenter requested that the proposed supplementary material be incorporated into the body of the proposed rules.³⁰ FINRA believes that this comment emanates from a misunderstanding of the role of supplementary material in FINRA rules. As noted in the Initial Filing and the Proposing Release, supplementary material is part of the rule and a provision's location as supplementary material is intended to improve the readability of the rule without affecting the weight, significance, or enforceability of the provision.

B. Comments on Proposed FINRA Rule 3110(a)

As proposed, FINRA Rule 3110(a) (Supervisory System) would require a member to have a supervisory system for the activities of its associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA and the Municipal Securities Rulemaking Board ("MSRB") rules. One commenter requested that FINRA delete proposed FINRA Rule 3110(a)'s reference to the MSRB rules.³¹ Proposed FINRA Rule 3110(a)'s reference to the MSRB rules was intended to clarify that members' supervisory systems must extend to compliance with MSRB rules and also to align FINRA's

²⁶ See, e.g., *Notice to Members* 97-19 (April 1997).

²⁷ See *Regulatory Notice* 12-05 (January 2012).

²⁸ See, e.g., *Regulatory Notice* 07-43 (September 2007).

²⁹ Sweeney.

³⁰ IMS.

³¹ ICI.

supervisory system requirement with the existing requirement under MSRB Rule G-27 (Supervision) to have a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations and MSRB rules.³² However, in light of a member's separate obligation to comply with MSRB Rule G-27, FINRA is deleting the proposal's references to the MSRB rules.

C. Comments on Deleted Supplementary Material Regarding One-Person OSJs

As proposed, FINRA Rule 3110 included supplementary material clarifying the conditions a firm must satisfy to establish a one-person OSJ consistent with proposed FINRA Rule 3110(a)(4)'s requirement to have one or more appropriately registered principals in each OSJ with authority to carry out the supervisory responsibilities assigned to that office. Specifically, proposed FINRA Rule 3110.03 (One-Person OSJs) expressly provided that the registered principal at a one-person OSJ ("on-site principal") cannot supervise his or her own sales activities and must be under the effective supervision and control of another appropriately registered principal ("senior principal"). The 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. In determining the schedule, the proposed supplementary material required a member to consider, among other factors, the nature and complexity of the securities activities for which the location is responsible, the nature and extent of contact with customers, and the disciplinary history of the principal at the one-person OSJ.

One commenter supported the proposed supplementary material,³³ although another commenter suggested that FINRA revise proposed FINRA Rule 3110.03 to specify that "no Registered Principal shall supervise his or her own sales activity," rather than relying on that statement in the Proposing Release.³⁴ However, numerous commenters raised concerns regarding the negative impact and costs of implementing the proposed requirement.³⁵ One commenter also stated that proposed FINRA Rule 3110.03 would create an inconsistency and serve little regulatory purpose by requiring the personal production of one-person OSJs to be supervised differently than an OSJ with multiple registered persons.³⁶ Several other commenters suggested that proposed FINRA Rule 3110.03 was unnecessary to ensure effective supervision³⁷

³² See MSRB Rule G-27(b) (Supervisory System).

³³ PIABA. PIABA also expressed overall support for proposed FINRA Rule 3110(a)(4) and the proposed supplementary material addressing the supervision of multiple OSJs by a single principal.

³⁴ FSI.

³⁵ Letter Type A, Brandenburger, Cetera, FSI, IMS, Putnam.

³⁶ Cetera.

³⁷ Letter Type A, Brandenburger, Putnam, IMS.

and could undermine many independent firms' overall supervisory structures³⁸ where home office principals supervise the sales activities of multiple field-OSJ principals to prevent conflicts of interest from self-supervision or use technology and annual inspections to augment their supervision.³⁹ Commenters also separately suggested that the requirement to have "on-site supervision on a regular periodic schedule" ignores firms' use of technology-based remote supervisory systems.⁴⁰ One commenter raised concerns that proposed FINRA Rule 3110.03 requires all necessary supervisory reviews of the one-person OSJ to be conducted by the senior principal and sought clarification that the proposed supplementary material does not limit comprehensive regional supervisory structures, where regional principals perform annual and unannounced inspections and a separate centralized supervisory unit within the home office is dedicated to overseeing specific functions that require specialized knowledge and experience such as correspondence, advertising, or trade review.⁴¹

FINRA believes that OSJs conduct critical functions and one-person OSJs present unique supervisory challenges. However, in light of commenters' continuing concerns regarding compliance costs and burdens, FINRA has decided that the best course is to eliminate the proposed supplementary material from the proposed rule.⁴² 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.⁴³ FINRA will apply to such locations the general requirements set forth in proposed FINRA Rule 3110(a)(5) that all registered persons must be assigned to an appropriately registered representative(s) or principal(s) who shall be responsible for supervising that person's activities and proposed

³⁸ Letter Type A, Brandenburger, IMS, Cetera.

³⁹ Cetera.

⁴⁰ Letter Type A, Brandenburger, Putnam, IMS.

⁴¹ FSI.

⁴² 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, FINRA's response to comments employs the new proposed numbers in all instances.

⁴³ See SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004) (reminding broker-dealers that small, remote offices require vigilant supervision and specifically noting that "[n]o individual can supervise themselves"); *NASD Regulatory & Compliance Alert*, Volume 11, Number 2 (June 1997) (cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves); see also *In re Stuart K. Patrick*, 51 S.E.C. 419, 422 (May 17, 1993) ("[s]upervision, by its very nature, cannot be performed by the employee himself") (SEC order sustaining application of the New York Stock Exchange's supervisory rule – also cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves).

FINRA Rule 3110(b)(6) that requires procedures prohibiting associated persons who perform a supervisory function from, among other things, supervising their own activities. In addition, FINRA will continue to monitor one-person OSJs for possible conflicts of interest or sales practice violations and may determine to address the matter further as part of a retrospective review process following an appropriate period after implementation of proposed FINRA Rule 3110.

D. Comments on Proposed FINRA Rule 3110.03

Proposed FINRA Rule 3110.03 (Supervision of Multiple OSJs by a Single Principal) clarifies the general requirement in proposed FINRA Rule 3110(a)(4) to have one or more appropriately registered principals in each OSJ with authority to carry out the supervisory responsibilities assigned to that office (each such person is hereinafter referred to as an “on-site principal”). Specifically, proposed FINRA Rule 3110.03 clarifies that the requirement to have an appropriately registered principal in each OSJ requires the designated on-site principal to have a physical presence, on a regular and routine basis, at the OSJ. FINRA strongly believes OSJs engage in critical functions, and the requirement to have on-site supervision by designating one or more on-site principals in each OSJ has been a long standing cornerstone in establishing a reasonable supervisory structure. As a result, proposed FINRA Rule 3110.03 sets forth a general presumption that a principal will not be designated and assigned to be the on-site principal pursuant to proposed FINRA Rule 3110(a)(4) to supervise more than one OSJ.

If a member determines it is necessary to assign one principal to be the designated on-site principal to supervise two or more OSJs, then the firm must consider, among other things, the following factors:

- Whether the on-site principal is qualified to supervise the activities and associated persons in each location;
- Whether the on-site principal has the capacity and time to supervise the activities and associated persons in each location;
- Whether the on-site principal is a producing registered representative;
- Whether the OSJ locations are in sufficiently close proximity to ensure that the on-site principal is physically present at each location on a regular and routine basis; and
- The nature of activities at each location, including size and number of associated persons, scope of business activities, nature and complexity of products and services offered, volume of business done, the disciplinary history of persons assigned to such locations, and any other indicators of irregularities or misconduct.

As originally proposed, supplementary material created a further general presumption that assigning a principal to be the on-site principal of more than two OSJs is unreasonable.

1. Clarification of Term “On-Site Principal”

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. Nevertheless, commenters requested that FINRA clarify in the rule text whether proposed FINRA Rule 3110.03’s terms “on-site supervisor” and “designated principal” refer to the same person.⁴⁴ In response, FINRA is revising proposed FINRA Rule 3110.03 to use the term “on-site principal” consistently throughout the provision.

