SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71179; File No. SR–FINRA–2013–025]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Granting Approval of a Proposed Rule Change To Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, as Modified by Amendment No. 1

December 23, 2013.

I. Introduction

On June 21, 2013, the Financial Industry Regulatory Authority, Inc. (''FINRA'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Exchange Act'' or ''Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change to adopt consolidated FINRA supervision rules.[3] The proposed rule change was published for comment in the **Federal Register** on July 8, 2013.[4] The Commission received seventeen (17) individual comment letters in response to the proposed rule change and five hundred sixty (560) comments using a form comment letter (''Letter Type A'').[5] On October 2, 2013, FINRA responded to the comments [6] and filed Amendment No. 1 to the proposed rule change. On October 4, 2013, the Commission published notice of Amendment No. 1 to solicit comment from interested persons and instituted proceedings pursuant to Section 19(b)(2)(B) of the Act to determine whether to approve or disapprove FINRA's proposal as modified by Amendment No. 1.[7] The Commission received three comment letters in response to the Notice and Proceedings Order.[8] On November 12, 2013, FINRA responded to comments to the proposed rule change, as modified by Amendment No. 1.[9] The Commission is publishing this order (''Order'') to approve the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.[10]

II. Description of Proposal

As further described in the Proposing Release, FINRA proposes to adopt consolidated FINRA broker-dealer supervision rules.[11] As part of the process of developing a new consolidated rulebook (''Consolidated FINRA Rulebook''),[12] the proposed rule change would (1) adopt FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System) to largely replace NASD Rules 3010 (Supervision) and 3012 (Supervisory Control System), respectively; (2) incorporate into FINRA Rule 3110 and its supplementary material the requirements of NASD IM–1000–4 (Branch Offices and Offices of Supervisory Jurisdiction), NASD IM–3010–1 (Standards for Reasonable Review), Incorporated NYSE Rule 401A (Customer Complaints), and Incorporated NYSE Rule 342.21 (Trade Review and Investigation); (3) replace NASD Rule 3010(b)(2) (often referred to as the ''Taping Rule'') with new FINRA Rule 3170 (Tape Recording of Registered

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] On June 10, 2011, FINRA filed with the SEC a proposed rule change to adopt the consolidated FINRA supervision rules (''2011 Filing''), which addressed the comments received in response to FINRA's *Regulatory Notice* 08–24 (May 2008). *See* Exchange Act Release No. 64736 (June 23, 2011), 76 FR 38245 (June 29, 2011) (Notice of Filing No. SR–FINRA–2011–028). FINRA withdrew the 2011 Filing on September 27, 2011. *See* Exchange Act Release No. 65477 (October 4, 2011), 76 FR 62890 (October 11, 2011) (Notice of Withdrawal of File No. SR–FINRA–2011–028).

[4] *See* Exchange Act Release No. 69902 (July 1, 2013), 78 FR 40792 (July 8, 2013) (Notice of Filing of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook) (''Proposing Release''). The comment period closed on July 29, 2013.

[5] *See* letters from Steven B. Caruso, Esq., Maddox Hargett Caruso, P.C., to Elizabeth M. Murphy, Secretary, SEC, dated July 12, 2013 (''Caruso''); Norman B. Arnoff, Esq., to Elizabeth M. Murphy, Secretary, SEC, dated July 19, 2013 (''Arnoff''); J.S. Brandenburger, Registered Principal, FSC Securities Corporation, to Elizabeth M. Murphy, Secretary, SEC, dated July 25, 2013 (''Brandenburger''); Steve Putnam, Financial Advisor, Raymond James Financial Services, to Elizabeth M. Murphy, Secretary, SEC, dated July 25, 2013 (''Putnam''); Nina Schloesser McKenna, General Counsel, Cetera Financial Group, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''Cetera''); Scott Cook, Senior Vice President and Chief Compliance Officer, Charles Schwab & Co., Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''Schwab''); Clifford Kirsch and Eric A. Arnold, Sutherland Asbill & Brennan LLP, on behalf of the Committee of Annuity Insurers, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''CAI''); David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''FSI''); Howard Spindel, Senior Managing Director, and Cassondra E. Joseph, Managing Director, Integrated Management Solutions USA, LLC, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''IMS''); Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''ICI''); Susanne Denby, Chief Compliance Officer, NFP Securities, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''NFP''); A. Heath Abshure, President and Arkansas Securities Commissioner on behalf of the North American Securities Administrators Association, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated August 6, 2013 (''NASAA''); Scott C. Ilgenfritz, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''PIABA''); Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''SIFMA''); Pamela Albanese, Legal Intern, and Christine Lazaro, Esq., Acting Director, Securities Arbitration Clinic of St. John's University School of Law, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''St. John's''); Brian P. Sweeney, Law Office of Brian P. Sweeney, to Elizabeth M. Murphy, Secretary, SEC, dated July 29, 2013 (''Sweeney''); Robert J. McCarthy, Director of Regulatory Policy, Wells Fargo Advisors, LLC, to Elizabeth M. Murphy, Secretary, SEC, dated July 29 2013 (''Wells Fargo''); *see also* Memorandum from the Division of Trading and Markets, SEC, dated August 29, 2013 (memorializing an August 5, 2013 conference call between SEC staff and Gary Goldsholle and Michael Post of the Municipal Securities Rulemaking Board (''MSRB'') to discuss FINRA's recently proposed rule change to adopt the proposed consolidated supervision rules) (''MSRB Memo''). The Notice and Proceedings Order, as defined in footnote 7, identified 555 comments as having been received using Letter Type A. This number has been updated to reflect 560 total number of submissions using Letter Type A.

[6] *See* letter from Patricia Albrecht, Assistant General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, SEC, dated October 2, 2013 (''October Response'').

[7] *See* Exchange Act Release No. 70612 (October 4, 2013), 78 FR 62831 (October 22, 2013) (Notice of Filing of Amendment No. 1 and Order Instituting Proceedings 2013–SR–FINRA–025) (''Notice and Proceedings Order''). The comment period closed on October 28, 2013.

[8] *See* letters from Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated October 17, 2013 (''ICI's October Letter''); David T. Bellaire, Esq., Executive Vice President & General Counsel, Financial Services Institute, to Elizabeth M. Murphy, Secretary, SEC, dated October 28, 2013 (''FSI's October Letter''); Andrea Seidt, President and Ohio Securities Commissioner on behalf of the North American Securities Administrators Association, Inc., to Elizabeth M. Murphy, Secretary, SEC, dated November 5, 2013 (''NASAA's November Letter''); *see also* Memorandum from the Division of Trading and Markets, SEC, dated November 12, 2013 (memorializing a November 8, 2013 conference call between SEC staff and Tamara Salmon of the ICI to discuss FINRA's recently proposed rule change to adopt the proposed consolidated supervision rules (''ICI Memo'').

[9] *See* letter from Patricia Albrecht, Assistant General Counsel, FINRA, to Elizabeth M. Murphy, Secretary, SEC, dated November 12, 2013 (''November Response'').

[10] The text of the proposed rule change, as modified by Amendment No. 1, is available on FINRA's Web site at *http://www.finra.org,* at the principal office of FINRA, and at the Commission's Public Reference Room. The October Response and the November Response are available on the Commission's Web site at *http://www.sec.gov.*

[11] *See infra* Section III, describing sections of the proposed rule change in the context of comments received.

[12] The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from the New York Stock Exchange (''Incorporated NYSE Rules'') (together, the NASD Rules and Incorporated NYSE Rules are referred to as the ''Transitional Rulebook''). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE. The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, *see* Information Notice, March 12, 2008 (Rulebook Consolidation Process).

Persons by Certain Firms); (4) replace NASD Rule 3110(i) (Holding of Customer Mail) with new FINRA Rule 3150 (Holding of Customer Mail); and (5) delete the following Incorporated NYSE Rules and NYSE Rule Interpretations: (i) NYSE Rule 342 (Offices—Approval, Supervision and Control) and related NYSE Rule Interpretations; (ii) NYSE Rule 343 (Offices—Sole Tenancy, and Hours) and related NYSE Rule Interpretations; (iii) NYSE Rule 351(e) (Reporting Requirements) and NYSE Rule Interpretation 351(e)/01 (Reports of Investigation); (iv) NYSE Rule 354 (Reports to Control Persons); and (v) NYSE Rule 401 (Business Conduct). FINRA modified its proposal in certain respects through Amendment No. 1, as described in the Notice and Proceedings Order.[13]

FINRA stated that it would announce the effective date of the proposed rule change in a *Regulatory Notice* to be published no later than 90 days following Commission approval. The effective date will be no later than 365 days following Commission approval.

III. Discussion of Comments and FINRA's Response

On July 8, 2013, the Commission published in the **Federal Register** FINRA's proposed rule change to adopt consolidated FINRA supervision rules.[14] The comment period ended on July 29, 2013 and the Commission received the 17 individual comment letters listed above as well as 560 comments using a form comment letter.[15] A few commenters generally supported the proposal, but many commenters raised specific concerns, including, among other things, references to MSRB rules; [16] the scope of the definition of the term ''covered accounts;'' [17] the application of a risk-based approach to supervision; [18] the conditions for establishing a one person office of supervisory jurisdiction (''OSJ''); [19] the requirements and presumptions relating to a single principal supervising multiple OSJs; [20] the documentation requirements relating to written and oral complaints; [21] and the lack of a cost benefit analysis. FINRA filed Amendment No. 1 to address commenter concerns and responded to comments in a letter dated October 2, 2013.[22]

On October 22, 2013, the Commission published in the **Federal Register** the Notice and Proceedings Order.[23] The comment period ended on October 28, 2013 and the Commission received the three comment letters listed above.[24] One commenter fully supported the proposal and the other two commenters restated concerns raised in their original letters.[25] One commenter raised an additional concern in response to Amendment No. 1.[26] FINRA responded to comments in a letter dated November 12, 2013.[27]

The sections below discuss: the comments received to the Proposing Release and the Notice and Proceedings Order; FINRA's October Response and November Response; and the Commission's findings.

A. General Comments

1. Support for Proposal

Several commenters to the Proposing Release expressed overall support for the proposed rule change [28] and specific changes FINRA made in response to comments on the 2011 Filing, including requiring that supervisory procedures and corresponding amendments be communicated to relevant associated persons rather than throughout the organization; eliminating the requirement that associated persons verify annually that they have reviewed their firm's written supervisory procedures; eliminating risk management from the additional content requirements under proposed FINRA Rule 3120; and clarifying that supplementary material is part of the rule and the location of language within the supplementary material does not affect the weight or significance of a provision.[29] Commenters also expressed support for FINRA's efforts to consolidate the existing NASD and Incorporated NYSE rules into the FINRA rulebook.[30]

In response to the Notice and Proceedings Order, one commenter expressed strong support for the proposed rule change, as modified by Amendment No. 1.[31] The commenter stated that the proposed rule change, as amended, ''will ensure that investors are protected by the robust supervision programs implemented by firms, and that firms can continue to effectively utilize their supervisory structures and procedures under clear regulatory requirements.'' [32]

2. Opposition to Risk-Based Review Principles

Two commenters to the Proposing Release opposed the proposed rules' flexibility permitting members to rely on risk-based or principles-based review standards for specific obligations, such as the review of securities transactions and correspondence, arguing that such flexibility would result in reduced or diminished supervisory requirements that would not achieve the purpose of protecting the investing public.[33]

FINRA responded by explaining that the proposed rules' risk-based approach for certain aspects of a member's supervisory procedures is intended to further strengthen, not diminish, investor protection by allowing firms the flexibility to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concern may be warranted.[34] FINRA also noted that the proposed rules further protect investors by retaining specific prescriptive requirements of NASD Rules 3010 and 3012, such as mandatory inspection cycles, prohibitions on who can conduct location inspections, and procedures for the monitoring of enumerated activities. FINRA also pointed to additional prescriptive requirements in the proposed rules, including special supervision for supervisory personnel rather than just the existing special supervision for producing managers, specific procedures to detect and investigate potential insider trading violations, and additional content requirements for specific firms' annual reports. FINRA noted that it understands concerns that additional guidance may be needed and intends to provide such guidance as circumstances warrant.

3. Reconsider Previously Proposed Supplementary Material

One commenter to the Proposing Release suggested that FINRA

[13] *See supra* note 7.

[14] *See supra* note 4.

[15] *See supra* note 5.

[16] ICI. *See also* MSRB Memo.

[17] Brandenburger, CAI, FSI, ICI, IMS, Letter Type A, Putnam, SIFMA.

[18] Cetera, ICI, IMS, SIFMA.

[19] Brandenburger, Cetera, IMS, Letter Type A, Putnam.

[20] CAI, Cetera, FSI, IMS, Wells Fargo.

[21] Caruso, NASAA, PIABA, St John's.

[22] *See supra* note 6.

[23] *See supra* note 7.

[24] *See supra* note 8. Due to a temporary closure of the **Federal Register,** the Notice and Proceedings Order was not published in the **Federal Register** until October 22, 2013.

[25] *See infra* note 32 and accompanying text; *see also supra* note 8.

[26] *See infra* Section III(A)(6)(C).

[27] *See supra* note 9.

