The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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FINRA Files With the SEC Proposed Supervision Rules that Consolidate and Revise NASD and NYSE Supervisory Rules

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 30-13 RE: FINRA FILES WITH THE SEC PROPOSED SUPERVISION RULES THAT CONSOLIDATE AND REVISE NASD AND NYSE SUPERVISORY RULES

As you know, FINRA continues to consolidate the regulatory rules of the NASD and the NYSE into FINRA Rules. As part of this process, FINRA recently filed with the SEC a proposal to adopt a FINRA rule that consolidates the supervision rules. [1] While the proposal has not yet been published by the SEC for comment, once published, there will only be a 21-day comment period. Due to the complexity of this proposal, we are informing you of it prior to its official publication by the SEC. The Institute is planning to file a comment letter that will address those aspects of the proposal that may be of particular interest to mutual fund underwriters, some of which are briefly summarized below. Time permitting, we will plan to circulate our comment letter prior to filing it.

Please note that this may be our last opportunity to provide feedback on these rules prior to their adoption. Members with comments on the proposal that they would like the Institute to consider raising in our comment letter should provide such comments to the undersigned by email (tamara@ici.org), no later than Friday, July 12th. Such email should detail the portion of the rule of concern, why it is of concern, and your recommendation for addressing the concern.

Overview of the Proposal

In general, FINRA's proposal would:

1. Adopt FINRA Rule 3110, relation to supervision, and Rule 3120, relating to supervisory control systems. These rules would largely replace NASD Rules 3010 and 3012, relating to the same topics;

2. Incorporate into FINRA Rule 3110 and its supplementary material the requirements of: NASD IM-1000-4, relating to branch offices and offices of supervisory jurisdiction (OSJs); NASD IM-3010-1, relating to standards for reasonable review; NYSE Rule 401A, relating to customer complaints; and NYSE Rule 342.21, relating to trade review and investigation;
3. Replace NASD Rule 3010(b)(2), the "taping rule," with a new FINRA Rule 3170, relating to tape recording of registered persons by certain firms;
4. Replace NASD Rule 3110(i), relating to holding of customer mail with a new FINRA Rule 3150 on this same topic; and
5. Delete several NYSE rules and rule interpretations.

Below is a brief summary of issues the Institute's members may want to consider as they review FINRA's proposal and its impact on principal underwriters of mutual funds. In certain places, which are indicated by bolded text, the Institute seeks input from members to determine whether a proposed revision is of concern to our members and should be addressed in our comment letter.If so, we seek information from members regarding such concern and what our letter should recommend to address it.

Issues in the Proposal That May Raise Concerns for Mutual Fund Underwriters

I. Definition of Branch Office, Rule 3110(e)(2)

The NASD's definition of "branch office" has long been problematic for mutual fund wholesalers who may conduct their activities either at home or at locations away from a FINRA member's office. While this definition excludes any location that is the associated person's primary residence so long as certain conditions are met, the rule denies this exclusion to any location that is responsible for supervising the activities of persons associated with the member at one or more non-branch location. Proposed FINRA Rule 3110(e)(2)(B) would continue to deny the exclusion from the definition of "branch office" to any location responsible for supervising the activities of persons at one or more non-branch locations. Based on the nature of the activities conducted by mutual fund regional distributors and wholesalers out of their homes, the Institute will again advocate for excluding homes of regional distributors and wholesalers from the rule's definition of "branch office."

II. Internal Inspections, Rule 3110(c)

NASD Rule 3010(c) requires each NASD member to review on a regular basis the activities of each office, including each non-branch location. The rule describes these reviews, which are intended to ensure that each of the broker-dealer's offices is protecting customers' interests, complying with applicable regulatory requirements, and dealing fairly with customers. As proposed, FINRA Rule 3110(c) would require:

- Every OSJ and branch office that supervises one or more non-branch locations to be inspected at least once each calendar year; and
- Every non-branch location to be inspected "on a regular periodic schedule" (i.e., at least every three years). The member's written supervisory and inspection procedures must set forth the schedule and an explanation regarding how the member has determined the frequency of such inspections.

