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July 29, 2013

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

Re: FINRA Consolidated Supervision Rules;  
File No. SR-2013-025

Dear Ms. Murphy:

The Investment Company Institute (“ICI”)<sup>1</sup> appreciates the opportunity to provide comments to the U.S. Securities and Exchange Commission on FINRA’s proposed consolidation of the supervision rules of the NASD and the NYSE.<sup>2</sup> While the Institute is generally supportive of the proposal, we recommend several revisions to it to accommodate our members’ concerns and better tailor the requirements of the rules, where appropriate, for those FINRA members that serve in the limited role of a mutual fund underwriter. In particular, the Institute recommends that FINRA:

- Revise the definition of “branch office” in Rule 3110(e)(2) to exclude mutual fund regional distributors and wholesalers who operate out of their homes but conduct no retail business or have any interaction with retail customers at such location;
- Better tailor the requirements of Rule 3110(c), relating to internal inspections, to the purpose of such inspections and not require an inspection when there is no public purpose to be served by it;

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$15.3 trillion and serve more than 90 million shareholders.

<sup>2</sup> See *Notice of Filing a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook*, SEC Release No. 34-69902; File No. SR-FINRA-2013-025 (July 1, 2013) (the “Release”).

- Revise Rule 3110(b)(2) to eliminate the requirement for principal underwriters to review transactions that do not involve any customer activity;
- Delete or revise Supplementary Material .11 under Rule 3110(b)(6)(C), relating to supervision of supervisory personnel, to enable members, when appropriate, to have a person associated with a mutual fund underwriter supervise a person who determines the supervisor's compensation or continued employment;
- Revise Rule 3110(b)(4) and its related Supplementary Material .08, relating to review of correspondence and internal communications, to clarify the treatment of internal communications and provide members greater flexibility in their use of electronic review systems or lexicon-based screening tools;
- Revise Rule 3110(d), which would govern transaction review and investigation, to (1) narrow the scope of "covered accounts" that must be identified and monitored; (2) exclude mutual fund underwriting from the definition of "investment banking services," thereby better aligning the rule's prohibitions to instances in which unlawful trading is more likely to occur; and (3) incorporate NYSE guidance into the Rule's Supplementary Material;
- Delete references to the rules of the Municipal Securities Rulemaking Board (MSRB) from Rule 3110(a), relating to supervisory systems, in deference to the MSRB, which pursuant to the Securities Exchange Act of 1934 ("Exchange Act"), is charged with enforcing its own rules; and
- Revise the criteria in Rule 3120, relating to supervisory control systems, that would trigger an additional reporting obligation to better accommodate the business and capital structure of mutual fund underwriters.

Each of these recommendations is discussed in more detail below.

## **I. OVERVIEW**

As the national association of the U.S. investment company industry, the Institute's interest in FINRA's proposal is limited to its impact on principal underwriters of registered open-end investment companies ("mutual funds"). The role of a mutual fund's principal underwriter is significantly and substantively different from broker-dealers that are involved in the offer and sale of securities to retail and institutional investors or in providing investment banking services. Generally, the role of a principal underwriter to a mutual fund complex is to promote the sale by retail broker-dealers and other financial intermediaries of fund shares through the underwriter's wholesalers and regional distributors. They typically do so by executing sales agreements between the fund and the retail distributors of the fund, and overseeing those ongoing relationships.

Many mutual fund principal underwriters that utilize registered representatives as wholesalers and regional distributors permit such representatives to work from home. It is not uncommon for the underwriter to structure its oversight of its representatives in a way that avoids both unnecessary intrusion into their employee's private lives and the costs associated with having to register each representative's home as a branch office. This oversight approach seems appropriate because the sole function of such employees is to provide information regarding affiliated mutual funds to financial intermediaries, not to individual retail investors. Typically, the materials used by these representatives are published with legends indicating that the materials are for broker-dealer-use only. Also, all marketing materials used are prepared and maintained by the home office, which obtains the requisite regulatory reviews and dictates the use of the materials. Wholesalers and regional distributors are prohibited from using any materials other than those prepared and authorized by the home office. Finally, since the materials are necessarily current (stale information would be immediately rejected by the financial advisors they are working with), there is little risk that they are using the wrong materials.

Mutual fund wholesalers typically do not: carry customer accounts, provide retail brokerage services, or maintain the fund's shareholder records. Instead, all account records and activity are handled by the fund's transfer agent and maintained on the transfer agent's records on behalf of the fund – not on behalf of the fund's underwriter. It is the retail distributors of the fund that are responsible for carrying the shareholders' accounts and performing all regulatory responsibilities relating to those accounts, such as compliance with the USA PATRIOT Act (*e.g.*, anti-money laundering (AML) screenings), sending confirmations and prospectuses, and maintaining required account records.

While retail broker-dealers can hold customer cash or securities in street name, maintain and leverage a customer's free credit balances, and hypothecate the customers' securities, mutual fund underwriters engage in none of these activities. Also, while a broker-dealer typically offers a variety of types of investment products or securities and the securities of multiple issuers, a fund's principal underwriter typically offers only the funds' shares. Unlike the underwriter activities undertaken by a broker-dealer that provides investment banking services, mutual fund underwriters are not involved in portfolio transactions effected by the fund; nor are they involved in any activities involving the mutual fund's portfolio (*e.g.*, decisions about which securities to purchase and sell). All of those activities are handled by the fund's investment adviser, which is registered under the Investment Advisers Act of 1940 and subject to regulation under that Act and the Investment Company Act of 1940.

SEC Rules 15c3-1 and 15c3-3 under the Exchange Act, which together form the foundation of the securities industry's financial responsibility framework, recognize the limited role played by mutual fund underwriters vis-à-vis other broker-dealers. Pursuant to the net capital rule, Rule 15c3-1, while the minimum net capital requirement for a mutual fund's principal underwriter is \$5000, the minimum net capital for a retail broker-dealer that holds mutual fund shares in street name is

\$250,000.<sup>3</sup> Rule 15c3-3 the “Customer Protection Rule,” is designed to ensure that customer’s funds and securities held by a dealer are adequately safeguarded. Importantly, Rule 15c3-3(k)(1) provides an exemption from the rule’s requirements for mutual fund underwriters as well as for broker-dealers whose activities as a broker-dealer are limited the sale and redemption of mutual fund shares. The unique treatment afforded mutual fund underwriters by these rules recognizes their limited role and the fact that, due to the nature of their activities, they do not put customers’ funds or securities at risk and there would appear to be no regulatory purpose for imposing a higher minimum net capital or customer protection reserve requirement on them.