[28] Cetera, NFP, Schwab, SIFMA, St. John's, Sweeney.

[29] Schwab, SIFMA.

[30] NASAA, PIABA, Wells Fargo.

[31] FSI's October Letter.

[32] *Id.*

[33] NASAA, PIABA.

[34] October Response.

reconsider its decision to delete supplementary material previously proposed in the 2011 Filing providing that for a member's supervisory system to be reasonably designed to achieve compliance with FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade), it must include supervision of all of a member's business lines irrespective of whether they require broker-dealer registration.[35] This commenter restated this concern in a second letter.[36] FINRA responded that it continues to believe that it was the best course to eliminate the proposed supplementary material from the proposed rule because of potential differences with the supervision requirements otherwise applicable to those business lines.[37] FINRA stated that it will continue to apply FINRA Rule 2010's standards to non-securities activities of members and their associated persons consistent with existing case law.

4. Cost Benefit Analysis

One commenter to the Proposing Release stated that the proposal's compliance costs would be minimal and outweighed by the benefits.[38] Other commenters suggested that the proposal lacked a sufficient cost benefit analysis,[39] with some commenters stating that FINRA had not provided any specific performance objectives or identified other metrics to which it may later refer to assess the effectiveness of the proposed changes.[40] One commenter acknowledged that it was not possible for FINRA to perform a thorough cost benefit analysis when the proposal was filed, but suggested that FINRA revisit the proposed rules within five years of their adoption to ensure they are achieving their stated purpose while avoiding unnecessary costs.[41]

FINRA responded that the proposed rule change, as amended, strives to minimize the membership's burden and cost of complying with the consolidated supervision rules, as consistent with their purposes.[42] FINRA noted that the consolidated supervision rules transfer many of the existing requirements in NASD Rules 3010 and 3012 relating to, among other things, supervisory systems, written procedures, internal inspections, review of correspondence, and supervisory controls. Thus, FINRA believes that transferring existing requirements does not raise additional costs or burdens for firms because firms have already developed the necessary procedures and supporting systems to comply with those requirements. FINRA further noted that the proposed rule change also would delete Incorporated NYSE Rule 342 and much of its supplementary material and interpretations as they are, in main part, either duplicative of, or not in alignment with, the proposed supervision requirements, thereby reducing potential costs to firms that are members of both FINRA and the NYSE.

In addition, FINRA noted that it has also applied a risk-based approach or similar flexibility for specified aspects of a member's supervisory procedures that is intended to allow firms the ability to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concerns may be warranted. Those aspects include:

- Permitting risk-based review of all transactions relating to a member's investment banking or securities business;[43]
- Permitting risk-based review of a member's correspondence and internal communications that fall outside of the subject matters listed in proposed FINRA Rule 3110(b)(4);[44]
- Providing exceptions, based on a member's size, resources, and business model, from proposed FINRA Rule 3110's provisions regarding the supervision of a member's supervisory personnel and the persons prohibited from conducting a location's inspections;[45]
- Requiring that only members reporting $200 million or more in gross revenues in the preceding year (increased from the $150 million threshold originally proposed in the 2011 Filing) include in the annual report required by FINRA Rule 3120 supplemental information from Incorporated NYSE Rule 342.30's annual report content requirements;[46]
- Aligning proposed FINRA Rule 3110(d)'s definition of ''covered account'' with respect to detecting and investigating potential insider trading violations with existing NYSE guidance in response to commenters' concerns regarding compliance costs and burdens;[47]
- Replacing NASD Rule 3110(i) (Holding of Customer Mail) and its strict time limits for holding customer mail with proposed FINRA Rule 3150 (Holding of Customer Mail), which generally allows a member to hold a customer's mail for a specific time period in accordance with the customer's written instructions if the member meets specified conditions;[48] and
- Deleting proposed supplementary material, in response to commenters' concerns regarding compliance costs and burdens that would have required a senior principal to have a physical presence on a regular periodic schedule at a one-person office of supervisory jurisdiction (''OSJ'') where the one-person OSJ principal was conducting sales-related activities.[49]

FINRA stated that it agrees that the proposed consolidated supervision rules should be subject to a retrospective review process following an appropriate period after their implementation to determine whether they are achieving their intended purpose or have become overly burdensome[50] and would seek to consult with the membership, the public, and other stakeholders in analyzing the economic impact of the rules.

[35] NASAA (referring to the 2011 Filing's proposed FINRA Rule 3110.01 (Business Lines)).

[36] NASAA's November Letter.

[37] October Response. *See also* November Response, stating that FINRA continues to support its analysis of these issues as described above.

[38] St. John's.

[39] Brandenburger, FSI, IMS, Letter Type A, Putnam.

[40] Brandenburger, FSI, IMS, Letter Type A.

[41] FSI.

[42] October Response.

[43] *See* proposed FINRA Rule 3110(b)(2) and FINRA Rule 3110.05, discussed further at *infra* Section III(E); *see also* Section E, page 12 of FINRA's October Response and Section 2(C), page 5 of FINRA's November Response.

[44] *See* proposed FINRA Rule 3110(b)(4) and FINRA Rule 3110.06, discussed further at *infra* Section III(F); *see also* Section F, page 14 of FINRA's October Response and Section 2(E)(i), page 6 of FINRA's November Response.

[45] *See* proposed FINRA Rule 3110(b)(6)(C)(ii) and FINRA Rule 3110(c)(3)(C), discussed further at *infra* Section III(H); *see also* Section H, page 19 and Section K, page 24 of FINRA's October Response and Section 2(D), page 5–6 of FINRA's November Response.

[46] *See* proposed FINRA Rule 3120(b), discussed further at *infra* Section III(M); *see also* Section N, page 34 of FINRA's October Response and Section 2(G), page 11 of FINRA's November Response.

[47] *See* proposed FINRA Rule 3110(d)(1)(A) through (D), discussed further at *infra* Section III(K); *see also* Section L, page 29 of FINRA's October Response and Section 2(F)(ii), page 10 of FINRA's November Response.

[48] *See* proposed FINRA Rule 3150(a) and (b).

[49] *See* Section C, page 8 of FINRA's October Response and Section 3, page 12 of FINRA's November Response.

[50] On September 19, 2013, FINRA issued a public statement, ''Framework Regarding FINRA's Approach to Economic Impact Assessment for Proposed Rulemaking,'' outlining the core principles defining FINRA's approach to conducting economic impact assessments for rulemaking. The framework applies specifically to significant new rule proposals, and therefore would not cover the current proposal. However, as noted in the framework, FINRA has historically taken into account the costs and burdens of its rulemaking, including the changes proposed in the proposed consolidated supervision rule filing.

5. Include Other Supervisory-Related Requirements

Some commenters to the Proposing Release requested that FINRA revise the proposal to include provisions addressing other supervisory-related issues.[51] These issues include, for example, establishing a minimum ratio of producing representatives to compliance officers,[52] requiring heightened supervision for associated persons with a high volume of complaints,[53] identifying and supervising suspicious withdrawal patterns,[54] and requiring special supervisory procedures for senior investors and non-English speaking customers.[55] FINRA responded that it believes that these matters should be considered as part of a member's establishment of a supervisory system and procedures reasonably designed to achieve compliance with the federal securities laws and FINRA rules, and the testing and verification of such procedures under FINRA Rule 3120.[56] In this regard, FINRA noted that it has issued guidance addressing areas of concern, including supervision of associated persons with disciplinary history,[57] verification of emailed instructions to transmit or withdraw assets,[58] and obligations relating to senior investors.[59]

6. Additional General Comments

One commenter to the Proposing Release suggested that proposed FINRA Rule 3110 would require firms to have compliance departments that operate independently from their sales activity.[60] FINRA responded that it disagrees with this interpretation of proposed FINRA Rule 3110 and stated that proposed FINRA Rule 3110, which is based primarily on existing requirements in NASD Rule 3010 and Incorporated NYSE Rule 342 relating to, among other things, supervisory systems, written procedures, internal inspections, and review of correspondence, is intended to allow firms the flexibility to establish their supervisory programs in a manner that reflects their business, size, and organizational structure.[61] FINRA further noted that proposed FINRA Rule 3110 would not require a member to have an independent compliance department.

Another commenter to the Proposing Release suggested incorporating the proposed supplementary material into the body of the proposed rules.[62] FINRA responded that supplementary material is part of the rule and a provision's location as supplementary material is intended to improve the readability of the rule without affecting the weight, significance, or enforceability of the provision.[63]

B. Comments on Proposed FINRA Rule 3110(a)

As proposed, FINRA Rule 3110(a) (Supervisory System) would have required a member to have a supervisory system for the activities of its associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA and the MSRB rules. One commenter to the Proposing Release requested that FINRA delete proposed FINRA Rule 3110(a)'s reference to the MSRB rules.[64] FINRA responded that the proposed reference to the MSRB rules was intended to clarify that members' supervisory systems must extend to compliance with MSRB rules and also to align FINRA's supervisory system requirement with the existing requirement under MSRB Rule G–27 (Supervision) to have a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and regulations and MSRB rules.[65] In light of a member's separate obligation to comply with MSRB Rule G–27, however, FINRA deleted the proposal's references to the MSRB rules in Amendment No. 1.

C. Comments on Deleted Supplementary Material Regarding One-Person OSJs

As proposed, FINRA Rule 3110 would have included supplementary material clarifying the conditions a firm must satisfy to establish a one-person OSJ consistent with proposed FINRA Rule 3110(a)(4)'s requirement to have one or more appropriately registered principals in each OSJ with authority to carry out the supervisory responsibilities assigned to that office. Specifically, proposed FINRA Rule 3110.03 (One-Person OSJs) expressly provided that the registered principal at a one-person OSJ (each such person is referred to in this paragraph C as the ''on-site principal'') cannot supervise his or her own sales activities and must be under the effective supervision and control of another appropriately registered principal (''senior principal''). The proposed supplementary material would have required that the designated senior principal be responsible for supervising the activities of the on-site principal at the one-person OSJ and conduct on-site supervision of the one-person OSJ on a regular periodic schedule to be determined by the member. In determining the schedule, the proposed supplementary material would have required a member to consider, among other factors, the nature and complexity of the securities activities for which the location is responsible, the nature and extent of contact with customers, and the disciplinary history of the principal at the one-person OSJ.

One commenter to the Proposing Release supported the proposed supplementary material,[66] while another commenter suggested that FINRA revise proposed FINRA Rule 3110.03 to specify that ''no Registered Principal shall supervise his or her own sales activity.'' [67] Numerous commenters raised concerns regarding the negative impact and costs of implementing the proposed requirement.[68] One commenter also stated that proposed FINRA Rule 3110.03 would create an inconsistency and serve little regulatory purpose by requiring the personal production of one-person OSJs to be supervised differently than an OSJ with multiple registered persons.[69] Several other commenters suggested that proposed FINRA Rule 3110.03 was unnecessary to ensure effective supervision [70] and could undermine many independent firms' overall supervisory structures [71]

[51] Sweeney, St. John's, PIABA. In addition, IMS suggested that FINRA include in the proposal a specific presumption that a member firm's supervisory procedures would be presumed acceptable to FINRA examiners if the firm's procedures are properly documented and reasonable in light of the scope of its business, the extent of its customer contact, and its disciplinary history. However, as FINRA has noted previously, members retain the responsibility to design and implement supervisory procedures that are appropriate for their specific businesses and structures. *See* Notice to Members 99–45 (June 1999).

[52] Sweeney.

[53] PIABA.

[54] PIABA.

[55] St. John's.

[56] October Response.

[57] *See, e.g.,* Notice to Members 97–19 (April 1997).

[58] *See Regulatory Notice* 12–05 (January 2012).

[59] *See, e.g., Regulatory Notice* 07–43 (September 2007).

[60] Sweeney.

[61] October Response.

[62] IMS.

[63] October Response.

[64] ICI. *See also* MSRB Memo.

[65] *See* MSRB Rule G–27(b) (Supervisory System).

[66] PIABA. PIABA also expressed overall support for proposed FINRA Rule 3110(a)(4) and the proposed supplementary material addressing the supervision of multiple OSJs by a single principal.

[67] FSI.

[68] Brandenburger, Cetera, FSI, IMS, Letter Type A, Putnam.

[69] Cetera.

[70] Brandenburger, IMS, Letter Type A, Putnam.

[71] Brandenburger, Cetera, IMS, Letter Type A.

where home office principals supervise the sales activities of multiple field-OSJ principals to prevent conflicts of interest from self-supervision, or use technology and annual inspections to augment their supervision.[72] Commenters also suggested that the requirement to have ''on-site supervision on a regular periodic schedule'' ignores firms' use of technology-based remote supervisory systems.[73] One commenter raised concerns that proposed FINRA Rule 3110.03 would require all necessary supervisory reviews of the one-person OSJ to be conducted by the senior principal and sought clarification that the proposed supplementary material does not limit comprehensive regional supervisory structures, where regional principals perform annual and unannounced inspections and a separate centralized supervisory unit within the home office is dedicated to overseeing specific functions that require specialized knowledge and experience such as correspondence, advertising, or trade review.[74]

FINRA responded that it believes that OSJs conduct critical functions and one-person OSJs present unique supervisory challenges. However, in light of commenters' continuing concerns regarding compliance costs and burdens, in Amendment No. 1, FINRA eliminated the proposed supplementary material from the proposed rule.[75] FINRA noted that, importantly, it believes that one-person OSJ locations where the on-site principal engages in sales-related activities that trigger OSJ designation should be subject to scrutiny, and firms should conduct focused reviews of such locations.[76] FINRA stated that such locations would be subject to the general provisions of proposed FINRA Rule 3110(a)(5) (requiring all registered persons to be assigned to an appropriately registered representative(s) or principal(s) who will be responsible for supervising that person's activities) and proposed FINRA Rule 3110(b)(6) (requiring procedures prohibiting associated persons who perform a supervisory function from, among other things, supervising their own activities).[77] In addition, FINRA noted that it would continue to monitor one-person OSJs for possible conflicts of interest or sales practice violations and may determine to address the matter further as part of a retrospective review process following an appropriate period after implementation of proposed FINRA Rule 3110.

