NSCP
NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS INC.

January 16, 2009

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street NW
Washington, DC 20006-1506

Re: Comments on Proposed FINRA Rule 4530 (Reporting Requirements)
FINRA Regulatory Notice 08-71 – Comment Letter

Dear Ms. Asquith:

I write this letter on behalf of the National Society of Compliance Professionals ("NSCP"). The NSCP is the largest organization in the securities industry serving compliance professionals exclusively through education, certification (CSCP), publications, consultation forums, and regulatory advocacy. Since its founding in 1987, NSCP membership has grown to over 1700 members including compliance professionals at broker-dealers, investment advisers, banks, insurance companies, and hedge funds.

The NSCP appreciates the opportunity to comment on Proposed Rule 4530 ("Proposed Rule"). Our comments are intended to offer constructive observations. This letter first addresses the purpose of the Proposed Rule, followed by a discussion regarding selected subject areas set forth in Regulatory Notice 08-71. The NSCP, opposes certain aspects of the Proposed Rule, supports others and asks for clarification of some proposed requirements.

Purpose of the Proposed Rule.

The Proposed Rule reflects part of FINRA's effort to develop a new, consolidated rulebook. It would integrate current NASD Rule 3070 (Reporting Requirements) and NYSE Rule 351 (Reporting Requirements). While the new rule largely continues existing Rule 3070 requirements, there are many new disclosure requirements for most FINRA members which are not also NYSE members ("Dual Members").

We believe the most important reason for requiring member firms to report on customer complaints, regulatory actions and litigation is customer protection. Knowledge of reportable events impacting firms serves to facilitate FINRA's ability to address risks to customers and securities markets.[1] We support efforts to help accomplish that goal. We are concerned however about efforts to capture potentially vast amounts of information about issues unrelated to FINRA's mission and jurisdiction.

There are many governmental and self regulatory agencies to police various aspects of the financial services industry. We are concerned about FINRA's apparent effort to expand the scope of its search for information to insurance industry matters, for example. This expansion increases the risk of duplicative regulatory oversight, confusion and greater expense for securities industry participants without offsetting benefits for regulatory purposes.

The Proposed Rule is aimed at protecting investors. We believe the Proposed Rule's current language misses that target. We believe reporting requirements should relate to situations of actual or potential customer harm. Said differently: Where there is customer harm, there should be reporting. Instead of embracing this simple formula, the Proposed Rule sweeps in areas and issues that range away from investor protection. FINRA has the opportunity to create a constructive, informative standard that members know how to comply with. Alternatively, FINRA can inundate members and FINRA personnel with reporting a vast array of non-investment related matters, thus diluting the effectiveness of reporting requirements. We encourage FINRA to choose the former.

General Observations.

Specificity Enhances Clarity. As compliance professionals our members are generally charged with managing the process of *event* reporting. We believe FINRA should aim to facilitate its members' understanding of what they must do to comply with the rule. While it is important to employ a principles-based approach in regulating many areas of the securities industry, we do not believe this area lends itself to that approach. In this area, we believe that greater specificity enhances clarity.

We applaud FINRA for its evident intent to achieve clarity through the discussion in the Notice and in proposing a Supplementary Materials Section (.01-.08). That may well be the best location for addressing several of the issues identified in this Comment Letter. As a general observation, we encourage FINRA to provide as many concrete examples of *reportable events* as possible.

The "should have known" standard is too demanding. As a general matter, we are concerned about the "should have known" standard. Since business organizations often are involved in a large number of activities, the ability to know all things without receiving a specific notification is quite challenging. Has FINRA established a standard for determining when a member firm "should have known of the existence" of the items enumerated in current Rule 3070?

Some events might require a great deal of time and effort to get an accurate understanding and develop a clear restatement of the facts. For example, a firm may learn of an event 29 calendar days after it occurred. A foreign regulator may have launched an investigation, or enforcement action, or issued an order in an enforcement action. Understanding that regulator's action can require extensive detective work, sometimes complicated by language and time zone differences. Notwithstanding a 20-20 hindsight conclusion that a firm "should have known" about the event, it is not uncommon for the news of an event to take several days or weeks before it reaches a firm's management or compliance department. The "should have known" standard could be arbitrarily employed in a game of "gotcha."