2. Home Office Principals; Costly and Burdensome Implementation

Two commenters raised concerns with proposed FINRA Rule 3110.03.⁴⁵ One commenter requested that FINRA either “exclude ‘up-the-chain’ home office supervision of producing field OSJ principals” or more clearly address how the “physical presence” requirement applies to home office employee supervisors. The commenter specifically raised concerns about whether a home office principal with supervisory responsibilities over a particular business line conducted in the OSJ becomes the “on-site principal” and therefore would be required to have a physical presence on a regular basis.⁴⁶ The second commenter stated that proposed FINRA Rule 3110.03 does not provide sufficient flexibility, is too costly and burdensome to implement, and fails to take into account firms’ various business structures.⁴⁷

Proposed FINRA Rule 3110(a)(4), which requires a firm to have an appropriately registered principal *in each OSJ* with authority to carry out the supervisory responsibilities assigned to that office by the member, is being transferred unchanged from current NASD Rule 3010(a)(4).⁴⁸ Due to inquiries from firms asking if they could assign one principal to be the designated on-site principal to two or more OSJs consistent with the requirements of NASD Rule 3010(a)(4), FINRA staff developed informal guidance and interpretations under NASD Rule 3010(a)(4). Proposed FINRA Rule 3110.03 reflects these interpretations and consolidates them in one rule.

FINRA believes the proposed rule continues to provide firms with the flexibility to design supervisory systems suited for their business models, by allowing some flexibility in the presence of on-site supervisors if the firm can determine that the on-site principal has sufficient time and resources to engage in meaningful supervision of the critical functions that occur at another OSJ. Firms can designate more than one on-site principal at an OSJ to supervise activities at that OSJ based on particular business lines, and each such principal designated as an

⁴⁴ Cetera, FSI.

⁴⁵ Cetera, CAI.

⁴⁶ Cetera.

⁴⁷ CAI.

⁴⁸ Emphasis added.

on-site principal is required to have a physical presence on a regular basis. However, the on-site principal(s) is one part of a firm's comprehensive supervisory chain and not all "up the chain" supervisors must be designated as the on-site principal.

3. Elimination of Presumption that More Than Two OSJs is Unreasonable

In the proposal, FINRA identified the parameters that it believes are reasonable by expressly including the general presumptions in the rule. The general presumption that one principal should be assigned to be the on-site principal at one OSJ and the general presumption that assigning one principal to be the on-site principal at more than two OSJs is unreasonable, were intended to provide firms with clarity. The presumptions established guidelines, not rules, and firms could overcome the presumptions by demonstrating that assigning one principal to supervise more than two OSJs is reasonable based on the relevant factors set forth in proposed FINRA Rule 3110.03.⁴⁹ However, in response to comments, FINRA is proposing 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.

E. Comments on Proposed FINRA Rule 3110(b)(2) and FINRA Rule 3110.05

Proposed FINRA Rule 3110(b)(2) (Review of a Member's Investment Banking and Securities Business) requires that a member have supervisory procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the member's investment banking or securities business. Proposed FINRA Rule 3110.05 (Risk-based Review of Member's Investment Banking and Securities Business) permits a member to use a risk-based system to review these transactions.

1. Additional Clarification Regarding "Risk-Based Review System"

Commenters requested additional clarification regarding how to comply with proposed FINRA Rule 3110(b)(2)'s requirement to review all transactions related to a member's investment banking and securities business if using a risk-based system to review transactions pursuant to proposed FINRA Rule 3110.05. Specifically, two commenters asked whether a member's supervisory system must take into account "all" transactions, but that under a "risk-based review system," a principal only is required to review a sample of transactions.⁵⁰

⁴⁹ Cetera also stated that this presumption inappropriately shifts the burden of proof to the member and does not appear justified given the lower "preponderance of the evidence" standard of proof in FINRA disciplinary proceedings. FINRA disagrees with the commenter's statement. Proposed FINRA Rule 3110(a) specifies the standard that a member's supervisory system be reasonably designed to achieve compliance with the applicable federal securities laws and regulations and FINRA rules, and it is the member's responsibility to demonstrate that its supervisory system meets this standard.

⁵⁰ SIFMA, IMS.

Similarly, another commenter asked whether a member firm determining parameters for a technological-based review system that would cause a trade to be flagged for more intensive review would be a “risk-based” approach that would conform to proposed FINRA Rule 3110(b)(2).⁵¹

As noted in the Proposing Release, the term “risk-based” describes the type of methodology a member may use to identify and prioritize for review those areas that pose the greatest risk of potential securities laws and self-regulatory organization (“SRO”) rule violations. In response to commenters’ requests for clarification on risk-based reviews, FINRA is proposing to amend proposed FINRA Rule 3110.05 to state that a member is not required to conduct detailed reviews of each transaction 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.

Accordingly, FINRA understands that a member’s procedures for the review of its transactions by a registered principal may include the use of technology-based review systems with parameters designed to assess which transactions merit further review. However, FINRA notes that the parameters would have to be reviewed by a principal and such review be documented in writing. As is always the case with the exercise of supervision under FINRA rules, a principal’s use of any automated supervisory system, aid, or tool for the discharge of supervisory duties represents a direct exercise of supervision by that principal, and the principal remains responsible for the discharge of supervisory responsibilities in compliance with the proposed rule. In addition, a principal relying on a risk-based review system is responsible for any deficiency in the system’s criteria that would result in the system not being reasonably designed.⁵²

2. Exclude Specific Types of Broker-Dealers

One commenter requested that FINRA either exclude mutual fund underwriters and other members that do not have or maintain customer relationships or effect transactions with or for retail investors from proposed FINRA Rule 3110(b)(2) or explain how such members are expected to document compliance.⁵³

As noted in the Proposing Release, proposed FINRA Rule 3110(b)(2) transfers NASD Rule 3010(d)(1)’s provision requiring principal review, evidenced in writing, of all transactions and clarifies that such review include all transactions relating to the member’s investment banking or securities business. Thus, members, regardless of their business activities, currently are required to have a principal review all of their transactions. In addition, if mutual fund underwriters do not effect transactions, then the firms would have no review obligations pursuant

⁵¹ Cetera.

⁵² *See also Regulatory Notice 07-53* (November 2007) (Deferred Variable Annuities) (discussing use of automated supervisory systems).

⁵³ ICI.

to proposed FINRA Rule 3110(b)(2). However, FINRA understands that some underwriters do have customer relationships that could involve customer transactions, in which case such member firms would need to review those transactions pursuant to proposed FINRA Rule 3110(b)(2). In addition, proposed FINRA Rule 3110.05 permits a mutual fund underwriter to use a risk-based approach to review its transactions.

F. Comments on Proposed FINRA Rule 3110(b)(4) and Related Supplementary Materials

FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) requires a member to have procedures to review incoming and outgoing written (including electronic) correspondence and internal communications relating to its investment banking or securities business.⁵⁴ In particular, the supervisory procedures must require the member's review of: (1) incoming and outgoing written (including electronic) correspondence to properly identify and handle in accordance with firm procedures, customer complaints, instructions, funds and securities, and communications that are of a subject matter that require review under FINRA rules and federal securities laws; and (2) internal communications to properly identify communications that are of a subject matter that require review under FINRA rules and federal securities laws.⁵⁵

1. Risk-Based Review of Internal Communications

Proposed FINRA Rule 3110.06 (Risk-based Review of Correspondence and Internal Communications) requires a member, by employing risk-based principles, to decide the extent to which additional policies and procedures for the review of incoming and outgoing written (including electronic) correspondence and internal communications that fall outside of the subject matters listed in proposed FINRA Rule 3110(b)(4) are necessary for its business and structure.

While acknowledging that the Proposing Release modifies proposed FINRA Rule 3110(b)(4) and FINRA Rule 3110.06 to more precisely reflect *Regulatory Notice 07-59's* guidance regarding the ability to use risk-based principles to review internal communications,

⁵⁴ In the Proposing Release, proposed FINRA Rule 3110(b)(4) transferred NASD Rule 3010(d)'s reference to "correspondence with the public" and used the term in related supplementary materials, proposed FINRA Rules 3110.06-.08. FINRA is revising proposed FINRA Rule 3110(b)(4) and proposed FINRA Rules 3110.06-.08 to refer to "correspondence" to be consistent with FINRA Rule 2210's (Communications with the Public) definition and use of the term "correspondence." *See also* FINRA Rule 2210(b)(2) (requiring that all correspondence be subject to the supervision and review requirements of existing NASD Rule 3010(d)).