One commenter to the Notice and Proceedings Order opposed the elimination of the previously proposed supplementary material that would have required a registered principal at a one-person OSJ to be under the effective supervision and control of another appropriately registered principal.[78] However, the commenter stated that ''the harm that may have resulted from its removal is remediated by further changes designed to make it clear that self-supervision is inappropriate, and [they] encourage FINRA to continue to follow up on its commitment to continue to examine the unique challenges posed by One-Person OSJs.'' [79] FINRA responded that, based on prior comments on and concerns with issues raised in the Proposing Release, it continues to believe that it was the best course to eliminate the proposed supplementary material from the proposed rule.[80]

D. Comments on Proposed FINRA Rule 3110.03

Proposed FINRA Rule 3110.03 (Supervision of Multiple OSJs by a Single Principal) would clarify the general requirement in proposed FINRA Rule 3110(a)(4) to have one or more appropriately registered principals in each OSJ with authority to carry out the supervisory responsibilities assigned to that office (an ''on-site principal''). Specifically, proposed FINRA Rule 3110.03 would clarify that the requirement to have an appropriately registered principal in each OSJ requires the designated on-site principal to have a physical presence, on a regular and routine basis, at the OSJ. FINRA stated that it strongly believes OSJs engage in critical functions, and the requirement to have on-site supervision by designating one or more on-site principals in each OSJ has been a long standing cornerstone in establishing a reasonable supervisory structure. As a result, proposed FINRA Rule 3110.03 sets forth a general presumption that a principal will not be designated and assigned to be the on-site principal pursuant to proposed FINRA Rule 3110(a)(4) to supervise more than one OSJ.

If a member determines it is necessary to assign one principal to be the designated on-site principal to supervise two or more OSJs, then the firm must consider, among other things, the following factors:

- Whether the on-site principal is qualified to supervise the activities and associated persons in each location;
- Whether the on-site principal has the capacity and time to supervise the activities and associated persons in each location;
- Whether the on-site principal is a producing registered representative;
- Whether the OSJ locations are in sufficiently close proximity to ensure that the on-site principal is physically present at each location on a regular and routine basis; and
- The nature of activities at each location, including size and number of associated persons, scope of business activities, nature and complexity of products and services offered, volume of business done, the disciplinary history of persons assigned to such locations, and any other indicators of irregularities or misconduct.

In the Proposing Release, the proposed supplementary material would have created a further general presumption that assigning a principal to be the on-site principal of more than two OSJs is unreasonable.

1. Clarification of Term ''On-Site Principal''

As originally proposed, FINRA Rule 3110.03 used the terms ''on-site supervisor'' and ''designated principal'' interchangeably throughout the provision. Commenters requested that FINRA clarify in the rule text whether proposed FINRA Rule 3110.03's terms ''on-site supervisor'' and ''designated principal'' refer to the same person.[81] In response, FINRA revised in Amendment No. 1 proposed FINRA Rule 3110.03 to use the term ''on-site principal'' consistently throughout the provision.

[72] Cetera.

[73] Brandenburger, IMS, Letter Type A, Putnam.

[74] FSI.

[75] The deletion of this proposed supplementary material has resulted in a change in numbering of the remaining supplementary material to proposed FINRA Rule 3110. For ease of reference, FINRA's responses to comments employ the new proposed numbers in all instances.

[76] *See* October Response (citing to SEC Division of Market Regulation, Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004) (reminding broker-dealers that small, remote offices require vigilant supervision and specifically noting that ''[n]o individual can supervise themselves''); NASD Regulatory & Compliance Alert, Volume 11, Number 2 (June 1997) (cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves); *see also* In re Stuart K. Patrick, 51 S.E.C. 419, 422 (May 17, 1993) (''[s]upervision, by its very nature, cannot be performed by the employee himself'') (SEC order sustaining application of the New York Stock Exchange's supervisory rule—also cited by Staff Legal Bulletin No. 17 as support for statement that individuals cannot supervise themselves)).

[77] October Response.

[78] NASAA's November Letter.

[79] NASAA's November Letter at p. 4.

[80] November Response.

[81] Cetera, FSI.

2. Home Office Principals; Costly and Burdensome Implementation

Two commenters to the Proposing Release raised concerns with proposed FINRA Rule 3110.03.[82] One commenter requested that FINRA either ''exclude 'up-the-chain' home office supervision of producing field OSJ principals'' or more clearly address how the ''physical presence'' requirement applies to home office employee supervisors. The commenter specifically raised concerns about whether a home office principal with supervisory responsibilities over a particular business line conducted in the OSJ becomes the ''on-site principal'' and therefore would be required to have a physical presence on a regular basis.[83] The second commenter stated that proposed FINRA Rule 3110.03 does not provide sufficient flexibility, is too costly and burdensome to implement, and fails to take into account firms' various business structures.[84]

FINRA responded that proposed FINRA Rule 3110(a)(4), which would require a firm to have an appropriately registered principal in each OSJ with authority to carry out the supervisory responsibilities assigned to that office by the member, is being transferred unchanged from current NASD Rule 3010(a)(4).[85] FINRA further stated that due to inquiries from firms asking if they could assign one principal to be the designated on-site principal to two or more OSJs consistent with the requirements of NASD Rule 3010(a)(4), FINRA staff developed informal guidance and interpretations under NASD Rule 3010(a)(4). FINRA stated that Proposed FINRA Rule 3110.03 reflects these interpretations and consolidates them in one rule.

FINRA further responded that it believes the proposed rule would continue to provide firms with the flexibility to design supervisory systems suited for their business models, by allowing some flexibility in the presence of on-site supervisors if the firm can determine that the on-site principal has sufficient time and resources to engage in meaningful supervision of the critical functions that occur at another OSJ.[86] FINRA noted that firms can designate more than one on-site principal at an OSJ to supervise activities at that OSJ based on particular business lines, and each such principal designated as an on-site principal is required to have a physical presence on a regular basis. FINRA further noted that the on-site principal(s) is one part of a firm's comprehensive supervisory chain and not all ''up the chain'' supervisors must be designated as the on-site principal.

3. Elimination of Presumption That More Than Two OSJs Is Unreasonable

In the proposal, FINRA expressly included two general presumptions in the rule: (1) one principal should be assigned to be the on-site principal at one OSJ; and (2) assigning one principal to be the on-site principal at more than two OSJs is unreasonable. Commenters to the Proposing Release expressed concern about the effect that the presumptions would have on smaller firms; and one commenter stated that the presumptions negated the flexibility that FINRA otherwise intends to provide.[87] FINRA stated that the general presumptions were intended to provide firms with clarity. FINRA noted that the presumptions established guidelines, not rules, and firms could overcome the presumptions by demonstrating that assigning one principal to supervise more than two OSJs is reasonable based on the relevant factors set forth in proposed FINRA Rule 3110.03.[88]

In response to comments, FINRA proposed in Amendment No. 1 to replace the presumption in the Proposing Release that assigning one principal to be the on-site principal at more than two OSJs is unreasonable with a general statement that assigning a principal to more than one OSJ will be subject to scrutiny.

E. Comments on Proposed FINRA Rule 3110(b)(2) and FINRA Rule 3110.05

Proposed FINRA Rule 3110(b)(2) (Review of a Member's Investment Banking and Securities Business) would require that a member have supervisory procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the member's investment banking or securities business. Proposed FINRA Rule 3110.05 (Risk-based Review of Member's Investment Banking and Securities Business) permits a member to use a risk-based system to review these transactions.

1. Additional Clarification Regarding ''Risk-Based Review System''

Commenters to the Proposing Release requested additional clarification regarding how to comply with proposed FINRA Rule 3110(b)(2)'s requirement to review all transactions related to a member's investment banking and securities business if using a risk-based system to review transactions pursuant to proposed FINRA Rule 3110.05. Specifically, two commenters sought clarification as to whether a member's supervisory system must take into account ''all'' transactions, considering that a principal only is required to review a sample of transactions under a ''risk-based review system.'' [89] Similarly, another commenter asked whether a member firm determining parameters for a technological-based review system that would cause a trade to be flagged for more intensive review would be a ''risk-based'' approach that would conform to proposed FINRA Rule 3110(b)(2).[90]

FINRA responded that proposed FINRA Rule 3110(b)(2) would transfer to the FINRA Rulebook NASD Rule 3010(d)(1)'s provision requiring principal review, evidenced in writing, of all transactions and clarifies that such review include all transactions relating to the member's investment banking or securities business.[91] FINRA stated that the term ''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 self-regulatory organization (''SRO'') rule violations. In response to commenters' requests for clarification on risk-based reviews, FINRA clarified in Amendment No. 1 that a member would not be required to conduct detailed reviews of each transaction if a member is using a reasonably designed risk-based review system that provides a member with sufficient information that permits the member to focus on the areas that pose the greatest numbers and risks of violation.

FINRA further responded that it understands that a member's procedures for the review of its transactions by a registered principal may include the use of technology-based review systems with parameters designed to assess which transactions merit further

[82] CAI, Cetera.

[83] Cetera.

[84] CAI.

[85] October Response.

[86] October Response.

[87] IMS, Wells Fargo.

[88] Cetera also stated that this presumption inappropriately shifts the burden of proof to the member and does not appear justified given the lower ''preponderance of the evidence'' standard of proof in FINRA disciplinary proceedings. FINRA stated that it disagrees with the commenter's statement. FINRA explained that Proposed FINRA Rule 3110(a) specifies the standard that a member's supervisory system be reasonably designed to achieve compliance with the applicable Federal securities laws and regulations and FINRA rules, and it is the member's responsibility to demonstrate that its supervisory system meets this standard. *See* October Response.

[89] IMS, SIFMA.

[90] Cetera.

[91] October Response.

review.[92] FINRA noted that the parameters would have to be reviewed by a principal and that review would have to be documented in writing. FINRA further noted, as is always the case with the exercise of supervision under FINRA rules, a principal's use of any automated supervisory system, aid, or tool for the discharge of supervisory duties represents a direct exercise of supervision by that principal, and the principal remains responsible for the discharge of supervisory responsibilities in compliance with the proposed rule. In addition, FINRA noted that a principal relying on a risk-based review system is responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed.[93]

2. Exclude Specific Types of Broker-Dealers

One commenter requested that FINRA either exclude ''mutual fund underwriters'' and other members that do not have or maintain customer relationships or effect transactions with or for retail investors from proposed FINRA Rule 3110(b)(2) or explain how those members are expected to document compliance.[94] FINRA stated that the proposed rules would apply a risk-based approach or similar flexibility for specified aspects of a member's supervisory procedures to allow firms the ability to establish their supervisory programs in a manner that reflects their business models, such as members with limited broker-dealer activities.[95] As noted above, FINRA stated that proposed FINRA Rule 3110(b)(2) would transfer NASD Rule 3010(d)(1)'s provision and would require a principal to review and evidence in writing all transactions and that such review would include all transactions relating to the member's investment banking or securities business. Thus, members, regardless of their business activities, currently are required to have a principal review all of their transactions. FINRA noted that if mutual fund underwriters do not effect transactions, then the firms would have no review obligations pursuant to proposed FINRA Rule 3110(b)(2).[96] FINRA stated that it understands that some underwriters do have customer relationships that could involve customer transactions, in which case such member firms would need to review those transactions pursuant to proposed FINRA Rule 3110(b)(2).[97] FINRA further stated that proposed FINRA Rule 3110.05 would permit a mutual fund underwriter to use a risk-based approach to review its transactions.[98]

In response to the Notice and Proceedings Order, the same commenter restated its recommendation that mutual fund underwriters be excluded from the provision in Rule 3110(b)(2) that would require principal underwriters to have supervisory procedures that require the review of all customer transactions and evidence such review in writing. The commenter acknowledged FINRA's response to its original comment that ''if mutual fund underwriters do not effect transactions, then the firms would have no review obligations pursuant to proposed FINRA Rule 3110(b)(2);'' however, the commenter remained concerned that mutual fund underwriters would be required to create, maintain, implement, and review on an ongoing basis a procedure for reviewing transactions since the requirement to have such procedures is imposed on all FINRA members without regard to whether the member effects customer transactions.[99]

FINRA responded that, if a member does not engage in any transactions relating to its investment banking or securities business, it would be sufficient under proposed Rule 3110(b)(2) for the member to acknowledge in its supervisory procedures that it does not engage in any such transactions and that it must have supervisory policies and procedures in place before doing so.[100]

F. Comments on Proposed FINRA Rule 3110(b)(4) and Related Supplementary Materials

Proposed FINRA Rule 3110(b)(4) (Review of Correspondence and Internal Communications) would require a member to have procedures to review incoming and outgoing written (including electronic) correspondence and internal communications relating to its investment banking or securities business.[101] In particular, the supervisory procedures would require the member's review of: (1) incoming and outgoing written correspondence to properly identify and handle in accordance with firm procedures: customer complaints, instructions, funds and securities, and communications that are of a subject matter that require review under FINRA rules and federal securities laws; and (2) internal communications to properly identify communications that are of a subject matter that require review under FINRA rules and the federal securities laws.[102]

1. Risk-Based Review of Internal Communications

Proposed FINRA Rule 3110.06 (Risk-based Review of Correspondence and Internal Communications) would require a member to decide, by employing risk-based principles, the extent to which additional policies and procedures for the review of incoming and outgoing written correspondence and internal communications that fall outside of the subject matters listed in proposed FINRA Rule 3110(b)(4) are necessary for its business and structure.