Such inspections must be documented by a written report that must be maintained for at

least three years and includes specified testing and verification of the member's applicable policies and procedures for activities that are listed in subdivision (c)(2)(A) of the rule. Pursuant to proposed Rule 3110(c)(2)(D), if a member does not engage in all of the listed activities at the location being inspected, "the member must identify those activities in the location's written inspection report and document in the report that supervisory policies and procedures for such activities must be in place at that location before the member can engage in them."

The Institute plans to again advocate for FINRA not requiring regular internal inspections of the homes of regional distributors and wholesalers on the basis that such inspections would not further the interest of any retail client or advance any regulatory or public interest.

III. Supervision of Supervisory Personnel, Rule 3110(b)(6)(C) and Supplementary Material .11, Supervision of Supervisory Personnel

These provisions in the proposed rule would require that a member's supervisory procedures prohibit an associated person who performs a supervisory function from "reporting to, or having their compensation or continued employment determined by, a person or persons they are supervising." If a member determines, however, that compliance with this prohibition is not possible "because of the member's size or a supervisory personnel's position within the firm, the member must document . . . the factors the members used to reach such determination" and how the member's supervisory arrangement otherwise comports with the rule's requirements. According to the proposed rule's Supplementary Material .11, this circumstance "generally will arise only in instances where: (a) the member is a sole proprietor in a single-person firm; (b) a registered person is the member's most senior executive officer (or similar position); or (c) a registered person is one of several of the member's most senior executive officers (or similar positions)."

Because of the unique organization of mutual fund complexes, there may be other instances in which an associated person is charged with supervising a person who determines the associated person's compensation. Accordingly, our comment letter may want to advocate that the rule include additional instances in which this circumstance will arise.To do so, however, we will need "real world" examples from members regarding instances in which it is not uncommon for an associated person to be charged with supervising activities of a person who determines the associated person's compensation. In the absence of such real world examples documenting the need to add additional examples to the rule, we likely will not raise this issue in our comment letter. [2]

IV. Review of Correspondence and Internal Communications, Rule 3110(b)(4); Supplementary Material .07, Risk-Based Review of Correspondence and Internal Communications; Supplementary Material .08, Evidence of Review of Correspondence and Internal Communications; Supplementary Material .09, Delegation of Correspondence and Internal Communication Review Functions; Supplementary Material .10, Retention of Correspondence and Internal Communications

Rule 3110(b)(4) would require that a member's supervisory procedures include procedures

for the review of incoming and outgoing written (including electronic) correspondence with the public and internal communications relating to the member's investment banking or securities business. The review must be conducted by a registered principal and evidenced in writing, either electronically or on paper. As regards internal communications, the procedures must ensure that the review identifies "those communications that are of a subject matter that require review under FINRA and MSRB rules and federal securities laws."

According to the Proposal, communications that must be reviewed include, but are not limited to: communications between non-research and research departments concerning a research report's contents; certain communications with the public that require a principal's pre-approval; the identification and reporting to FINRA of customer complaints; and the identification and prior written approval of changes in account name(s) or designation(s) regarding customer orders. [3]

Proposed Supplementary Material .07 would require a member, by using risk-based principles, to decide the extent to which additional policies and procedures for the review of incoming and outgoing written correspondence with the public and internal communications that fall outside of the subject matter of the rule are necessary for its business and structure.

Proposed Supplementary Material .08 would require that evidence of the required review of correspondence and internal communications be chronicled either electronically or on paper and clearly identify the reviewer, the internal communication or correspondence that was reviewed, the date of the review, and any actions taken as a result of "any significant regulatory issues identified during the review." According to the Proposal, members that use electronic review systems or lexicon-based screening tools must maintain documentation necessary to demonstrate that the communication was actually reviewed and maintain the information required by the rule. [4] An issue that members should consider is whether any electronic review systems or lexicon-based screening tools they currently use have the ability to create the required documentation or whether the documentation requirements will preclude the continued use of tools.

