

VIA ELECTRONIC MAIL

June 13, 2008

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

RE: Rulebook Consolidation Proposals

Dear Ms. Asquith:

Following the July 2007 consolidation of the NASD and NYSE Regulation into FINRA, FINRA established a process to develop a new consolidated rulebook.¹ The new FINRA Rules will apply to all FINRA members and are to be proposed in phases. On May 14, 2008, FINRA released a series of Regulatory Notices intended as the first step in the process of rulebook consolidation (Rule Proposals). The recent Rule Proposals address the following areas:

- Financial Responsibility,
- Supervision and Supervisory Controls,
- Books and Records, and
- Investor Education and Protection.

The Financial Services Institute² (FSI) recognizes that combining the rulebooks of the predecessor regulatory authorities represents a significant challenge. We commend FINRA for recognizing in the rulebook consolidation process an opportunity to develop a new organizational framework for the rules, consider new approaches to regulatory concerns, and delete obsolete rules. With so many changes in the structure and substance of the rulebook being considered, we believe industry input is more important than ever. We, therefore, praise FINRA for seeking industry comment on the Rule Proposals prior to submitting them to the SEC.

The Rule Proposals are of particular interest to FSI. FSI supports efforts to reorganize, update, and streamline industry regulations. This approach is clearly demonstrated in the financial responsibility, books and records, and investor education and protection Rule Proposals. In these areas, FSI offers recommendations for further improvement to the text of the Rule Proposals. In the supervision and supervisory control Rule Proposal, however, FINRA has attempted to

¹ See FINRA Information Notice entitled "Rulebook Consolidation Process" (March 12, 2008) at <http://www.finra.org/RulesRegulation/NoticestoMembers/2008Notices/P038121>.

² The Financial Services Institute, Voice of Independent Broker-Dealers and Independent Financial Advisors, was formed on January 1, 2004. Our members are broker-dealers, often dually registered as federal investment advisers, and their independent contractor registered representatives. FSI has 119 Broker-Dealer member firms that have more than 138,000 affiliated registered representatives serving more than 14 million American households. FSI also has more than 12,500 Financial Advisor members.

introduce a principles-based approach to familiar regulatory issues. This approach appears to greatly expand FINRA's jurisdiction and the liability exposure for IBDs. As a result, our most detailed comments relate to the supervision and supervisory controls Rule Proposal.

As an additional concern, it is unclear to us whether prior interpretative guidance related to the former NASD Rules will apply to the Rule Proposals. We believe FINRA should clarify the application of NASD Notices to Members and other guidance to the Rule Proposals so that firms understand the continuing relevance of this guidance, if any, to their business operations. This information would be appropriate in the Supplementary Material for each Rule Proposal.

With regard to the specific Rule Proposals, we offer our comments below. If we have not discussed specific changes, we have no objections to the Rule Proposal.

Background on FSI Members

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

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

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping

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

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

Americans plan for and achieve their financial goals. FSI's primary goal is to insure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Comments

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

1. Financial Responsibility⁵

- Rule Proposal 4110. Capital Compliance – While many of the provisions of the Rule Proposal apply to clearing firms, FSI is concerned with the precedent set by section 4110(a) that allows FINRA to prescribe greater net capital or net worth requirements than those otherwise applicable. We feel strongly that in situations where FINRA requires members to increase net capital beyond SEC requirements, it is incumbent upon FINRA to demonstrate that it is exercising this power equitably. Therefore, we recommend that FINRA clearly delineate the factors it will consider in determining when to require greater net capital or net worth.

We also have some concerns with subsection 4110(c) of the Rule Proposal. Specifically, we are concerned about the impact on smaller or start up firms of the requirement that capital infusions be tied up for a one-year period absent written permission from FINRA for is.⁶ We believe this requirement may present a significant challenge to such firms. As a result, we recommend that the provision be struck from the Rule Proposal or, in the alternative, that FINRA clearly delineate the factors it will consider in determining whether to grant permission for the early withdrawal of capital infusions and establish a reasonable time period in which FINRA must approve or reject such a request. Requiring certain members to obtain written approval from FINRA before withdrawing capital in excess of 10% of the member's excess net capital represents a significant departure from prior NASD requirements. We recommend that FINRA simply maintain the current SEC requirements. However, should FINRA adopt the proposed pre-approval requirements, we once again suggest establishing a reasonable period in which FINRA must approve or reject such a request. We also suggest increasing the pre-approval threshold to 20% to align with SEC requirements. We ask that FINRA also delineate the factors it will consider in determining whether to grant permission for the firm to withdraw capital in excess of the threshold percentage. Finally, we request clarification as to whether FINRA will base its pre-approval on capital calculated when the request was filed or whether FINRA will require the member to re-compute capital at some point after the request was filed.