Some commenters suggested that FINRA should further align proposed FINRA Rule 3110.06 with the guidance in *Regulatory Notice* 07–59.[103] One commenter stated that the proposed rule could be interpreted as requiring a member to review all internal communications.[104] Two commenters to the Proposing Release requested additional guidance on the appropriate scope of internal communications requiring review and methodology for identifying those communications.[105] Commenters further suggested that any firm that does not engage in activities that are of a subject matter that require review should not be required to review its internal communications for references to those activities.[106] One commenter stated that requiring such firms to review internal communications for reference to those activities would result in significant costs that are not justified by the limited additional investor protection

[92] *Id.*

[93] *See also Regulatory Notice* 07–53 (November 2007) (Deferred Variable Annuities) (discussing use of automated supervisory systems).

[94] ICI and ICI's October Letter.

[95] October Response.

[96] October Response and November Response.

[97] October Response.

[98] *Id.*

[99] *See* ICI's October Letter, page 5.

[100] November Response.

[101] In the Proposing Release, proposed FINRA Rule 3110(b)(4) transferred NASD Rule 3010(d)'s reference to ''correspondence with the public'' and used the term in related supplementary materials, proposed FINRA Rules 3110.06–.08. In Amendment No. 1, FINRA revised proposed FINRA Rule 3110(b)(4) and proposed FINRA Rules 3110.06–.08 to refer to ''correspondence'' to be consistent with FINRA Rule 2210's (Communications with the Public) definition and use of the term ''correspondence.'' *See also* FINRA Rule 2210(b)(2) (requiring that all correspondence be subject to the supervision and review requirements of existing NASD Rule 3010(d)).

[102] In Amendment No. 1, FINRA revised proposed FINRA Rule 3110(b)(4) and FINRA Rule 3110.06 to delete references to the MSRB rules, consistent with the deletion of such reference in proposed FINRA Rule 3110(a) discussed above.

[103] ICI, IMS, Schwab, SIFMA.

[104] ICI and ICI's October Letter.

[105] CAI, ICI.

[106] Brandenburger, FSI, IMS, Letter Type A, Putnam.

benefits.[107] Other commenters urged FINRA to further revise proposed FINRA Rule 3110.06 to state that ''[t]hrough the use of risk-based principles, firms can determine the extent to which the review of their internal communications is necessary.'' [108]

FINRA responded that, with respect to the review of internal communications, *Regulatory Notice* 07–59 states that ''with the exception of the enumerated areas requiring review by a supervisor, members may decide, employing risk-based principles, the extent to which review of any internal communications is necessary in accordance with the supervision of their business.'' [109] FINRA responded that it believes that proposed FINRA Rule 3110.06 would accurately reflect this guidance by stating that ''[b]y employing risk-based principles, a member must decide the extent to which additional policies and procedures for the review of . . . internal communications that are not of a subject matter that require review under FINRA rules and federal securities laws are necessary for its business and structure.'' FINRA stated that, consistent with this guidance, proposed FINRA Rule 3110.06 would not require the review of every internal communication.[110] For example, if a member does not engage in any activities that are of a subject matter that require review, the proposed rule would not require that the member review its internal communications for references to those activities, provided that its supervisory procedures acknowledge that factor as part of the member's determination that its procedures are reasonably designed to achieve compliance with applicable federal securities laws and FINRA rules. Accordingly, FINRA declined to amend the proposal in response to the comments.

[107] FSI.

[108] IMS, SIFMA.

[109] *See Regulatory Notice* 07–59 (December 2007), at 3, 9.

[110] *See id.* at 11 (specifically noting that the guidance neither created new supervisory requirements nor required the review of every communication, and that, ''[w]ith respect to the review of internal electronic communications, the guidance states that—with the exception of the enumerated areas requiring review by a supervisor—a firm may use risk-based principles, including an examination of existing review processes, to determine the extent to which review of any internal communications is necessary''); *see also* November Response (ICI raised the same issue in its October Letter and FINRA responded that it believes that its guidance set forth in Regulatory Notice 07–59, as codified in proposed FINRA Rule 3110.06, addresses this concern).

2. Evidence of Review of Communications Using Lexicon-Based Screening Tools

Proposed FINRA Rule 3110.07 (Evidence of Review of Correspondence and Internal Communications) would clarify that merely opening a communication is not a sufficient review. Rather, a member must identify what communication was reviewed, the identity of the reviewer, the date of the review, and the actions taken by the member as a result of any significant regulatory issues identified during the review.

Commenters suggested that firms using lexicon-based screening tools as a risk-based means of reviewing communications should not need to maintain the documentation required by proposed FINRA Rule 3110.07 evidencing review for those communications that do not generate review alerts/hits for further review.[111] One commenter suggested that it should be sufficient for a member to demonstrate that it has reasonably designed controls in place to ensure that the screening tools are subject to review and are operating as intended,[112] while other commenters suggested revising proposed FINRA Rule 3110.07 to provide that ''[f]or those communications subjected to electronic review, the member must maintain documentation reasonably sufficient to demonstrate the parameters of such review.'' [113]

FINRA noted that it had previously declined to accept the suggestion that a member does not have to retain the specified information fields required by proposed FINRA Rule 3110.07 for communications reviewed through electronic review systems or lexicon-based screening tools if those messages do not generate review alerts.[114] FINRA stated that it believes that not only is the required documentation necessary to demonstrate that the communication was actually reviewed, but that failure to record and retain this information, such as the identity of the reviewer, could be inconsistent with a member's record retention obligations under FINRA and SEC rules.[115] FINRA further noted that, although proposed FINRA Rule 3110.07 would permit the use of lexicon-based screening tools and other automated systems, as noted in *Regulatory Notice* 07–59, members utilizing automated tools or systems in the course of their supervisory review of electronic communications must have an understanding of the limitations of those tools or systems and should consider what, if any, further supervisory review is necessary in light of those limitations.

With respect to communications reviewed by electronic surveillance tools that are not selected for further review, FINRA stated that, it would be sufficient to demonstrate compliance with proposed FINRA Rule 3110.07 if the electronic surveillance system has a means of electronically recording evidence that those communications have been reviewed by that system.[116] FINRA further stated that it would be permissible to use an electronic surveillance or reviewing tool that, with respect to communications that do not generate alerts, only captures the specified information fields to the extent necessary to comply with applicable FINRA and SEC rules.[117] Additionally, FINRA stated that, consistent with previous guidance discussing the use of any automated supervisory systems or tools to discharge supervisory duties, the use of electronic surveillance tools to review communications represents a direct exercise of supervision by the supervisor (including any use of such tools by the supervisor's delegate to review communications). FINRA noted that the supervisor remains responsible for the discharge of supervisory responsibilities in compliance with the rule and is responsible for any deficiency in the system's criteria that would result in the system not being reasonably designed.[118]

3. Retention of Correspondence and Internal Communications

Proposed FINRA Rule 3110.09 (Retention of Correspondence and Internal Communications) would require, among other things, that a member retain internal communications and correspondence of associated persons relating to the member's investment banking or securities business for the period of time and accessibility specified in Exchange Act Rule 17a–4(b) (not less than three years, the first two years in an easily accessible place).

[111] ICI, ICI's October Letter, IMS, SIFMA.

[112] ICI and ICI's October Letter.

[113] IMS, SIFMA.

[114] October Response.

[115] *Id.,* citing proposed FINRA Rule 3110.09 (Retention of Correspondence and Internal Communications) and Exchange Act of 1934 Rule 17a–4(b)(4) (requiring, among other things, that a broker-dealer's retained communications records include any approvals of communications sent).

[116] October Response.

[117] November Response.

[118] November Response at page 8. *See* Regulatory Notice 07–53 (November 2007) (Deferred Variable Annuities) (discussing use of automated supervisory systems).

One commenter to the Proposing Release requested that FINRA expand the record retention period in proposed FINRA Rule 3110.09 to six years to match the record retention period in Exchange Act Rule 17a–4(c) (requiring broker-dealers to preserve for a period of not less than six years after the closing of any customer's account any account cards or records relating to the terms and conditions with respect to the opening and maintenance of the account) and to the eligibility provisions for customer arbitration disputes in FINRA Rule 12206 (Time Limits).[119] A second commenter restated this concern in a second letter.[120] FINRA responded that firms are already subject to very extensive record retention requirements regarding communications about firms' business as such.[121] In FINRA's view, the cost of extending the record retention period from three years to six years would unnecessarily raise costs and create recordkeeping inconsistencies. FINRA stated that the proposed supplementary material purposefully aligns the record retention period for communications with the SEC's record retention period for the same types of communications to achieve consistent regulation in this area.

G. Comments on Proposed FINRA Rule 3110(b)(5)

Proposed FINRA Rule 3110(b)(5) (Review of Customer Complaints) would require members to have supervisory procedures to capture, acknowledge, and respond to all written (including electronic) customer complaints.

1. Exclusion of Oral Complaints

Several commenters to the Proposing Release suggested that members should be required to reduce an oral complaint to writing or to provide the customer with a form.[122] Commenters also suggested that oral complaints should not be too difficult to capture,[123] with one commenter stating that NYSE members have been required to capture and assess oral complaints for a number of years.[124] One commenter restated its concern with regard to the exclusion of oral complaints from proposed FINRA Rule 3110(b)(5).[125] FINRA stated that it did not include oral complaints because they are difficult to capture and assess, whereas members can more readily capture and assess written complaints.[126] FINRA further stated that it continues to believe that proposed FINRA Rule 3110(b)(5) should include only written customer complaints. FINRA noted that it encourages members to provide customers with a form or other format that will allow customers to communicate their complaints in writing. FINRA further noted that the failure to address a valid customer complaint, written or oral, may be a violation of FINRA Rule 2010.[127]

FINRA further responded that this aspect of the proposed rules would not change existing rules, explaining that although Incorporated NYSE Rule 401A previously required firms to acknowledge and respond to specified customer complaints (both oral and written), to harmonize the NASD and NYSE rules in the interim period before completion of the Consolidated FINRA Rulebook, FINRA amended Incorporated NYSE Rule 351(d) (Reporting Requirements) to limit the definition of ''customer complaint'' to include only written complaints, thereby making the definition substantially similar to that in NASD Rule 3070(c) (Reporting Requirements).[128]

2. Require More Than Written Acknowledgement and Response

One commenter to the Proposing Release suggested that proposed FINRA Rule 3110(b)(5)'s requirement to capture, acknowledge, and respond to customer complaints was insufficient and that firms should be required to conduct an adequate and objective review and ongoing monitoring of claims that include, where appropriate, ''bona fide'' offers of resolution, including trade reversal and cancellation, good faith pre-arbitration or litigation discussion, or negotiation.[129]

FINRA responded that it understands the commenter's concerns that members have procedures in place to take appropriate and meaningful action with respect to customer complaints and expects that a member's supervisory procedures will be reasonably designed to respond to customer complaints.[130] In addition, FINRA noted that members have reporting and records preservation obligations for customer complaints that assist FINRA in monitoring whether a member's supervisory procedures for capturing, acknowledging, and responding to written customer complaints are reasonably designed.[131]

H. Comments on Proposed FINRA Rule 3110(b)(6) and FINRA Rule 3110.10

Proposed FINRA Rule 3110(b)(6) (Documentation and Supervision of Supervisory Personnel) is based largely on existing provisions in NASD Rule 3010(b)(3) requiring a member's supervisory procedures to set forth the member's supervisory system and to include a record of the member's supervisory personnel with such details as titles, registration status, locations, and responsibilities. In addition, the

[119] PIABA.

[120] NASAA's November Letter.

[121] *See* October Response citing generally Exchange Act Rule 17a–4(b)(4); *see also* November Response, stating that FINRA continues to support its analysis of these issues as described above.

[122] Caruso, NASAA, PIABA, St John's.

[123] Caruso, NASAA, PIABA.

[124] Caruso.

[125] NASAA's November Letter.

[126] October Response; *see also* November Response stating that FINRA continues to support its analysis of these issues as described above.