⁵⁵ FINRA is revising proposed FINRA Rule 3110(b)(4) and FINRA Rule 3110.06 to delete references to the MSRB rules, consistent with the deletion of such reference in proposed FINRA Rule 3110(a) discussed above.

some commenters suggested that FINRA should further align proposed FINRA Rule 3110.06 with *Regulatory Notice 07-59*'s guidance.⁵⁶ One commenter stated that the proposed rule could still be interpreted as requiring a member to review all internal communications.⁵⁷ Two commenters also requested additional guidance on the appropriate scope of internal communications requiring review and methodology for identifying such communications.⁵⁸ Commenters further suggested that any firm that does not engage in activities that are of a subject matter that require review should not be required to review its internal communications for references to such activities.⁵⁹ One commenter stated that requiring such firms to review internal communications for reference to those activities will result in significant costs that are not justified by the limited additional investor protection benefits.⁶⁰ Other commenters suggested that FINRA further revise proposed FINRA Rule 3110.06 to state that “[t]hrough the use of risk-based principles, firms can determine the extent to which the review of their internal communications is necessary.”⁶¹

Regulatory Notice 07-59 states that with respect to the review of internal communications, “with the exception of the enumerated areas requiring review by a supervisor, members may decide, employing risk-based principles, the extent to which review of any internal communications is necessary in accordance with the supervision of their business.”⁶² FINRA believes that proposed FINRA Rule 3110.06 accurately reflects this guidance by stating that “[b]y employing risk-based principles, a member must decide the extent to which additional policies and procedures for the review of . . . internal communications that are not of a subject matter that require review under FINRA rules and federal securities laws are necessary for its business and structure.” Also, consistent with *Regulatory Notice 07-59*'s guidance regarding the review of internal communications, proposed FINRA Rule 3110.06 does not require the review of every internal communication.⁶³ Thus, for instance, if a member does not engage in any activities that are of a subject matter that require review, the proposed rule would not require that the member review its internal communications for references to such activities, provided that its supervisory procedures acknowledged that factor as part of the member's determination that its

⁵⁶ Schwab, SIFMA, IMS, ICI.

⁵⁷ ICI.

⁵⁸ ICI, CAI.

⁵⁹ FSI, Letter Type A, Brandenburger, Putnam, IMS.

⁶⁰ FSI.

⁶¹ SIFMA, IMS.

⁶² *See Regulatory Notice 07-59* (December 2007), at 3, 9.

⁶³ *See id.* at 3 (specifically noting that the guidance neither created new supervisory requirements nor required the review of every communication, and that, “[w]ith respect to the review of internal electronic communications, the guidance states that—with the exception of the enumerated areas requiring review by a supervisor—a firm may use risk-based principles, including an examination of existing review processes, to determine the extent to which review of any internal communications is necessary”).

procedures were reasonably designed to achieve compliance with applicable federal securities laws and FINRA rules. Accordingly, FINRA is not proposing any revisions in response to the comments received.

2. Evidence of Review of Communications Using Lexicon-Based Screening Tools

Proposed FINRA Rule 3110.07 (Evidence of Review of Correspondence and Internal Communications) clarifies that merely opening a communication is not sufficient review. Instead, a member must identify what communication was reviewed, the identity of the reviewer, the date of review, and the actions taken by the member as a result of any significant regulatory issues identified during the review.

Commenters suggested that firms using lexicon-based screening tools as a risk-based means of reviewing communications should not need to maintain the documentation required by proposed FINRA Rule 3110.07 evidencing review for those communications that do not generate review alerts/hits for further review.⁶⁴ Instead, one commenter suggested that it should be sufficient for a member to demonstrate that it has reasonably designed controls in place to ensure that the screening tools are subject to review and are operating as intended,⁶⁵ while other commenters suggested revising proposed FINRA Rule 3110.07 to provide that “[f]or those communications subjected to electronic review, the member must maintain documentation reasonably sufficient to demonstrate the parameters of such review.”⁶⁶

As noted in the Proposing Release, FINRA previously declined to accept the suggestion that a member does not have to retain the specified information fields required by proposed FINRA Rule 3110.07 for communications reviewed through electronic review systems or lexicon-based screening tools if those messages do not generate review alerts. As FINRA stated, not only is the required documentation necessary to demonstrate that the communication was actually reviewed, failure to record and retain such information, such as the identity of the reviewer, could be inconsistent with a member’s record retention obligations required under FINRA and SEC rules.⁶⁷ Although proposed FINRA Rule 3110.07 permits the use of lexicon-based screening tools and other automated systems, as noted in *Regulatory Notice 07-59*, members utilizing automated tools or systems in the course of their supervisory review of electronic communications must have an understanding of the limitations of such tools or systems and should consider what, if any, further supervisory review is necessary in light of such

⁶⁴ SIFMA, ICI, IMS.

⁶⁵ ICI.

⁶⁶ SIFMA, IMS.

⁶⁷ See proposed FINRA Rule 3110.09 (Retention of Correspondence and Internal Communications); see also Securities Exchange Act of 1934 (“SEA”) Rule 17a-4(b)(4) (requiring, among other things, that a broker-dealer’s retained communications records include any approvals of communications sent).

limitations. However, with respect to communications reviewed by electronic surveillance tools that are not selected for further review, it would be sufficient to demonstrate compliance with proposed FINRA Rule 3110.07 if the electronic surveillance system has a means of electronically recording evidence that those communications have been reviewed by that system.

3. Retention of Correspondence and Internal Communications

Proposed FINRA Rule 3110.09 (Retention of Correspondence and Internal Communications) requires, among other things, that a member retain internal communications and correspondence of associated persons relating to the member's investment banking or securities business for the period of time and accessibility specified in SEA Rule 17a-4(b) (not less than three years, the first two years in an easily accessible place).

One commenter requested that FINRA expand the record retention period in proposed FINRA Rule 3110.09 to six years to match the record retention period in SEA Rule 17a-4(c) (requiring broker-dealers to preserve for a period of not less than six years after the closing of any customer's account any account cards or records relating to the terms and conditions with respect to the opening and maintenance of the account) and to the eligibility provisions for customer arbitration disputes in FINRA Rule 12206 (Time Limits).⁶⁸ FINRA notes that firms are already subject to very extensive record retention requirements regarding communications about firms' business as such.⁶⁹ FINRA also believes that the cost of extending the record retention period from three years to six years would unnecessarily raise costs and create recordkeeping inconsistencies. As noted in the Proposing Release and the Initial Filing, the proposed supplementary material purposefully aligns the record retention period for communications with the SEC's record retention period for the same types of communications to achieve consistent regulation in this area.

G. Comments on Proposed FINRA Rule 3110(b)(5)

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

1. Exclusion of Oral Complaints

Several customers argued that members should be required to reduce an oral complaint to writing or to provide the customer with a form.⁷⁰ Commenters also suggested that oral

⁶⁸ PIABA.

⁶⁹ *See generally* SEA Rule 17a-4(b)(4).

⁷⁰ PIABA, NASAA, St John's, Caruso.

complaints should not be too difficult to capture,⁷¹ with one commenter stating that NYSE members have been required to capture and assess oral complaints for a number of years.⁷²

As noted in the Proposing Release and the Initial Filing, FINRA did not include oral complaints because they are difficult to capture and assess, whereas members can more readily capture and assess written complaints. For these reasons, FINRA continues to believe that proposed FINRA Rule 3110(b)(5) should include only written customer complaints. However, as stated in the Proposing Release and the Initial Filing, FINRA encourages members to provide customers with a form or other format that will allow customers to communicate their complaints in writing. FINRA further reminds members that the failure to address a valid customer complaint, written or oral, may be a violation of FINRA Rule 2010.⁷³

FINRA notes that this aspect of the proposed rules does not change existing rules. Although Incorporated NYSE Rule 401A previously required firms to acknowledge and respond to specified customer complaints (both oral and written), to harmonize the NASD and NYSE rules in the interim period before completion of the Consolidated FINRA Rulebook, FINRA amended Incorporated NYSE Rule 351(d) (Reporting Requirements) to limit the definition of “customer complaint” to include only written complaints, thereby making the definition substantially similar to that in NASD Rule 3070(c) (Reporting Requirements).⁷⁴

2. Require More than Written Acknowledgement and Response

One commenter suggested that proposed FINRA Rule 3110(b)(5)’s requirement to capture, acknowledge, and respond to customer complaints was insufficient and that firms should

⁷¹ PIABA, NASAA, Caruso.