External Findings [Proposed Rule 4530(a)(1)(A)].

This provision requires reporting whenever a member or associated person has been found to have violated any securities, insurance, commodities, financial or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body, self-regulatory organization or business or professional organization.

Overbreadth. New paragraph (a)(1)(A) would expand the current requirement to include reports on findings of violations related to insurance and commodities.[2]

We question the proposed requirement to report insurance-related findings. Similarly Proposed Rule 4530(e) would require members to file copies of insurance-related criminal and civil complaints and arbitration claims. We observe that the Notice does not offer the reason for reporting such matters. We believe the reporting of such matters would impose an increased burden on members and provide information of little relevance to FINRA's regulatory purpose.

Insurance-related matters may have nothing to do with a member firm or associated person's conduct. Reporting all insurance-related matters could extend to a broad array of incidents which relate exclusively to insurance contract issues and have nothing to do with a member firm's or associated person's conduct.[3] The NASD published an interpretation in 1992 which stated that there is no need to report a matter specifically related to an insurance-related settlement where a dispute related "neither to securities activities nor allegations of theft or misappropriation of funds or securities or forgery."[4] We recommend that FINRA consider comparable language for the Proposed Rule, or consider publishing an interpretation, perhaps in the Supplementary Material.

As currently written, matters related to fixed life insurance, fixed annuities, casualty, health, and property insurance claims must be reported. Not only are these matters outside FINRA's regulatory authority, but we believe the resulting volume of general insurance issues would result in an unmanageable volume of information being filed, to the detriment of industry resources and FINRA's ability to sort though the relevant data. In the aftermath of Hurricane Katrina, for example, insurance claim litigation skyrocketed. Automobile insurance coverage claims are filed constantly. Reporting claims of this nature are clearly not within the scope of issues intended to be addressed in the Proposed Rule. Narrowing the scope of this provision to require reporting of the items currently enumerated in Rule 3070 will avoid excessive reporting for members and FINRA will avoid an administrative nightmare.

The Proposed Rule would also seem to require a member affiliated with an insurance company to report on insurance-related litigation involving affiliates, up-stream or downstream, that have nothing to do with the member itself which would only add to the volume of reports. Also, the proposal would appear to require a member to report on litigation involving insurance carried out by an associated person through an agency unrelated to the member firm such as issues related to property and casualty insurance, medical insurance or other such matters. As you are aware, many registered personnel are permitted to conduct insurance business for insurance companies unrelated to the member. As you are further aware, insurance complaints and litigation outside of securities issues is under the purview of state insurance regulators. The current wording of the proposal would be akin to a state insurance regulator requiring the reporting of securities-related matters. We believe that the requirements should be limited to

reporting civil litigation or arbitration involving insurance products that are registered or treated as securities (e.g., variable annuities). To do otherwise will generate data far in excess of what is useful or appropriate to FINRA's underlying purpose.

The term "business or professional organizations" lacks clarity. The Proposed Rule expands the scope of potential reportable findings to include violations of rules or standards of conduct by "business or professional organizations" as opposed to "financial business or professional organizations." It appears to us that this scope of *reportable events* will extend well beyond those contemplated when the policy establishing reporting requirements was first adopted. As indicated by the SEC in 1995, the purpose of rule 3070 is to permit the association to separately collect data on a timely basis to substantially enhance its ability to detect and investigate sales practices violations through the early identification of problem registered representatives.[5] Would not the expansion of reportable events to include any business or professional organization disputes and conduct standard findings potentially implicate issues totally unrelated to investor protection? Would not a Chamber of Commerce or trade association decision be beyond the boundaries established for FINRA regulatory oversight? Does a community improvement association, finding that a member's display of an offending (but FINRA compliant) sign rise to the level of a *reportable event*? At a minimum, we suggest that the types of entities/groups considered relevant as "business or professional organizations" be clearly defined and examples of such organizations be provided.

