FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

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VIA ELECTRONIC MAIL

July 29, 2013

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

Re: File No. SR-FINRA-2013-025, Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook

Dear Ms. Murphy:

On June 21, 2013, the Financial Industry Regulatory Authority (FINRA) filed a notice of proposed rule change (Proposed Rules) to adopt new changes to the Consolidated FINRA Supervision Rules.[1] The Proposed Rules consolidate NASD Rule 3010 and NASD Rule 3012 into proposed FINRA Rule 3110 and 3120, governing the supervision and supervisory controls of Branch Offices and Offices of Supervisory Jurisdiction (OSJs). The Financial Services Institute[2] (FSI) appreciates the opportunity to comment on this important proposal.

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 advisers are especially well positioned 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 201,000 independent financial advisers – or approximately 64% percent of all practicing registered representatives – operate in the IBD channel.[3] These financial advisers are self-

[1] Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook (Proposing Release), Release No. 34-69902, File No. SR-FINRA-2013-025; 70 Fed. Reg. 40,792 (July 8, 2013).
[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 100 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 35,000 Financial Advisor members.
[3] Cerulli Associates at http://www.cerulli.com/.

employed independent contractors, rather than employees of the IBD firms. These financial advisers 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 advisers are typically "main street America" – it is, in fact, almost part of the "charter" of the independent channel. The core market of advisers affiliated with IBDs is comprised of clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisers 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 advisers 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 advisers 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 advisers. 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 advisers 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

While we applaud FINRA's efforts to address several of FSI's previous comments on these Proposed Rules,[5] particularly our concerns regarding an obligation to supervise outside business activities, we remain concerned with several aspects of the Proposed Rules. These concerns are detailed below:

- **The Absence of Cost-Benefit Analysis -** With the recent hiring of its new Chief Economist, FINRA has indicated that the development of new rules would include the review and analysis of relevant data on securities firms and markets in order to facilitate an analysis of their associated costs, benefits and regulatory impact.[6] FINRA has stated that the Chief Economist will serve to ensure that "FINRA's regulations are intelligently fashioned to protect investors and maintain market integrity without imposing needless costs and burdens on investors and the industry."[7] FSI strongly supports financial regulatory agencies, and particularly FINRA, taking additional measures to conduct robust economic analysis of proposed rules.

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[4] These "centers of influence" may include lawyers, accountants, human resources managers, or other trusted advisers.
[5] *See* Comments by David T. Bellaire, Esq., Financial Services Institute, Re: SR-FINRA-2011-028 (July 20, 2011), *available at* http://www.sec.gov/comments/sr-finra-2011-028/finra2011028-11.pdf; *see also* Letter from the Financial Services Institute to Marcia E. Asquith (June 13, 2008), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p038772.pdf.
[6] Dave Michaels, "Finra Hires First Chief Economist to Boost Cost-Benefit Analysis", Bloomberg, (April 30, 2013), *available at* http://www.bloomberg.com/news/2013-04-30/finra-hires-first-chief-economist-to-boost-cost-benefit-analysis.html.
[7] *Id.*

As recently outlined in Executive Order 13563, cost-benefit analysis for government agency rulemakings should:

1. Propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs;
2. Tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations;
3. Select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits; and
4. To the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt; and identify and assess available alternatives to direct regulation, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made by the public.[8]

Although FINRA is not subject to the Executive Order, recent court rulings have addressed the SEC's obligations with regard to regulatory cost-benefit analysis. The D.C. Circuit has found that Section 3(f) of the Securities Exchange Act requires the SEC to conduct cost-benefit analysis of new rules or be in violation of the Administrative Procedures Act.[9] The court reiterated the language of the Securities Exchange Act: "Whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[10] While FSI acknowledges that FINRA is in the early process of adopting a cost-benefit methodology, the Proposed Rules are especially appropriate for such a cost-benefit review due to their wide ranging impact and granular specificity. While FINRA has described the statutory basis for the Proposed Rules and dedicated a portion of the rule filing to a discussion of the burden on competition, it has not conducted any analysis nor spoken generally of the costs and benefits of the proposed regulation. Contrast FINRA's Proposed Rules with the SEC's recent proposal to reform money market mutual funds[11] and it becomes clear that, beyond speaking generally of the need for further regulation and responding to comments of previous iterations of these rule changes, FINRA has not conducted a thorough evaluation of the costs and benefits of its proposed regulation, nor identified or contemplated alternative regulatory approaches. Therefore, since performing a thorough cost-benefit analysis was not possible at the time these Proposed Rules were offered, we urge the SEC to require FINRA to revisit the Proposed Rules within five years of their adoption to ensure they are achieving their stated purpose while avoiding unnecessary costs.