The SEC also recognized the limited role played by mutual fund underwriters when it adopted rules under the Market Reform Act of 1990 (the “Reform Act”). In particular, SEC Rules 17h-1T and 17h-2T exempt mutual fund underwriters from having to file a risk assessment on SEC Form 17-H each quarter. These rules were adopted in 1992 to establish a risk assessment and recordkeeping reporting system for broker-dealers pursuant to authority conferred on the SEC by the Reform Act. As adopted (and proposed), Rules 17h-1T and 17h-2T exempt from the filing requirements on SEC Form 17-H mutual fund underwriters without regard to the size or revenues of such underwriters.<sup>4</sup> According to the Commission’s release adopting Rules 17h-1T and 17h-2T and Form 17-H, this exemption was adopted based on the Commission’s belief that “these limited purpose firms pose limited systemic or customer risk and are beyond the intended scope of the Reform Act . . .”<sup>5</sup>

Another recognition of the limited role played by mutual fund underwriters can be found in the Securities Investor Protection Act. While FINRA’s members are generally required to be covered by insurance under SIPA, since its enactment in 1970, persons whose business as a broker or dealer consists exclusively of the distribution of registered open-end investment companies or unit investment trusts are expressly excluded from SIPA.<sup>6</sup> This exclusion is based on the fact that a mutual fund underwriter does not present the two risks that the SIPA was enacted to address: (1) the risk of loss that would result from a broker-dealer’s failure; and (2) loss of investor confidence in the U.S. securities markets.

In other words, there are very significant and substantive differences between the operations of a retail broker-dealer and a mutual fund underwriter. And just as the SEC has taken these difference into account when adopting net capital, customer protection, and risk assessment reporting rules and

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<sup>3</sup> The minimum net capital requirements in Rule 15c3-1 range from \$5000 to \$250,000.

<sup>4</sup> It does so by exempting from the rule’s filing requirements any broker-dealer that is exempt from the provisions of SEC Rule 15c3-3 pursuant to paragraph (k)(1) (discussed above).

<sup>5</sup> See *Adoption of Rules 17h-1T and 17h-2T*, SEC Release No. 34-30929 (July 16, 1992) at p. 8.

<sup>6</sup> Subsequent to its original enactment, when Congress considered revisions to SIPA proposed in 1975 and 1977, the issue of SIPA’s exclusion for underwriters was considered, debated, and retained.

Congress has taken them into account in enacting SIPA and establishing an insurance program for investors holding brokerage accounts, we believe that FINRA, too, should take these difference into account in revising its consolidated supervisory rules. This approach will avoid imposing on mutual fund underwriters a one-size-fits-all regulatory model that does not comport with the limited nature of their operations and that was designed with retail broker-dealers in mind. Each of the rules we recommend be revised to accommodate the unique nature of a mutual fund underwriter's business is set forth below.

We note that our recommendations to address the impact of the proposed rules on mutual fund underwriters seem consistent with FINRA's current project to define categories of broker-dealers that conduct a limited business and do not process or handle customer funds or securities. Apparently, the goal of this project, as recently explained by Robert Colby, FINRA's Chief Legal Officer, is to determine for such limited purpose dealers the appropriateness of applying certain FINRA rules to them or revising such rules to address their unique circumstances.<sup>7</sup> Our recommendations also seem consistent with FINRA's interest in better understanding whether the rules they impose upon members, or certain members, benefit investors and therefore justify the costs associated with them.<sup>8</sup>

## **II. RULE 3110(e)(2), THE DEFINITION OF "BRANCH OFFICE"**

As proposed, the definition of "branch office" in NASD Rule 3010(g)(2)(A) would become FINRA Rule 3110(e)(2). As with the existing NASD rule, Subdivision (e)(2)(A)(ii) of the proposed rule would exclude from this definition "any location that is the associated person's primary residence" so long as certain conditions are met. These conditions appear designed, in large part, to ensure that: associated persons are not using their homes to conduct a public securities business, the member is aware of each associated person operating out of his or her home, and any of the member's business conducted through such location is captured in the members' records and supervisory systems. We have no concerns with this portion of the rule, and we believe the conditions are appropriate and serve a valid regulatory and public purpose. Unfortunately, however, many associated persons of mutual fund underwriters who act as wholesalers or regional distributors of the fund are unable to take advantage of this exclusion currently and as proposed to be retained. This is because, under Rule 3010(g)(2)(B), if the associated person operating out of his or her home "is responsible for supervising the activities" of

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<sup>7</sup> See "A Few Minutes with FINRA," (June 2013), a "new online video series in which senior FINRA staff discuss timely regulatory topics and respond to comments from firms on specific areas of concern." According to Mr. Colby, the first category of FINRA members being considered as part of this limited purpose broker-dealer project are members that sell hedge funds to institutional clients. We recommend that, as part of this limited broker-dealer project, FINRA consider addressing the limited role played by mutual fund underwriters.

<sup>8</sup> *Ibid.* According to Mr. Colby, FINRA is currently assessing the economic impact of existing and future rules to determine, in part, whether they benefit investors and whether the costs associated with such rules are justified.

other associated persons of the member, their primary residence is deemed a “branch office.” This treatment is problematic for mutual fund underwriters due to their distribution structure.

As discussed above, it is not uncommon for a mutual fund’s principal underwriter to utilize its associated persons as regional distributors<sup>9</sup> to promote sale of the fund shares by retail broker-dealers and other financial intermediaries. The regional distributors, in turn, utilize wholesalers, who are associated persons of the underwriter, to promote sales of fund shares. In this structure, the wholesalers report to and are supervised by the regional distributor of the principal underwriter, who is responsible for supervising their conduct.

Typically, these regional distributors and wholesalers do not meet directly with prospective investors, nor do they make investment recommendations to retail investors.<sup>10</sup> Instead, their role is to educate broker-dealers and other financial intermediaries about the funds they are promoting and encourage broker-dealers and financial intermediaries to offer and sell fund shares to investors. It is not uncommon for these regional distributors and wholesalers to work out of their homes and cars, spending much of their time traveling to meet with financial intermediaries or holding seminars or other events to educate financial intermediaries about the funds. The vast majority of their work is usually done at locations away from their homes or the underwriter’s offices.

Business-related activities conducted in the homes of these regional distributors and wholesalers are usually limited to phone calls and emails (on the registered broker-dealer’s systems) between the principal underwriter, distributors, wholesalers, and financial intermediaries; completing travel and expense reports and reports on their meetings with intermediaries; and review of documents forwarded to and from the principal underwriter. Most, if not all, of these activities could take place at any location, including a hotel room.

Original documents relating to the distributor’s or wholesaler’s activities are maintained by the principal underwriter pursuant to its recordkeeping requirements, not at a regional distributor’s or wholesaler’s home location. The regional distributor’s “tools of the trade” – sales literature, presentations, and prospectuses – would be maintained at the principal place of business of the broker-dealer. The distributor’s business correspondence would be subject to the underwriter’s supervision and maintained, to the extent required, by the underwriter. Similarly, the regional distributor’s emails

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<sup>9</sup> Some principal underwriters use other terms, such as regional managers or divisional directors, to describe the persons who are responsible for supervising the activities of the wholesalers. Regardless of how the fund’s principal underwriter refers to these persons, their functions are as described in this letter.

<sup>10</sup> The one instance in which a regional distributor or wholesaler may meet with retail investors is when the distributor or wholesaler make a joint presentation with representatives of a retail broker-dealer at a seminar organized by the retail broker-dealer for its clients. None of these sessions would occur at the regional distributor’s or wholesaler’s home; nor would they result in the distributor or wholesaler carrying customer accounts or creating required records.

would be sent and received through the underwriter's email systems as required by the law. There are no customer transactions occurring at or through these locations. There are no interactions with retail customers occurring at these locations – nor are these locations held out to the public as locations from which a broker-dealer (*i.e.*, the fund's principal underwriter) conducts business. Moreover, any supervisory activities occurring out of the regional distributors' locations also are limited. They largely consist of providing the wholesalers the tools of the trade (as described above), approving travel and expense reports, holding conference calls, mentoring the wholesalers and monitoring their activities, and reviewing management reports.