⁷² Caruso.

⁷³ In addition, FINRA’s investor education literature advises customers to communicate any complaints to their broker-dealer in writing, especially if customers have lost money or there were any unauthorized trades made in the customers’ accounts. *See* FINRA’s pamphlet [Investor Complaint Program: What to Do When Problems Arise](#); *see also* NASD Rule 2340(a) (Customer Account Statements) (requiring a customer account statement to, among other things, advise the customer that any oral communications should be re-confirmed in writing to further protect the customer's rights, including rights under the Securities Investor Protection Act (SIPA)).

⁷⁴ *See* Securities Exchange Act Release No. 58533 (September 12, 2008), 73 FR 54652 (September 22, 2008) (Order Approving File No. SR-FINRA-2008-036). FINRA adopted FINRA Rule 4530 to replace NASD Rule 3070 and comparable provisions in Incorporated NYSE Rule 351. *See* Securities Exchange Act Release No. 63260 (November 5, 2010), 75 FR 69508 (November 12, 2010) (Notice of Filing of Amendments No. 1 and 2 and Order Granting Accelerated Approval of File No. SR-FINRA-2010-034). FINRA Rule 4530 became effective on July 1, 2011. *See* Regulatory Notice 11-06 (February 2011).

be required to conduct an adequate and objective review and ongoing monitoring of claims that include, where appropriate, “bona fide” offers of resolution, including trade reversal and cancellation, good faith pre-arbitration or litigation discussion, or negotiation.⁷⁵

FINRA understands the commenter’s concerns that members have procedures in place to take appropriate and meaningful action with respect to customer complaints and expects that a member’s supervisory procedures will be reasonably designed to respond to customer complaints. In addition, members have reporting and records preservation obligations for customer complaints that assist FINRA in monitoring whether a member’s supervisory procedures for capturing, acknowledging, and responding to written customer complaints are reasonably designed.⁷⁶

H. Comments on Proposed FINRA Rule 3110(b)(6) and FINRA Rule 3110.10

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

- Proposed FINRA Rule 3110(b)(6)(C) requires a member to have procedures prohibiting its supervisory personnel from supervising their own activities and reporting to, or having their compensation or continued employment determined by, a person the supervisor is

⁷⁵ Arnoff. Arnoff also requested that it be mandatory for broker-dealers to pay for the customer’s litigation and arbitration expenses if good faith and objectively sound procedures of supervision, compliance, inspection, and claims handling are not followed. FINRA considers the comment to be outside the scope of the proposed rule change. However, the [FINRA Dispute Resolution Arbitrator’s Guide](#) discusses when arbitration fees and expenses may be waived or awarded.

⁷⁶ See FINRA Rule 4513 (Records of Written Customer Complaints) (requiring each member to keep and preserve in each OSJ either a separate file of all written customer complaints that relate to that office (including complaints that relate to activities supervised from that office) and action taken by the member, if any, or a separate record of such complaints and a clear reference to the files in that office containing the correspondence connected with such complaints); *see also* FINRA Rule 4530 (requiring each member to promptly report to FINRA, but in any event not later than 30 calendar days, after the member knows or should have known of whether the member or a member’s associated person is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery, as well as report to FINRA statistical and summary information regarding written customer complaints in such detail as FINRA shall specify by the 15th day of the month following the calendar quarter in which customer complaints are received by the member).

supervising (subject to a limited size and resources exception to this general requirement); and

- Proposed FINRA Rule 3110(b)(6)(D) requires a member to have procedures to prevent the standards of supervision required pursuant to proposed FINRA Rule 3110(a) from being reduced in any manner due to any conflicts of interest that may be present with respect to the associated person being supervised, such as the person's position, the amount of revenue such person generates for the firm, or any compensation that the supervisor may derive from the associated person being supervised.

Proposed FINRA Rule 3110.11 (Supervision of Supervisory Personnel) indicates that the exception provided in proposed FINRA Rule 3110(b)(6)(C) is generally intended for a sole proprietor in a single-person firm or where a supervisor holds a very senior executive position within the firm.

1. Support for New Provisions

Several commenters supported proposed FINRA Rules 3110(b)(6)(C) and (D),⁷⁷ with one commenter stating that the provisions "should never be diluted."⁷⁸ Specifically referring to proposed FINRA Rule 3110(b)(6)(D)'s conflicts of interest proscriptions, one commenter stated that the provision eliminates the opportunity for activities going unchecked or supervision being more lenient on the basis of self-interest,⁷⁹ while another commenter agreed that conflicts of interest relating to the compensation of the supervisor and the person being supervised should not needlessly compromise the effectiveness of supervisory procedures.⁸⁰ Referring to proposed FINRA Rule 3110(b)(C)'s prohibitions against supervisory personnel supervising their own activities, a commenter concurred that self-supervision is inappropriate.⁸¹

2. Heightened Supervision

As noted in the Proposing Release, proposed FINRA Rule 3110(b)(6)(C) would replace NASD Rule 3012(a)(2)'s provisions concerning the supervision of a producing manager's customer account activity and the requirement to impose heightened supervision when any producing manager generates 20 percent or more of the revenue of the business units supervised by the producing manager's supervisor. One commenter suggested that FINRA retain the heightened supervisory requirement for producing managers that meet the 20 percent threshold

⁷⁷ SIFMA, Sweeney, Cetera, St. John's.

⁷⁸ Sweeney.

⁷⁹ St. John's.

⁸⁰ SIFMA.

⁸¹ Cetera.

and apply FINRA Rule 3110(b)(6)(C) to producing managers that do not meet the 20 percent threshold.⁸²

Although FINRA understands the commenter's concerns regarding the need for effective supervision of producing managers, FINRA believes that proposed FINRA Rule 3110(b)(6)(C)'s provisions addressing the supervision of all supervisory personnel, rather than just producing managers, are better designed to prevent supervisory situations from occurring that would not lead to effective supervision. In addition, proposed FINRA Rule 3110(b)(6)(D)'s conflicts of interest provisions are designed to further ensure effective supervision of supervisory personnel.

3. Review of Senior Executive's Activities

One commenter stated that proposed FINRA Rule 3110(b)(6)(C) could prevent compliance professionals in the firm from reviewing the firm's most senior person's activities where that senior person occasionally produces revenue, and might force a firm to hire a "senior principal" if the senior person in the firm determines the compliance professionals' compensation or continued employment with the firm.⁸³

FINRA disagrees with the commenter's interpretation of proposed FINRA Rule 3110(b)(6)(C). Although proposed FINRA Rule 3110(b)(6)(C)(ii) does generally require a member to have procedures prohibiting its supervisory personnel from, among other things, reporting to, or having their compensation or continued employment determined by, a person the supervisor is overseeing, the same provision specifically provides an exception from this prohibition if a member determines that compliance with such prohibition is not possible because of a member's size or a supervisory personnel's position within the firm. If a member determines to rely on the exception, proposed FINRA Rule 3110(b)(6)(C) requires a member to document the factors it used to reach such determination and how the supervisory arrangement otherwise complies with proposed FINRA Rule 3110(a). Proposed FINRA Rule 3110.10 further provides non-exclusive examples of situations where the exception would generally apply, including where a registered person is a senior executive officer (or holds a similar position). Proposed FINRA Rule 3110(b)(6)(C) and FINRA Rule 3110.10 do not require that a member hire additional personnel to rely on the exception.

