Invested in America

May 8, 2017

By Electronic Mail (pubcom@finra.org)

Jennifer Piorko Mitchell
Vice President and Deputy Corporate Secretary
Office of Corporate Secretary
FINRA
1735 K Street NW
Washington, DC 20006-1506

Re: Special Notice – Engagement Initiative

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") Special Notice (the "Notice"), which requests comment on FINRA's current engagement programs.[2] SIFMA is uniquely positioned to offer feedback on these programs because our membership includes a substantial number of FINRA's nearly 4,000 members, and they interact daily with FINRA's rules, programs, and staff. These interactions have significant impacts on our shared members' ability to conduct their business servicing investors, providing access to the capital markets, and supporting economic growth.

SIFMA supports FINRA's mission of providing effective oversight of the securities industry to ensure the integrity of our markets and the protection of investors. Both investors and member firms benefit from effective oversight. Investors benefit from the important safeguards that FINRA delivers through its regulatory programs. Member firms benefit from the investor confidence that follows from a well-regulated market. The suggestions in this letter are intended to support robust and efficient regulation that maintains the highest levels of investor protection. SIFMA is heartened that FINRA is not only making a concerted effort to increase engagement with its membership and improve

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] Special Notice – Engagement Initiative (Mar. 21, 2017), http://www.finra.org/ industry/special-notice-032117.

its transparency, but also reflecting an openness to other suggestions for enhancing programs vital to its mission.

SIFMA also supports the FINRA360 initiative, of which the Notice is an initial part. Through the FINRA360 initiative, FINRA is conducting a comprehensive self-evaluation and organizational improvement initiative. FINRA's stated objective in this effort is to ensure that it is operating as the most effective self-regulatory organization ("SRO") it can be, working to protect investors and promote market integrity in a manner that supports strong and vibrant capital markets. The Notice is an excellent start to the FINRA360 initiative, and we urge FINRA to use the FINRA360 initiative to review all its operations. For example, similar requests for comment on FINRA's examination and enforcement programs would be very helpful, and would allow member firms to build on the substantive comments about those areas we include in this letter.

In this letter, we address several of the topics that FINRA raises in the Notice.[3] Additionally, we provide member views on the current state of FINRA's examination and enforcement programs, which our shared members have identified as needing improvement in a timely manner.

I. <u>The Foundation of Self-Regulation</u>

The foundation of self-regulation provides the lens in which to view our comments. Historically, securities regulation has been accomplished through a combination of government regulation and self-regulation. In passing the Securities Exchange Act of 1934, the Maloney Act of 1938, and the Exchange Act Amendments of 1975, Congress concluded that regulation of the security industry via SROs was a mutually beneficial balance between government and industry interests.[4] In this model, the government should benefit by being able to leverage its resources through SROs, while the industry should benefit from being supervised by SROs familiar with the nuances of industry operations.[5]

Although the SRO model has been successful overall, it sometimes comes with inefficiencies due to overlap and inconsistencies. In fact, FINRA itself was formed in 2007 to address a major source of inefficiency in member regulation. For years, NASD and NYSE acted as parallel regulators, with overlapping jurisdiction that frequently yielded duplicative and inconsistent results. FINRA's formation was a huge step forward in consolidating member regulation in one place, and FINRA has worked tirelessly and transparently since its inception to consolidate the NASD and NYSE rulebooks.

Since 2007, FINRA's role has grown and changed, resulting in the loss of certain benefits

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[3] SIFMA plans to submit additional comments on FINRA's Dispute Resolution Programs in a separate letter prior to the June 19, 2017 deadline.

[4] Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50700 (Mar. 8, 2005), https://www.sec.gov/rules/concept/34-50700.htm.

[5] *Id.*

of the SRO model. FINRA has assumed many of the regulatory responsibilities of the securities exchanges, become the main examining authority for broker-dealers, and dramatically expanded governance of its membership. As it took on these additional responsibilities, our members have found that certain benefits of the SRO model, such as member input and familiarity with industry operations, have diminished to the extent that many of them now view FINRA less as an SRO and more as a government regulator.

Ultimately, the diminished benefits of the SRO model have resulted from the blending together of two foundational yet separate elements that FINRA's role rests on. First, the element of regulation *per se*, which should be carried out through the proposal, adoption, and publication of rules with member input considered. Second, the elements of examination and enforcement to assure compliance with rules and to address violations. SIFMA has found that these elements have blended in recent years, with examination findings and enforcement actions based on policies that are not clearly expressed in FINRA's rulebook and therefore lack member input.