In other words, none of the customer protection concerns NASD Rule 3010 or FINRA Rule 3110 seek to address by treating an associated person's primary residence as a branch office would be present with these locations. For these reasons, the Institute respectfully requests that FINRA's proposed Rule 3110(e)(2) permit the primary residence of mutual fund distributors who supervise the activities of mutual fund wholesalers to qualify for the rule's exclusion from the definition of "branch office." To address our concern, we recommend that the provisions of proposed Rule 3110(e)(2)(B) be revised to read:

(B) Notwithstanding the exclusion in subparagraph (2)(A), any location that is responsible for supervising the activities of persons associated with the member at one or more non-branch office locations of the member is considered to be a branch office. The provisions of this subparagraph (2)(B) shall not apply to any location that qualifies for the exclusion in subparagraph (2)(A) if such location is used exclusively by an associated person of a member whose business qualifies for the exemption in SEA Rule 15c3-3(k)(1).<sup>11</sup>

### III. RULE 3110(c), INTERNAL INSPECTIONS

Related to the issue of which locations qualify as a branch office or a non-branch location is the issue of internal inspections. NASD Rule 3010(c) requires, and FINRA Rule 3110(c) proposes to require, each member to conduct an internal inspection of each branch office and non-branch location of the member. Such review must be "reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations." With respect to non-branch locations, which would be applicable to many of the locations utilized by associated persons of mutual fund underwriters (*i.e.*, the homes of their regional distributors and wholesalers), the rule would require such locations to be inspected "on a regular periodic schedule," which shall be determined based on the "nature and complexity of the securities activities for which the

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<sup>11</sup> We believe the most efficient way to describe the business of a mutual fund underwriter in this and other provisions in the proposed rules is to reference the exemption for such broker-dealers in Exchange Act Rule 15c3-3(k)(1). We note that the SEC utilized a similar approach in 1992 when it excluded mutual fund underwriters from the scope of SEC Rules 17h-1T and 17h-2T, as discussed above.

location is responsible and the nature and extent of contact with customers.”<sup>12</sup> As discussed below, the proposed rule will present a number of challenges to mutual fund underwriters without enhancing the protection of customers.

#### **A. Compliance Staff Reviews**

With respect to the required inspections, proposed Rule 3110(c)(3)(B) would prohibit the person conducting the inspection from being assigned to the location or being directly or indirectly supervised by, other otherwise report to, an associated person assigned to the location. A strict reading of this prohibition could be read to prohibit a member’s compliance staff from inspecting the office of supervisory jurisdiction he or she works out of. This may be the result even though the compliance staff person reports to a compliance supervisor and not to the branch manager. Without making accommodation for such arrangements, this rule could result in disruptions to current supervisory systems without enhancing the protection of investors. To address this concern, we recommend that FINRA clarify, in the rule or the adopting release, that compliance personnel who operate independently from the branch or office of supervisory jurisdiction to which they are assigned are permitted to inspect such branch or office of supervisory jurisdiction.

#### **B. Review of Customer Changes**

We additionally recommend that FINRA clarify the requirements of Rule 3110(c)(2)(E), which would require a member’s internal inspection to include a review of “changes of customer account information, including address and investment objectives changes.” This appears to be a significant expansion of a member’s current review responsibilities. Indeed, this provision could be read to require a review of *every* change to a customer’s account regardless of its substance or materiality. By contrast, NASD Rule 3012 currently requires members only to review and monitor changes to a customer’s address or investment objectives. Notwithstanding this significant expansion of a member’s responsibilities, the Release contains no explanation or justification for it. In the absence of a compelling reason for it, we recommend that FINRA clarify, in the rule or in the adopting release, that Rule 3110(c)(2)(E) requires a member to review (and validate) only those changes to customer account information involving a change to the customer’s address or investment objectives.

#### **C. The Inspection Cycle**

With respect to the timing of the periodic inspections, we question the regulatory or public purpose to be served by FINRA presuming that all members should conduct an inspection of each

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<sup>12</sup> Pursuant to Supplementary Material .14, there is a presumption that members should conduct an inspection of each home of regional distributor or wholesaler (*i.e.*, each non-branch location) at least every three years.

home of a regional distributor or wholesaler at least every three years.<sup>13</sup> We note that the Release fails to explain why an inspection cycle of three years or other prescribed period is presumptively reasonable for all FINRA members. We are concerned that this presumption will result in mutual fund underwriters feeling compelled to adopt the three-year cycle and allocate limited resources accordingly, even though a longer inspection cycle may be more appropriate as a result of the limited activities conducted at these offices and even though the costs of these frequent inspections can be expected to outweigh their benefit. In the absence of any “red flags” or identified risks associated with a registered representative’s home office, this result seems contrary to FINRA’s interest in tailoring its regulatory requirements to reflect a member’s limited business and its interest in ensuring that the costs associated with their rules benefit investors and are justified. We recommend that FINRA eliminate any presumption regarding what constitutes an appropriate period between inspections and instead leave up to each member’s determination the appropriate inspection period.

#### **D. Documenting the Areas Reviewed During an Inspection**

In addition to conducting the internal inspection, the member must produce a written report documenting it and maintain the report for at least three years. Subdivision (c)(2)(A) of the rule lists which of the member’s policies and procedures must be tested as part of the inspection and documented in the written report “if applicable to the location being inspected.” Importantly, the items listed would appear to have little application to locations utilized by the regional distributors or wholesalers of a mutual fund underwriter.<sup>14</sup> For each required inspection conducted, the member must also “prevent the inspection standards . . . from being reduced in any manner due to any conflicts of interest that may be present.” This provision, too, would not appear relevant to inspections conducted of a regional distributor’s or wholesaler’s home.

While the rule appears to contemplate situations in which the location being inspected “does not engage” in the activities listed in the rule for testing, it still requires the members to conduct the internal inspection. In such instances, the rule would require the member to “identify those activities [not engaged in at the location] in the location’s written inspection report and document in the report that supervisory policies and procedures for such activities must be in place at that location before the member can engage in them.”<sup>15</sup> As a result of these requirements, it can be expected that the written internal inspection reports prepared following an inspection of the home of a regional distributor or wholesaler will largely consist of a discussion of those supervisory policies and procedures that *do not*

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<sup>13</sup> See Supplementary Material .14 that, as mentioned previously, contains this presumption but notes that a longer periodic reporting period can be used if the member documents certain factors to support such longer period.

<sup>14</sup> These items are the safeguarding of customer assets, maintaining books and records, supervision of supervisory personnel, transmittal of customer funds and accounts, and changes to customer account information.

<sup>15</sup> See proposed Rule 3110(c)(2)(D).