4. Limited Exception

One commenter requested that FINRA either delete or revise proposed FINRA Rule 3110.10 to expand the list of situations where a firm may rely on the exception to include situations where a person supervises a senior person for only a limited purpose or function.⁸⁴

⁸² NASAA.

⁸³ IMS.

⁸⁴ ICI.

FINRA addressed a similar comment in the rule filing and declined to make any revisions to proposed FINRA Rule 3110.10. The exception in proposed FINRA Rule 3110(b)(6)(C) is specifically based on a member's inability to comply with the general supervisory requirements because of the member's size or supervisory personnel's position within the firm.⁸⁵ As stated in the Proposing Release, proposed FINRA Rule 3110.10 reflects FINRA's belief that a member will generally rely on the exception for a sole proprietor in a single-person firm or where a supervisor holds a very senior executive position within the firm. However, a member may still rely on the exception in other instances where it cannot comply because of its size or the supervisory personnel's position within the firm, provided the member documents the factors used to reach its determination and how the supervisory arrangement with respect to the supervisory personnel otherwise complies with proposed FINRA Rule 3110(a).⁸⁶

5. Conflicts of Interest

Commenters expressed concern that requiring members to have procedures to prevent the supervision standards from being reduced in any manner due to any conflicts of interest that may be present was inconsistent with the existing "reasonably designed" standard set forth in proposed FINRA Rule 3110(a) (and current NASD Rule 3010(a)) and the proposed rules' risk-based supervision principles.⁸⁷ One commenter questioned whether proposed FINRA Rule 3110(b)(6)(D) creates a strict liability standard with respect to eliminating conflicts of interest.⁸⁸ To address these concerns, commenters requested that FINRA revise proposed FINRA Rule 3110(b)(6)(D) to clarify that firms must mitigate conflicts of interest as part of designing and establishing a reasonable supervisory system,⁸⁹ with two commenters suggesting that FINRA amend the proposed supplementary material to require a member to have ". . . procedures reasonably designed to prevent the [standards of supervision] supervisory system required pursuant to paragraph (a) of this Rule from being reduced [in any manner]" ⁹⁰

⁸⁵ Proposed FINRA Rule 3110(b)(6)(C)'s exception is based, in large part, on the exception in NASD Rule 3012 from the general supervisory requirement for a producing manager's customer account activity. *See* NASD Rule 3012(a)(2)(A)(ii) ("Limited Size and Resources" Exception).

⁸⁶ To clarify that proposed FINRA Rule 3110.10 provides non-exclusive examples of situations where the exception would generally apply, FINRA is revising the provision to delete the term "only" prior to providing the examples.

⁸⁷ Schwab, SIFMA, Cetera, IMS.

⁸⁸ Schwab. NASAA raised similar concerns, asking whether proposed FINRA Rule 3110(b)(6)(C) requires a member's supervisory procedures to be designed to limit all conflicts of interest or solely be reasonably designed to eliminate conflicts of interest.

⁸⁹ Schwab, SIFMA, IMS.

⁹⁰ SIFMA, IMS.

In response, FINRA is revising proposed FINRA Rule 3110(b)(6)(D) to respond to commenters, thereby clarifying that the provision does not create a strict liability obligation requiring identification and elimination of all conflicts of interest. 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 paragraph (a) of this Rule from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised”

J. Comments on Proposed FINRA Rule 3110(b)(7) and FINRA Rule 3110.11

Proposed FINRA Rule 3110(b)(7) (Maintenance of Written Supervisory Procedures) requires a member to retain and keep current a copy of the member’s written supervisory procedures at each OSJ and at each location where supervisory activities are conducted on behalf of the member.

Proposed FINRA Rule 3110.11 (Use of Electronic Media to Communicate Written Supervisory Procedures) permits a member to satisfy its obligation to communicate its written supervisory procedures, and any amendments thereto, using electronic media, provided that the member complies with specific conditions, including that the written supervisory procedures have been promptly communicated to, and are readily accessible by, all associated persons to whom such supervisory procedures apply based on their activities and responsibilities.

Two commenters requested that FINRA permit firms the flexibility to determine who should receive which portions of their written supervisory procedures, if any, and not interpret proposed FINRA Rule 3110(b)(7) to require communication of written supervisory procedures and amendments to non-supervisory personnel.⁹¹ The commenters stated that at many firms, written supervisory procedures are intended solely for supervisors while other documents (*e.g.*, compliance policies) are intended for the broader audience of all associated persons. In addition, the commenters noted that there may be written supervisory procedures (*e.g.*, how employee correspondence and trading are reviewed) that member firms do not want to be disseminated because the broad dissemination of such procedures may undermine their effectiveness.

As noted in the Proposing Release, FINRA addressed a similar request and declined to make any changes. FINRA continues to believe that it is important that all associated persons have knowledge of the supervisory procedures relevant to their activities.⁹² However, proposed FINRA Rule 3110(b)(7) and related supplementary material do not prohibit a firm from providing only its supervisory personnel with the written supervisory procedures’ parameters

⁹¹ SIFMA, IMS.

⁹² *See also Notice to Members 99-45* (June 1999) (distinguishing between a member’s compliance procedures and written supervisory procedures and specifying that “[i]t is crucial that all persons associated with a member be informed of any changes in the supervisory system and applicable written procedures. [NASD Rule 3010(b)(3)], therefore, requires members to inform all associated persons of such changes.”).

detailing how a firm monitors or reviews its associated persons' activities to detect and prevent potential violative conduct (*e.g.*, parameters detailing how a firm reviews an associated person's correspondence or trading).

K. Comments on Proposed FINRA Rule 3110(c) and Proposed FINRA Rules 3110.13 and 3110.14

Proposed FINRA Rule 3110(c)(1) (Internal Inspections), based largely on NASD Rule 3010(c)(1), retains the existing requirements for each member to review, at least annually, the businesses in which it engages and inspect each office on a specified schedule. The provision also retains the existing requirement that the member's annual review must be reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA rules.⁹³

1. Impose Additional Inspection Safeguards

Although one commenter supported proposed FINRA Rule 3110(c)(1),⁹⁴ another commenter suggested that firms be required to conduct more frequent inspections to ensure that risks created by a firm's size, location, and resources are addressed.⁹⁵ The commenter also suggested that firms hire third-party vendors to monitor a firm's activities and conduct independent compliance audits, as well as have a registered principal or compliance professional sign off on all compliance, supervisory, and inspection reports representing that to their knowledge and good faith belief, the report is true and correct.

FINRA is not making changes to proposed FINRA Rule 3110(c)(1). As stated in both the Proposing Release and the Initial Filing, the proposed rule change generally provides members with flexibility to conduct their inspections using only firm personnel. Such flexibility, in turn, assists firms in managing compliance costs. With respect to addressing potential risk gaps, proposed FINRA Rule 3120 requires that firms test and verify, at least annually, that the member's supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA rules and, if necessary, create any additional or amended supervisory procedures in response to those test results. This testing and verification would necessarily include any supervisory procedures regarding a member's inspections to ensure that inspections have not been compromised by any potential risks inherent to a member's size, location, or resources.

⁹³ FINRA is revising proposed FINRA Rule 3110(c)(1) to delete references to the MSRB rules, consistent with the deletion of such reference in proposed FINRA Rule 3110(a) discussed above.

⁹⁴ St. John's.

⁹⁵ Arnoff.

2. Exclude Residences from Inspections

Two commenters requested that FINRA exclude residences from proposed FINRA Rule 3110(c)(1)'s required inspections of a firm's locations,⁹⁶ with one commenter suggesting that other types of review, such as review of a registered person's email would be a more effective way of identifying potential red flags.⁹⁷

FINRA disagrees with the commenters' suggestions to exclude from proposed FINRA Rule 3110(c)'s inspection requirements those residences that would be considered an OSJ or supervisory branch office, non-supervisory branch office, or non-branch location. FINRA has previously noted that inspections are a crucial component of detecting and preventing regulatory and compliance problems of associated persons working at unregistered offices. Some unregistered offices also operate as separate business entities under names other than those of the members. While FINRA does not encourage or discourage such arrangements, a large number of geographically separate offices present the potential that sales practice problems will not be as quickly identified as would be the case for larger, centralized branch offices.⁹⁸ Remote supervision, such as reviewing email for "red flags," would not be a sufficient substitution for an actual inspection, although red flags identified through such means could be helpful in determining whether to conduct unannounced location inspections.