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[8] Executive Order 13563, "Improving Regulations and Regulatory Review," 76 Fed. Reg. 3,821, (January 21, 2011).
[9] *Business Roundtable v. Securities and Exchange Commission*, 647 F.3d 1144, 1148 (D.C. Cir. 2011).
[10] Securities Exchange Act of 1934 §3(f), 15 U.S.C. § 78c(f).
[11] See Money Market Fund Reform, Amendments to Form PF, Release No. 33-9408, File No. S7-03-13, Fed. Reg. 36,834 (June 19, 2013).

- **One-Person OSJs (Proposed FINRA Rule 3010(a)(4) and Supplementary Material .03) -** The hallmark of effective regulation is that it is clear and the requirements are easily comprehensible. FSI has discussed Supplementary Material .03 with several of its members and received varying interpretations of the requirements imposed by the proposed language. FSI is concerned that the language, as written, is open to many interpretations and therefore difficult to apply to real-world scenarios. We believe FINRA intends Supplementary Material .03 to implement the requirement that no producing registered principal be allowed to supervise his or her own sales activity. We believe these requirements could be stated with more clear and concise language than Supplementary Material .03 currently uses. As such, FSI suggests the following alternative language for Supplementary Material 03:

  "No Registered Principal shall supervise his or her own sales activity."

  Additionally, we are unclear as to whether Supplementary Material .03 creates the requirement that only one "senior principal" be assigned to supervise the activities of the on-site principal. Many IBD firms have adopted comprehensive regional supervisory structures to supervise their one-person OSJs and other branch offices. Regional principals are experienced compliance professionals responsible for annual inspections and other supervisory functions. Because they are located closer to the action and have a smaller constituency to monitor, these regional principals are able to conduct announced and unannounced inspections with greater frequency. Most IBD firms have also created separate centralized supervisory units housed within their home offices that are dedicated to the oversight of specific functions which may require specialized knowledge and experience, such as correspondence, advertising or trade review.

  FSI fears Supplementary Material .03 would undermine such efforts by requiring all necessary supervisory review be conducted by the senior principal as opposed to a combination of qualified registered principals with various areas of expertise. It is difficult to see how such a limitation would further FINRA's and member firms' desire to have robust and effective supervisory structures in place. As a result, we ask the SEC to instruct FINRA to clarify Supplemental Material .03 so that it states clearly that the senior principal supervisory functions may be performed by more than one individual.

- **Supervision of Multiple OSJs by a Single Principal (Proposed FINRA Rule 3010(a)(4) and Supplementary Material .04) –** FSI notes that FINRA clarified in the proposing release that the terms "on-site supervisor" and "designated principal" as used in Supplementary Material .04 "refer to one person – the on-site principal assigned and designated to supervise the OSJ pursuant to FINRA Rule 3110(a)(4)."[12] We appreciate this clarification, but request that FINRA be required to include it within the Supplementary Material itself to facilitate a complete understanding of the requirements without reference to this proposing release.

- **Internal Communications Review (Proposed FINRA Rule 3111(b)(4) and Supplementary Material 07) -** The Proposed Rules maintain the current requirements for firms to have supervisory procedures for the review of correspondence. These include the incorporation of existing guidance regarding the supervision of electronic communications included in Regulatory Notice 07-59. That Regulatory Notice requires supervisory procedures for the review of incoming and outgoing written

[12] See page 45 of the Proposing Release.

and electronic correspondence with the public and internal communications relating to certain business activities. However, the Proposed Rules and Supplementary Material .07 appear to reach beyond these existing requirements by requiring the adoption of supervisory procedures requiring the review of "internal communications to identify those communications that are of a subject matter that require review under FINRA and MSRB rules and federal securities laws."[13]

Reviewing internal communications is appropriate for firms that engage in research or investment banking. Firms that engage in in these activities must monitor the discussions between sales staff and research staff to ensure no conflicts of interest or misuse of information. However, the vast majority of IBD firms do not engage in research or investment banking activities and, therefore, we believe it is clear that reviewing their internal communications to detect research or investment banking related communications would prove fruitless. As a result, the significant costs associated with such firms reviewing internal communications are not justified by the limited additional investor protection benefits.

In fact, by requiring this review of internal communications, FINRA will be detracting from firms' correspondence review compliance programs by expanding the lexicon of keywords and resulting volume of communications to unmanageable levels. Firms will have to allocate resources and personnel away from more pressing compliance concerns to review a high volume of internal communications that pose an insignificant risk of FINRA rule violations. While FINRA has indicated that firms may use a risk-based approach to implementing this requirement, we have concerns that the Proposed Rules' language as currently written forces an unnecessary obligation on IBD firms. We therefore suggest that FINRA amend the language to specifically state that firms who do not engage in research or investment banking activities are exempt from the internal communications review requirement. In the alternative, FINRA could make the review of internal communications a suggested practice, rather than a mandatory requirement, for firms not engaged in research and/or investment banking. This would provide more clarity to firms who remain concerned with their obligations in spite of the proposed risk-based approach.

