

6/9/08

Below please find my comments regarding some of the proposed changes

#### Supervision and Supervisory Controls

- Proposed Rule 3110(a). Supervisory System - The Proposed Rule requires firms to “establish and maintain a system to supervise the activities of each associated person...” I have concerns about the use of the term “associated person” in the Proposed Rule. First, I believe that firms should not be required to include, within their supervisory system, persons who hold permissive licenses under NASD Rule 1021(a) and 1031(a), but are otherwise not directly engaged in the securities business of the firm (e.g., support functions).

Next, I believe the use of this term may unintentionally expand FINRA’s jurisdiction to include a member’s affiliates and the affiliate’s employees in situations where they merely provide incidental services to the firm or where the affiliate reports to a senior executive who is also a registered principal of the firm. As a result, I recommend that FINRA amend the language to require firms to “establish and maintain a system to supervise the activities of each registered representative or registered principal actively engaged in the securities business of the firm...” In addition, I am concerned that subsection 3110(a)(2)’s requirement that firms designate “an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages” is overly broad. The language suggests that firms must designate registered principals with supervisory responsibilities for outside business activities (e.g., investment advisory services or fixed insurance product sales).

Through this Rule Proposal, FINRA appears to be expanding their jurisdiction into areas that are the responsibility of other regulators. We note that recent press reports indicate that some insurance regulators share our concerns.<sup>9</sup> As a result, I believe the language would greatly expand the liability exposure of independent broker-dealer firms whose financial advisors engage in numerous outside activities. Therefore, I recommend that the language of the Proposed Rule revert to that of current NASD Rule 3010 which reads in relevant part: “The designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker/dealer is required.”

Finally, I believe that Proposed Rule subsection 3110(a)(4) should be edited so that it is clear that a registered principal may be assigned the responsibility of supervising more than one Office of Supervisory Jurisdiction (OSJ) and/or non-OSJ branch office. I believe that broker-dealer firms and their registered principals should be allowed to determine the appropriate number of offices assigned to each OSJ manager. The Proposed Rule should clearly reflect that firms have this freedom in designing their supervisory system. I also believe Supplementary Material .04 should be re-written to remove the clear bias for a one supervised office per OSJ manager structure. I also believe the requirement of a “physical presence, on a regular and routine basis” is overly burdensome, biased against IBD firms, and without justification in a world in which electronic supervisory methods are so prevalent and effective. I urge FINRA to strike this language from the Supplementary Material. I also seek clarification of the terms “diverse” and “complex” as used in Supplementary Material .02. These terms are too vague to provide firms the necessary guidance when determining whether to designate a location as an OSJ.

- Proposed Rule 3110(b) – The Proposed Rule makes similar use of the term “associated person” as in 3110(a). I have the same concerns about the language in this context. In addition, we are concerned that 3110(b)(1) requires firms to “establish, maintain, and enforce written procedures to supervise the types of

business in which it engages...” As in 3110(a)(2) above, I believe this language is overly broad and represents a significant expansion of a broker-dealer firm’s supervisory responsibilities and FINRA’s jurisdiction. Therefore, I recommend that the language be rewritten to limit the requirement to “establish, maintain, and enforce written procedures to supervise the types of business in which it engages for which registration as a broker/dealer is required”.

I also believe subsection 3110(b)(2) should state clearly that the firm’s supervisory procedures for review of investment banking and securities business may be risk based. This language is contained in the Supplementary Material .06, but I believe it should appear in the rule itself. Subsection 3110(b)(3) of the Proposed Rule is poorly drafted and needs significant revision to provide firms with clarity. FSI believes the phrase “conduct any investment banking or securities business” is too vague. As a result, I urge FINRA to replace it with the phrase “participate in any manner” as used in the current NASD Rule 3040. This language is far clearer and has been the subject of years of NASD interpretation. In addition,