3. Remove Presumption for Periodic Inspection Schedules

One commenter requested that FINRA delete proposed FINRA Rule 3110.13 (Presumption of Three-Year Limit for Periodic Inspection Schedules), which sets forth a general presumption of a three-year limit for periodic non-branch location inspection schedules, and allow each member to determine what would be an appropriate inspection period for their non-branch locations.⁹⁹

FINRA declines to make the suggested change. Proposed FINRA Rule 3110.13 provides members with the flexibility to use an inspection schedule period that is either shorter or longer than three years. If a member chooses to use a periodic inspection schedule longer than three years, then the proposed supplementary material requires the member to properly document the factors used in determining the appropriateness of the longer schedule.

4. Test and Verify Policies and Procedures Regarding Specified Activities

Proposed FINRA Rule 3110(c)(2)(A) relocates provisions in NASD Rule 3012 regarding the review and monitoring of specified activities, such as transmittals of funds and securities and

⁹⁶ ICI, IMS.

⁹⁷ IMS.

⁹⁸ *See Notice to Members 98-38 (May 1998).*

⁹⁹ ICI.

customer changes of address and investment objectives. Specifically, proposed FINRA Rule 3110(c)(2)(A) requires a member to test and verify a location's procedures for:

- Safeguarding of customer funds and securities;
- Maintaining books and records;
- Supervision of supervisory personnel;
- Transmittals of funds or securities from customers to third party accounts, from customer accounts to outside entities, from customer accounts to locations other than a customer's primary residence, and between customers and registered representatives, including the hand-delivery of checks; and
- Changes of customer account information, including address and investment objective changes and validation of such changes.

With respect to the transmittal of funds or securities from customers to third party accounts, the proposal eliminates NASD Rule 3012's parenthetical text ("*i.e.*, a transmittal that would result in a change in beneficial ownership)" to clarify that all transmittals to an account where a customer on the original account is not a named account holder are included.

One commenter objected to the deletion of the parenthetical (*i.e.*, a transmittal that would result in a change in beneficial ownership) relating to the transmittal of funds or securities from third-party accounts, as the deletion could expand application of the rule to transfers not currently captured by existing rule text, such as transfers from a joint account to an account of one of the joint account holders. The commenter suggested that the proposed change is inconsistent with contractual agreements involving joint account holders and member firms, potentially conflicts with applicable state and federal laws, and impacts member firms' operations.¹⁰⁰

FINRA believes that the deletion of the reference to beneficial ownership aids in preventing conflict of law issues, as the meaning of that term may vary depending on the context in which it is used and the law applying to that situation. In addition, the provision does not prohibit transfers to third-party accounts, but only requires a firm to have procedures for the monitoring of such transfers and have a means of customer confirmation, notification, or follow-up that can be documented. Such follow-up procedures provide an important investor protection function by verifying that the customer was aware of the transfer.

Another commenter asked whether proposed FINRA Rule 3110(c)(2)(A)'s requirement to review changes of customer account information, including address and investment objective changes, requires a member to review all changes of customer account information.¹⁰¹ In response, FINRA notes that, consistent with existing requirements,¹⁰² a member must review all

¹⁰⁰ Schwab.

¹⁰¹ ICI.

¹⁰² *See, e.g.*, NASD Rule 3010(c)(2)(F).

changes of customer account information and not only address and investment objective changes. Examples of other changes to customer account information would include, without limitation, changes to a customer's name, marital status, telephone, email, or other contact information. However, a firm may delegate reviews of such changes to an appropriately qualified person who is not a principal, unless another FINRA or SEC rule would require principal review (*e.g.*, FINRA Rule 4515 (Approval and Documentation of Changes in Account Name or Designation) prohibiting an account name or designation change unless authorized by a qualified and registered principal designated by the member).

Two commenters also requested that FINRA permit member firms to identify in their written supervisory or compliance procedures or other field manual the activities enumerated in FINRA Rule 3110(c)(2)(A) that they do not engage in rather than requiring them to be documented in a location's written inspection report.¹⁰³ In *Regulatory Notice* 08-24, the proposal provided that a member must document the enumerated activities in which it did not engage in its written supervisory procedures. However, in response to commenters' objections, FINRA revised the proposed rule change to retain the requirement that a member identify in a location's written inspection report any enumerated activities the member does not engage in at that location and document in that location's report that the member must have in place at that location supervisory policies and procedures for those activities before the location can engage in them.

However, in light of the continued comments, FINRA is proposing to revise proposed Rule 3110(c)(2)(D) to require members to identify in their written supervisory procedures *or* in the location's written inspection report the activities enumerated in FINRA Rule 3110(c)(2)(A) the member does not engage in at a particular location and document in their written supervisory procedures *or* that location's written inspection report that supervisory policies and procedures must be in place for those activities at that location before the member can engage in them. FINRA believes this will provide firms with additional flexibility in meeting the requirement, while still allowing an examiner to readily determine what enumerated activities a location does not engage in by referencing the firm's written supervisory procedures or the location's most recent inspection report.

5. Conflicts of Interest

Commenters expressed concerns that proposed FINRA Rule 3110(c)(3)(A) could be interpreted to create a new strict liability standard that would require members to eliminate all conflicts of interest with respect to a location's inspections¹⁰⁴ and suggested revising the provision to provide more flexibility.¹⁰⁵ In response, FINRA is revising proposed FINRA Rule 3110(c)(3)(A) to require that a member have "procedures reasonably designed to prevent the effectiveness of the inspections required pursuant to paragraph (c)(1) of this Rule from being

¹⁰³ ICI, FSI.

¹⁰⁴ SIFMA, IMS, Cetera.

¹⁰⁵ SIFMA, IMS, CAI.

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.”

One commenter also asked whether the requirement to consider the “economic, commercial, or financial interests in the associated persons and businesses being inspected” when determining if conflicts of interest have reduced inspection standards is intended to prohibit an OSJ principal from conducting inspections of branch and non-branch offices designated to that OSJ principal if he receives overrides from business conducted at that location.¹⁰⁶ FINRA notes that the revised language in proposed FINRA Rule 3110(c)(3)(A) clarifies that a member’s procedures must take into consideration factors such as economic, commercial, or financial interests in the associated persons and businesses being inspected, when determining if members have procedures reasonably designed to reduce conflicts of interest that may be present with respect to a location being inspected. The provision is not intended to address directly who a member may designate to inspect a location. However, a member assigning an OSJ principal to inspect a branch or non-branch office designated to that OSJ principal would need to ensure that it complies with proposed FINRA Rules 3110(c)(3)(B) (prohibitions regarding who may conduct inspections) and 3110(c)(3)(C) (limited exception from these prohibitions), which are discussed further below.

6. Associated Persons Conducting Inspections

Proposed FINRA Rule 3110(c)(3)(B) generally prohibits an associated person from conducting a location’s inspection if the person is either assigned to that location or is directly or indirectly supervised by someone assigned to that location. One commenter asked whether compliance personnel who operate independently from the branch office or OSJ to which they are assigned (and are supervised by the compliance manager and not by the branch office or OSJ manager) would be permitted to inspect such branch or OSJ.¹⁰⁷ In response, FINRA notes that the proposed provision would not prohibit compliance personnel assigned to a member’s separate compliance department and supervised solely by the compliance department from conducting a location’s inspections. Such an arrangement helps to protect against the potential conflicts of interest the provision is designed to address.

7. Reliance on the Limited Size and Resources Exception

Proposed FINRA Rule 3110(c)(3)(C) provides an exception for those members that cannot comply with proposed FINRA Rule 3110(c)(3)(B)’s restrictions prohibiting certain associated persons from conducting a location’s inspection, either because of a member’s size or its business model. Proposed FINRA Rule 3110.14 (Exception to Persons Prohibited from Conducting Inspections) sets forth the general view that a member with only one office or an independent contractor business model will need to rely upon the exception.

¹⁰⁶ Cetera.

¹⁰⁷ ICI.