*apply* to the location based on the nature of activities conducted at such location and boiler plate language “that supervisory policies and procedures for such activities [listed in the rule as areas that must be tested] must be in place at that location before the member can engage in them.” We question the regulatory value or public purpose to be served by such a report. Indeed, in light of the fact that these inspections appear intended to ensure that each of the broker-dealer’s offices is protecting customers’ interests and dealing fairly with customers, and in light of the fact that non-branch locations of a mutual fund underwriter’s regional distributors or wholesalers engage in conduct wholly unrelated to these issues, there would appear to be no public or regulatory purpose advanced by requiring a report that primarily consists of a discussion of what is *not* being tested as part of the inspection. To address this concern, we recommend that Rule 3110 be revised to add a new subdivision (c)(2)(E) as follows:

(E) An inspection is not required of any non-branch location if (i) such location is used exclusively by an associated person of a member whose business qualifies for the exemption in SEA Rule 15c3-3(k)(1); (ii) the activities listed in subparagraph (c)(2)(A) do not occur at the location; and (iii) the member oversees the conduct of such location to ensure compliance with all applicable regulatory requirements.

It is important to note that, under our recommended approach, the underwriter’s regional distributors and wholesalers who operate out of their homes (*i.e.* at a non-branch location) would still be subject to the supervisory procedures of the member and the member’s oversight to ensure that such persons’ activities comply with all applicable regulatory requirements (*e.g.*, review of correspondence; approval of sales literature and communications with the public). Their activities would also be reviewed in an inspection of the member’s home office, which is appropriate because all the relevant books and records would be maintained at the home office and the communications of the wholesalers and regional distributors would be reviewed and maintained there. Also, the persons working out of such locations would remain subject to the annual compliance meeting required by proposed Rule 3110(a)(7), which requires the “participation of each registered representative and registered principal, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the member at which compliance matters relevant to the activities of the representative(s) and principal(s) are discussed.” These annual compliance meetings should be sufficient for ensuring that these locations are operating in compliance with the law and overseen by the member.

If FINRA elects not to adopt this exception, in lieu of requiring each internal inspection report to document the areas that do not apply to home office locations, it should permit the member to include in its compliance policies and procedures a record of the types of areas that will not be included in the periodic internal inspection because they are inapplicable to such locations along with the required statement that the “supervisory policies and procedures for such areas must be in place at such locations before the member can engage in them.” This would seem preferable to repeating this

information in every report prepared following the internal inspection of the home office of a regional distributor or wholesaler.<sup>16</sup>

#### **IV. RULE 3110(b)(2), REVIEW OF TRANSACTIONS**

Proposed Rule 3110(b)(2) would incorporate into FINRA's new supervisory rule the requirement of NASD Rule 3010(d)(1), which requires that all transactions be subject to a principal's review and evidenced in writing. Supplementary Material .06 would be added to the new rule to clarify that members "may use a risk-based review system" to comply with the review requirement. According to the Release, the use of the phrase "risk-based" "describes the type of methodology a member may use to identify and prioritize for review those areas that pose the greatest risk of potential securities laws and SRO rule violations. . . . FINRA believes that allowing risk-based review in limited circumstances improves investor protection by ensuring that those areas that pose the greatest potential for investor harm are reviewed more quickly to uncover potential violations."<sup>17</sup>

The Release is entirely silent regarding the impact of Rule 3110(b)(2) and Supplementary Material .06 on those FINRA members that, like mutual fund underwriters, do not have or maintain customer relationships or effect customer transactions. To address this omission, we recommend that the rule be revised to exclude those members that do not have or maintain customer relationships or effect transactions with or for retail investors. Such exclusion seems appropriate in light of the fact that, due to the limited nature of the activities of a mutual fund underwriter, such review is not necessary to protect investors. It also seems consistent with FINRA's interest in better tailoring its regulatory requirements to a member's business and its interest in ensuring that the costs associated with a regulatory requirement do not exceed the benefits of such requirement. If FINRA elects not to revise this rule to exclude mutual fund underwriters, we recommend that it explain in the adopting release how such members are expected to document their compliance with this requirement.

#### **V. RULE 3110(b)(6)(C) AND SUPPLEMENTARY MATERIAL .11, SUPERVISION OF SUPERVISORY PERSONNEL**

Proposed Rule 3110(b)(6)(C) is intended to "address potential abuses in connection with the supervision of supervisors."<sup>18</sup> It does so by requiring a member's supervisory procedures to include

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<sup>16</sup> Enabling a member to document in its compliance policies and procedures the areas that will not be included in an internal inspection is similar to the approach FINRA permits members to use in connection with some suitability analyses. In particular, FINRA Regulatory Notice 11-25 permits a member that "reasonably determines that certain [suitability] factors do not require analysis with respect to a category of customers or accounts . . . to document the rationale for this decision in its procedures or elsewhere, rather than documenting the decision on a recommendation-by-recommendation or customer-by-customer basis." See FINRA Regulatory Notice 11-25 (May 2011) at A.3. on p. 4.

<sup>17</sup> Release at pp. 45-46.

<sup>18</sup> Release at p. 16.

provisions prohibiting an associated person who performs a supervisory function from either supervising their own activities or reporting to, or having their compensation or continued employment determined by, someone they are supervising. An exception from this prohibition is permitted if the member determines, because of the member's size or a supervisory personnel's position within the firm, that compliance with this requirement "is not possible." A member relying on this exception must document the factors used to reach its determination and how the member's "supervisory arrangement with respect to such supervisory personnel otherwise comports with [the rule's requirements]." According to proposed Supplementary Material .11, relating to supervision of supervisory personnel, the exception referenced in Rule 3110(b)(6)(C) "generally will arise only in instances" where the member is a sole proprietor in a single-person firm or a registered person is either the member's most senior or one of several of the member's most senior executive officers (or in a similar position).

While the Institute appreciates the flexibility FINRA intends to provide from the prohibition in this rule, Supplementary Material .11 significantly and unduly narrows the flexibility provided by the rule's text. Based on this narrowing, we are concerned that the Supplementary Material will preclude mutual fund underwriters from relying on the rule's exception when reliance on it is appropriate. For example, a FINRA member within a fund complex may have an affiliate or subsidiary that is a federally-registered investment adviser. In such arrangements, it is not uncommon for an associated person of the advisory firm to wear multiple hats, one of which may require registration with FINRA as a Series 7 and 24 representative. Because of the Series 24 license, the associated person may be called upon to supervise, for a limited purpose (*e.g.*, review of advertising or marketing material produced by the adviser that will be used by a FINRA member), a more senior person who only has a Series 7 license.

For mutual fund underwriters, it is also not uncommon for a Series 24 principal who performs supervisory functions to report to senior business management of a mutual fund distributor, some of whom are Series 6 or 7 registered representatives and some of whom determine both compensation and/or continued employment. Since the primary function of such senior business management has very little to do with their FINRA securities licenses, with limited exceptions, it does not make sense for them to have to register as Series 24 principals.<sup>19</sup> Such limited circumstances should not present the types of conflicts or abuses that Rule 3110(b)(6)(C) is intended to address.

To ensure that the rule does, in fact, provide members sufficient flexibility to accommodate situations such as those discussed above and is not so rigid that it precludes reliance on it when appropriate, we recommend that FINRA delete Supplementary Material .11. We note that, notwithstanding the deletion of this Supplementary Material, a member relying on the exception in Rule 3110(b)(6)(C) would still be required to document the factors used to reach its determination

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<sup>19</sup> One such limited exception might be for those members of the senior management business team who are on the Board of Directors of a regulated entity.

that it is eligible for the exception and how the member's supervisory arrangements otherwise comport with the rule's requirements. The member would also be required, as provided in Rule 3110(b)(6)(D), to ensure that its supervisory procedures are not "reduced in any manner, due to any conflicts of interest that may be present" as a result of the supervisory arrangement.

