FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT BROKER-DEALERS AND INDEPENDENT FINANCIAL ADVISORS
www.financialservices.org

VIA ELECTRONIC MAIL

January 16, 2008

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

RE: FINRA Regulatory Notice 08-71: Reporting Requirements

Dear Ms. Asquith:

On November 28 2008, the Financial Industry Regulatory Authority, Inc. (FINRA) requested comment on a proposal relating to broker-dealer reporting requirements. The reporting requirements are designed to provide important regulatory information that assists FINRA in the identification of problem members, branch offices, and financial advisors in order to detect and investigate sales practice violations in a timely manner. As part of the ongoing rulebook consolidation project, FINRA proposes replacing NASD Rule 3070 and NYSE Rule 351, that require the reporting of certain regulatory events and quarterly statistical information regarding written customer complaints, with a single reporting rule to be known as FINRA Rule 4530 (Proposed Rule).[1]

The Financial Services Institute[2] (FSI) recognizes that combining the rulebooks of the predecessor regulatory authorities represents a significant challenge. With so many changes in the structure and substance of the rulebook being considered, we believe industry input is more important than ever. We, therefore, commend FINRA for seeking industry comment on the Proposed Rule prior to submitting it to the SEC. In addition, we applaud FINRA's decision to extend the reporting period in the Proposed Rule from ten (10) to thirty (30) days. Nevertheless, we have serious concerns about other aspects of the Proposed Rule which are outlined in this letter.

Background on FSI Members

The independent broker-dealer (IBD) community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned

[1] See the Proposed Rule and FINRA's request for comment in FINRA Regulatory Notice 08-71 at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117454.pdf.

[2] The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 117 Broker-Dealer member firms that have more than 130,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 12,000 Financial Advisor members.

to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 98,000 independent financial advisors – or approximately 42.3% percent of all practicing registered representatives – operate in the IBD channel.[3] These financial advisors are self-employed independent contractors, rather than employees of the IBD firms. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.[4] Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's primary goal is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Comments

The following is a summary of FSI's specific comments on the Proposed Rule:

- Scope of Proposed Rule is Overly Broad – The Proposed Rule represents a significant expansion of the scope of the existing reporting requirements. For example, Section 4530(a)(1)(A) of the Proposed Rule expands broker-dealer reporting obligations well beyond the securities business of broker-dealer firms by including violations of any insurance, commodities, financial or investment-related laws, rules, laws, regulations or standards of conduct of any domestic or foreign regulatory body, self-regulatory organization or business or professional organization. Events involving foreign regulatory bodies are also added to the reporting obligations of Sections 4530(a)(1)(C), (D), (F), and (G). In addition, Section 4530(a)(1)(G) would require the reporting of insurance related civil litigation or arbitration matters that meet the reporting thresholds. In effect, these sections expand FINRA's reach to include matters over which it does not have jurisdiction. We oppose any attempt on FINRA's part to extend its jurisdiction beyond the broker-dealer activities it is authorized to regulate.

[3] Cerulli Associates Quantitative Update: Advisor Metrics 2007, Exhibit 2.04. Please note that this figure represents a subset of independent contractor financial advisors. In fact, more than 138,000 financial advisors are affiliated with FSI member firms. Cerulli Associates categorizes the majority of these additional advisors as part of the bank or insurance channel.

[4] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisors.

We are also concerned that the proposed expansion of broker-dealer reporting obligations will unnecessarily occupy valuable resources that could be supporting more meaningful compliance efforts. For example, we believe the Proposed Rule would require broker-dealers to dedicate resources to proactive examination of an affiliated financial advisor's property and casualty or life insurance business to insure the firm reports in a timely manner any matters, which FINRA may later conclude the firm should have known about.[5] Reporting of matters related to outside business activities like these is of particular concern to IBD firms whose financial advisors engage in a wide range of such activities, including the sale of fixed insurance products through multiple product sponsors. Such activities are not only beyond the jurisdiction of FINRA, but are also beyond the scope of the broker-dealer's legal authority, practical ability, or obligation to supervise. The scope of the Proposed Rule will thus place an undue and unenforceable burden on IBD firms. We urge FINRA to scale back the scope of the Proposed Rule by adopting the language of NASD Rule 3070.

