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NASAA

August 06, 2013

Submitted electronically to rule-comments@sec.gov

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

RE: Release No. 34-69902, File Number SR-FINRA-2013-025

Dear Ms. Murphy:

On behalf of the North American Securities Administrators Association (NASAA),[1] I hereby submit the following comments in response to Release No. 34-69902, File No. SR-FINRA-2013-025 entitled Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook ("the Release").[2] NASAA appreciates the opportunity to offer its comments on the above referenced proposal, which is designed to incorporate and eliminate duplicative National Association of Securities Dealers ("NASD"), Financial Industry Regulatory Authority ("FINRA"), and New York Stock Exchange ("NYSE") rules and guidance regarding supervision.

While many of the newly proposed rules are substantially similar to the supervision rules already in place, FINRA has proposed some significant changes to its supervision rules. Below, NASAA provides its comments on some of these more significant changes in FINRA's proposal.

I. Removal of Supervision of Non-Securities Business Lines from the Proposed Rules

In response to comments, FINRA removed language from the originally proposed Supplementary Material .01 which stated that for a firm'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 the member's business lines

[1] NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as the forum for these regulators to work with each other in an effort to protect investors at the grassroots level and to promote fair and open capital markets.
[2] SEC Release No. 34-69902; File No. SR-FINRA-2013-025 (July 1, 2013) *available at* http://www.sec.gov/rules/sro/finra/2013/34-69902.pdf.

irrespective of whether they require broker-dealer registration."[3] FINRA removed this language after a number of commenters contended that FINRA could not subject member firms' non-securities business to FINRA rules. In NASAA's view, this was a missed opportunity to strengthen FINRA's supervision rules.

In today's increasingly complex financial marketplace, investors are often offered myriad of financial products by their brokers. Some of these products are securities, while others are banking, insurance, or other products. To the investor, however, all of the products are financial products being offered by the same person – his or her broker. Because many of FINRA's members offer their customers more than securities products, it should be expected that FINRA members have procedures in place that ensure their associated persons are being supervised in their activities, irrespective of whether the business line requires registration as a broker-dealer, as all these business lines are being conducted in the context of a firm's securities business with the firms securities customers. It is in this context that FINRA should require its members to have appropriate supervision procedures in place covering non-securities related business lines.

In its proposal, FINRA maintains that it will "continue to apply FINRA Rule 2010's standards to its non-securities activities of members and their associated persons consistent with existing case law."[4] A stronger approach to investor protection, however, would make explicit reference to and require a firm's supervisory procedures be reasonably designed to ensure that *all* of its business lines are supervised in such a way as to ensure compliance with FINRA Rule 2010. It its original proposal FINRA did just that. It is NASAA's view that FINRA should revisit this issue and reinsert the deleted language from Supplementary Material .01.

II. Elimination of "Heightened Supervision" of Producing Managers in NASD Rule 3012(a)(2)

In Proposed Rule 3110(b)(6)(c) FINRA has explicitly removed the "Heightened Supervision" requirement currently found in NASD Rule 3012(a)(2)(c), which requires additional supervision "when any producing manager's revenues rise above a specific threshold."[5] The "Heightened Supervision" standard for producing managers has been replaced with a more general risk-based requirement, found in Proposed Rule 3110(b)(6)(D). The proposed rule

> require[s] 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

[3] *Id*. at 36.
[4] *Id*. at 36-37.
[5] *Id*. at 16.

> 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 associated person conducting the supervision may derive from the associated person being supervised.[6]

This new requirement does not adequately replace the clear and easily understandable requirements of the "Heightened Supervision" requirements for producing managers that are currently in place. As other commenters have pointed out, the newly proposed rule is unclear as to what degree FINRA members must go in designing their supervision procedures to avoid conflicts of interest.[7] Specifically, there is a lack of clarity surrounding whether a member firm's supervision procedures must be designed to limit all conflicts of interest or solely be reasonably designed to eliminate conflicts of interest. NASAA views the uncertainty created by the proposed rule as a step back from the clearer, more easily understood "Heightened Supervision" requirements of the current rule, especially in the context of producing managers that meet the threshold contained in NASD Rule 3012(a)(2)(c) – an area where FINRA has previously acknowledged a greater potential for conflicts to exist.