If FINRA declines to delete Supplementary Material .11, we recommend that the Supplementary Material be revised to expand the list of instances in which a member may rely on the exception provided by Rule 3110(b)(6)(C). Such expansion should include circumstances, such as those discussed above, in which a supervisor, for a limited purpose or a limited function, supervises the activities of a person who determines the supervisor's compensation or continued employment.

## **VI. RULE 3110(B)(4) AND SUPPLEMENTARY MATERIAL .08, REVIEW OF CORRESPONDENCE AND INTERNAL COMMUNICATIONS**

### **A. Intended Scope of "Internal Communications"**

As proposed, Rule 3110(b)(4) would require a member's supervisory procedures to include provisions for the review "of incoming and outgoing written (including electronic) correspondence with the public and internal communications relating to the member's investment banking or securities business." As noted in the Release, this provision was intended to be narrowed to address the concern of commenters (including the Institute) that it appeared to require review of *all* internal communications.<sup>20</sup> Unfortunately, FINRA's modification has not adequately addressed our concerns, as explained below.

We believe that the proposed rule could be read to require the review of almost all internal communications.<sup>21</sup> This is because, while the rule would require the review of incoming and outgoing "internal communications relating to the member's investment banking or securities business," it does not define which of the member's "internal communications" are considered to relate to the member's business. As a result, aside from perhaps a personal internal email from one employee to another, it is not clear how a member's review obligation would be modified by the change in the rule's scope from "all" internal communications to "internal communications relating to the member's investment banking or securities business."

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<sup>20</sup> The version of Rule 3110(b)(4) previously published for comment would have required the review of all internal communications.

<sup>21</sup> See also Release at p. 47 (which states that a member's procedures must provide for the member's review of its internal communications to properly identify communications *that are of a subject matter that require review* under FINRA or MSRB rules and the federal securities laws and that, by employing risk-based principles, the member must decide the extent to which additional policies and procedures for the review of *additional internal communications are necessary for its business and structure*.) [Emphasis added.] See, also, the Institute's discussion in Section VII of this letter regarding our concerns with FINRA including references to the MSRB's rules in its proposal.

While the rule text is ambiguous regarding which internal communications must be reviewed, the Release attempts to explain the parameters of the review requirement. According to the Release the following are some – *but not all* – of the internal communications that must be reviewed:

- Communications between non-research and research departments concerning a research report's contents (NASD Rule 2711(b)(3) and NYSE Rule 472(b)(3));
- Certain communications with the public that require a principal's pre-approval (FINRA Rule 2210);
- The identification and reporting to FINRA of customer complaints (FINRA Rule 4530); and
- The identification and prior written approval of changes in account name(s) (including related accounts) or designation(s) (including error accounts) regarding customer orders (FINRA Rule 4515).<sup>22</sup>

Although this discussion is somewhat helpful, the list of communications is not exhaustive and, because the rule does not define what is meant by the phrase “relating to the member’s investment banking or securities business,” the rule may still be read to require a review of *all* internal communications, except those that are of a purely personal nature.<sup>23</sup>

We therefore strongly recommend that FINRA revise this rule and the related Supplementary Material to provide greater certainty regarding which communications, or types of communications, members are – and are not – required to review for purposes of Rule 3110(b)(4). We recognize that it may not be possible or practical for FINRA’s rule to provide a comprehensive list of all internal communications that are, and are not, subject to review. Notwithstanding this, there are two additional categories of documents that we think FINRA should clarify the treatment of. In particular, we recommend that FINRA make clear that internal communications used to train or educate the member’s registered representatives on the member’s products and services are subject to review. By contrast, it should clarify that internal communications that are privileged or that relate to operational issues are not subject to review. For those internal communications not expressly categorized by FINRA as either warranting, or not warranting, review, we recommend FINRA make clear that, in implementing the requirements of Rule 3110(b)(4), “a firm may use risk-based principles . . . to determine which review of any internal communications is necessary” as provided in Regulatory Notice

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<sup>22</sup> Release at p. 12.

<sup>23</sup> The Release also notes that Rule 3110(b)(4) and Supplementary Material .07 have been modified “to more precisely reflect the guidance in Regulatory Notice 07-59 that a member must have supervisory procedures to provide for the member’s review of its internal communications to properly identify [those] that are of a subject matter that require review under FINRA or MSRB rules . . . .” Release at p. 47. We note, however, that the guidance in Regulatory Notice 07-59 is limited to using a risk-based model to review internal *electronic* communications.

07-59.<sup>24</sup> We also recommend that FINRA clarify that, with respect to such communications, a member may tailor its policies and procedures based on the member's size and activities.<sup>25</sup> These clarifications are necessary because not all internal communications warrant review or the same level of review and because not all FINRA members have the same business model or size and present the same risk to the investing public.

### **B. Use of Electronic Review Systems or Lexicon-Based Screening Tools**

Due to the ever-increasing use of electronic media and communications, many FINRA members use electronic screening and monitoring software or programs to facilitate their review of such communications. We are concerned that proposed Supplementary Material .08 might be read to preclude the continued use of such tools. This is because this Supplementary Material requires that the evidence of review of a communication required by proposed Rule 3110(b)(4) "clearly identify the review, the internal communication or correspondence with the public that was reviewed, the date of review, and the actions taken by the member as a result of any significant regulatory issues identified during the review."

While commenters had suggested that FINRA clarify "that a member does not have to retain the specified information fields required by Supplementary Material .08 for communications that are reviewed through electronic review systems or lexicon-based screening tools if [the messages reviewed] do not generate review alerts," FINRA declined to accept this suggestion. According to the Release, "the required documentation is necessary to demonstrate *that the communication was actually reviewed*. In addition, failing to record and retain such information, such as the identity of the reviewer, could be contrary to a member's record retention obligations required under both FINRA and SEC rules."<sup>26</sup>

The Institute does not oppose requiring members to maintain documentation evidencing the review of communications required by FINRA's rule and the member's supervisory procedures. We do

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<sup>24</sup> FINRA Regulatory Notice 07-59 (December 2007) at p. 3. This Notice further provides that "the guidance neither creates new supervisory requirements *nor requires the review of every communication*. Rather, it sets forth *principles that firms should consider* in developing supervisory systems and procedures *for electronic communications* to aid in accomplishing that they are reasonably designed to achieve compliance with applicable federal securities laws and SRO rules." [Emphasis added.] *Ibid*.

<sup>25</sup> For example, a member may determine to have a supervisor review only those incoming communications that may have regulatory value (*e.g.*, customer complaints, checks, transactional information) but not routine items of correspondence. Also, a mutual fund underwriter that logs correspondence with regulatory value but forwards it to the fund's transfer agent for processing, should only be required to document the receipt and forwarding of the correspondence and not the fund's transfer agent's processing of the item. Indeed to require an underwriter that does not conduct business with retail customers to report on the transfer agent's processing of such communications may be difficult and would serve no regulatory purpose under FINRA's rules, which do not extend to transfer agents' activities.