- Reporting of Internal Findings Inappropriately Requires Firms to Reach Legal Conclusions – Section 4530(a)(3) requires reporting when "the member has concluded that an associated person of the member or the member itself has violated any securities, insurance, commodities, financial or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or self regulatory organization." The reporting requirement obligates broker-dealer firms to reach legal conclusions as to whether they or their financial advisors engaged in violative conduct. Since regulators, broker-dealers, financial advisors, and the courts frequently disagree about whether a given set of facts involves a violation, we believe the Proposed Rule will frequently place broker-dealers in the perilous position of being second-guessed by FINRA, a plaintiff's attorney representing a financial advisor whose activity was reported to FINRA by the broker-dealer, or both.

  We are also concerned that an obligation to report an internal conclusion may very well lead broker-dealers to choose not to reach such conclusions in the course of their internal review processes. At the time NASD Rule 3012 and 3013 were proposed, broker-dealers expressed concern that the NASD would use the reports and review processes contemplated by those rules as a roadmap for disciplinary action against a firm or financial advisor. NASD officials assured firms that the NASD would not do so, and that broker-dealers would be given latitude to resolve deficiencies uncovered during the annual review. We believe the Proposed Rule's requirement to report internal conclusions represents a dramatic and unexplained shift in FINRA's approach to self-policing. As a result, we believe the reporting requirements will have a chilling effect on a broker-dealer's internal review processes and, thus, undermine investor protection. Therefore, we urge FINRA to eliminate the requirement to report internal findings as required by Section 4530(a)(3) of the Proposed Rule.

  If FINRA opts to retain the internal findings reporting obligations in the final rule, we also encourage you to adopt the guidance provided by NYSE Information Memo 06-11 into the Supplementary Material. This Information Memo further clarifies the reporting obligations of broker-dealer firms under this provision of the Proposed Rule. We would also recommend that FINRA provide reporting firms with qualified immunity to

[5] Section 4530(a) of the Proposed Rule would require member firms to report required information promptly, "but in any event not later than 30 calendar days, after the member knows or should have known of the existence of any" reportable event.

encourage accurate reporting without the repercussions associated with a good faith report that is later determined to be based on an incorrect legal conclusion.

- Reporting Standard for Internal Findings is Too Vague – Supplementary Material .01 explains that Section 4503(a)(3) of the Proposed Rule would not require broker-dealers to "report an isolated violation by the member or an associated person of the member that can be reasonably viewed as a ministerial violation of the applicable rules that did not result in customer harm and was remedied promptly upon discovery."[6] Therefore, the Supplementary Material announces a four-prong test for minor violations to escape reporting. The violation must be: (a) isolated, (b) ministerial, (c) result in no customer harm, and (d) be remedied promptly. We find this standard too subjective and vague to provide broker-dealers with certainty as they seek to apply it to their reporting obligations. A few examples will demonstrate the point:

    - If two or more ministerial violations not resulting in investor harm are noted during the same branch office inspection and promptly remedied, can they be considered isolated violations? If a ministerial violation not resulting in investor harm is promptly remedied and not reported, but later is found to have recurred again, can the firm continue to define the violation as isolated?
    - Are book and recordkeeping violations identified during a branch office inspection ministerial? If the branch office inspection reveals that a single client file contains a client signed blank form, is this a ministerial violation?
    - If an isolated ministerial violation not resulting in investor harm can be resolved in two (2) weeks, has it been remedied promptly? What if it takes four (4) weeks to remedy the violation?

  We believe these questions demonstrate the uncertainty inherent in the proposed Supplementary Material. Because we believe the Proposed Rule should draw bright lines for broker-dealer reporting requirements, we recommend that Supplementary Material .01 be amended to require the reporting of only those violations that have resulted in customer harm.