- **Internal Inspection Review (FINRA Rule 3110(c)) -** The Proposed Rules add requirements from existing NASD Rule 3012 to review and monitor specified activities, such as transmittals of funds and securities and customer changes of address and investment objectives. Specifically, firms are required 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.

[13] FINRA Rule 3111(b)(4)

The new rule also clarifies that if a location being inspected does not engage in one or more of the activities listed above, the member must identify those activities in the location's written inspection report and document that supervisory policies and procedures must be in place before the location can engage in them. We believe these expectations are better suited for a firm's written supervisory procedures or field manual, which all associated persons must adhere to, rather than documented in individual annual inspection reports. We request that FINRA re-evaluate this requirement to allow firms the ability to rely upon their written supervisory procedures or other field manual to document this requirement.

- **"Covered Accounts" and Insider Trading Transaction Review and Inspection (Proposed Rule 3310(d)) -** The Proposed Rules require a broker-dealer firm to have supervisory procedures for the review of securities transactions that are effected for the accounts of the firm or associated persons of the firm as well as any other "covered account." These procedures must be designed to identify trades that may violate provisions of the Securities Exchange Act, SEC insider trading rules, or FINRA rules prohibiting insider trading and manipulative and deceptive devices. The definition of "covered account" includes:

    - Any account held by the spouse, domestic partner, child, parent, sibling, son-in-law, daughter-in-law, father-in-law, or mother-in-law of a person associated with the member;
    - Any account introduced or carried by the member in which a person associated with the member has a beneficial interest;
    - Any account introduced or carried by the member over which a person associated with the member has the authority to make investment decisions; and
    - Any account of a person associated with a member that is disclosed to the member pursuant to NASD Rule 3050 or NYSE Rule 407.

  We are very concerned with the expansion of the definition of "covered account" to include those outside of a registered person's nuclear family, particularly siblings, adult children, and in-laws. FINRA has failed to identify and articulate the necessity for this broad expansion or the specific risk the expansion intends to address. FINRA makes the presumption that not only do associated persons have a close relationship with these individuals, but will have access to information related to their securities accounts or, in the alternative, their siblings, adult children, and in-laws will willingly provide this information. We do not believe this is realistic or appropriate. While those in the associated person's household may have a reasonable expectation that their accounts will be disclosed to and monitored by the associated person's firm, siblings, adult children, and in-laws do not have any such understanding or expectation. While FINRA clarifies that the expansion of the definition does not require firms to monitor those accounts held outside of the firm, this expanded definition will require associated persons to seek out information from these individuals and provide it to their firm. Firms will then have to identify any relevant accounts held at or introduced by the firm and monitor them. We believe this is a completely unnecessary and an inappropriate intrusion into associated persons' personal relationships. Furthermore, FINRA has not provided any data or other evidence upon which it has relied to demonstrate the benefits and related costs associated with the expansion of the definition of "covered accounts", nor has FINRA indicated that there has been a recent explosion of insider trading cases involving siblings or in-laws. And in

fact, FINRA has touted the benefits of its own electronic surveillance systems, which is the primary source of insider-trader leads.[14] FINRA is already utilizing the most effective tools and has dedicated enormous resources to monitoring and detecting insider trading, resources which are funded through industry fees and fines. We do not believe that, from a cost-benefit analysis perspective, imposing these additional requirements onto firms will provide any additional net benefit for the detection of insider trading. FINRA states that it does not believe accounts of an associated person's adult children or spouses pose any less risk of insider trading violations but does not address the perceived risk of accounts held by siblings or in-laws. FINRA's own electronic surveillance system is likely to be more effective in identifying insider trading violations by those individuals with an incidental relationship to the registered person, including siblings and in-laws. Additionally, FINRA has not provided any rationale as to why firms should incur additional costs in this regard, particularly when such efforts will detract from firms' existing compliance obligations. Finally, FINRA has not defined with the term "domestic partner" included under the definition of covered accounts in the Proposed Rule.

As a result of the foregoing, we urge the SEC to require FINRA to redraft the Proposed Rules to extend the definition of covered account only to the registered person's nuclear family.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with the SEC on this and other important regulatory efforts.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 803-6061.

Respectfully submitted,

David T. Bellaire, Esq.
Executive Vice President & General Counsel

[14] Wall Street Journal, "Wall Street Regulator Tries Its Own Algorithm," December 22, 2010, available at http://online.wsj.com/article/SB10001424052748703814804576035950655394730.html and The New York Times, "For Wall Street Watchdog, All Grunt Work, Little Glory," on December 1, 2011, available at http://dealbook.nytimes.com/2011/12/01/for-wall-street-watchdog-all-grunt-work-little-glory/?_r=0.