<sup>26</sup> Release at p. 49. [Emphasis added.]

oppose, however, FINRA imposing standards on this documentation that are so rigorous so as to preclude the necessary and appropriate use of electronic reviewing tools, including lexicon-based systems.<sup>27</sup> We strongly recommend that the rule and its Supplementary Material permit the use of such reviewing tools so long a member creates and maintains records demonstrating that it has controls in place that are reasonably designed to ensure that the reviewing tool screens communications subject to review and is operating as intended.<sup>28</sup> Thereafter, when the system is operational, the member should only be required to maintain records documenting the review of those communications that have generated review alerts, including records documenting who reviewed the communication, the date of review, and the actions taken as a result of the review. A member should not be required to document each and every communications reviewed by the tool. Instead, once the member documents use of the tool, the member should only be required to document the review of those communications that generated an electronic risk alert. We recommend that, when this rule and its Supplementary Material are adopted, this issue is addressed in a way that will not frustrate members' use of electronic review tools.

## **VI. RULE 3110(d), TRANSACTION REVIEW AND INVESTIGATION**

Proposed FINRA Rule 3110(d)(1) would require a member to have supervisory procedures to review securities transactions that are effected for a member's or associated person's accounts, as well as any other "covered account" to "identify trades that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices." This rule, which would codify in FINRA's consolidated rules a requirement from NYSE Rule 342.21, would impose a new transaction review requirement on FINRA members.<sup>29</sup> According to FINRA, "the primary purpose of the rule is to identify insider trading" because "robust transaction review . . . provides a deterrent effect that can prevent insider trading and other manipulative or deceptive trading activity by associated persons."<sup>30</sup> The rule would also require any member that engages "in investment banking services,"<sup>31</sup> to file with FINRA each quarter a written report that is signed by a senior officer of the member and describes each internal investigation undertaken of any trade that may violate rules of the SEC or FINRA that prohibit insider trading and manipulative and deceptive devices. We recommend that this rule be revised to address the concerns discussed below.

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<sup>27</sup> FINRA previously has recognized the appropriateness of lexicon-based search methodologies as part of the risk-based oversight of public appearances. *See* FINRA Regulatory Notice 11-39 (August 2011) at p. 2.

<sup>28</sup> This approach is similar to other electronic tools utilized by members, such as those that generate exception reports.

<sup>29</sup> It bears noting that the NYSE's rule was designed for NYSE members effecting transactions in NYSE-listed securities. The rule was neither designed nor implemented to address any concerns with mutual fund underwriters.

<sup>30</sup> Release at pp. 70 and 73.

<sup>31</sup> As defined in the rule, the term "investment banking services," would include any person "acting as an underwriter."

### **A. Covered Accounts**

As proposed, Rule 3110(d) would require each member to include in its supervisory procedures a process for the review of securities that are transacted for the account of the member or the member's associated persons, as well as for "any other covered account." The term "covered account" would be defined in the rule to mean any account: (1) held by the spouse, domestic partner, child, parent, sibling, soon-in-law, daughter-in-law, father-in-law, or mother-in-law of a person associated with a member if the account is introduced or carried by the member; (2) introduced or carried by the member if a person associated with the member has a beneficial interest in the account or the authority to make investment decisions; and (3) disclosed to the member pursuant to NASD Rule 3050 or NYSE Rule 407, as applicable.

As proposed, the term "covered account" would extend to family members beyond those that are covered by other existing FINRA rules or rules of the SEC and the NYSE.<sup>32</sup> For example, the term would now include the accounts of any in-laws of a representative – based on nothing more than the fact that the holder of the account is related to a registered representative through a child's marriage. The expanded breadth of this term will also significantly expand a member's responsibility under this rule. We are quite concerned with this expansion and its impact on members, particularly mutual fund underwriters. Not only can this breadth be expected to violate the legitimate privacy expectations of persons whose very personal financial information would now fall within the member's view and be subject to the member's review, it can also be expected to impose considerable burdens on members that would be required to identify the accounts of relatives of associated persons (some of whom may, in fact be estranged from or not close to the associated person) and monitor and supervise those accounts.<sup>33</sup>

These burdens will be especially acute for those principal underwriters that provide services to, but are not affiliated with, a fund complex and who, therefore, are currently relieved from having to adopt and administer a code of ethics under SEC Rule 17j-1. Notwithstanding the considerable

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<sup>32</sup> See, e.g., FINRA Rule 2711, governing Research Analysts and Research Reports, SEC Rule 17j-1 under the Investment Company Act of 1940, governing Personal Investment Activities of Investment Company Personnel, and Supplementary Material .21 to NYSE Rule 342. FINRA's Rule 2711 only extends to individuals whose principal residence is the same as the research analyst's principal residence and expressly excludes unrelated persons who share the same residence as the research analyst so long as such persons are financially independent from one another. The SEC's rule is designed to prohibit fraudulent, deceptive or manipulative acts by fund personnel in connection with their personal transactions in securities held or to be acquired by the fund. Its scope includes directors, officers, or general partners of a fund or the fund's investment adviser as well as any director, officer, or general partner of a principal underwriter who, in the ordinary course of business, makes, participates in, or obtains information regarding the fund's trading activities. The NYSE's rule is limited to a review of trades that "are effected for the account of the member or member organization or for the accounts of members or employees of the member or member organization and their family members."

<sup>33</sup> This may be particularly true of unaffiliated third-party underwriters that are expressly exempt from SEC Rule 17j-1.

burdens FINRA's revised rule would impose on such underwriters and other FINRA members, the Release is wholly silent regarding why it is necessary for FINRA's rule to sweep so much broader than other similar regulatory rules. It is also silent regarding why the breadth of the current rule is no longer adequate for FINRA to fulfill its regulatory mission and address regulatory concerns. In the absence of such justification, we submit that such a significant expansion of the information that must be obtained and reviewed by a member is unwarranted and not supportable. We therefore recommend that the rule's scope be scaled back to be more reasonable and consistent with rules of the SEC and the NYSE, as well as with FINRA Rule 2711.

## **B. Investment Banking Services**

As noted above, the proposed rule would require any member that engages in "investment banking services" to file with FINRA *each quarter*, a written report that is signed by a senior officer of the member and describes each internal investigation undertaken of any trade that may violate the rules of the SEC or FINRA that prohibit insider trading and manipulative and deceptive devices. According to the Release, FINRA deliberately intended to include mutual fund underwriters in the definition of "investment banking services." In support of its determination to include mutual fund underwriters, FINRA notes that "because individuals engaged in investment banking activities *may have special access to material, non-public information, which increases the risk of insider trading by those individuals*, FINRA believe that this additional reporting requirement [for members engaged in investment banking activities] is appropriate."<sup>34</sup> Moreover, "to the extent *commenters are correct* that certain types of underwriting activities do not present the same risk of insider trading, *the instances of reporting obligations on firms that only engage in those activities should not be significant.*"<sup>35</sup>

We are perplexed by FINRA's response to commenters' concerns regarding the incongruity of subjecting mutual fund underwriters to a rule whose "primary purpose" is to prevent insider trading by members that provide "investment banking services." Traditional investment banking services involve financial institutions, such as broker-dealers, assisting individuals, corporations, and governments in raising money. As a result of the nature of this activity, a firm that provides investment banking services likely has access to non-public information that could be used to engage in insider-trading or deceptive or manipulative activity, in violation of the Federal securities laws. Accordingly, it seems wholly appropriate for FINRA to require such firms to be more vigilant about their covered persons' trading activity and investigate any suspicious trading. The same does not hold true for mutual fund underwriters.