Internal Conclusions [Proposed Rule 4530(a)(3)].

Proposed Rule 4530(a)(3) would require a FINRA member to report its conclusions that the member or an associated person has violated "any securities, insurance, commodities, financial or investment-related laws, rules or standards of conduct of any domestic or foreign regulatory body or self-regulatory organization." Member firms would not be required to report their conclusions of violations of business or professional organization rules or conduct standards. Isolated ministerial violations which are remedied promptly and do not implicate customer harm are excluded.

The requirement to report all internal disciplinary actions is extremely broad and burdensome. The following questions and issues must be resolved:

Whose responsibility is it? RRs are frequently appointed by multiple insurance carriers. Many carriers are not affiliated with a FINRA member. Is a member firm responsible for reporting on the actions of those carriers vis-à-vis an associated person? How can members become aware of this information? What about actions taken by a member's affiliate which is not associated with FINRA?

If a disciplinary action is taken by an affiliated company, is that action considered to be an internal conclusion or an external finding? Would the member be required to report "business dispute" issues between an affiliated company and an associated person as "disciplinary action?" Here is an example involving the termination of an RR and recoupment of advanced commissions. Many firms have RRs on a level stipend in their early years, or as a means of incenting seasoned reps to come on-board who may face a temporary drop in income. If the relationship does not work out, the RR is terminated and future commissions may be withheld to compensate for insurer losses incurred. Contractually-based, the RR receives level commissions in return for giving up rights to commissions earned during that time frame if certain goals are

not met. The firm might treat this as a termination for cause. While not reaching otherwise reportable levels, when coupled with the exercise of the firm's contractual right to "withhold" commissions, could this be construed as a *reportable event*?

Former Associated Persons requirement is cumbersome. The Proposed Rule includes an interpretation (.07) requiring reporting a 4530 (a) or (c) *event* relating to a former associated person if the event occurred while the individual was associated with the member. What would a firm's obligation be to investigate a possible violation? Given that the RR is no longer with the firm, obtaining the RR's side of the story would be difficult, if not impossible. Would firms be at risk for defamation claims if they report violations without the former RR's input? Shouldn't there be a time limit for *event* reporting if discovered after a RR's termination? Potential violations could be discovered many years after termination. The person may no longer be in the industry or could even be deceased. Larger firms often have a high turnover of both registered and other associated persons. The passage of time could mean that a member firm has thousands of former associated persons. Whether an event actually occurred during a particular person's association with a firm could be challenging to investigate. We recommend that a more precise description of type of *reportable events* be developed and a reasonable time limit for required reporting be established.

Scope of Internal Conclusions is too broad. We recommend that the Internal Conclusions portion of the Proposed Rule not be included. If FINRA chooses to include the requirement we urge FINRA to define what an "internal conclusion" means, with greater specificity. When has a member "concluded" that a violation has occurred? Suppose an internal audit report indicated findings of potential law, rule or conduct standards violations. While the writer of such a report might injudiciously assert that violations have occurred, it would be necessary for management, perhaps in consultation with inside or outside counsel to investigate the assertions contained in the report. Management and counsel may ultimately determine a violation has or has not occurred or, as is often the case, a firm's management may be unable to determine that a violation has occurred with any degree of certainty. Member firms should not be rushed into reporting tentative conclusions by virtue of a specific number of days to report. This is made more difficult by a requirement that a report be made from a date when the firm "should have known."

It is unclear when an event becomes "reportable." Currently under 3070(b) a firm is required to report when the firm knows or should have known of the existence of an *event*. Under Proposed Rule 4530(a)(3), a firm would be required to report when it has concluded an RR has violated rules, regulations or standards of conduct. What constitutes a conclusion? This would be difficult to implement with certainty.