[127] FINRA also pointed to its investor education literature that advises customers to communicate any complaints to their broker-dealer in writing, especially if customers have lost money or there were any unauthorized trades made in the customers' accounts. *See* FINRA's pamphlet *Investor Complaint Program: What to Do When Problems Arise; see also* NASD Rule 2340(a) (Customer Account Statements) (requiring a customer account statement to, among other things, advise the customer that any oral communications should be re-confirmed in writing to further protect the customer's rights, including rights under the Securities Investor Protection Act (SIPA)).

[128] *See* Exchange Act Release No. 58533 (September 12, 2008), 73 FR 54652 (September 22, 2008) (Order Approving File No. SR–FINRA–2008–036). FINRA adopted FINRA Rule 4530 to replace NASD Rule 3070 and comparable provisions in Incorporated NYSE Rule 351. *See* Securities Exchange Act Release No. 63260 (November 5, 2010), 75 FR 69508 (November 12, 2010) (Notice of Filing of Amendments No. 1 and 2 and Order Granting Accelerated Approval of File No. SR–FINRA–2010–034). FINRA Rule 4530 became effective on July 1, 2011. *See* Regulatory Notice 11–06 (February 2011).

[129] Arnoff. This commenter also requested that it be mandatory for broker-dealers to pay for the customer's litigation and arbitration expenses if good faith and objectively sound procedures of supervision, compliance, inspection, and claims handling are not followed. FINRA responded that it considers the comment to be outside the scope of the proposed rule change. The *FINRA Dispute Resolution Arbitrator's Guide* discusses when arbitration fees and expenses may be waived or awarded.

[130] October Response.

[131] *See* FINRA Rule 4513 (Records of Written Customer Complaints) (requiring each member to keep and preserve in each OSJ either a separate file of all written customer complaints that relate to that office (including complaints that relate to activities supervised from that office) and action taken by the member, if any, or a separate record of such complaints and a clear reference to the files in that office containing the correspondence connected with such complaints); *see also* FINRA Rule 4530 (requiring each member to promptly report to FINRA, but in any event not later than 30 calendar days, after the member knows or should have known of whether the member or a member's associated person is the subject of any written customer complaint involving allegations of theft or misappropriation of funds or securities or of forgery, as well as report to FINRA statistical and summary information regarding written customer complaints in such detail as FINRA shall specify by the 15th day of the month following the calendar quarter in which customer complaints are received by the member).

proposed rule would include two new provisions as described in more detail in the Proposing Release:

• Proposed FINRA Rule 3110(b)(6)(C) would require a member to have procedures prohibiting its supervisory personnel from supervising their own activities and reporting to, or having their compensation or continued employment determined by, a person the supervisor is supervising (subject to a limited size and resources exception); and

• Proposed FINRA Rule 3110(b)(6)(D) would require a member to have procedures to prevent the standards of supervision required pursuant to proposed FINRA Rule 3110(a) from being reduced in any manner due to any conflicts of interest that may be present with respect to the associated person being supervised, such as the person's position, the amount of revenue such person generates for the firm, or any compensation that the supervisor may derive from the associated person being supervised.

Proposed FINRA Rule 3110.11 (Supervision of Supervisory Personnel) would indicate that the exception provided in proposed FINRA Rule 3110(b)(6)(C) is generally intended for a sole proprietor in a single-person firm or where a supervisor holds a very senior executive position within the firm.

1. Support for New Provisions

Several commenters to the Proposing Release supported proposed FINRA Rules 3110(b)(6)(C) and (D),[132] with one commenter stating that the provisions ''should never be diluted.'' [133] Specifically referring to conflict of interest proscriptions in proposed FINRA Rule 3110(b)(6)(D), one commenter stated that the provision eliminates the opportunity for activities going unchecked or supervision being more lenient on the basis of self-interest,[134] while another commenter agreed that conflicts of interest relating to the compensation of the supervisor and the person being supervised should not needlessly compromise the effectiveness of supervisory procedures.[135] Referring to the prohibitions against supervisory personnel supervising their own activities in proposed FINRA Rule 3110(b)(C), one commenter concurred that self-supervision is inappropriate.[136]

2. Heightened Supervision

As noted in the Proposing Release, proposed FINRA Rule 3110(b)(6)(C) regarding the prohibition of supervisory personnel from supervising their own activities and reporting to, or having their compensation or continued employment determined by a person the supervisor is supervising, would replace NASD Rule 3012(a)(2)'s provisions concerning the supervision of a producing manager's customer account activity and the requirement to impose heightened supervision when any producing manager generates 20 percent or more of the revenue of the business units supervised by the producing manager's supervisor. One commenter to the Proposing Release suggested that FINRA retain the heightened supervisory requirement for producing managers that meet the 20 percent threshold and apply FINRA Rule 3110(b)(6)(C) to producing managers that do not meet the 20 percent threshold.[137] This commenter restated this concern in a second letter.[138]

FINRA responded that, although it understands the commenter's concerns regarding the need for effective supervision of producing managers, FINRA believes that proposed FINRA Rule 3110(b)(6)(C)'s provisions addressing the supervision of all supervisory personnel, rather than just producing managers, would be better designed to prevent supervisory situations that would not lead to effective supervision.[139] In addition, FINRA noted that proposed FINRA Rule 3110(b)(6)(D)'s conflicts of interest provisions would be designed to further ensure effective supervision of supervisory personnel.

3. Review of Senior Executive's Activities

One commenter to the Proposing Release stated that proposed FINRA Rule 3110(b)(6)(C) could prevent compliance professionals in the firm from reviewing the firm's most senior person's activities when that senior person occasionally produces revenue, and might force a firm to hire a ''senior principal'' if the senior person in the firm determines the compliance professionals' compensation or continued employment with the firm.[140]

FINRA disagreed with the commenter's interpretation of proposed FINRA Rule 3110(b)(6)(C) and stated that although proposed FINRA Rule 3110(b)(6)(C)(ii) generally would require a member to have procedures prohibiting its supervisory personnel from, among other things, reporting to, or having their compensation or continued employment determined by, a person the supervisor is overseeing, the same provision specifically provides an exception if a member determines that compliance with the prohibition is not possible because of a member's size or a supervisor's position within the firm. FINRA further stated that a member relying on the exception must document the factors it used to reach its determination that it can rely on the exception and how the supervisory arrangement otherwise complies with proposed FINRA Rule 3110(a). FINRA noted that proposed FINRA Rule 3110.10 would further provide non-exclusive examples of situations when the exception would generally apply, including when a registered person is a senior executive officer (or holds a similar position) and that proposed FINRA Rule 3110(b)(6)(C) and FINRA Rule 3110.10 do not require a member to hire additional personnel.[141]

4. Limited Exception

One commenter requested that FINRA either delete proposed FINRA Rule 3110.10 or revise it to expand the list of situations in which a firm may rely on the exception to include situations where a person supervises a senior person for only a limited purpose or function.[142]

FINRA declined to make any revisions to proposed FINRA Rule 3110.10. FINRA explained that the exception in proposed FINRA Rule 3110(b)(6)(C) is specifically based on a member's inability to comply with the general supervisory requirements because of the member's size or supervisor's position within the firm.[143] FINRA stated that proposed FINRA Rule 3110.10 reflects its view that a member would generally rely on the exception for a sole proprietor in a single-person firm or when a supervisor holds a very senior executive position within the firm. FINRA noted that a member may rely on the exception in other instances where it cannot comply because of its size or the supervisor's position within the firm, provided the member

[132] Cetera, SIFMA, Sweeney, St. John's.

[133] Sweeney.

[134] St. John's.

[135] SIFMA.

[136] Cetera.

[137] NASAA.

[138] NASAA's November Letter.

[139] October Response; *see also* November Response, stating that FINRA continues to support its analysis of these issues as described above.

[140] IMS.

[141] October Letter.

[142] ICI and ICI's October Letter.

[143] October Response Letter (noting that Proposed FINRA Rule 3110(b)(6)(C)'s exception is based, in large part, on the exception in NASD Rule 3012 from the general supervisory requirement for a producing manager's customer account activity and citing to NASD Rule 3012(a)(2)(A)(ii) (''Limited Size and Resources'' Exception)).

documents the factors used to reach its determination and how the supervisory arrangement with respect to the supervisory personnel otherwise complies with proposed FINRA Rule 3110(a).[144] To clarify that proposed FINRA Rule 3110.10 would provide non-exclusive examples of situations where the exception would generally apply, FINRA revised the provision in Amendment No. 1 to delete the term ''only'' prior to providing the examples.

The same commenter restated this recommendation in its comments to the Notice and Proceedings Order and stated that FINRA's response to its previous comment did not sufficiently address the concerns or examples raised in its comments to the Proposing Release.[145] In response, FINRA re-emphasized that the revisions to proposed Rule 3110.10's list of examples where a member would need to rely on the exception is non-exclusive.[146] FINRA further stated that it continues to support the principle set forth in proposed Rule 3110(b)(6)(C) that supervisory personnel must not report to, or have their compensation or continued employment determined by, a person they are supervising unless the firm complies with the permitted exception.

5. Conflicts of Interest

Commenters to the Proposing Release expressed concern that requiring members to have procedures to prevent their supervision standards from being reduced in any manner due to any conflicts of interest that may be present was inconsistent with the existing ''reasonably designed'' standard in proposed FINRA Rule 3110(a) (and current NASD Rule 3010(a)) and the proposed rules' risk-based supervision principles.[147] One commenter questioned whether proposed FINRA Rule 3110(b)(6)(D) creates a strict liability standard with respect to eliminating conflicts of interest.[148] Commenters requested that FINRA revise proposed FINRA Rule 3110(b)(6)(D) to clarify that firms must mitigate conflicts of interest as part of designing and establishing a reasonable supervisory system.[149] Two commenters suggested that FINRA amend the proposed supplementary material to require a member to have '' . . . procedures reasonably designed to prevent the supervisory system required pursuant to paragraph (a) of this Rule from being reduced. . . .'' [150]

In response, FINRA revised proposed FINRA Rule 3110(b)(6)(D) in Amendment No. 1 to clarify that the provision does not create a strict liability obligation requiring identification and elimination of all conflicts of interest. As revised, proposed FINRA Rule 3110(b)(6)(D) would require that a member have ''procedures reasonably designed to prevent the supervisory system required pursuant to paragraph (a) of this Rule from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised . . . .'' [151]

I. Comments on Proposed FINRA Rule 3110(b)(7) and FINRA Rule 3110.11

Proposed FINRA Rule 3110(b)(7) (Maintenance of Written Supervisory Procedures) would require a member to retain and keep current a copy of the member's written supervisory procedures at each OSJ and at each location where supervisory activities are conducted on behalf of the member.

Proposed FINRA Rule 3110.11 (Use of Electronic Media to Communicate Written Supervisory Procedures) would permit a member to satisfy its obligation to communicate its written supervisory procedures, and any amendments to those procedures, using electronic media, provided that the written supervisory procedures have been promptly communicated to, and are readily accessible by, all associated persons to whom the supervisory procedures apply based on their activities and responsibilities.

Two commenters to the Proposing Release requested that FINRA permit firms the flexibility to determine who should receive which portions of their written supervisory procedures, if any, and not interpret proposed FINRA Rule 3110(b)(7) to require communication of written supervisory procedures and amendments to non-supervisory personnel.[152] The commenters stated that, at many firms, written supervisory procedures are intended solely for supervisors while other documents (*e.g.,* compliance policies) are intended for the broader audience of all associated persons. In addition, the commenters noted that there may be written supervisory procedures (*e.g.,* how employee correspondence and trading are reviewed) that member firms do not want to be disseminated because the broad dissemination of those procedures may undermine their effectiveness.

FINRA stated that it continues to believe that it is important that all associated persons have knowledge of the supervisory procedures relevant to their activities.[153] FINRA notes that proposed FINRA Rule 3110(b)(7) and related supplementary material would not prohibit a firm from providing only its supervisory personnel with the written supervisory procedures' parameters detailing how a firm monitors or reviews its associated persons' activities to detect and prevent potential violative conduct (*e.g.,* details about how a firm reviews an associated person's correspondence or trading).

J. Comments on Proposed FINRA Rule 3110(c) and Proposed FINRA Rules 3110.13 and 3110.14

Proposed FINRA Rule 3110(c)(1) (Internal Inspections), based largely on NASD Rule 3010(c)(1), would retain the existing requirements for each member to review, at least annually, the businesses in which it engages and inspect each office on a specified schedule. The provision would also retain the existing requirement that the member's annual review must be reasonably designed to assist the member in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations and FINRA rules.[154]

1. Impose Additional Inspection Safeguards

Although one commenter to the Proposing Release supported proposed FINRA Rule 3110(c)(1),[155] another commenter suggested that firms should be required to conduct more frequent inspections to ensure that risks created by a firm's size, location, and resources are addressed.[156] The commenter also suggested requiring firms to hire third-party vendors to monitor their activities and conduct independent compliance

[144] *Id.*

[145] ICI's October Letter.

[146] November Response Letter.

[147] Cetera, IMS, Schwab, SIFMA.

[148] Schwab. NASAA raised similar concerns, asking whether proposed FINRA Rule 3110(b)(6)(C) requires a member's supervisory procedures to be designed to limit all conflicts of interest or solely be reasonably designed to eliminate conflicts of interest.