NASAA, however, also recognizes that there are situations under which the current rule fails to provide adequate investor protection. Under the current rule, "Heightened Supervision" is only triggered once a "branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor."[8] In NASAA's view, there are situations in which additional supervision may be required even though the 20% threshold has not been met. For producing managers that do not meet the 20% threshold, FINRA's newly proposed, more risk-based approach is appropriate and should apply. For producing managers that meet the 20% threshold, the current rule should remain. The newly proposed rule, if given proper clarity as to the risks that must be balanced, may well provide investors with additional protections not offered by the current rule. The proposed rule would allow firms to tailor their supervision procedures to provide varying supervision levels to producing managers that do not meet the 20% threshold but may still require additional supervision.

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[6] *Id*. at 17.
[7] *See* letter from John Polanin and Clair Santaiello, Co-Chairs, Compliance and Regulatory Policy Committee 2011, Securities Industry and Financial Markets Association ("SIFMA"), to Elizabeth Murphy, Secretary, Securities and Exchange Commission (July 20, 2011) *available at* http://www.sec.gov/comments/sr-finra-2011-028/finra2011028-10.pdf; *See also* letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (July 29, 2013) *available at* http://www.sec.gov/comments/sr-finra-2013-025/finra2013025-6.pdf.
[8] NASD Rule 3012(a)(2)(c)(3).

III. Explicit Elimination of the Requirement to "Capture, Acknowledge, and Respond" to Oral Complaints in Proposed Rule 3110(b)(5)

Newly proposed Rule 3110(b)(5) permanently removes member firms' obligation to "capture, acknowledge, and respond" to oral customer complaints, to the detriment of investor protection. Proposed Rule 3110(b)(5) limits the definition of "customer complaint" to only complaints made in writing, making permanent a temporary change in the definition of "customer complaint" found in Incorporated NYSE Rule 351(d), which originally required the "capture, acknowledge[ment], and review" of all customer complaints.[9] As other commenters have noted, this significantly reduces a customer's ability to have complaints addressed by his broker. NASAA notes, as have other commenters, that nearly all brokers-dealers' first instruction to customers when they have complaints is to call their broker. If there is no obligation for firms to "capture, acknowledge, or respond" to these calls, the ability an investor has to seek redress is severely limited.

FINRA justifies the removal of oral complaints from the definition of customer complaints on the grounds "that oral complaints are difficult to capture and assess, and they raise competing views as to the substance of the complaint being alleged."[10] FINRA further maintains that "oral complaints do not lend themselves as effectively to a review program as written complaints, which are more readily documented and retained."[11] While written complaints may be more easily documented and retained, the burden and added expense to FINRA members of also capturing and reviewing oral complaints is limited. As others have noted, many firms have been successfully capturing and acknowledging oral complaints for years.[12] Additionally, many FINRA members already record the conversations between their brokers and the firms' clients, such that FINRA members are likely already capturing many of investors' oral complaints.[13]

By eliminating oral complaints from the definition of customer complaints, FINRA has greatly limited a customer's ability to bring a problem to his or her broker's attention. FINRA and its member firms encourage people to invest regardless of income or education. Not all investors have the ability to pen a written letter of complaint to a broker-dealer. An investor may lack the sophistication or necessary skills or abilities to reduce their concerns to writing. Others may not have the mastery of the language needed to draft a written complaint, could lack the typographical skills or electronic resources to draft a letter or email, or may simply be reluctant

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[9] *See* Release at 14-15.
[10] *Id*. at 15.
[11] *Id.*
[12] *See* Letter from Scott Ilgenfritz, President, Public Investors Arbitration Bar Association ("PIABA"), to Elizabeth Murphy, Secretary, Securities and Exchange Commission (July 29, 2013) *available at* http://www.sec.gov/comments/sr-finra-2013-025/finra2013025-12.pdf.
[13] *Id*.

to express their concerns in writing. Furthermore, others may be physically unable to reduce their complaints to writing, such as investors who are blind, elderly, or face other physical limitations resulting in a diminished capacity. FINRA's rules must ensure that its members are obliged to acknowledge and respond to these investors' complaints. At a minimum, Rule 3110(b)(5) should require member firms to provide some way for customers with a diminished capacity that would prevent them reducing their complaint to writing to lodge a non-written complaint with their brokers and to subject these complaints to the same regulatory treatment as written complaints.