Proposed Supplementary Material .09 would allow a supervisor/principal to delegate review functions to an unregistered person though the supervisor/principal would remain ultimately responsible for the performance of all necessary supervisory reviews. Supervisors/principals would, however, be required to "take reasonable and appropriate action to ensure delegated functions are properly executed and . . . evidence performance of their procedures sufficiently to demonstrate overall supervisory control."

Proposed Supplementary Material .10 would require a member to retain its internal communications and correspondence of associated persons as required by SEC Rule 17a-4(b) under the Securities Exchange Act of 1934 (i.e., not less than three years, the first two years in an easily accessible place). It further provides that the "names of the persons who prepared the outgoing correspondence and who reviewed [it] shall be ascertainable from the retained records."

V. Transaction Review and Investigation, Rule 3110(d)

Rule 3110(d) requires each member to include in its supervisory procedures a process for reviewing securities transactions "that are effected for the account(s) of the member or the member's associated person and any other covered account" to identify trades that may

violate Federal law or FINRA rules prohibiting insider trading and manipulative and deceptive devices. [Emphasis added.] According to the Proposal:

> In the Initial Filing, FINRA states that a 'member's procedures should take into consideration the nature of the member's business, which includes an assessment of the risks presented by different transactions and different departments within a firm. Thus, while some members may need to develop restricted lists and/or watch lists, other members may only need to periodically review employee and proprietary trading. . . . [T]here is no requirement that a member examine every trade or every employee or every proprietary trade. [5]

The rule also requires a member "engaging in investment banking services" to file with FINRA the following written reports that are signed by a senior officer of the member: [6]

1. Within 10 business days of the end of each calendar quarter, a report describing each internal investigation initiated in the previous calendar quarter under Rule 3110(d) including the identity of the member; the date the internal investigation commenced; the status of each open investigation; the resolution of any internal investigation reached during the previous calendar quarter; and, with respect to each investigation, the identity of the security, trades, accounts, associated persons of the member, or associated person of the member's family members holding a covered account, under review and the member's policies and procedures for the review of accounts.
2. Within five business days of completion of an internal investigation in which a violation of law was determined, the member shall file a written report detailing the completion of its investigation, the results of the investigation, any internal disciplinary action taken, and any referral of the matter to a regulatory agency or organization.

For purposes of Rule 3110(d), the term "covered account" is defined to include each of the following:

- Any account held by the spouse, domestic partner, child, parent, sibling, son-in-law, daughter-in-law, father-in-law, or mother-in-law of a person associated with a member where such account is introduced or carried by the member;
- Any account introduced or carried by the member in which a person associated with the member has a beneficial interest;
- Any account introduced or carried by the member over which an associated person of the member has the authority to make investment decisions; and
- Any account of a person associated with a member that is disclosed to the member pursuant to NASD Rule 3050 or NYSE Rule 407, as applicable.

According to the Proposal, "the only outside trading activity members are required to review under this provision is activity in a covered account that is disclosed to the member pursuant to other FINRA rules." [7] The Proposal also notes that "firms are under no obligation under this provision to review transaction information in accounts to which they do not have access to confirmations and account statements." [8]

As used in this rule, the term "investment banking services" would be defined to include "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." The Proposal specifically states that the distribution activities undertaken by firms in connection with investment

companies and 529 plans are included within the definition of “investment banking services” for purposes of this rule. [9] According to the Proposal,

> Because individuals engaged in investment banking activities may have special access to material, non-public information, which increases the risk of insider trading by those individuals, FINRA believes that this additional reporting requirement is appropriate. To the extent the commenters are correct that certain types of underwriting activities do not present the same risks of insider trading, the instances of reporting obligations on firms that only engage in those activities should not be significant. To the extent such firms do have internal reporting investigative actions to report, FINRA believes they should be reported. [10]

The Institute plans to recommend excluding principal underwriters of mutual funds from the definition of “investment banking” in this rule, notwithstanding FINRA’s previous rejection of this recommendation.