[149] IMS, Schwab, SIFMA.

[150] IMS, SIFMA.

[151] *See also* Section H(5), page 23 of the October Response.

[152] IMS, SIFMA.

[153] October Response Letter, referring to Notice to Members 99–45 (June 1999) (distinguishing between a member's compliance procedures and written supervisory procedures and specifying that ''[i]t is crucial that all persons associated with a member be informed of any changes in the supervisory system and applicable written procedures. [NASD Rule 3010(b)(3)], therefore, requires members to inform all associated persons of such changes.'').

[154] FINRA is revising proposed FINRA Rule 3110(c)(1) to delete references to the MSRB rules, consistent with the deletion of such reference in proposed FINRA Rule 3110(a) discussed above.

[155] St. John's.

[156] Arnoff.

audits, as well as to have a registered principal or compliance professional sign off on all compliance, supervisory, and inspection reports representing that to their knowledge and good faith belief, the report is true and correct.

FINRA responded that the proposed rule change would generally provide members with flexibility to conduct their inspections using only firm personnel.[157] This flexibility, in turn, would assist firms in managing compliance costs. FINRA stated that, with respect to addressing potential risk gaps, proposed FINRA Rule 3120 would require that firms test and verify, at least annually, that the member's supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA rules and, if necessary, create any additional or amended supervisory procedures in response to those test results. FINRA noted that this testing and verification would necessarily include any supervisory procedures regarding a member's inspections to ensure that inspections have not been compromised by any potential risks inherent to a member's size, location, or resources. Therefore, FINRA declined to make changes to proposed FINRA Rule 3110(c)(1) in response to comments.

2. Exclude Residences From Inspections

Two commenters to the Proposing Release requested that FINRA exclude residences from proposed FINRA Rule 3110(c)(1)'s required inspections of a firm's locations.[158] One of these commenters suggested that other types of review, such as review of a registered person's email would be a more effective way of identifying potential red flags.[159] One commenter repeated its request that FINRA not subject home offices to the inspection requirements for supervisory branch offices and non-branch locations.[160]

FINRA declined to adopt the commenters' suggestions to exclude residences from proposed FINRA Rule 3110(c)'s inspection requirements. FINRA stated that inspections are a crucial component of detecting and preventing regulatory and compliance problems of associated persons working at unregistered offices.[161] Some unregistered offices also operate as separate business entities under names other than those of the members. FINRA noted that while FINRA does not encourage or discourage such arrangements, a large number of geographically separate offices present the potential that sales practice problems will not be as quickly identified as would be the case for larger, centralized branch offices.[162] FINRA stated that remote supervision, such as reviewing email for ''red flags,'' would not be a sufficient substitution for an actual inspection, although red flags identified through such means could be helpful in determining whether to conduct unannounced location inspections.

3. Remove Presumption for Periodic Inspection Schedules

One commenter to the Proposing Release requested that FINRA delete proposed FINRA Rule 3110.13 (Presumption of Three-Year Limit for Periodic Inspection Schedules), which sets forth a general presumption of a three-year limit for periodic non-branch location inspection schedules, and allow each member to determine what would be an appropriate inspection period for their non-branch locations.[163] One commenter restated the same concerns and questioned the regulatory or public purpose to be served by FINRA presuming that all members should conduct an inspection of each home of a regional distributor or wholesaler at least every three years in accordance with proposed FINRA Rule 3110.13 (General Presumption of Three-Year Limit for Periodic Inspection Schedules) relating to non-branch locations.[164]

FINRA responded that it believes that the proposed annual inspection cycle in FINRA Rule 3110(c)(1)(A) remains appropriate for home offices of regional distributors where supervisory activities are occurring.[165] FINRA stated that it believes that home offices of regional distributors or wholesalers that are not registered branch office locations and from which no supervision is occurring, should remain subject to the proposed periodic inspection cycle in FINRA Rule 3110(c)(1)(C). FINRA noted that proposed FINRA Rule 3110.13 would provide members with the flexibility to use an inspection schedule period that is either shorter or longer than three years.[166] FINRA also noted that if a member chooses to use a periodic inspection schedule longer than three years, the proposed supplementary material would require the member to properly document in its written supervisory and inspection procedures the factors used in determining why a longer periodic inspection cycle is appropriate for that location.[167] Therefore, FINRA declined to make the changes suggested by the commenter.

4. Test and Verify Policies and Procedures Regarding Specified Activities

Proposed FINRA Rule 3110(c)(2)(A) would relocate provisions in NASD Rule 3012 regarding the review and monitoring of specified activities, such as transmittals of funds and securities and customer changes of address and investment objectives. Specifically, proposed FINRA Rule 3110(c)(2)(A) would require a member to test and verify a location's procedures for:

- Safeguarding of customer funds and securities;
- Maintaining books and records;
- Supervision of supervisory personnel;
- Transmittals of funds or securities from customers to third party accounts, from customer accounts to outside entities, from customer accounts to locations other than a customer's primary residence, and between customers and registered representatives, including the hand-delivery of checks; and
- Changes of customer account information, including address and investment objective changes and validation of such changes.

With respect to the transmittal of funds or securities from customers to third party accounts, the proposal would eliminate NASD Rule 3012's parenthetical text (''*i.e.,* a transmittal that would result in a change in beneficial ownership'') to clarify that all transmittals to an account where a customer on the original account is not a named account holder are included. One commenter to the Proposing Release objected to the deletion of the parenthetical, stating that it could expand application of the rule to transfers not currently captured by existing rule text, such as transfers from a joint account to an account of one of the joint account holders. The commenter suggested that the proposed change is inconsistent with contractual agreements involving joint account holders and member firms, potentially

[157] October Response.

[158] ICI, IMS.

[159] IMS.

[160] ICI October Letter.

[161] October Response; *see also* November Response, stating that it continues to support proposed FINRA Rule 3110's inspection requirements and believes that the proposed annual inspection cycle in FINRA Rule 3110(c)(1)(A) remains appropriate for home offices of regional distributors where supervisory activities are occurring.

[162] *See* Notice to Members 98–38 (May 1998).

[163] ICI.

[164] ICI's October Letter.

[165] October Response and November Response.

[166] October Response and November Response.

[167] October Response and November Response.

conflicts with applicable state and federal laws, and impacts member firms' operations.[168]

FINRA responded that the deletion of the reference to beneficial ownership would aid in preventing conflict of law issues, as the meaning of that term may vary depending on the context in which it is used and the law applying to that situation.[169] FINRA noted that the provision would not prohibit transfers to third-party accounts, but only requires a firm to have procedures for the monitoring of such transfers and a means of customer confirmation, notification, or follow-up that can be documented. FINRA stated that it believes that such follow-up procedures would provide an important investor protection function by verifying that the customer was aware of the transfer.

Another commenter to the Proposing Release asked whether proposed FINRA Rule 3110(c)(2)(A)'s requirement to review changes of customer account information, including address and investment objective changes, requires a member to review all changes of customer account information.[170] FINRA responded that, consistent with existing requirements,[171] a member must review all changes of customer account information and not only address and investment objective changes.[172] Examples of other changes to customer account information would include, without limitation, changes to a customer's name, marital status, telephone, email, or other contact information. FINRA noted that a firm may delegate reviews of such changes to an appropriately qualified person who is not a principal, unless another FINRA or SEC rule would require principal review (*e.g.,* FINRA Rule 4515 (Approval and Documentation of Changes in Account Name or Designation) prohibiting an account name or designation change unless authorized by a qualified and registered principal designated by the member).

Two commenters also requested that FINRA permit member firms to identify in their written supervisory or compliance procedures or other field manuals the activities enumerated in FINRA Rule 3110(c)(2)(A) that they do not engage in rather than requiring them to be documented in a location's written inspection report.[173] FINRA noted that it had originally proposed, in *Regulatory Notice* 08–24, that a member must document the enumerated activities in which it did not engage in its written supervisory procedures, and that, it had revised the proposed rule change in response to commenters' concerns to retain the requirement that a member identify in a location's written inspection report any enumerated activities the member does not engage in at that location and document in that location's report that the member must have in place at that location supervisory policies and procedures for those activities before the location can engage in them.[174]

In light of the continued comments, FINRA revised proposed Rule 3110(c)(2)(D), in Amendment No. 1, to require members to identify in their written supervisory procedures *or* in the location's written inspection report the activities enumerated in FINRA Rule 3110(c)(2)(A) the member does not engage in at a particular location and document in their written supervisory procedures *or* that location's written inspection report that supervisory policies and procedures must be in place for those activities at that location before the member can engage in them. In FINRA's view, this would provide firms with additional flexibility in meeting the requirement, while still allowing an examiner to readily determine what enumerated activities a location does not engage in by referencing the firm's written supervisory procedures or the location's most recent inspection report.[175]

5. Conflicts of Interest

Commenters to the Proposing Release expressed concern that proposed FINRA Rule 3110(c)(3)(A) could be interpreted to create a new strict liability standard that would require members to eliminate all conflicts of interest with respect to a location's inspections[176] and suggested revising the provision to provide more flexibility.[177] FINRA responded by revising proposed FINRA Rule 3110(c)(3)(A) in Amendment No. 1 to require that a member have ''procedures reasonably designed to prevent the effectiveness of the inspections required pursuant to paragraph (c)(1) of this Rule from being compromised due to the conflicts of interest that may be present with respect to the location being inspected, including but not limited to, economic, commercial, or financial interests in the associated persons and businesses being inspected.''[178]

One commenter to the Proposing Release also asked whether the requirement to consider the ''economic, commercial, or financial interests in the associated persons and businesses being inspected'' when determining if conflicts of interest have reduced inspection standards is intended to prohibit an OSJ principal from conducting inspections of branch and non-branch offices designated to that OSJ principal if he receives overrides from business conducted at that location.[179] In Amendment No. 1, FINRA clarified that a member's procedures must take into consideration factors such as economic, commercial, or financial interests in the associated persons and businesses being inspected, when determining if members have procedures reasonably designed to reduce conflicts of interest that may be present with respect to a location being inspected.[180] FINRA stated that the provision is not intended to address directly who a member may designate to inspect a location. FINRA further noted that a member assigning an OSJ principal to inspect a branch or non-branch office designated to that OSJ principal would need to ensure that it complies with proposed FINRA Rules 3110(c)(3)(B) (prohibitions regarding who may conduct inspections) and 3110(c)(3)(C) (limited exception from these prohibitions), which are discussed further below.

6. Associated Persons Conducting Inspections

Proposed FINRA Rule 3110(c)(3)(B) would generally prohibit an associated person from conducting a location's inspection if the person is either assigned to that location or is directly or indirectly supervised by someone assigned to that location. One commenter to the Proposing Release asked whether compliance personnel who operate independently from the branch office or OSJ to which they are assigned (and are supervised by the compliance manager and not by the branch office or OSJ manager) would be permitted to inspect such branch or OSJ.[181] FINRA noted that the proposed provision would not prohibit compliance personnel assigned to a member's separate compliance department and supervised solely by the compliance department from

[168] Schwab.

[169] October Response.

[170] ICI.

[171] *See, e.g.,* NASD Rule 3010(c)(2)(F).

[172] October Response.

[173] FSI, ICI.

[174] October Response.

[175] October Response Letter.

[176] Cetera, IMS, SIFMA.

[177] CAI, IMS, SIFMA.

[178] October Response.

[179] Cetera.

[180] October Response.

[181] ICI.

conducting a location's inspections.[182] In FINRA's view, such an arrangement helps to protect against the potential conflicts of interest the provision is designed to address.

7. Reliance on the Limited Size and Resources Exception

Proposed FINRA Rule 3110(c)(3)(C) would provide an exception for those members that cannot comply with proposed FINRA Rule 3110(c)(3)(B)'s restrictions prohibiting certain associated persons from conducting a location's inspection, either because of a member's size or its business model. Proposed FINRA Rule 3110.14 (Exception to Persons Prohibited from Conducting Inspections) would set forth the general view that a member with only one office or an independent contractor business model will need to rely upon the exception.

One commenter to the Proposing Release requested that FINRA amend proposed FINRA Rule 3110.14 to include home or administrative office personnel conducting home or administrative office inspections as one of the enumerated situations covered by proposed FINRA Rule 3110.14.[183] FINRA responded that proposed FINRA Rule 3110.14 would reflect FINRA's belief that a member will generally rely on the exception in instances where the member has only one office or has a business model where small or single-person offices report directly to an OSJ manager who is also considered the offices' branch office manager.[184] FINRA noted that a member may still rely on the exception in proposed FINRA Rule 3110(c)(3)(c) in other instances provided it documents the factors the member used in making its determination that it needs to rely on the exception.[185]

K. Comments on Proposed FINRA Rule 3110(d)

Proposed FINRA Rule 3110(d)(1) (Transaction Review and Investigation) would require a member to have supervisory procedures to review securities transactions that are effected for a member's or its associated persons' accounts, as well as any other ''covered account,'' to identify trades that may violate the provisions of the Act, its regulations, or FINRA rules prohibiting insider trading and manipulative and deceptive devices. The proposed rule would also require members to promptly conduct an internal investigation into any such trade to determine whether a violation has occurred, and would require firms engaged in ''investment banking services'' to report information regarding these investigations to FINRA.