I am concerned that the Proposed Rule’s subsection 3110(b)(3) once again seeks to broaden member firms’ responsibility for outside activities by including approved activities “within the scope of the member’s business...” This issue is of particular concern for IBD firms, whose financial advisors engage in many outside activities, including investment advisory services through their own investment advisor entity. This is a significant departure from the guidance included in NASD Notice to Members 94-44 and 96-33.10 I believe this existing guidance should remain in effect and urge FINRA to incorporate explicitly the guidance into the Proposed Rule. In addition, we are concerned that this section of the Proposed Rule could require the firm to supervise the non-securities activities of dual employees who have corporate responsibilities for related entities. These activities should be exempt from the requirements of 3110(b)(3). I also have concerns with subsection 3110(b)(4) of the Proposed Rule. Once again, this section is poorly written. I believe the “supervisory procedures must ensure” language should be replaced by the phrase “supervisory procedures must be reasonably designed...” to make the provision consistent with traditional concepts of reasonable supervision. In addition, the section would require a registered principal to review “correspondence with the public and internal communications.” I believe the Proposed Rule should state clearly that such review could be risk-based and delegated to appropriate personnel. This language is part of Supplementary Material .09 and .11, but we believe it is of such importance that it should be included in the Proposed Rule itself. Subsection 3110(b)(6)(C) of the Proposed Rule should be clarified such that home office employees are exempt from the requirement. In addition, supplementary material should be adopted that explains that the receipt of commission overrides does not equate to having one’s compensation “determined by” a person who is supervised. In Subsection 3110(b)(6)(D) of the Proposed Rule, I find the use of the phrase “procedures preventing the supervision required by this Rule from being lessened in any manner” imposes an unrealistic standard upon the brokerdealer. As a result, we advocate a more reasonable requirement of “procedures reasonably designed to achieve compliance with this Rule.”

Finally, I recommend that FINRA amend Subsection 3110(b)(7) of the Proposed Rule to state clearly that written supervisory procedures may be maintained electronically at each OSJ or location where supervisory activities are conducted.

- Proposed Rule 3110(c) – This section of the Proposed Rule deals with internal inspections. I believe the requirements of written inspection reports included in subsection 3110(c)(2)(A) should be amended so as to avoid specifically requiring inclusion of testing and verification of policies and procedures that may be conducted by the firm at their home office or other location rather than at a branch or non-branch location (e.g., address changes). We also believe subsection 3110(c)(3)(A) should exempt the firm’s home office staff so that firms are not obligated to hire outside consultants to perform their inspections of these individual’s activities. I

recommend that subsection 3110(c)(3)(B) should be amended. Once again, I find the use of the phrase “procedures preventing the supervision required by this Rule from being lessened in any manner” imposes an unrealistic standard upon the broker-dealer. As a result, I advocate a more reasonable requirement of “procedures reasonably designed to achieve compliance with this Rule.” I recommend that Supplementary Material .14 be amended to require “the quality of supervision at remote locations is reasonably designed to ensure compliance...” Finally, I recommend that Supplementary Material .16 be amended to reflect the terms of the current limited size and resource exception. Specifically, I would rewrite subsection (b) to read “regardless of the member’s size and resources, the member has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices’ branch office manager.”

- Proposed Rule 3120. Supervisory Control System – FSI objects to FINRA’s proposal in subsection 3120(b) to apply certain content requirements from NYSE Rule 342.30 to reports created by firms with \$150 million or more in gross revenue. The proscriptive nature of this Proposed Rule is contrary to the principles-based approach of NASD Rule 3012 and does not appear to add significant value to the process. Additionally, the required report represents a significant new burden for firms that are not dual members and a significant continued burden for firms that are dual members. As a result, I advocate that FINRA eliminate subsection 3120(b) and (c) in their entirety.

- Proposed Rule 3150. Holding of Customer Mail – I am concerned that the Proposed Rule establishes unreasonable requirements for the holding of customer mail. For example, the Proposed Rule would require firms to be able to communicate with the customer whose mail is being held in a timely manner to provide important account information. While I understand the objective behind the proposed language, it is important to note that mail is oftentimes held specifically because the client is unreachable (e.g., overseas travel or active military service). I believe this language should be clarified or struck from the Proposed Rule. The Proposed Rule also utilizes the phrase “extended time” without providing a definition. I believe FINRA should define the term or insert a specific period of time into the Rule.

Finally, I have concerns about the requirement that firms “take actions reasonably designed to ensure that the customer’s mail is not tampered with...” I believe this requirement should be amended to read, “take actions reasonably designed to avoid tampering with the customer’s mail...”

9 See “FINRA is Overreaching, Some Say”, by Sara Hansard of InvestmentNews (June 2, 2008) at [http://search.crowpeak.com/cpt\\_redirect/53?account=42805acf6921&qid=516&ht=?account=42805acf6921&qid=516](http://search.crowpeak.com/cpt_redirect/53?account=42805acf6921&qid=516&ht=?account=42805acf6921&qid=516).

10 See NASD NtM 94-44 at [http://finra.complinet.com/finra/display/display.html?rbid=1189&record\\_id=1159003885&element\\_id=1159003712&highlight=94-44#r1159003885](http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159003885&element_id=1159003712&highlight=94-44#r1159003885). See NtM 96-33 at [http://finra.complinet.com/finra/display/display.html?rbid=1189&record\\_id=1159002404&element\\_id=1159002337&highlight=96-33#r1159002404](http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159002404&element_id=1159002337&highlight=96-33#r1159002404).

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