IV. Addition of "Risk-Based" Review Standards for Certain Obligations

In its proposal, FINRA allows its members to craft a number of its supervisory procedures using "risk-based principles."[14] While NASAA fully supports the use of risk-based analysis and reviews and appreciates the flexibility such reviews and analyses offer FINRA members, not all areas lend themselves to such an approach. Furthermore, risk-based principles are effective only when there is clarity regarding the risks to be considered and balanced. In its proposal, FINRA offers very little guidance as to what are acceptable risk-based principles in the supervision context.

As other commenters have previously noted, this new flexibility given to firms may reduce the protection afforded investors by the supervision standards, particularly in the area of approving transactions and reviewing communications.[15] NASAA agrees with these commenters. FINRA claims that the risk-based reviews provide greater investor protection and the proposed rules "retain certain specific prescriptive requirements of NASD Rule 3010 and 3012" and add new requirements where necessary.[16] Without providing guidance as to how the procedures should be crafted and what risks should be considered, NASAA does not agree that the increased flexibility afforded broker-dealers in creating their risk-based supervisory procedures increases protections for investors. Nor do the retained or added "prescriptive requirements" negate the possible dilution of investor protection created by this new flexibility. Without providing additional clarity, FINRA has again taken a step backwards on investor protection by allowing its members to design their supervision procedures based on vague risk-based principles.

V. Proposed Changes to Rule 3110(d) (Transaction Review and Investigation)

Proposed FINRA Rule 3110(d), in order to ensure compliance with the Insider Trading and Securities Fraud Enforcement Act of 1988, as adopted in Section 15(g) of the Exchange Act,

[14] *See e.g.* Release at 10 (review of transactions), 12 (review of communications), and 21 (transfer of funds).
[15] *See* PIABA Letter, *supra*, note 12.
[16] *See* Release at 33-34.

proposes to incorporate and expand certain aspects of Incorporated NYSE Rule 342.21. Incorporated NYSE Rule 342.21 requires broker-dealers to "review trades in NYSE-listed securities and related financial instruments that are effected for the member's account or for the accounts of the member's employees and family members." FINRA's newly proposed Rule 3110(d) extends this requirement to all securities and expands the types of accounts that must be supervised. More specifically, Proposed Rule 3110(d) expands the definition of "covered accounts" to "include the accounts of parents, siblings, fathers-in-law, mothers-in-law, and domestic partners [of an associated person] if the account is held at or introduced by the member."

NASAA supports the expansion of the rule to require the monitoring of not just NYSE-listed securities and financial instruments but all securities. NASAA also supports FINRA's proposed expansion of the definition of "covered accounts" as it relates to accounts that must be monitored by firm supervisors to prevent insider trading and other deceptive or manipulative trading. NASAA, however, would support a more modern and realistic definition of "covered accounts" that keeps in mind the complexities of the relationships and information sharing opportunities present in today's sophisticated marketplace.

VI. Conclusion

While NASAA supports FINRA in its efforts to incorporate and eliminate duplicative NASD, FINRA, and NYSE rules and guidance regarding supervision and supports many of the changes proposed by FINRA in the above mentioned release, it is NASAA's view that several substantive changes proposed weaken investor protection, while others miss opportunities to strengthen it. NASAA appreciates the opportunity offer its comments, and should you have any questions regarding the comments in this letter, please do not hesitate to contact Joseph Brady, NASAA General Counsel, at jb@nasaa.org or 202-737 0900.

Sincerely,

A. Heath Abshure
NASAA President
Arkansas Securities Commissioner