Commenters to the Proposing Release expressed concerns related to the scope of the proposed definition of ''covered account'' and the extension of the reporting requirements to certain types of investment banking services that commenters asserted pose less risk of insider trading.

1. Definition of ''Covered Account''

As proposed, FINRA Rule 3110(d)(3)(A) would have defined ''covered account'' as: (i) the accounts of parents, siblings, fathers-in-law, mothers-in-law, and domestic partners if the account is held at or introduced by the member and (ii) accounts that are reported to the member pursuant to NASD Rule 3050 (Transactions for or by Associated Persons) or Incorporated NYSE Rule 407 (Transactions—Employees of Members, Member Organizations and the Exchange), as applicable.[186] Multiple commenters expressed concern about the breadth of the definition of ''covered account,'' and in particular the extension of the term to include more remote family members.[187] Several commenters noted that the proposed definition went beyond the terms of existing NYSE rules and guidance, on which proposed Rule 3110(d) is based, and would create unnecessary difficulty for firms in monitoring trading in the accounts of more distant relatives, with whom an associated person may not have regular contact. Multiple commenters suggested that FINRA harmonize the scope of the term ''covered account'' with existing NYSE guidance and with SEC rules addressing similar types of concerns (*e.g.,* the scope of the SEC's Code of Ethics rules for investment advisers).[188]

In response, FINRA revised the proposed rule in Amendment No. 1 to align the definition of ''covered account'' with existing NYSE guidance, which it noted has been in place since 1989.[189] FINRA specified that under the revised definition, the term ''covered account'' would include any account introduced or carried by the member that is held by: (1) The spouse of a person associated with the member; (2) a child of the person associated with the member or such person's spouse, provided that the child resides in the same household as or is financially dependent upon the person associated with the member; (3) any other related individual over whose account the person associated with the member has control; or (4) any other individual over whose account the associated person of the member has control and to whose financial support such person materially contributes.[190] In FINRA's view, the amended definition strikes an appropriate balance between ensuring that trading activity in the accounts that present the greatest risk of insider trading are reviewed while not imposing undue compliance burdens on firms.

2. Internal Investigation Reporting

a. Definition of ''Investment Banking Services''

As proposed, FINRA Rule 3110(d)(2) would impose reporting requirements for internal investigations undertaken by members that engage in ''investment banking services.'' Proposed FINRA Rule 3110(d)(3)(B) would define the term ''investment banking services'' to include, without limitation, acting as an underwriter, participating in a selling group in an offering for the issuer, or otherwise acting in furtherance of a public offering of the issuer; acting as a financial adviser in a merger or acquisition; and providing venture capital or equity lines of credit or serving as placement agent for the issuer or otherwise acting in furtherance of a private offering of the issuer. Two

[182] October Response.

[183] CAI.

[184] October Response.

[185] In Amendment No. 1, FINRA sought to clarify that proposed FINRA Rule 3110.14 provides non-exclusive examples of situations where the exception would generally apply, by revising the provision to delete the term ''only'' prior to providing the examples.

[186] One commenter sought to confirm that the proposed rule would not modify obligations imposed by NASD Rule 3050. *See* CAI. FINRA responded that nothing in proposed Rule 3110(d) would alter reporting obligations pursuant to other FINRA rules, including NASD Rule 3050.

[187] Brandenburger, CAI, FSI, ICI, IMS, Letter Type A, Putnam, SIFMA. Several commenters also expressed the view that the term ''domestic partner'' was vague. *See* Brandenburger, CAI, FSI, IMS, Letter Type A. Because FINRA is proposing to narrow the scope of the term, including removing the reference to domestic partners, FINRA did not address this comment.

[188] CAI, ICI, IMS, Schwab, SIFMA, Wells Fargo. Some commenters also expressed concerns that expanding the scope of the definition could raise potential privacy issues relating to personal financial information. *See* CAI, FSI, ICI, IMS, Schwab, SIFMA, Wells Fargo. FINRA stated that it believes that these concerns were addressed in Amendment No. 1; however, FINRA does not believe the initial definitions implicated privacy concerns since the accounts covered by the rule must be introduced or carried by the firm.

[189] *See* NYSE Information Memo 89–17 (April 4, 1989).

[190] In addition to ''covered accounts,'' the proposed rule also applies to accounts of the member, accounts introduced or carried by the member in which a person associated with the member has a beneficial interest or the authority to make investment decisions, and accounts of a person associated with the member that are disclosed to the member pursuant to NASD Rule 3050 or Incorporated NYSE Rule 407, as applicable.

commenters to the Proposing Release questioned the definition of ''investment banking services,'' noting that the term includes underwriting products that present less risk of insider trading, such as mutual funds and variable insurance products.[191]

FINRA acknowledged that both commenters repeated objections to which FINRA responded in the Proposing Release. FINRA further noted that it does not believe that any of the categories of activities identified by the commenters should be categorically excluded from the definition of ''investment banking services'' given its limited use for the purposes of proposed FINRA Rule 3110.[192]

FINRA disagreed with the commenters' assertions that FINRA failed to take into account the potential costs and burdens to firms associated with adopting policies and procedures and systems to ensure compliance with the rule. FINRA noted that these entities are already subject to Section 15(g) of the Act, which requires all broker-dealers to ''establish, maintain, and enforce written policies and procedures reasonably designed . . . to prevent the misuse . . . of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer.'' [193] FINRA stated that firms are permitted to use a risk-based approach to monitoring transactions that takes into account a firm's specific business model, which would include the type of underwriting activity performed by the firm. In fulfilling their obligations, FINRA noted that firms may determine that certain departments or employees pose a greater risk and examine trading in those accounts accordingly. FINRA further noted that there is no implied obligation on firms as to how best to conduct the reviews. Thus, FINRA responded that it would expect that firms with underwriting activity limited to mutual funds may adopt significantly different review procedures than a firm engaged in more traditional investment banking activity. FINRA proposed to amend the rule in Amendment No. 1 to include the phrase ''reasonably designed'' to acknowledge more clearly that firms with different business models may adopt different procedures and practices.[194] As amended, the proposed rule would require each member to include in its supervisory procedures a process for the review of securities transactions reasonably designed 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.[195]

In response to the Notice and Proceedings Order, one commenter restated its concern that mutual fund underwriters should be excluded from the definition of ''investment banking services.'' The commenter stated that FINRA disregarded or failed to consider ''the costs and burdens associated with members being required to establish, maintain, implement, and review on an ongoing basis policies and procedures to comply with each rule FINRA adopts, even those rules that do not apply to the member's business.[196] FINRA stated that it continues to believe that the primary costs and burdens associated with the proposed rule change would arise in developing and implementing policies and procedures for reviewing transactions and conducting investigations, not in reporting those investigations to FINRA. FINRA also noted that it believes that the type of ''investment banking services'' in which a firm engages, and the relative level of risk of insider trading those activities present, may be a factor in assessing the reasonableness of such a firm's procedures; however, FINRA stated that it does not believe that it should affect the analysis of whether a firm engaged in ''investment banking services'' has a reporting obligation once potentially violative trades have already been identified and internal investigations have begun.

b. Required Investigation Reports

One commenter to the Proposing Release stated that, in defining ''investment banking services'' broadly, FINRA disregarded the cumulative effect a ''misapplied'' rule can have on a firm's compliance obligations and has substantially underestimated ''the unnecessary questions and confusion surrounding the rule's implementation that the firm is likely to face.'' [197] FINRA noted that the commenter did not include examples of the types of questions or confusion that are likely to arise. FINRA responded that the reporting obligation is triggered only after an investigation has been initiated and that it believes that the primary costs and burdens associated with the proposed rule change would arise in developing and implementing policies and procedures and in conducting investigations, not in reporting those investigations to FINRA.[198] FINRA noted that that certain types of ''investment banking services'' may present less risk of insider trading than others, and firms are permitted to take these risks into account when developing their policies and procedures; however, FINRA stated that neither commenter offered an explanation as to why investigations should not be reported when the reports are only required after a firm has identified trades that may violate applicable laws or rules other than to note that these firms may pose less risk to begin with.[199]

FINRA maintained that it continues to believe that firms engaged in investment banking services should be required to report the results of their investigations to FINRA when these investigations are only required after a firm has already identified and begun investigating a trade that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices.[200] FINRA further noted that, although the fact that certain firms may present a lower risk of insider trading may be a factor in assessing the reasonableness of a firm's procedures, FINRA does not believe it should affect the analysis of whether a firm has a reporting obligation once potentially violative trades have already been identified and investigated.

One commenter to the Proposing Release stated that by not including any

[191] CAI, ICI.

[192] October Response. Although one commenter asserted that ''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,'' FINRA responded that, ''if a member did not have an open internal investigation or either initiate or complete an internal investigation during a particular calendar quarter, the member would not be required to submit a report for that quarter.'' *See* October Response; *see also* ICI.

[193] See Section L(2), page 31 of the October Response.

[194] FINRA noted that the ''reasonably designed'' standard already applied to the transaction review procedures required by the provision pursuant to the overarching language applicable to all of a member's procedures in paragraph (b)(1) of the proposed rule change. FINRA is proposing to repeat the phrase in paragraph (d) to avoid an implication that it did not already apply to the procedures governing transaction review.

[195] *See* Section L(2), page 32 of the October Response.

[196] ICI's October Letter.

[197] SIFMA.

[198] October Response.

[199] One commenter questioned the need for the rule at all in light of FINRA Rule 4530. *See* ICI. FINRA pointed to its previous statement that proposed FINRA Rule 3110(d) would require more targeted and detailed reporting than FINRA Rule 4530(b), which requires reporting only where a member concludes or reasonably should have concluded a securities-related law or rule was violated. Moreover, FINRA noted that Rule 4530 does not require firms to report every instance of noncompliant conduct. *See Regulatory Notice* 11–06 (February 2011) (discussing scope of requirement to report internal conclusions of violation).

[200] October Response.

materiality or reasonableness standard, the reporting requirement seems unduly broad and likely to result in reports on activity that ultimately is determined to be lawful.[201] FINRA amended the proposed rule language in Amendment No. 1 to include the phrase ''reasonably designed'' to acknowledge more clearly that firms with different business models may adopt different procedures and practices. The same commenter restated its recommendation in a second letter requesting that FINRA more formally incorporate guidance from NYSE Information Memo 06–06 into the rule's supplementary material to address the scope of the rule's investigation and reporting requirements.[202] FINRA responded that it does not believe that it is necessary to adopt the guidance from NYSE IM 06–06 as supplementary material.[203]

FINRA noted that it agrees with the guidance from NYSE IM 06–06 that not all reviews will result in an internal investigation. FINRA further noted that it also agrees that, as part of implementing a firm's risk-based approach to these requirements, a firm's procedures 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 through an internal investigation. Similar to the guidance set forth in NYSE IM 06–06, FINRA stated that it does not expect that every trade highlighted in an exception or other report would require a firm to conduct an internal investigation and FINRA would expect that ''firms that utilize such reports will maintain additional written procedures that set forth guidelines or criteria for reasonable follow-up steps for determining which trades initially highlighted merit further review.'' [204]

L. Comments on Proposed FINRA Rule 3110(e)

Proposed FINRA Rule 3110(e) (Definitions) retains, without change, the definition of ''branch office'' in NASD Rule 3010(g) (Definitions). The definition specifically excludes some locations from being considered a branch office, including an associated person's primary residence, if certain conditions are met. However, if any excluded location, including an associated person's residence, is responsible for supervising the activities of a member's associated persons at one or more non-branch locations, the location is considered a branch office.

Commenters to the Proposing Release suggested that FINRA either revise the branch office definition 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 locations [205] or eliminate the distinctions among OSJs, branch offices, and a registered person's home office and require annual audits for all offices other than the main office that are over a certain minimum business threshold (*e.g.,* $300,000 in annual sales).[206]

In response, FINRA noted that the branch office definition is being transferred unchanged from current NASD Rule 3010(g). FINRA explained that the uniform branch office definition was developed in 2005 after several years of discussions with the NYSE, NASAA, and NASD. In FINRA's view, the current definition provides appropriate exemptions from registration, and that those exemptions should not be expanded at this time. FINRA further explained that the OSJ definition, which industry members have relied upon for many years in designing their supervisory systems, is also being transferred unchanged from NASD Rule 3010(g). FINRA also noted that adopting a location audit requirement based solely on a specified sales threshold could exclude many offices engaging in activities enumerated in the OSJ definition from being inspected.

In response to the Notice and Proceedings Order, a commenter restated its request that FINRA revise proposed FINRA Rule 3110(e)(2)(B) to exclude from the definition of ''branch office'' the homes of regional distributors and wholesalers of mutual fund underwriters. The commenter suggested that FINRA revise the provision to include the statement that ''[t]he 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).'' [207] The commenter further suggested that FINRA not subject such home offices to the inspection requirements for supervisory branch offices and non-branch locations. In its comments to the Proposing Release, the commenter questioned the regulatory or public purpose to be served by FINRA presuming that all members should conduct an inspection of each home of a regional distributor or wholesaler at least every three years in accordance with proposed FINRA Rule 3110.13 (General Presumption of Three-Year Limit for Periodic Inspection Schedules) relating to non-branch locations.[208] The commenter indicated that FINRA's previous response did not sufficiently address its concerns regarding the treatment as branch offices of such personal residences that are not held out to the public and do not conduct a public securities business.