In this letter, we have considered the Notice in two specific contexts. First, FINRA's function as an SRO. We considered the notice in terms of the specific precepts of self-regulation and the ways to improve the benefits of FINRA as a self-regulator. Second, FINRA's function as an SRO for the securities industry. We considered our members' experiences with FINRA's programs.

Turning to the Notice, FINRA presents several topic areas for consideration, including FINRA's engagement through its committees and rulemaking process, as well as other areas, including reporting on FINRA's operations. We address these in turn, and we provide member views on FINRA's current examination and enforcement programs, among other areas.

II. FINRA's Engagement Through Committees

FINRA dedicates a significant portion of the Notice to a very helpful, detailed description of its committee mechanisms, which include advisory, *ad hoc*, and district committees. We support FINRA's use of committees to provide feedback on rule proposals, regulatory initiatives, and industry issues. As noted above, leverage of member firm expertise is a fundamental principle of self-regulation in the securities markets. Member firms should be able to readily lend their expertise and input to FINRA through the committee process, and they should also be able to see tangible results from their feedback.

Practically speaking, the current operation of the FINRA committee process does not give member firms the ability to provide meaningful input, which, in some cases, results in low member involvement. FINRA provides very little transparency on the selection and composition of the various committees. Committee rosters are not publicly available or easily accessible, leaving member firms with no way to contact committee members to provide input. In addition, there is no public information about how often the committees meet, which has become less often in recent years, the matters they discuss, and the actions that they take. We often hear that committee members are "sworn to secrecy" as part of

their committee work, thereby limiting the ability for colleagues to discuss with each other and provide input and share their expertise. We also hear that some committees serve primarily as a means for FINRA to communicate to members, without the opportunity for members to communicate back to FINRA. Further, it is also often hard to determine whether committee feedback, when it is sought, is actually incorporated.

SIFMA certainly supports FINRA's efforts to engage members through the committee mechanism, and we recommend the following enhancements to solidify the proper role of the committees in FINRA:

- Empower FINRA's advisory, *ad hoc*, and district committees with a greater role in the rulemaking process, development of regulatory initiatives, and resolution of industry issues by:
    - returning to a more robust meeting schedule to seek member input;
    - explaining and making consistent the process for appointing committee members;
    - providing a public list of the names of committee members so that member firms can contact them directly to discuss topics of concern;
    - disseminating meeting agendas well in advance, meeting minutes, and recommendations given to the Board so that members can more effectively engage with FINRA's efforts and track how proposals evolve as they progress through committees to the Board; and
    - demonstrating ways in which committee feedback was incorporated, thereby signifying that such feedback is valued, which increases member involvement.

III. Engagement in Connection with FINRA Rulemaking

FINRA is fundamentally a membership organization. In this role, FINRA ideally would regulate based on information and expertise from its member firms, a defining characteristic of self-regulation. To achieve this goal, engagement with, and accessibility to, member firms is crucial. The interaction must be grounded in the principles of transparency, clarity, consistency, and finality.

For the most part, FINRA's formal rulemaking process works well. We appreciate that FINRA generally presents multiple opportunities for comment on significant rulemaking proposals – both through the publication of Regulatory Notices and the SEC's notice and comment process for SRO rule filings. We also appreciate FINRA's ongoing efforts to bolster its economic analysis of proposed rule changes. We would like to see more rigorous application of FINRA's framework for economic impact assessment, especially when consulting with key stakeholders in the development of rules and aggregating data to assess a proposal's cost effectiveness, including consideration of alternative means of regulation.[6]

[6] *See* Framework Regarding FINRA's Approach to Economic Impact Assessment for Proposed Rulemaking (Sept. 2013), https://www.finra.org/sites/default/files/Economic%20Impact%20Assessment_0_0.pdf.

In addition, we would also like to see FINRA do more to consider *and* internalize member input on regulatory matters. Based on our experience, FINRA does not sufficiently consider and internalize member input or gather enough cost and benefit data– often resulting in unworkable or unnecessarily costly rules. This concern materialized, for example, in the proposals for NASD Rule 2821 and the Comprehensive Automated Risk Data System ("CARDS").[7] On this point, we suggest that FINRA be more transparent in how it incorporates comments in final rules, because it would facilitate more effective engagement from members.