- Rule Proposal 9557. Procedures for Regulating Activities Under Rules 4110, 4120 and 4130 Regarding a Member Experiencing Financial or Operational Difficulties – We are concerned that the two business days provided by the Rule Proposal are simply not enough time for a member experiencing financial difficulties to evaluate

⁵ See FINRA Regulatory Notice 08-23 entitled "Proposed Consolidated FINRA Rules Governing Financial Responsibility" (May 14, 2008) at <http://www.finra.org/RulesRegulation/NoticestoMembers/2008Notices/P038509>.

⁶ See FINRA Rule Proposal 4110(c)(1).

whether to pursue an expedited appeal.⁷ We recognize FINRA's desire to resolve these matters quickly, but believe this desire must be balanced against the broker-dealer's need to carefully consider their decision. As a result, we recommend that the Rule Proposal be amended to provide firms five business days in which to request a hearing. We believe this period would provide firms with sufficient time to evaluate their options while also ensuring FINRA can achieve its goal of investor protection.

2. Supervision and Supervisory Controls⁸

- Rule Proposal 3110(a). Supervisory System – FSI believes that consideration should be given to a risk-based approach to supervisory systems, one that would establish levels of supervision based on the functions of certain associated persons. For example, supervisory requirements for persons who hold permissive licenses under NASD Rule 1021(a) and 1031(a), but otherwise are not directly engaged in the securities business of the firm (e.g., support functions) should be different than the supervisory requirements for registered persons actively engaged in the securities business. We believe that establishing supervisory controls that are more tailored to each class of associated persons will result in tighter supervisory controls while reducing the expense of unnecessary supervisory controls over certain associated persons. Likewise, we believe specifically identifying the scope of "associated persons" would provide clarity. We do not believe it is FINRA's intent to require a member to impose supervisory controls over individuals that are not engaged in the business of securities but are, for example, employees of affiliates who merely provide incidental services to the firm or where the affiliate reports to a senior executive who is also a registered principal of the firm.

In addition, we are concerned that subsection 3110(a)(2)'s requirement that firms designate "an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages" is overly broad. The language suggests that firms must designate registered principals with supervisory responsibilities for outside business activities (e.g., investment advisory services or fixed insurance product sales). Through this Rule Proposal, FINRA appears to be expanding its jurisdiction into areas that are the responsibility of other regulators. We note that recent press reports indicate that some insurance regulators share our concerns.⁹ We are also concerned that the language would greatly expand the liability exposure of independent broker-dealer firms whose financial advisors engage in numerous outside activities without a corresponding benefit to investors. After all, most selling away activity is actively concealed from the broker-dealer's compliance personnel. Therefore, we recommend that the language of the Rule Proposal revert to that of current NASD Rule 3010 which reads in relevant part: "The designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker/dealer is required."

⁷ See Rule Proposal 9557(e).

⁸ See FINRA Regulatory Notice 08-24 entitled "Proposed Consolidated FINRA Rules Governing Supervision and Supervisory Controls" (May 14, 2008) at <http://www.finra.org/RulesRegulation/NoticestoMembers/2008Notices/PO38506>.

⁹ See "FINRA is Overreaching, Some Say", by Sara Hansard of InvestmentNews (June 2, 2008) at http://search.crownpeak.com/cpt_redirect/53?account=42805acf6921&qid=516&ht=?account=42805acf6921&qid=516.

We believe that Rule Proposal subsection 3110(a)(4) and Supplementary Material .04 should be revised to allow a registered principal to be assigned the responsibility of supervising more than one Office of Supervisory Jurisdiction (OSJ) and/or non-OSJ branch office. FSI believes that each broker-dealer and its registered principals should determine the appropriate number of offices assigned to each OSJ manager. The Rule Proposal should clearly state that firms have discretion in designing their supervisory system.

In addition, we believe the requirement of a “physical presence, on a regular and routine basis” is overly burdensome and unnecessary, as electronic supervisory methods are so prevalent and effective. We urge FINRA to strike this language from the Supplementary Material.

We also seek clarification of the terms “diverse” and “complex” as used in Supplementary Material .02. These terms are too vague to provide firms the necessary guidance when determining whether to designate a location as an OSJ.