FINRA declined to amend proposed FINRA Rule 3110's branch office definition.[209] FINRA noted that the commenter's request to exclude from the branch office definition the homes of regional distributors and wholesalers of mutual fund underwriters based on the exemption provided in Rule 15c3–3(k)(1) of the Exchange Act would be over-broad as that exemption would extend beyond mutual fund underwriters. FINRA stated that when supervisory activities occur at such locations, it does not believe that an exclusion from the branch office definition is appropriate for regional distributors working from home offices and that such an exclusion would undermine the core principle underlying the registration of branch offices and OSJs that recognizes the critical nature of locations where supervision is occurring.

M. Comments on Proposed FINRA Rule 3120

Proposed FINRA Rule 3120 (Supervisory Control System) requires a member to test and verify its supervisory procedures and prepare and submit to its senior management a report at least annually summarizing the test results and any necessary amendments to those procedures. The proposed rule also requires a member that reported $200 million or more in gross revenue (total revenue less, if applicable, commodities revenue) on its FOCUS reports in the prior calendar year to include additional content in the report it submits to senior management. The required additional content includes a tabulation of the reports pertaining to the previous year's customer complaints and internal investigations made to FINRA. Also, the report must include a discussion of the preceding year's compliance efforts, including procedures and educational

[201] ICI.

[202] ICI's October Letter.

[203] November Response.

[204] *See* Section 2(F), page 11 of November Response.

[205] ICI.

[206] Sweeney.

[207] ICI's October Letter.

[208] *Id.*

[209] November Response.

programs, in each of the following areas: (1) Trading and marketing activities; (2) investment banking activities; (3) antifraud and sales practices; (4) finance and operations; (5) supervision; and (6) anti-money laundering.

One commenter requested that FINRA exclude mutual fund underwriters from the additional content requirements because those firms, which may meet the $200 million threshold solely through receipt of 12b–1 fees, are not the type of ''complex'' firms FINRA intended to address when proposing the additional content requirements.[210] FINRA responded that the additional content requirements are incorporated from the annual report content requirements of Incorporated NYSE Rule 342.30 (Annual Report and Certification) that provide valuable information for FINRA's regulatory program.[211] FINRA also stated that this information will be valuable compliance information for the senior management of the firm. FINRA noted that some content requirements relate to regulatory obligations, such as supervision and anti-money laundering, that apply to all member firms, regardless of their business activities. Because all the content requirements are not relevant to every firm, FINRA revised proposed FINRA Rule 3120, in Amendment No.1, to clarify that a member's report must include the additional content, to the extent applicable to the member's business.[212]

The same commenter restated its request for FINRA to revise proposed FINRA Rule 3120 to exclude mutual fund underwriters from the proposed rule's additional content requirement.[213] The commenter suggested that FINRA revise proposed FINRA Rule 3120 to avoid having 12b–1 fees (characterized by the commenter as pass-through revenues) counted as the member's gross revenue for purposes of calculating the additional content requirements' $200 million threshold. FINRA noted that the commenter did not indicate how a mutual fund underwriter's gross revenue calculation, which may vary depending on the amount of 12b–1 fees, is different from other members with gross revenue calculations that may vary significantly depending on the amount and nature of revenue received.[214] For these reasons, FINRA responded that it continues to believe the rule should require each member meeting the specified threshold to provide the additional content, to the extent applicable to its business.

N. Comments Outside the Scope of the Proposal

One commenter, while recognizing the statutory framework applicable to proposed SRO rulemaking, nonetheless requested additional time to review, analyze, and develop comment letters for more comprehensive FINRA rule changes.[215] Another commenter suggested that firms should make available to the ''public investor education facilities'' regarding their products, activities, and services.[216] One commenter suggested that a firm's compliance and ongoing oversight of its associated persons' outside business activities (''OBA'') could be further enhanced through updates of OBA information captured by FINRA's Central Registration Depository.[217] Another commenter suggested that, in addition to FINRA Rule 3270's (Outside Business Activities of Registered Persons) requirement that a registered person provide a firm with written notice prior to engaging in any OBA, that FINRA should require firms to supervise OBAs.[218] The same commenter also suggested that FINRA require firms to prevent the ''spoilation of evidence'' once it is reasonably foreseeable that an arbitration might be filed. One commenter suggested that FINRA draft standard, pro forma, baseline written supervisory procedures that firms can adapt to their businesses.[219] FINRA responded that it appreciates the commenters' input on these matters, but it considers these comments to be outside the scope of the current proposal.

IV. Commission Findings

The Commission has carefully reviewed the proposed rule change, the comments received, and FINRA's responses to comments, and finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association. In particular, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act,[220] which, among other things, requires that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. In addition, the Commission finds that the proposed rule change is consistent with Section 15A(b)(9) of the Act,[221] in that the proposed rules do not impose any unnecessary or inappropriate burden on competition.

The Commission believes that FINRA, through its responses and through proposed changes in Amendment No. 1, has addressed commenters' concerns, other than those that it determined are outside the scope of the current proposal. The proposed rule change was informed by FINRA's consideration of, and the incorporation of many suggestions made in comments on the 2011 Filing, the Proposing Release, and the Notice and Proceeding Order. Proposed Amendment No. 1 reflects FINRA's efforts to further address

[210] ICI. ICI alternatively suggested that FINRA exclude from proposed FINRA Rule 3120's ''gross revenue'' definition any 12b–1 revenues a mutual fund underwriter receives.

[211] *See* October Response; *see also Regulatory Notice* 08–24 (noting that the supplemental information in Incorporated NYSE Rule 342.30's annual report was a valuable tool for the NYSE regulatory program and would also be valuable information for FINRA's regulatory program going forward).

[212] In addition, FINRA is revising proposed FINRA Rule 3120 to delete references to the MSRB rules, consistent with the deletion of such reference in proposed FINRA Rule 3110(a) discussed above.

[213] ICI October Letter.

[214] November Response.

[215] CAI. *See* Exchange Act Section 19(b) for the statutory framework for SRO rulemaking.

[216] Arnoff. This commenter also suggested that the proposed consolidated supervision rules be tested for efficacy based on risk-based considerations in specified topical areas (*e.g.,* supervisory depth, avoidance of supervisory conflicts, suitability, best execution, prevention of unauthorized trading, systemic problems, defined responsibility and non-delegable duties, customer complaints). FINRA responded that it also considers this comment to be outside of the scope of the proposal, but that it would expect these matters to be considered as part of a member's establishment of a supervisory system and procedures reasonably designed to achieve compliance with the federal securities laws and FINRA rules, and the testing and verification of such procedures under FINRA Rule 3120.

[217] NFP.

[218] PIABA. FINRA Rule 3270.01 also requires that, upon receipt of a written notice, a firm must consider whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the firm and/or the firm's customers or (2) be viewed by customers or the public as part of the firm's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. In addition, based on the firm's review of such factors, the firm must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including where circumstances warrant, prohibiting the activity. A firm also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of NASD Rule 3040 (Private Securities Transactions of an Associated Person).

[219] IMS. FINRA noted that although it considers IMS's comment to be outside the scope of the proposal, FINRA's Tools Web page includes a ''WSP Checklist'' that members may consult when drafting or revising their written supervisory procedures.

[220] 15 U.S.C. 78o–3(b)(6).

[221] 15 U.S.C. 78o–3(b)(9).

commenter concerns and minimize burdens resulting from the proposed rule's requirements. Additionally, many of the amendments are designed to revert to existing requirements in the NASD and NYSE rules. For example, in Amendment No. 1, FINRA proposed to respond to commenter concerns by, among other things:

• Deleting references to MSRB rules, noting that members are separately obligated to comply with MSRB Rule G–27;

• Deleting proposed FINRA Rule 3110.03 (One-Person OSJs), in light of comments concerning the negative impact and costs of the proposed requirement, especially for independent firms; [222]

• Replacing the presumption in proposed FINRA Rule 3110.03 (Supervision of Multiple OSJs by a Single Principal) that assigning one principal to be the on-site principal at more than two OSJs is unreasonable with a general statement that assigning a principal to more than one OSJ will be subject to scrutiny;

• Modifying proposed Rule 3310.05 to incorporate additional clarification regarding a member's risk-based review system;

• Clarifying in proposed FINRA Rules 3110(b)(6)(D) and 3110(c)(3)(A) that the provisions do not create a strict liability obligation requiring identification and elimination of all conflicts of interest;

• Revising the definition of ''covered account'' in proposed FINRA Rule 3110(d) to align the definition with existing NYSE guidance; and

• Clarifying in proposed FINRA Rule 3120(b) that a firm must only comply with the requirement to include certain additional content in its report to senior management only to the extent applicable to the member's business, noting that not all the content requirements are relevant to every firm.

Additionally, in its responses, FINRA provided guidance and clarifications concerning the provisions noted above and other provisions, as well as general matters, about which commenters raised concerns. For example, FINRA responded to comments concerning costs,[223] the application of a risk-based approach,[224] review of correspondence and internal communications,[225] review of transactions,[226] review of customer complaints,[227] and maintenance and communication of written supervisory procedures,[228] among others.

In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation.[229] As discussed above, the Commission believes that the proposed rule change, as amended by Amendment No. 1, is consistent with Sections 15A(b)(6) and 15A(b)(9) of the Act. The Commission ''has long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme.'' [230] By harmonizing current NASD and NYSE supervisory rules into one consolidated FINRA rulebook, the proposed rule will protect investors and the public interest while also enhancing efficiency. Among other things, the proposed rule would incorporate additional flexibility in some instances by permitting firms to implement risk-based principles consistent with a firm's business model. The proposed rule also takes into account potential inefficiencies that firms could experience if FINRA adopted the expanded definition of ''covered accounts.'' As a result, FINRA amended the definition in Amendment No. 1 to align it with current guidance.

The Commission also believes that the proposed rule takes into account competitive concerns that could arise from different supervisory approaches for different product lines, business models, business size, and resources. Moreover, by permitting a risk-based principles approach when applying certain supervisory standards, the proposed rule is designed to allow firms to implement supervisory policies and procedures and programs in a manner consistent with their business models.

The Commission has reviewed the record for the proposed rule change and notes that the record does not contain any information to indicate that the proposed rule would have a significant effect on capital formation. The Commission believes that the effect of the proposed rule is beneficial and that the changes will enhance investor confidence by promoting robust supervisory policies and procedures, programs, and controls that can be flexibly applied to account for member firms' business models.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[231] that the proposed rule change (SR–FINRA–2013–025), as modified by Amendment No. 1 be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[232]

Kevin M. O'Neill,

Deputy Secretary.

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[222] The Commission notes that FINRA urges firms to conduct focused reviews of one-person OSJs that conduct sales-related activity.

[223] *See supra* Sections III(D)(2), III(F)(1), and III(K)(2).

[224] *See supra* Sections III(E)(1), III(F)(1), and III(F)(2).

[225] *See supra* Section III(F).

[226] *See supra* Section III(E).

[227] *See supra* Section III(G).

[228] *See supra* Section III(I).

[229] *See* 15 U.S.C. 78c(f).

[230] SEC, Division of Market Regulation (now known as, Division of Trading and Markets), Staff Legal Bulletin No. 17: Remote Office Supervision (March 19, 2004).

[232] 17 CFR 200.30–3(a)(12).

DEPARTMENT OF STATE

[Public Notice 8578]

Culturally Significant Objects Imported for Exhibition Determinations: ''Miró: The Experience of Seeing''

SUMMARY: Notice is hereby given of the following determinations: Pursuant to the authority vested in me by the Act of October 19, 1965 (79 Stat. 985; 22 U.S.C. 2459), Executive Order 12047 of March 27, 1978, the Foreign Affairs Reform and Restructuring Act of 1998 (112 Stat. 2681, *et seq.;* 22 U.S.C. 6501 note, *et seq.*), Delegation of Authority No. 234 of October 1, 1999, Delegation of Authority No. 236–3 of August 28, 2000 (and, as appropriate, Delegation of Authority No. 257 of April 15, 2003), I hereby determine that the objects to be included in the exhibition ''Miró: The Experience of Seeing,'' imported from abroad for temporary exhibition within the United States, are of cultural significance. The objects are imported pursuant to loan agreements with the foreign owner or custodian. I also determine that the exhibition or display of the exhibit objects at the Seattle Art Museum, Seattle, WA, from on or about February 13, 2014, until on or about May 18, 2014, the Nasher Museum of Art at Duke University, from on or about August 28, 2014, until on or about February 22, 2015, the Denver Art Museum, from on or about March 22, 2015, until on or about June 28, 2015, and at possible additional exhibitions or venues yet to be determined, is in the national interest. I have ordered that Public Notice of these Determinations be published in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: For further information, including a list of the exhibit objects, contact Julie Simpson, Attorney-Adviser, Office of the Legal Adviser, U.S. Department of State (telephone: 202–632–6467). The mailing address is U.S. Department of