Obtaining information from "foreign regulatory bodies." The Proposed Rule requires that *reportable events* by "foreign regulatory bodies" be reported within 30 days from when a firm knew or "should have known." Foreign regulatory bodies are not necessarily compelled to apprise member firms of their actions. There is no centralized forum where a firm can identify this information.

As a general matter, reporting foreign regulator actions can be challenging since we might be unaware of that action for a lengthy time period. In that regard, we question the "should have known" aspect of the Proposed Rule. Once again, some foreign regulators may not

share FINRA's sense of urgency in reporting investigations, or other *reportable events* to member firms domiciled in the U.S.

For these reasons, we urge FINRA to either eliminate this portion of the proposal or, at a minimum, provide that the 30 day period regarding foreign regulatory findings be tied to actual notice of such findings.

Internal Conclusion Reporting.

NYSE Rule 351(a)(1) Experience. Proposed Rule 4530(a)(3) would require a member to report "internal conclusions" (more specifically, instances in which a member has concluded that it or an associated person(s) has violated securities, insurance, commodities, financial or investment-related laws, rules, regulations or standards of conduct of any domestic or foreign regulatory body or SRO). As explained in Proposed Supplementary Material .01, a member would not be required to report an isolated violation that can reasonably be viewed as a ministerial violation that did not result in customer harm and was remedied promptly upon discovery.

In the discussion regarding Internal Conclusions, the Notice asserts that NYSE rule 351(a)(1) "requires firms to report their internal conclusions of the enumerated violative conduct." We are uncertain that the NYSE Rule [351(a)(1)] was uniformly interpreted and understood by NYSE members as suggested in Release 08-71. Our reading of Information Memo 06-11 indicates that the reporting requirements of 351(a)(1) include a number of exceptions and implicit interpretations permitting those exceptions. We note that items .01 and .02 of the Supplementary Materials include an abbreviated version of NYSE Information Memo 06-11. Is it FINRA's intent to omit certain portions of Memo 06-11? While not a model of clarity, the Memo appears to provide more guidance than the derivative portions located in Item .01 and .02 of the Supplementary Materials. We note for example that certain violative conduct did not implicate a need to make a filing.[6] Are we to understand that those exceptions continue to apply, or will a clearer discussion of differences from the 06-11 Memo be forthcoming?

Members should not be required to make legal decisions. We believe that many firms understood a reportable event to occur when there was a finding by a court or regulatory agency of a violation. Given the challenges of determining whether violative conduct had occurred, some NYSE members chose to "punt" that issue to the NYSE regulatory staff for interpretation. Other member firms either chose to reach a conclusion and report, or deferred a conclusion for lengthy periods of time. More importantly, we question the propriety of requiring business persons to reach a legal conclusion about any action concerning itself or an associated person. While some actions might be generally agreed by all observers to be violations, it is not clear that all actions could be similarly determined. Lawyers, regulators and courts regularly dispute whether actions by firms and individuals are violative of rules. Forcing non-lawyers to reach legal conclusions is unfair and inappropriate. Given the potential consequences of such decisions, firms have often been reluctant to reach such conclusions. Legal counsel often advise against acknowledging law or rule violations since such admissions can be pounced on by private litigants. A firm's management can identify and address behavior it deems inappropriate without reaching legal conclusions.

There are many potential risks of reaching legal conclusions. Firms are likely to be second-guessed by regulators and challenged by associated persons branded as rules or conduct

standard violators. We believe this approach could serve to chill members' internal review and self-policing efforts. Those efforts should be encouraged. We urge FINRA to reconsider this aspect of the Proposed Rule.

"Isolated Ministerial Violations" can be interpreted in many ways. Different firms can construe this requirement differently. Supplementary Material .01 explains that members need not "report an isolated violation by the member or an associated person of the member that can be reasonably viewed as a ministerial violation of the applicable rules that did not result in customer harm and was remedied promptly upon discovery." This establishes a four-prong test for minor violations to escape reporting. The violation must be: (a) isolated, (b) ministerial, (c) result in no customer harm, and (d) be remedied promptly. This standard is subjective and vague. Members need certainty when considering their reporting obligations. A few examples demonstrate the point:

What if a violation was initially considered an isolated ministerial violation, but a repeat violation occurred? Would it no longer be considered ministerial as it is no longer "isolated" and if so, within what time frame would a repeat of the violation become reportable?