On regulatory guidance, we appreciate FINRA's current efforts, and we believe those efforts should only increase. The regulatory guidance and FAQs that FINRA publishes are extremely helpful on the specific topics that they address, such as trade reporting and OATS. That being said, in our experience, FINRA is not always willing to provide specific written guidance on questions at issue, leading to compliance difficulties. In other cases, a request for guidance leads to extended discussions between FINRA and member firms, resulting in the request not being resolved and more confusion rather than clarity.

Overall, we would appreciate more guidance from FINRA, and its approach to regulatory guidance should be grounded in the key principles of transparency, clarity, consistency, and finality. When FINRA provides guidance, it should be in writing, publicly available, and accessible and consistent with the underlying rules. In addition, the guidance should be clearly stated, so that it drives compliance, does not create confusion, and does not introduce an interpretation unsupported or inconsistent with the relevant rules. Perhaps most important, FINRA should be definitive in issuing guidance. In other words, if members request guidance on an issue, then FINRA should be definitive on whether it will address the issue. If it does agree to address an issue, FINRA should do so as expeditiously as possible. And if FINRA decides not to address an issue, it should make that decision clear.

In a separate category from formal rulemaking and regulatory guidance is a phenomenon that member firms refer to as "regulation by enforcement." Specifically, member firms often find themselves subject to enforcement actions or examination findings that are based not on specific regulatory requirements developed through the formal rulemaking process, or even through official guidance, but rather on unofficial legal positions taken by FINRA staff – for example, a position taken in a settlement with a particular firm that then becomes an "interpretation" which is applied to all firms. In another example, FINRA decisions are based on statements in speeches given by FINRA staff or on outdated guidance in Regulatory Notices. Member firms find "regulation by enforcement" extremely troublesome because it creates legal standards and imposes retroactive regulatory requirements and legal liability outside the formal rulemaking process.

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[7] Both proposals were hotly debated by FINRA's members and the public. NASD Rule 2821 (n/k/a FINRA Rule 2330) was originally proposed in 2004 and became effective in May 2008 after undergoing four amendments to address member concerns and interpretative issues. FINRA withdrew its CARDS proposal in May 2015 after substantial concerns were raised by member firms and investors alike.

The following are specific examples of enforcement actions where our members believe that FINRA is regulating through its enforcement department:

- *Mutual Share Fund Class* – In a settlement via Letter of Acceptance, Waiver and Consent ("AWC") involving charges for mutual funds in charitable and retirement accounts that "may" have been eligible for discounted share classes, FINRA found that the firm failed to supervise for potential discounts under FINRA Rule 3110. However, FINRA did not address the threshold issue of whether the firm was actually required to offer a discount couched as a "may" rather than "must" in the prospectus. Thus, FINRA found a supervisory violation without the underlying activity being in clear violation of any rule. Taking notice of this AWC, additional firms undertook their own reviews and self-reported potential violations under FINRA Rule 4530(b). In each instance, the self-reporting led to an enforcement action, but apparently, no action was taken against any non-reporting firms.

- *Market Access Controls* – FINRA examination staff reviewed a firm's market access procedures pursuant to SEC Rule 15c3-5 and despite finding no market access violations, referred supervisory findings to enforcement for disposition. The supervisory findings related to methodologies for determining credit limits for customers. Staff suggested that instead of setting a general credit limit that applied to all customers, there should have been individual credit limits for each customer, and recommended that the firm update their procedures, which they did. It has been under review by enforcement since 2013.

- *Surveillance Procedures* – A firm paid a substantial fine to settle a complaint alleging that it failed to have adequate surveillance procedures, in particular, sufficient automated tools for reviewing wash trading. At the time, the only guidance FINRA offered in this area was NTM 02-21, which included the following suggestion that online brokers needed more automated tools: "Online firms should also consider conducting computerized surveillance of account activity to detect suspicious transactions and activity."[8] In another matter based on similar facts that went to hearing, a panel found in favor of the firm, finding that NTM 02-21 offered no further discussion of the type or degree of automation that clearing firms should have had.

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[8] FINRA NTM 02-21 (Apr. 2002) at p. 7, http://www.finra.org/sites/default/files/ NoticeDocument/ p003704.pdf.

- *Inbound Wires* – A firm was the recipient of large dollar inbound wires from an individual, who was fraudulently wiring in money from a prop account at a major wire house. The wires themselves did not trigger any red flags because the firm had many wealthy customers who also wired in large amounts of money. Ultimately, the firm was alerted that the individual was stealing money. In a subsequent enforcement proceeding, FINRA found that the firm failed to have adequate supervisory controls over inbound wires, which is not required by FINRA rules and is not the practice at many firms. The driving factor for the firm to settle the matter was the threat by FINRA of an anti-money laundering charge.