One commenter requested that FINRA amend proposed FINRA Rule 3110.14 to include home or administrative office personnel conducting home or administrative office inspections as one of the enumerated situations covered by proposed FINRA Rule 3110.14.¹⁰⁸ As the Proposed Release noted, FINRA previously considered this comment. Proposed FINRA Rule 3110.14 reflects FINRA's belief that a member will generally rely on the exception in instances where the member has only one office or has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager. However, a member may still rely on the exception in proposed FINRA Rule 3110(c)(3)(c) in other instances provided it documents the factors the member used in making its determination that it needs to rely on the exception.¹⁰⁹

L. Comments on Proposed FINRA Rule 3110(d)

Proposed FINRA Rule 3110(d)(1) (Transaction Review and Investigation) requires a member to have supervisory procedures to review securities transactions that are effected for a member's or its associated persons' accounts, as well as any other "covered account," to identify trades that may violate the provisions of the SEA, its regulations, or FINRA rules prohibiting insider trading and manipulative and deceptive devices. The proposed rule also requires members to promptly conduct an internal investigation into any such trade to determine whether a violation has occurred, and firms engaged in "investment banking services" are required to report information regarding these investigations to FINRA.

The commenters' primary concerns related to the scope of the proposed definition of "covered account" and the reporting requirements extending to certain types of investment banking services that commenters asserted pose less risk of insider trading. As discussed below, FINRA is proposing to revise the definition of "covered account" in response to these comments but is not proposing changes to the reporting requirement.

1. Definition of "Covered Account"

As proposed, FINRA Rule 3110(d)(3)(A) defined "covered account" to apply to two types of accounts: (i) the accounts of parents, siblings, fathers-in-law, mothers-in-law, and domestic partners if the account is held at or introduced by the member and (ii) accounts that are reported to the member pursuant to NASD Rule 3050 (Transactions for or by Associated Persons) or Incorporated NYSE Rule 407 (Transactions—Employees of Members, Member

¹⁰⁸ CAI.

¹⁰⁹ To clarify that proposed FINRA Rule 3110.14 provides non-exclusive examples of situations where the exception would generally apply, FINRA is revising the provision to delete the term "only" prior to providing the examples.

Organizations and the Exchange), as applicable.¹¹⁰ Multiple commenters objected to the breadth of the definition of “covered account,” in particular, the extension of the term to include more remote family members.¹¹¹ Several commenters noted that the proposed definition went beyond the terms of existing NYSE rules and guidance, on which proposed Rule 3110(d) is based, and would create unnecessary difficulty for firms in monitoring trading in the accounts of more distant relatives, with whom an associated person may not have regular contact. Multiple commenters suggested that FINRA harmonize the scope of the term “covered account” with existing NYSE guidance and with SEC rules addressing similar types of concerns (*e.g.*, the scope of the SEC’s Code of Ethics rules for investment advisers).¹¹²

In light of the concerns raised by commenters, FINRA is proposing amendments to the definition of “covered account” to align the definition with existing NYSE guidance, which has been in place since 1989.¹¹³ Under the revised definition, the term “covered account” includes 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.¹¹⁴ FINRA believes that the amended definition strikes an appropriate balance between ensuring that trading activity in the accounts that present

¹¹⁰ One commenter sought to confirm that the proposed rule would not modify obligations imposed by NASD Rule 3050. *See* CAI. Nothing in proposed Rule 3110(d) would alter reporting obligations pursuant to other FINRA rules, including NASD Rule 3050.

¹¹¹ Brandenberger, CAI, FSI, ICI, IMS, Letter Type A, Putnam, SIFMA. Several commenters also expressed the view that the term “domestic partner” was vague. *See* Brandenberger, CAI, FSI, IMS, Letter Type A. Because FINRA is proposing to narrow the scope of the term, including removing the reference to domestic partners, FINRA is not addressing this comment.

¹¹² CAI, ICI, IMS, Schwab, SIFMA, Wells Fargo. Some commenters also expressed privacy concerns with the breadth of the proposed definition. *See* CAI, FSI, ICI, IMS, Schwab, SIFMA, Wells Fargo. FINRA believes that the proposed changes described below respond to the concerns; however, FINRA does not believe the initial definitions implicated privacy concerns since the accounts covered by the rule must be introduced or carried by the firm.

¹¹³ *See* NYSE Information Memo 89-17 (April 4, 1989).

¹¹⁴ In addition to “covered accounts,” the proposed rule also applies to accounts of the member, accounts introduced or carried by the member in which a person associated with the member has a beneficial interest or the authority to make investment decisions, and accounts of a person associated with the member that are disclosed to the member pursuant to NASD Rule 3050 or Incorporated NYSE Rule 407, as applicable.

the greatest risk of insider trading are reviewed while not imposing undue compliance burdens on firms.

2. Internal Investigation Reporting

As proposed, FINRA Rule 3110(d)(2) imposes reporting requirements for internal investigations undertaken by members that engage in “investment banking services.” Proposed FINRA Rule 3110(d)(3)(B) defines the term “investment banking services” to include, without limitation, acting as an underwriter, participating in a selling group in an offering for the issuer, or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger or acquisition; providing venture capital or equity lines of credit or serving as placement agent for the issuer or otherwise acting in furtherance of a private offering of the issuer. Two commenters objected to the definition of “investment banking services,” noting that the term includes underwriting products that present less risk of insider trading, such as mutual funds and variable insurance products.¹¹⁵

Both commenters repeat objections noted in the Proposing Release and to which FINRA responded; however, FINRA reiterates that it does not believe that any of the categories of activities identified by the commenters should be categorically excluded from the definition of “investment banking services” given its limited use for the purposes of proposed FINRA Rule 3110. As noted in the Proposing Release, all members, including those who engage in “investment banking services,” are subject to Section 15(g) of the SEA and, under the proposed rule change, are required to include in their supervisory procedures a process for reviewing securities transactions and promptly conducting an internal investigation into any trade that may violate the provisions of the SEA, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices. The only additional requirement of those firms that engage in “investment banking services” is that they report information regarding their internal investigations to FINRA.¹¹⁶

FINRA disagrees with the commenters’ assertions that FINRA has failed to take into account the potential costs and burdens to firms associated with adopting policies and procedures and systems to ensure compliance with the rule. As an initial matter, FINRA notes that these same entities are already subject to Section 15(g) of the SEA, which requires all broker-dealers to “establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer.” As emphasized throughout the Proposing Release, firms

¹¹⁵ CAI, ICI.

¹¹⁶ Although one commenter asserts that “the proposed rule would require any member that engages in ‘investment banking services’ to file with FINRA *each quarter*, a written report that is signed by a senior officer of the member,” as noted in the Proposing Release, “if a member did not have an open internal investigation or either initiate or complete an internal investigation during a particular calendar quarter, the member would not be required to submit a report for that quarter.” *See* ICI (emphasis in original).

are permitted to take a risk-based approach to monitoring transactions that takes into account a firm's specific business model, which would include the type of underwriting activity performed by the firm. In fulfilling their obligations, firms may determine that certain departments or employees pose a greater risk and examine trading in those accounts accordingly. As the Proposing Release noted, there is no implied obligation on firms as to how best to conduct the reviews. Thus, FINRA would expect that firms with underwriting activity limited to mutual funds may adopt significantly different review procedures than a firm engaged in more traditional investment banking activity. FINRA is proposing amending the rule to include the phrase "reasonably designed" to acknowledge more clearly that firms with different business models may adopt different procedures and practices.¹¹⁷ 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."