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<sup>34</sup> Release at p. 75. [Emphasis added.]

<sup>35</sup> Release at pp. 75-76. [Emphasis added.]

As discussed above, the business of a mutual fund underwriter is quite limited. It is also quite different than the type of underwriting activities undertaken by investment banking firms. Unlike such firms, mutual fund underwriters do not structure any deals involving the fund's issuance of securities or the structure of fund offerings. A mutual fund's trading activity occurs away from the underwriter and is conducted by the mutual fund's investment adviser.<sup>36</sup> In those instances in which a mutual fund's underwriter or its associated persons may have access to non-public trading information of the fund (*e.g.*, where the fund's underwriter and adviser are related entities) provisions of both the Investment Company Act of 1940 and the Investment Advisers Act of 1940 already ensure the protection of such information to prevent its misuse without the need for FINRA also to adopt rules in this area.<sup>37</sup>

In other words, because the basis for the proposed rule is to prevent insider trading, there appears to be no public purpose for including mutual fund underwriters, which present low, if any, risk of insider trading, in the select group of FINRA members – *i.e.*, those conducting an investment banking business – that will be subject to additional reporting requirements. Our concern with including mutual fund underwriters in the scope of this new requirement is exacerbated by FINRA's statements in the Release that, if the rule's application to mutual fund underwriters is misplaced, it should not be of concern to such firms because they may never need to submit the required reports.<sup>38</sup> This response wholly overlooks the costs and burdens associated with adopting and implementing the policies and procedures and systems that must be put in place to ensure compliance with the rule even if they never trigger the filing of a report.

Consistent with FINRA's interest in tailoring its rules as necessary to protect public investors, and its interest in considering the costs associated with its rules vis-à-vis the public benefit of such rules, we strongly recommend that FINRA expressly exclude mutual fund underwriters from the definition of "investment banking services" in this rule. In particular, we recommend that the proposed definition in Rule 3110(d)(3)(B) be revised by adding the following to the end of the proposed definition:

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<sup>36</sup> It should additionally be noted that, since 2004, SEC Rule 12b-1(h)(2) has prohibited the use of fund brokerage to compensate broker-dealers for selling fund shares. As a result, a fund's investment adviser can "use its selling broker to execute transactions in portfolio securities only if the fund or its adviser has implemented policies or procedures designed to ensure that its selection of selling brokers for portfolio securities transactions is not influenced by considerations about the sale of fund shares." *See Prohibition on the Use of Brokerage Commissions to Finance Distribution; Final Rule*, SEC Release No. IC-26591 (September 2, 2004).

<sup>37</sup> *See* SEC Rule 17j-1 under the Investment Company Act of 1940 and Section 204A of the Investment Advisers Act of 1940. Importantly, SEC Rule 17j-1(c) expressly requires both the fund "and each investment adviser and principal underwriter of the Fund [to] adopt a written code of ethics containing provisions reasonably necessary to prevent its Access Persons" from engaging in unlawful actions involving the fund. As defined in the rule, the term "access person" would include "any director, officer, or general partner of a principal underwriter who, in the ordinary course of business, makes, participates in or obtains information regarding the purchase or sale of covered securities of the Fund . . ."

<sup>38</sup> Release at pp. 75-76.

(B) The term “investment banking services” shall include, without limitation . . . Notwithstanding this definition, a member that qualifies for the exemption in SEA Rule 15c303(k)(1) shall not be deemed to be engaging in “investment banking services” as used in this Rule.

### C. Required Quarterly Reports of Investigation

As noted above, Rule 3110(d) would require a member engaging in investment banking services to conduct an internal investigation of *any* trade that *may* violate prohibitions relating to insider trading or involve manipulative and deceptive devices and to file a report with FINRA quarterly regarding such investigation(s). By not including any materiality or reasonableness standard, this reporting requirement seems unduly broad and likely to result in reports on activity that ultimately is determined to be lawful.

According to the Release, Rule 3110(d) is intended to codify in FINRA’s rules a requirement from NYSE Rule 342.21. And yet, FINRA’s proposal omits important and relevant guidance the NYSE has published to assist its members in implementing Rule 342.21. In particular, NYSE’s Information Memo 06-06 (February 17, 2006) provides in relevant part as follows:

Rule 342.21 does not specify the manner in which each member and member organization should identify and investigate such trades. Rather, the Rule sets forth broad requirements, leaving each member or member organization to put in place a process that appropriately satisfies the requirement to have procedures that are reasonably designed to identify Potentially Violative Trades (as defined below), which should include establishing guidelines or criteria for taking reasonable follow-up steps to determine which Trades are Potentially Violative Trades and, therefore, merit further review via a Rule 342.21(b) ‘internal investigation.’

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. . . not every Trade subjected to a firm inquiry or review *will result in a reportable Rule 342.21(b) internal investigation.* [Emphasis added.] However, when a firm subjects a Trade to a level of review sufficient to constitute a Rule 342.21(b) internal investigation, members and member organizations must, without exception, report in one or more Rule 351(e) filings every Rule 342.21(b) internal investigation that is commenced.

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*Accordingly, firms should ensure that they have written procedures in place that are “reasonably designed” to identify Potentially Violative Trades. Such procedures must be*

***written and must cover all areas of the firm responsible for identifying Potentially Violative Trades. The Exchange recognizes that different areas of the firm may be susceptible to different types of violative conduct or trading abuses contemplated by the Specified Prohibitions. Therefore, the Exchange expects that the firm's written procedures will contain guidelines or criteria for follow-up steps for each area of the firm which are reasonably designed for the particular business of that area.*** [Emphasis in original.]

In other words, the NYSE's rule, which FINRA is incorporating into Rule 3110(d), does not appear to require the same broad level of investigation and reporting that FINRA proposes. As a result, even those NYSE members that have been subject to the NYSE's rule may find their reporting requirements under Rule 342.21 significantly increased under FINRA Rule 3110(d). To avoid this result, we recommend that FINRA add Supplementary Material under Rule 3110(d) that is consistent with NYSE Information Memo 06-06.

In addition, however, we question the need for this rule in light of FINRA Rule 4530. As of 2011, FINRA Rule 4530 has required each member of FINRA to promptly report to FINRA after the member has concluded or reasonably should have concluded that an associated person of a member or the member has violated *any* securities, commodities, financial, or investment related laws, rules, regulations, or standards of conduct whether domestic, foreign, or of a self-regulatory organization. Supplementary Material .01 to the rule clarifies that the rule does not require reporting of every instance of noncompliance conduct, but only violative conduct by a firm that has "widespread or potential widespread impact to the member, its customers, or the markets . . ." among other things. The reporting required by FINRA Rule 4530 should amply address and provide FINRA notice, in a more reasonable manner, of the information it now seeks through proposed Rule 3110(d). Also, because Rule 4530 only requires reporting after a member has concluded, or reasonably concluded, a violation of law has occurred, members are able to avoid premature and unnecessary reporting of conduct that the member ultimately concludes was lawful.