- *Fraudulent Takeover of an Account* – A customer account was taken over by a person who stole the customer's cellphone and changed the account credentials. The firm did not generate alerts when assets moved out of the account. FINRA took the position that the firm should have had a control in place to flag the activity, even though there is no rule requiring that type of control.

To address these "regulation by enforcement" and guidance concerns, SIFMA recommends that FINRA:

- Create a strategic plan to review and update FINRA's rules and guidance on a periodic basis, and make the plan and updates publicly available. This plan would include:
  - taking steps to assure that the rulebook is clear about what conduct is permitted and what is not; and
  - engaging in the formal rulemaking process to address areas that are not adequately governed by existing rules.
- Where FINRA believes its rules need clarification, it should publish specific industry-wide guidance, rather than targeting a few firms through enforcement action, and vet industry guidance through relevant committees.
- Create a board-approved advisory committee to periodically review settled enforcement matters, similar in composition and mandate to National Adjudicatory Council ("NAC"), which reviews decisions resulting from the adjudication process. The committee would offer its views on whether legal positions taken in the matters are consistent with the rules and industry practice.

IV. Reporting on FINRA Operations

SIFMA has been expressing concern for some time about the transparency of operations of all SROs, including FINRA. In particular, we have expressed concern about FINRA's funding because there is little transparency into the magnitude of regulatory and related fees collected by FINRA and the amounts that FINRA spends on regulatory activities. FINRA charges its members membership, trading activity, testing, personnel and branch fees. There is virtually no public information currently available about how FINRA specifically uses the revenues it receives from its fees and other income, including the income FINRA receives from its contracts with the market exchanges. The lack of

transparency makes it difficult for members to evaluate the reasonableness of FINRA's fees in light of its income from various sources.

SIFMA understands that the SRO model is premised on being supported by member funding, but SROs do not have unlimited authority to charge their members. We recommend that FINRA:

- Review its fees more broadly to align the amount of fees it charges with its actual cost of regulation.
- Ensure that the fees are equitably and reasonably allocated.
- Provide detailed public disclosure as to how it allocates the revenue it receives from its various fees and other sources of income.

V. Additional Comments

Below we provide additional comments on FINRA's examination and enforcement programs as well as general comments on FINRA's coordination with other regulators, communication with members and follow-up inquiries. We appreciate FINRA's openness to other suggestions for enhancing programs vital to its mission.

A. Enforcement Program / Rationalization of Fines

SIFMA recognizes that enforcement of rules, notwithstanding the adversarial nature, is a cornerstone of self-regulation. We have identified the following areas of FINRA's enforcement program that could be more efficient, fair and transparent without any detrimental impact to FINRA's mission and its ability to provide effective oversight.

Our members experience FINRA's enforcement functions through multiple departments, including the Department of Enforcement and the Department of Market Regulation's Legal Section. In their experience, these separate departments are not fully coordinated and have different mandates and approaches. SIFMA believes that it would be not only more efficient, but also more effective, to centralize enforcement functions within one department. We also recommend the following enhancements to a centralized enforcement department, most of which are already in place, but infrequently or inconsistently exercised among the multiple enforcement departments:

- Give good credit to firms that cooperate and remediate violations in a timely manner, and publicize when good credit is given.
- Consider whether formal action is necessary for system glitches when there is no customer harm.
- Use FINRA Rule 8210 in accordance with internal guidelines.
- Remove barriers to access and freely provide transcripts when requested.

SIFMA recognizes FINRA's efforts to impose sanctions consistently and fairly by adopting and publishing sanction guidelines. We further recognize that the guidelines provide direction to FINRA adjudicators rather than prescribing fixed sanctions for particular

violations. Yet we are concerned that FINRA adjudicators are not following the guidelines, resulting inconsistent and unfair sanctions. We are also troubled that adjudicators are either not providing or adequately describing their rationale for a particular sanction, whether during settlement negotiations or in their final decision. This rationale would include their reasons for a fine that falls outside the ranges listed in the guidelines, and their reasons for accepting or rejecting any aggravating or mitigating factors. Certainly, we recognize that imposing fines is an important oversight mechanism to deter future violations, but we also believe it is imperative for FINRA to comply with its published sanction guidelines and to explain the rationale behind sanctions. To address these concerns, FINRA should:

- When imposing a fine, clearly explain the rationale behind the fine, including any aggravating and mitigating factors.
- As suggested above to review settled enforcement actions, create a board-approved advisory committee to benchmark and review the appropriateness of fines that were imposed.