- Rule Proposal 3110(b). Written Procedures – Subsection 3110(b)(1) requires firms to “establish, maintain, and enforce written procedures to supervise the types of business in which it engages...” As in 3110(a)(2) above, we believe this language is overly broad and represents a significant expansion of a broker-dealer firm’s supervisory responsibilities and FINRA’s jurisdiction. Therefore, we recommend that the language be revised to limit the requirement to “establish, maintain, and enforce written procedures to supervise the types of business in which it engages for which registration as a broker/dealer is required”.

FSI also believes subsection 3110(b)(2) should state clearly that the firm’s supervisory procedures for review of investment banking and securities business may be risk-based. Although Supplementary Material .06 provides for a risk-based approach, the Rule Proposal requires “review...of all transactions.” We believe there is an inherent conflict in these statements that should be resolved by introducing the concept of risk-based review in the Rule Proposal itself.

Subsection 3110(b)(3) appears once again to broaden member firms’ responsibility for outside business activities. Our concerns are heightened by our uncertainty about the status of NASD Rule 3030. If Rule 3030 will be incorporated in a future Rule Proposal, our apprehension may be alleviated. However, if Rule Proposal 3110(b)(3) is intended to replace both NASD Rules 3030 and 3040, we are extremely concerned that the language includes approved activities “within the scope of the member’s business...” This issue is of particular concern for IBD firms, whose financial advisors engage in many outside business activities, including investment advisory services through their own investment advisor entity. This Rule Proposal represents a significant departure from the guidance included in NASD Notice to Members 94-44 and 96-33.¹⁰ We believe this existing guidance should remain in effect and urge FINRA to incorporate it into the Rule Proposal. In addition, we are concerned that this section of the Rule Proposal could require the firm to supervise the non-securities

¹⁰ See NASD NtM 94-44 at

http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159003885&element_id=1159003712&highlight=94-44#r1159003885. See NtM 96-33 at http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159002404&element_id=1159002337&highlight=96-33#r1159002404.

activities of dual employees who have corporate responsibilities for related entities. These activities should be exempt from the requirements of 3110(b)(3). The Rule Proposal could also be interpreted as requiring the supervision of passive investments by associated persons. Such activities should not be subjected to the full scope of 3110's supervisory rules. Instead, subsection 3110(b)(3) should provide firms with the flexibility to design their own policies and procedures to address these issues. In addition, we believe the first sentence of 3110(b)'s use of the phrase "conduct any investment banking or securities business" is too vague. As a result, we urge FINRA to replace it with the phrase "participate in any manner" as used in the current NASD Rule 3040. This language is clearer and has been the subject of years of NASD interpretation and guidance.

FSI also has concerns with subsection 3110(b)(4) of the Rule Proposal. Once again, we believe this section needs clarification. Specifically, the "supervisory procedures must ensure" language should be replaced by the phrase "supervisory procedures must be reasonably designed..." to make the provision consistent with traditional concepts of reasonable supervision. In addition, the section would require a registered principal to review "correspondence with the public and internal communications." We believe the Rule Proposal should state clearly that such review could be risk-based and delegated to appropriate personnel. This language is part of Supplementary Material .09 and .11, but we believe it is of such importance that it should be included in the Rule Proposal itself.

Subsection 3110(b)(6)(C) of the Rule Proposal should be clarified such that home office employees are exempt from the requirement. In addition, Supplementary Material should be adopted that explains the receipt of commission overrides does not equate to having one's compensation "determined by" a person who is supervised.

In subsection 3110(b)(6)(D) of the Rule Proposal, we find the use of the phrase "procedures preventing the supervision required by this Rule from being lessened in any manner" imposes an unrealistic standard upon the broker-dealer. As a result, we advocate a more reasonable requirement of "procedures reasonably designed to achieve compliance with this Rule." Finally, we recommend that FINRA amend Subsection 3110(b)(7) of the Rule Proposal to state clearly that written supervisory procedures may be maintained electronically at each OSJ or location where supervisory activities are conducted.

Finally, FSI believes the proposed language of Supplementary Material .08 should be changed from "member's associated persons and their family members" to "accounts owned by a registered person directly or through beneficial ownership, interest, or control, including immediate family members". The Rule Proposal's language is overly broad and inconsistent with existing NASD Rule 3050. Our suggested change makes clear that firms are obligated to review beneficial interest accounts of registered persons and their immediate family members.

- Rule Proposal 3110(c). Internal Inspections – This section of the Rule Proposal deals with internal inspections. We believe the requirements of written inspection reports included in subsection 3110(c)(2)(A) should be amended so as to avoid specifically requiring inclusion of testing and verification of policies and procedures that may be conducted by the firm at their home office or other location rather than at a branch or

non-branch location (e.g., address changes). We also believe subsection 3110(c)(3)(A) should exempt the firms' home office staff so that firms are not obligated to hire outside consultants to perform their inspections of these individual's activities.