One commenter expressed concern that, in defining "investment banking services" broadly, FINRA has disregarded the cumulative effect a "misapplied" rule can have on a firm's compliance obligations and has substantially underestimated "the unnecessary questions and confusion surrounding the rule's implementation that the firm is likely to face."¹¹⁸ The commenter did not include examples of the types of questions or confusion that are likely to arise, and FINRA stresses that the definition applies only to the reporting obligation in the proposed rule. As noted above, the reporting obligation is triggered only after an investigation has been initiated. FINRA believes that the primary costs and burdens associated with the proposed rule change would arise in developing and implementing policies and procedures and in conducting investigations, not in reporting those investigations to FINRA. The Proposing Release explicitly recognized that certain types of "investment banking services" may present less risk of insider trading than others, and firms are permitted to take these risks into account when developing their policies and procedures; however, neither commenter has offered an explanation as to why investigations should not be reported when the reports are only required after a firm has identified trades that may violate applicable laws or rules other than to note that these firms may pose less risk to begin with.¹¹⁹

¹¹⁷ FINRA notes that the "reasonably designed" standard already applied to the transaction review procedures required by the provision pursuant to the overarching language applicable to all of a member's procedures in paragraph (b)(1) of the proposed rule change. FINRA is proposing to repeat the phrase in paragraph (d) to avoid an implication that it did not already apply to the procedures governing transaction review.

¹¹⁸ SIFMA.

¹¹⁹ One commenter questioned the need for the rule at all in light of FINRA Rule 4530. *See* ICI. As FINRA explained in the rule filing, proposed FINRA Rule 3110(d) requires more targeted and detailed reporting than FINRA Rule 4530(b), which requires reporting only where a member concludes or reasonably should have concluded a securities-related law or rule was violated. Moreover, FINRA Rule 4530 does not require firms to report

FINRA continues to believe that firms engaged in investment banking services should be required to report the results of their investigations to FINRA when these investigations are only required after a firm has already identified and begun investigating a trade that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices. Although the fact that certain firms may present a lower risk of insider trading may be a factor in assessing the reasonableness of a firm's procedures, FINRA does not believe it should affect the analysis of whether a firm has a reporting obligation once potentially violative trades have already been identified and investigated.

M. Comments on Proposed FINRA Rule 3110(e)

Proposed FINRA Rule 3110(e) (Definitions) retains, without any changes, the definition of "branch office" in NASD Rule 3010(g) (Definitions). The definition specifically excludes some locations from being considered a branch office, including an associated person's primary residence, if certain exceptions are met. However, if any excluded location, including an associated person's residence, is responsible for supervising the activities of a member's associated persons at one or more non-branch locations, the location is considered a branch office.

Commenters suggested that FINRA either revise the branch office definition to exclude mutual fund regional distributors and wholesalers who operate out of their homes but conduct no retail business or have any interaction with retail customers at such locations¹²⁰ or dispense with the distinctions among OSJs, branch offices, and a registered person's home office and require annual audits for all offices other than the main office that are over a certain minimum business threshold (e.g., \$300,000 in annual sales).¹²¹

In response, FINRA notes that the branch office definition is being transferred unchanged from current NASD Rule 3010(g). The uniform branch office definition was developed in 2005 after several years of discussions with the NYSE, NASAA, and NASD. FINRA believes the current definition provides appropriate exemptions from registration, and such exemptions should not be expanded at this time. Similarly, the OSJ definition, which industry members have relied upon for many years in designing their supervisory systems, is being transferred unchanged from NASD Rule 3010(g). FINRA also notes that adopting a location audit requirement based solely on a specified sales threshold could exclude many offices engaging in activities enumerated in the OSJ definition from being inspected.

every instance of noncompliant conduct. *See Regulatory Notice* 11-06 (February 2011) (discussing scope of requirement to report internal conclusions of violation).

¹²⁰ ICI.

¹²¹ Sweeney.

N. Comments on Proposed FINRA Rule 3120

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 (total revenue less, if applicable, commodities revenue) on its FOCUS reports in the prior calendar year to include additional content in the report it submits to senior management. The required additional content includes a tabulation of the reports pertaining to the previous year's customer complaints and internal investigations made to FINRA. Also, the report must include a discussion of the preceding year's compliance efforts, including procedures and educational programs, in each of the following areas: (1) trading and marketing activities; (2) investment banking activities; (3) antifraud and sales practices; (4) finance and operations; (5) supervision; and (6) anti-money laundering.

One commenter requested that FINRA exclude mutual fund underwriters from the additional content requirements as such firms, which may meet the \$200 million threshold solely through receipt of 12b-1 fees, are not the type of "complex" firms FINRA intended to address when proposing the additional content requirements.¹²²

As noted in the Proposing Release, the additional content requirements are incorporated from the annual report content requirements of Incorporated NYSE Rule 342.30 (Annual Report and Certification) that provide valuable information for FINRA's regulatory program.¹²³ Also, as noted in the Initial Filing, such information will be valuable compliance information for the senior management of the firm. In addition, some content requirements relate to regulatory obligations, such as supervision and anti-money laundering, that apply to all member firms, regardless of their business activities. However, because all the content requirements are not relevant to every firm, FINRA is revising proposed FINRA Rule 3120 to clarify that a member's report must include the additional content, to the extent applicable to the member's business.¹²⁴

O. Comments Outside the Scope of the Proposal

One commenter, while recognizing the required statutory framework applicable to proposed SRO rulemaking, requested additional review time for more comprehensive FINRA

¹²² ICI. ICI alternatively suggested that FINRA exclude from proposed FINRA Rule 3120's "gross revenue" definition any 12b-1 revenues a mutual fund underwriter receives.

¹²³ *See also Regulatory Notice* 08-24 (noting that the supplemental information in Incorporated NYSE Rule 342.30's annual report was a valuable tool for the NYSE regulatory program and would also be valuable information for FINRA's regulatory program going forward).

¹²⁴ In addition, FINRA is revising proposed FINRA Rule 3120 to delete references to the MSRB rules, consistent with the deletion of such reference in proposed FINRA Rule 3110(a) discussed above.

rule changes.¹²⁵ Another commenter suggested that firms make available to the public investor education facilities regarding their products, activities, and services.¹²⁶ One commenter suggested that a firm's compliance and ongoing oversight of its associated persons' outside business activities ("OBA") could be further enhanced through updates of OBA information captured by CRD.¹²⁷ Another commenter suggested that FINRA require firms to supervise OBAs in addition to FINRA Rule 3270's (Outside Business Activities of Registered Persons) requirement that a registered person provide a firm with written notice prior to engaging in any OBA.¹²⁸ The same commenter also suggested that FINRA require firms to prevent the "spoilage of evidence" once it is reasonably foreseeable that an arbitration might be filed. In addition, a commenter suggested that FINRA draft standard, pro forma, baseline written supervisory procedures firms can adapt to their businesses.¹²⁹ While FINRA appreciates the commenters' input on these matters, FINRA considers these comments to be outside the scope of the current proposal.

¹²⁵ CAI.

¹²⁶ Arnoff. Arnoff also suggested that the proposed consolidated supervision rules be tested for efficacy based on risk-based considerations in specified topical areas (*e.g.*, supervisory depth, avoidance of supervisory conflicts, suitability, best execution, prevention of unauthorized trading, systemic problems, defined responsibility and non-delegable duties, customer complaints). FINRA also considers this comment to be outside of the scope of the proposal. However, as stated previously in responding to commenters' requests to revise the proposal to include provisions addressing other supervisory-related issues, FINRA would expect these matters to be considered as part of a member's establishment of a supervisory system and procedures reasonably designed to achieve compliance with the federal securities laws and FINRA rules, and the testing and verification of such procedures under FINRA Rule 3120.

¹²⁷ NFP.

¹²⁸ PIABA. FINRA Rule 3270.01 also requires that, upon receipt of a written notice, a firm must consider whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the firm and/or the firm's customers or (2) be viewed by customers or the public as part of the firm's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. In addition, based on the firm's review of such factors, the firm must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including where circumstances warrant, prohibiting the activity. A firm also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of NASD Rule 3040 (Private Securities Transactions of an Associated Person).

¹²⁹ IMS. Although FINRA considers IMS's comment to be outside the scope of the proposal, FINRA's [Tools](#) web page includes a "Written Supervisory Procedures Checklist" that members may consult when drafting or revising their written supervisory procedures.

Elizabeth M. Murphy
October 2, 2013
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FINRA believes that the foregoing, along with the discussion in the Proposing Release, fully responds to the issues raised by the commenters. If you have any questions, please contact me at 202-728-8026.

Sincerely,

A handwritten signature in cursive script, appearing to read "Patricia Albrecht". The signature is written in black ink and is positioned above the printed name.

Patricia Albrecht