B. Examination Program

SIFMA recognizes the strides FINRA has made in improving its examination program to reduce inefficiencies and effectively employ its resources. Specifically, we recognize the efforts taken by FINRA to apply a more "risk-based" approach to the conduct of its exams, particularly those conducted by Market Regulation. We understand that several firms have observed notable changes to FINRA's examination program because of this enhanced approach. Nonetheless, to further enhance the quality of FINRA's examinations, we suggest the following changes:

- Improve the knowledge base of examiners on FINRA's rules and member firms' businesses. In turn, examiners should take positions that reflect what FINRA's rules actually require.
- Adhere to the reasonableness standard by correcting examiners' common misconception that perfection is required of a reasonably designed supervisory system.
- Instill in examiners that a reasonably designed supervisory system is not one-size-fits-all; rather, it is fundamentally tailored to the firm's size and business.
- Provide an avenue for firms to express substantive questions while an exam is in progress to avoid "point of no return" at the exam's conclusion.
- Enhance coordination among exam staff to avoid duplicative requests during exams and to ensure proper socialization of previously-produced information.
- Allow flexibility in reporting data to FINRA, rather than mandating specific and complex requirements that are not required to be maintained by regulation.
- Incorporate the information that FINRA receives from firms that complete the voluntary Risk Control Assessment into decisions about whether to examine the firm and how to scope examinations of the firm.
- Reinforce with examiners at all levels the importance of providing members with maximum transparency into the specific rule and compliance concern upon which an information request is founded.

- Issue recommendations, rather than exceptions, in instances where FINRA is unable to substantiate a finding by reference to clear language in a rule or related guidance.

C. Coordination with Other Regulators

Understanding that the current regulatory structure involves some duplication and overlap, it is critical that FINRA coordinate with other regulators to minimize duplication with and overlap between regulatory efforts, especially in rulemaking and on enforcement and examination matters. SIFMA's members have encountered situations of settling an enforcement proceeding with FINRA, only to have the SEC take its own action for the same violations. The same can be said in the examination context. For example, in FINRA and the SEC's Office of Compliance Inspections and Examinations ("OCIE") regulatory and examination priorities for 2017, SIFMA notes that there are at least seven areas of overlap in review of high risk and recidivist brokers; sales practices; senior investors, microcap securities; cybersecurity, anti-money laundering; municipal advisers; and trading practices. To the extent this overlap in priorities leads to duplicative examinations or enforcement actions between the SEC and FINRA, it is an inefficient use of resources and an unfair piling on when it comes to fines and enforcement defense costs.

D. Communication with Members

SIFMA greatly appreciates FINRA senior management's continual engagement with the industry through conferences, committee meetings, and other forums. We also appreciate their receptivity to feedback and questions. To address many of the outstanding concerns made throughout this letter, we believe that FINRA should engage *internally* to address two areas where communication with members is inconsistent in message and tone and oftentimes duplicative. First, the views espoused by senior management are often inconsistent with staff, and their views are not distilled down to the staff as well. For example, senior management may extoll the virtues of a reasonableness standard for firms' supervisory systems and that guidance, particularly informal, does not have the force of rule, but in members' experience, examination staff are often implementing a standard of perfection and strict adherence to informal guidance. Second, communications between the home and district offices as well as between departments are oftentimes inconsistent and/or duplicative. To address these concerns, SIFMA believes that FINRA should adopt a "One FINRA" policy to ensure communications with member firms are consistent in message and tone amongst all FINRA staff.

E. Regulatory Disclosure Inquiry Volumes

SIFMA would like FINRA to review its practices and procedures for regulatory filings such as the Forms U4 and U5. Our members feel that nearly every filing made is met with a follow up inquiry from staff requesting clarification or more documentation. These inquiries are not easily addressed and have consequences. For example, arbitration disclosures are often met with inquiries before the facts have been gathered and hearings held. Seeking such information early in an arbitration interferes with the litigation process and puts the firm in an awkward position of having to explain to FINRA why an extension

is required pending the litigation. FINRA should provide greater flexibility in filings and offer more guidance so that our members are making relevant, full disclosures.

In conclusion, we thank you for being receptive to SIFMA's concerns, which is an important first step to achieving the balance in the SRO model that we seek. We welcome the opportunity to further discuss our suggestions.

Sincerely,

Kenneth E. Bentsen, Jr.
President and CEO