We also recommend that subsection 3110(c)(3)(B) be amended. Once again, we find the use of the phrase "procedures preventing the supervision required by this Rule from being lessened in any manner" imposes an unrealistic standard upon the broker-dealer. As a result, we advocate the more realistic standard of "procedures reasonably designed to achieve compliance with this Rule."

We recommend that Supplementary Material .14 be amended to require "the quality of supervision at remote locations is reasonably designed to ensure compliance..."

Finally, we recommend that Supplementary Material .16 be amended to reflect the terms of the current limited size and resource exception. Specifically, we would rewrite subsection (b) to read, "the member has a business model, regardless of the member's size and resources, where small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager." This language is necessary to insure that independent firms of any size can take advantage of this important exception.

- Rule Proposal 3120. Supervisory Control System – FSI objects to FINRA's proposal in subsection 3120(b). The Rule Proposal would incorporate certain content requirements from NYSE Rule 342.30 into reports created by firms with \$150 million or more in gross revenue. The prescriptive nature of the proposed rule runs contrary to the principles-based approach of current NASD Rule 3012 and does not appear to add significant value. The tabulation of customer complaints and investigations appears duplicative when compared with other proposed and existing rules. These content requirements also duplicate requirements contained in NASD Rules 3012 and 3013. In fact, the proposed rule practically mirrors requirements of NASD IM-3013 that requires meetings between the CEO and CCO to discuss compliance issues. Additionally, the required report represents a new burden for non-dual member firms and a continued burden for firms that are dual members. Some of the areas identified in 3120(b)(2) such as finance and risk management fall out of the responsibilities of many compliance departments. As a result, we advocate that FINRA eliminate subsections 3120(b) and (c) in their entirety.
- Rule Proposal 3150. Holding of Customer Mail – FSI is concerned that the Rule Proposal establishes unreasonable requirements for the holding of customer mail. For example, the Rule Proposal would require firms to be able to communicate with the customer whose mail is being held in a timely manner to provide important account information. While we understand the objective behind the proposed language, it is important to note that mail is oftentimes held specifically because the client is unreachable (e.g., overseas travel or active military service). We believe this language should be clarified or struck from the Rule Proposal. The Rule Proposal also utilizes the phrase "extended time" without providing a definition. We believe FINRA should define the term or insert a specific time period into the Rule. Finally, we have concerns about the requirement that firms "take actions reasonably designed to ensure that the customer's mail is not tampered with..." We believe this requirement should be amended to read, "take actions reasonably designed to avoid tampering with the customer's mail..."

3. Books and Records¹¹

- Rule Proposal 4512. Customer Account Information – Rule Proposal 4512(a)(1)(C) should be revised to read "registered representative responsible for the account" rather than the broad and potentially vague "associated person responsible for the account." We understand and appreciate the importance of consistency with Rule 17a-3, but we think that use of the term "associated person" combined with the phrase "responsible for the account" is simply too broad and vague. If FINRA insists on using the term "associated person" in this subsection, then the phrase "responsible for the account" should be amended or defined to make its meaning and scope clearer to firms. In addition, FSI recommends that subsections 4512(a)(1)(C) and 4512(a)(3) of this Rule Proposal be amended to state that firms must maintain "evidence of approval" for each account rather than a "signature". We believe this change is necessary to reflect the use of initials and/or electronic approvals to evidence approval. Subsection 4512(b) should be revised so that it does not require the collection of extensive data to process a simple address update, name change, or other similar modification to pre-existing account data. Instead, we believe the Rule Proposal should conform to the requirements by Securities Exchange Act Rule 17a-3.¹²
- Rule Proposal 4513. Records of Written Customer Complaints – The Rule Proposal should be clarified to apply only to "written customer complaints that relate to activities subject to regulation by FINRA" in order to exclude complaints related to outside business activities. We also would encourage FINRA to remain consistent in its document retention periods by changing the retention period for customer complaints from the proposed four years to either three or six years as required elsewhere.

Conclusion

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

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

Respectfully submitted,



Dale E. Brown, CAE
President & CEO

¹¹ See FINRA Regulatory Notice 08-25 entitled "Proposed Consolidated FINRA Rules Governing Books and Records Requirements" (May 14, 2008) at <http://www.finra.org/RulesRegulation/NoticestoMembers/2008Notices/P038507>.

¹² See 17 C.F.R. § 240.17a-3(a)(17)(B).