- Calculation of Monetary Thresholds Should Not Include Attorney's Fees – Supplementary Material .05 requires firms to include attorney's fees in their calculation of the dollar value of any judgment, award, or settlement that may require reporting under Section 4530(a)(1)(G) of the Proposed Rule. FSI believes that including attorney's fees in this calculation will effectively lower the reporting threshold by including factors that bear little relation to the underlying customer harm involved in the matter. Once again, some examples will demonstrate the point:

    - A broker-dealer or financial advisor may choose to defend vigorously even a specious claim due to the importance they place on their reputation, while another firm may choose to settle such claims quickly without significant legal fees. Why should the firm mounting the aggressive defense be penalized because of their tactical decision to defend their reputation?
    - Billable rates for attorney's fees vary greatly across the country. Securities attorneys located in New York City are likely to bill at a higher rate than similarly experienced lawyers in other parts of the country. Why should the billing rate of the attorney affect the reporting obligation of the firm?

[6] See at page 15 of FINRA Notice 08-71.

- Some firms have negotiated reduced billing rates or caps on fees with law firms they use frequently, while other broker-dealers lack the volume of claims or other legal work necessary to negotiate such a deal. Why should the firm who is in greater need of legal services avoid reporting that the other firm cannot?

We believe the dollar value of any judgment, award, or settlement plus interest is a fair indicator of the investor harm and should determine the reporting obligation of firms and financial advisors. As a result, we recommend the Supplementary Material .05 be amended to remove attorney's fees from the calculation of monetary thresholds.

- Clarification of Application to Affiliated Firms Needed – We request clarification of the Proposed Rule's application to business entities affiliated with the broker-dealer firm. Specifically, would the member be required to report disciplinary actions taken by affiliated companies? If so, are these reports considered internal findings (i.e., subject to reporting under Section 4530(a)(3)), or external findings (i.e., subject to reporting under Section 4530(a)(1)(A)? We ask that FINRA clarify these points for the benefit of all broker-dealer firms.

- Reasonable Limitations Needed on Reporting of Violations by Former Associated Persons – Supplementary Material .07 states that broker-dealers must report under Sections 4530(a) and (c) events "relating to a former associated person if the event occurred while the individual was associated with the" firm. This would include the obligation to report internal findings under Section 4530(a)(3). Given that the financial adviser is no longer affiliated with the broker-dealer firm and has little incentive to cooperate in that firm's investigation, obtaining the financial advisor's cooperation is expected to be difficult, if not impossible. Still the Proposed Rule would ask these firms to reach legal conclusions without all of the necessary information to do so. Therefore, we request that FINRA only apply Section 4530(a)(3) to financial advisors currently affiliated with the broker-dealer firm.

- Reporting Thresholds are Too Low – The reporting thresholds of twenty five thousand dollars ($25,000) for member firms and fifteen thousand ($15,000) or two thousand five hundred ($2,500) for financial advisors were originally proposed more than thirteen (13) years ago. We believe they should be adjusted to reflect a reasonable rate of inflation over this period-of-time. Therefore, we recommend that the Proposed Rule be amended to reflect the following reporting thresholds:

  - Proposed Rule 4530(a)(1)(9)
    - Thirty thousand dollars ($30,000) for financial advisors;
    - Fifty thousand dollars ($50,000) for broker-dealers.

  - Proposed Rule 4530(a)(2)
    - Five thousand dollars ($5,000) for financial advisors.

- Eliminate Redundant Reporting Obligations – We urge FINRA to work aggressively to eliminate reporting redundancies that currently exist between the Proposed Rule and Forms U4, U5 and BD. We recognize that FINRA has committed to do so in Notice 08-71.[7] However, we note that the NASD made this same commitment in 1995 without

[7] See Notice 08-71 at page 3.

resulting progress on the initiative.[8] As a result, we believe the time to eliminate these redundancies is now and urge FINRA to undertake the project with urgency by exempting matters disclosed on Forms U4, U5, and BD from the reporting requirements.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to achieve further efficiency in the reporting process while maintaining investor protection.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 770 980-8487.

Respectfully submitted,

Dale E. Brown, CAE
President & CEO

[8] See Exchange Act Release No. 34-35956, 60 FR 36841 (July 18, 1995): "Further, upon implementation of the redesigned CRD which will provide more ready access to registration information, the NASD will undertake to review the proposed reporting rule to determine whether certain of the duplicative requirements may be eliminated. To the degree that such modifications are feasible, the NASD would intend to delete such provisions from the proposed rule."