If two or more ministerial violations not resulting in investor harm are noted during the same branch office inspection and promptly remedied, can they be considered isolated violations? If a ministerial violation not resulting in investor harm is promptly remedied and not reported, but later is found to have recurred, can the member continue to define the violation as isolated?

Are books and recordkeeping violations identified during a branch office inspection ministerial? If the branch office inspection reveals that a single client file contains a client-signed blank form, is this a ministerial violation?

If an isolated ministerial violation not resulting in investor harm can be resolved in two weeks, has it been remedied promptly? What if it takes four weeks to remedy the violation?

Are audit findings Internal Conclusions? Would findings from field office reviews be deemed internal conclusions? We believe not.

While we oppose characterizing internal conclusions as *reportable events*, we recommend that if included in the final rule, that Internal Conclusions are those decisions made by designated members of a firm's senior management. We also recommend that reporting only those violations that have resulted in customer harm should be required.

Reporting Thresholds. The proposed reporting thresholds for member firms ($25,000) and for RR's ($15,500) are too low. These reporting thresholds were established more than ten years ago. Given the average rate of inflation during the last ten years, we recommend establishing reporting thresholds as follows: The reporting threshold called for by Proposed Rule 4530(a)(1)(9) should be: $30,000 for RRs and $50,000 for Members. The reporting threshold for Proposed Rule 4530(a)(2), where an associated person is the subject of disciplinary action involving a fine in excess of $2,500, should be $5,000.

Reporting Deadline [Proposed Rule 4530(a)].

The Proposed Rule would extend the time period for reporting events specified in Proposed Rule 4530(a)(1).

We support the extension of the time period for reporting specified events from 10 business days to 30 calendar days. We express concern that, given the proposed increase in scope of reportable events, that some member firms, especially those associated with large multi-service organizations, might encounter difficulty in gathering information from affiliated organizations. For example, a broker-dealer affiliated with a major insurance conglomerate, could encounter difficulty in meeting the time limitation if certain events, *e.g.*, customer complaints, are filed with an insurance company but do not immediately reach the FINRA broker-dealer member. Also, keep in mind that an RR may be licensed and registered to sell the insurance products of scores of insurance companies.

We note that Proposed Rule 4530(b) requires associated persons to report (a)(1) *events* promptly to their associated vender. Promptly is not defined or included in the 30 day prescribed time period. Obviously, a member may not learn of a reportable event within 30 days. We presume that a member has 30 days from the date its associated person apprised it of a *reportable event*.

Calculating Monetary Thresholds – Civil Litigation or Arbitration; Other Claims for Damages [Proposed Rule 4530(a)(1)(G)].

Proposed Supplementary Material .06 for Proposed Rule 4530 would require a member to include attorneys fees and interest in the total amount when calculating whether the monetary thresholds for reportable civil litigation and arbitration events have been met.

Attorneys fees and interest should not be included in the calculation. First, we presume that the requirement would not extend to unresolved litigation/arbitration matters, *i.e.*, no special disclosure need be made pursuant to paragraph (a)(1)(G) to describe pending litigation with ad damnum clauses exceeding the threshold amounts. Attorneys fees have little to do with an underlying course of action. Rather, they indicate the passage of time or how much litigants are willing to spend.

Second, we believe the goal of the Proposed Rule is satisfied without including attorneys fees and interest. At a minimum, such a requirement can be expected to cause over-reporting. Including attorneys fees and interest in these calculations effectively lowers the reporting threshold. More importantly, fees and interest bear little if any relationship to the underlying harm caused to customers.

Some member firms may choose to defend claims vigorously. If claims are specious or threaten a firm's reputation, a firm may invest enormous time and expense in defending them. Many firms believe they would become "patsies" if they earned a reputation as early settlers. Some matters are vigorously defended "on principle," *i.e.*, a strong belief that no wrongdoing occurred.