To avoid overly broad and premature reporting and tailor the rule's reporting requirement to instances that are likely to involve insider or unlawful trading, we recommend that the rule only require reports of investigations that are undertaken because the member has reason to believe that unlawful trading has occurred or may have occurred or where the member has reason to believe that there likely has been a violation of law.<sup>39</sup>

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<sup>39</sup> Consistent with Supplementary Material .01 to FINRA Rule 4530, FINRA should consider revising Rule 3110(d) to require reporting only of those violations that have a "widespread or potential widespread impact to the member, its customers or the markets, or [violations] that arise from a material failure of the member's systems, policies or practices involving numerous customers, multiple errors or significant dollar amounts."

## VII. RULE 3110(a), REFERENCES TO THE MUNICIPAL SECURITIES RULEMAKING BOARD<sup>40</sup>

FINRA proposes to incorporate in its supervisory rules a reference to rules of the MSRB. As such, a member whose supervisory system is not reasonably designed to achieve compliance with all applicable MSRB rules would be in violation of FINRA Rule 3110(a). In support of this, the Release states that the “SEC staff has confirmed FINRA staff’s view that a violation of the MSRB rules would also be a violation *of the federal securities laws*, as it would constitute a violation [Section 15B(c)(1) of the Securities Exchange Act of 1934].”<sup>41</sup>

A dealer that is dually registered with the MSRB as a municipal securities dealer and with FINRA as a broker-dealer would be subject to the rules of the MSRB and the rules of FINRA appropriate to the transactions being effected and the business being conducted (*e.g.*, sales of municipal securities would be subject to the MSRB rules and authority; sales of securities would be subject to FINRA’s rules and authority). The MSRB has a rule that governs its registrants’ supervisory obligations – *i.e.*, Rule G-27. A municipal securities dealer that violates this rule would be subject to sanctions by the MSRB. We fail to see why a municipal securities dealer, assuming it is dually registered with FINRA as a broker-dealer, would also be subject to a regulatory action by FINRA for violating FINRA Rule 3110 solely by virtue of the fact that it violated MSRB Rule G-27. A violation of the MSRB’s rules may be sanctioned by the MSRB as a violation of both the MSRB’s rules and Section 15B(c)(1) of the Securities Exchange Act without the need to rely additionally on a FINRA rule. Accordingly, aside from being able to cite the dealer under an MSRB rule *and* a FINRA rule for a single violation, there would appear to be no public purpose served by referencing the MSRB in Rule 3110.<sup>42</sup> We therefore recommend the deletion of this reference to the rules of the MSRB.

## VIII. RULE 3120, SUPERVISORY CONTROL SYSTEMS

Proposed Rule 3120 would replace NASD Rule 3012, which currently governs a member’s supervisory control system. As with the current NASD rule, the new rule would require members to: establish, maintain, and enforce a system of supervisory control policies and procedures; test and verify those procedures; and create additional, or amend existing, supervisory procedures where warranted based on the results of such testing and verification. Rule 3120 would also continue to require a member’s designated principal (or principals) to submit to the member’s senior management at least

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<sup>40</sup> Many of the Institute’s members that are principal underwriters to mutual funds also serve as principal underwriters to 529 education savings plans, which are municipal fund securities. As a result, in addition to being registered with FINRA, these members are registered with and regulated by the MSRB as municipal securities dealers.

<sup>41</sup> Release at fn. 4. Section 15B(c)(1). [Emphasis added.]

<sup>42</sup> We are not aware of instances in which the MSRB’s rules enable a dual registrant that violates an MSRB rule to also be cited by the MSRB for violating a FINRA rule.

annually a report detailing the member's supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

New to the rule would be a requirement imposed on only those members that "reported \$200 million or more in gross revenue" during a calendar year. This new requirement is that the member's annual supervisory report include additional information relating to "a tabulation of reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year" and a discussion of the member's "compliance efforts" for the previous year in the following areas: trading and market activities; investment banking activities;<sup>43</sup> antifraud and sales practices; financial and operations; supervision; and anti-money laundering.

The Release notes that the \$200 million reporting threshold in the proposed rule was "increased from the \$150 million threshold originally proposed."<sup>44</sup> In FINRA's view,

the revised threshold strikes the appropriate balance as it encompasses larger dual member firms, members engaged in significant underwriting activities (including variable annuity principal underwriting and fund distributions) and substantial trading activities or market making business, and members with extensive sales platforms – approximately 160 member firms in total. The additional content requirements applicable to such firms *would provide a valuable resource in the context of understanding and examining those firms and their activities, which can generally be more complex or sizeable than smaller firms' activities.*<sup>45</sup>

We understand that, because of the nature of the financial transactions between a mutual fund, its principal underwriter, and the retail distributors of mutual fund shares, in which 12b-1 fees or other revenues may flow from the fund through the underwriter and to the retail distributors, a mutual fund underwriter may, in fact, meet the \$200 million threshold of the rule during the year. This is because it is not uncommon for a fund underwriter, which serves as the "middleman" between the fund and the fund's retail distributors to serve as the conduit for 12b-1 revenues that are paid by the fund to its distributors. Though these 12b-1 payments may show up as gross revenues of a mutual fund underwriter, they are really revenue that is paid by the underwriter to the fund's distributors.

Under Rule 3120, these 12b-1 payments may trigger the requirement for an underwriter to provide the supplemental annual supervisory report to senior management. And yet, mutual fund underwriters do not appear to be the "complex" firms FINRA had in mind in proposing this rule and

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<sup>43</sup> We presume that the term "investment banking activities" as used in this rule has a meaning different from the use of that term in Rule 3110(d) where the definition is expressly limited to its use under Rule 3110.

<sup>44</sup> Release at p. 30.

<sup>45</sup> Release at pp. 30-31. [Emphasis added.]

Elizabeth M. Murphy, Secretary

July 29, 2013

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the supplemental information contained in such reports would appear to be of questionable value due to the limited nature of the underwriter's business.

To avoid imposing the costs and burdens that would result from this supplemental reporting requirement on those underwriters that serve as conduits for the payment of 12b-1 fees from the fund to the fund's distributors, we strongly recommend that Rule 3120 exempt any FINRA member that qualifies for the exemption in Rule 15c3-3(k)(1) under the Exchange Act from Rule 3120's requirement to include supplemental information in their annual report to senior management. Alternatively, FINRA could address our concerns by excluding from the rule's definition of "gross revenue" any revenue the underwriter receives as a payment from the fund pursuant to Rule 12b-1 under the Investment Company Act of 1940 that the underwriter pays to a fund intermediary within 3 months of their receipt. This alternative would address our concerns with mutual fund underwriters triggering the \$200 million threshold by serving as a conduit for the 12b-1 revenues paid by the fund to the fund's distributors.

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The Institute appreciates the opportunity to share these comments on FINRA's proposed rules and we appreciate the Commission's consideration of the issues discussed above. If you have any questions concerning our comments or require additional information regarding any of our recommendations, please do not hesitate to contact the undersigned by phone (202-326-5825) or email ([tamara@ici.org](mailto:tamara@ici.org)).

Sincerely,

/s/

Tamara K. Salmon

Senior Associate Counsel