VI. Reference to MSRB Rules in Rule 3110(a)

In addition to requiring members’ supervisory systems to be reasonably designed to achieve compliance with applicable securities laws and FINRA’s rules, FINRA has proposed to require such systems to be reasonably designed to achieve compliance with the rules of the Municipal Securities Rulemaking Board (MSRB), “which NASD Rule 3010(a) does not explicitly reference.” [11] The Institute plans to oppose this change as FINRA does not regulate MSRB registrants. [12] Moreover, the MSRB has its own rule, MSRB Rule G-27, governing the supervisory obligations of MSRB registrants. As such, it seems inappropriate for an MSRB registrant that may violate MSRB Rule G-27 to also be cited by FINRA for violating FINRA Rule 3110.

VII. Rule 3120, Supervisory Control System

Proposed Rule 3120 would require members to designate and specifically identify to FINRA one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that tests and verifies the member’s supervisory procedures and creates new procedures or revised existing procedures where a need for such is identified by the testing and verification. The designated principal must annually submit to the member’s senior management a report detailing the testing, any deficiencies found, and any remedial actions taken in response.

In addition, in any year in which a member reports $200 million or more in gross revenue, the report provided to senior management must include the following information:

- Information on customer complaints and internal investigations reported to FINRA during the preceding year; and
- A discussion of the preceding year’s compliance efforts, including procedures and educational programs in the following six areas: trading and market activities; investment banking activities; antifraud and sales practices; finance and operations; supervision; and anti-money laundering.

For purposes of this rule, “gross revenue” means either: (1) total revenue reported on FOCUS Form Part II or IIA (line 4030) less commodities revenue (line 3990) if applicable; or (2) total revenue as reported on FOCUS Form Part II CSE (line item 4030) less, if applicable,

commissions on commodity transactions and commodity gains and losses (line items 3991, 3924, and 3904, respectively).

The Institute plans to recommend that FINRA exclude mutual fund underwriters from this additional reporting requirement. Our letter will note that the areas such report would cover are not relevant to the business of mutual fund underwriters.We request, however, input from members regarding the proposed $200 million threshold and how it may impact mutual fund underwriters.

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endnotes

[1] See SR-FINRA-2013-025, Proposed Rule Change to Adopt the Consolidated FINRA Supervision Rules, which is available on FINRA's website at: http://www.finra.org/Industry/Regulation/RuleFilings/2013/P286230 (the "Proposal").

[2] It should be noted that Rule 3110(b)(6)(D) would require a member's supervisory procedures to expressly include "procedures preventing the standards of supervision requirements . . . from being reduced in any manner due to conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the firm, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised." To the extent that members provide the "real world" examples that need to be addressed in the rule, we might advocate that this "conflict of interest" requirement would sufficiently address regulatory concerns with such examples.

[3] Proposal at pp. 13-14.

[4] Proposal at p. 50.

[5] Proposal at p. 70.

[6] Cf. FINRA Rule 4530, which requires reporting to FINRA of various actions in which it is determined a violation of law has occurred. By contrast, the current proposal would require reports of all investigations, regardless of materiality, that involve a review of trades "that may violate the provisions of the Exchange Act, the rules thereunder, or FINRA rules prohibiting insider trading and manipulative and deceptive devices."

[7] The "other FINRA rules" reference refers to NASD Rule 3050 and NYSE Rule 407. Proposal at p. 70.

[8] Proposal at p. 74.

[9] Proposal at p. 76.

[10] Proposal at pp. 76-77 [Emphasis added].

[11] Proposal at p 6.

[12] Such registrants are exclusively regulated by the MSRB. FINRA does, however,

inspect MSRB registrants for compliance with the MSRB’s rules.

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