Billable rates for attorneys vary widely across the country. New York and Los Angeles lawyers generally charge more than Pocatello, Idaho lawyers to prosecute a case. Large firms having a higher volume of claims and other legal work can negotiate reduced billing rates and cap fees. Similarly, fees charged by claimants' lawyers can vary widely across the country and may be awarded by courts and arbitrators in a widely disparate manner. Why should firms be required to include legal fees in calculating thresholds?

Interest rates assessed in disputed matters essentially reflect the passage of time. Some matters may be brought after a potential claim has been dormant for several years. Some litigation and arbitration matters may be conducted over several years.

The vagaries of time and geography should not be relied upon to determine threshold reporting. Such a methodology would clearly operate in a discriminatory fashion against many firms. We recommend that attorneys fees and interest not be included in the calculation of monetary damages.

Duplicative Reporting Obligations. We urge FINRA to work aggressively to eliminate reporting redundancies that currently exist between the Proposed Rule and Forms U4, U5 and BD. We recognize that FINRA has committed to do so in Notice 08-71. However, we note that this same commitment was made by the NASD in 1995 without making much headway. We believe now is the time to address duplicative and sometimes inconsistent reporting requirements. We urge FINRA to seize this opportunity, and make every effort to have this change in place when Proposed Rule 4530 takes effect.

We look forward to discussing the issues we have addressed in this letter with FINRA staff members, if that would be helpful. Please contact me at 860.672.0843 with any questions.

Thank you for considering our comments.

Sincerely,

Joan Hinchman

[1] We note that current NYSE Rule 351 and NASD Rule 3070 were engendered by the SEC's Large Firm Project Report, conducted by the SEC in conjunction with the NASD and NYSE. Driven by a concern over the frequency and severity of sales abuses, regulators sought to identify sales practice problems at an earlier stage. *See* SEC Release No. 34-36211 (September 8, 1995).

[2] We question the need to report on commodities-related findings since FINRA clearly has no regulatory authority in those subject areas and only limited authority in insurance, i.e.; variable contracts and perhaps indexed products if SEC Rule 151A becomes effective.

[3] Members of our letter-drafting committee recall that the language of NASD Rule 3070(a)(8), prior to interpretive clarification, prompted members whose associated persons or affiliates engaged in insurance sales to report a variety of complaints and findings. Many of those reports were superfluous to the purpose of the rule. The NASD was inundated with thousands of reports from firms or associated persons selling the products of various insurance carriers.

[4] *See* January 2, 2002 letter from Shirley H. Weiss FINRA website:
http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P002716

[5] *See* Exchange Act Release No. 36211, 60FR 48182 (Sept. 18, 1995)(Approving Release) and NASD Notice to Members 85-81. The NASD *asserted [t]he new rule will provide important new regulatory information that will assist the NASD in the timely identification of problem members, branch offices, and registered representatives in*

order to more aggressively detect and investigate sales practice violations. The NYSE and NASD reporting rules were approved as consistent with the requirements of the 1934 Act. The 1934 Act and NASD rules are targeted at securities law violations. See Sections 15A(b)(6) and (7) of the 1934 Act.

[6] See for example: *Accordingly, if a firm has concluded that an individual has engaged in violative conduct and imposes discipline less severe than that which is required to be reported under NYSE Rule 351(a)(10), then the firm* ***need not*** *make a filing under NYSE Rule 351(a)(1) with respect to that employee's conduct.*

Similarly, if a firm determines to discharge a registered employee as a direct consequence of misconduct, the NYSE expects a Form U5 filing will be made that clearly identifies the circumstances resulting in the termination. An RE-3 filing need not be made since the Form U5 filed with the NYSE would satisfy the requirements of the rules. Should a non-registered employee be discharged for violative conduct, the NYSE expects an RE-3 filing would be made identifying the circumstances that resulted in the termination.