

## COMMENT LETTER

October 17, 2013

# ICI Files Letter with SEC Recommending SEC Disapprove FINRA's Proposed Consolidated Supervisory Rules (pdf)

October 17, 2013 Elizabeth M. Murphy, Secretary U.S. Securities and Exchange Commission 100 F Street, NE Washington, D.C. 20549-1090 RE: FINRA's Consolidated Supervisory Rules; File No. SR-FINRA-2013-025 Dear Ms. Murphy: The Investment Company Institute (the "Institute" or "ICI")<sup>1</sup> appreciates the opportunity to provide comments in response to the Securities and Exchange Commission's order relating to instituting proceedings to determine whether to approve or disapprove a proposed FINRA rule change.<sup>2</sup> The FINRA rule change that is the subject of the Order proposes to replace existing NASD rules governing supervision and supervisory control systems with new FINRA Rule 3110, relating to supervision, and Rule 3120, relating to supervisory control systems ("FINRA's proposal"). For the reasons discussed below, unless FINRA's proposal is significantly amended, we strongly recommend that the Commission disapprove it. OVERVIEW The Institute's members have a strong interest in FINRA's proposal inasmuch as mutual fund underwriters are FINRA members that would be subject to the revised rules. Indeed, when the 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$15.2 trillion and serve more than 90 million shareholders. 2 See Securities and Exchange Commission Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change, as modified by Amendment No. 1, to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, SEC Release No. 34-70612 (Oct. 4, 2013) ("Order"). Elizabeth M. Murphy, Secretary October 17, 2013 Page 2 Commission published FINRA's proposal for comment, we filed a letter that detailed how the business of a mutual fund underwriter differs significantly from that of FINRA's other members. As a result of these differences, we noted that many provisions within FINRA's proposal were either inapplicable to or problematic for such underwriters.<sup>3</sup> We were quite disappointed that, when the revised proposal was filed with the Commission, it largely failed to take into account the unique business of mutual fund underwriters and, consequently, it did not address our concerns. As a result, we strongly recommend that the SEC disapprove FINRA's proposal until such time as it is more appropriately tailored to accommodate the limited business of certain FINRA members, such as mutual fund underwriters, and ensure that the benefits of the new regulatory requirements will exceed

the increased regulatory costs and burdens resulting from them. ICI'S CONTINUING CONCERNS WITH FINRA'S PROPOSAL ICI's overriding concern with FINRA's proposal is that it proposes a "one-size-fits-all" regulatory scheme for all FINRA members regardless of, among other factors, their size, the nature of their business, and their interaction with customers and customer funds and securities. In light of the diversity among the businesses conducted by FINRA's members, this seems an inappropriate and inefficient way to regulate. Of particular concern to the Institute is the impact this one-size-fits-all approach will have on mutual fund underwriters. To explain the mismatch between FINRA's proposal and the business of such underwriters, ICI's Letter began by discussing in detail the very significant and substantive difference between the operations of a retail-broker dealer or an investment banking firm and the business of a mutual fund underwriter. It noted, for example, that the Commission has taken these differences into account when adopting net capital, customer protection, and risk assessment reporting rules, and Congress has taken them into account in enacting the Securities Investor Protection Act and establishing an insurance program for investors holding brokerage accounts (i.e., SIPC insurance, which is not required of mutual fund underwriters). ICI's Letter recommended that, in lieu of continuing to regulate broker-dealers from a one-size-fits-all perspective, FINRA modernize its rules and better tailor them to the type of business conducted by a FINRA member and the type of abuses FINRA seeks to address through its rules.<sup>4</sup> The revisions FINRA made to its proposal in response to commenters' concerns, including those of the ICI, have not resolved our concerns. We had hoped that FINRA would have been more receptive to avoiding a one-size-fits-all approach to its rules in light of the fact that it had previously <sup>3</sup> See Letter from the undersigned to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated July 29, 2013, commenting on File No. SR-FINRA-2013-025)(“ICI's Letter”), which is available on the SEC's website at: <http://www.sec.gov/comments/sr-finra-2013-025/finra2013025-8.pdf>. <sup>4</sup> In particular, ICI's Letter recommended that, where appropriate, FINRA provide an exemption from its new rules for those broker-dealers that are entitled to the exemption in Rule 15c3-3(k)(1) under the Securities Exchange Act of 1934, which would include mutual fund underwriters and other broker-dealers that conduct a limited business. Elizabeth M. Murphy, Secretary October 17, 2013 Page 3 publicly announced that it is currently (1) working on a project that would define, for regulatory purposes, categories of broker-dealers that conduct a limited business and do not process or handle customer funds or securities and (2) assessing the economic impact of existing and future rules to determine whether they benefit investors and whether the costs associated with such rules are justified.<sup>5</sup> These projects should result in FINRA better aligning its rules to the nature of its members' business and ensuring that such rules will, in fact, benefit investors. FINRA's current proposal, however, is not consistent with this new approach to rulemaking. For all of these reasons, we recommend that the Commission disapprove the proposal unless it is significantly revised. In support our recommendation we note that, notwithstanding the detailed discussion in ICI's Letter, our concerns appear largely to have been dismissed by FINRA without, in our view, a satisfactory explanation. Below is a summary of these recommendations<sup>6</sup> and FINRA's response to them.<sup>7</sup> 1. Rule 3310(e)(2), The Definition of “Branch Office” – ICI's letter recommended that FINRA revise its proposed definition of “branch office” to enable the homes of regional distributors and wholesalers of mutual fund underwriters to take advantage of the exception in the rule for home locations. In support of this recommendation, our letter noted that, unlike other persons whose homes qualify for the exception, mutual fund wholesalers and regional distributors do not conduct any retail business or have any interaction with retail customers at their homes. Treating these homes as branch offices subjects them to registration and regulation that would not seem necessary in the public interest. In response to our recommendation, FINRA's Letter states:

[T]he branch office definition is being transferred unchanged from current NASD Rule 3010(g). The uniform branch office definition was developed in 2005 after several years of discussion with the NYSE, NASAA, and NASD. FINRA believes the current definition provides appropriate exemptions from registration, and such exemptions should not be expanded at this time.<sup>8</sup> 5 See ICI's Letter at p. 5. 6 These recommendations, each of which is discussed in detail in ICI's Letter, are presented in the order they appear in ICI's Letter. Rather than repeating the contents of ICI's Letter in its entirety, we have attached the ICI's Letter and would like the Commission to consider its contents as part of our comments on the Order. 7 FINRA's response to commenters' comments can be found in Letter from Patricia Albrecht, Associate General Counsel, FINRA to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated Oct. 2, 2013 ("FINRA's Letter"), which is available at: <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p356072.pdf>. 8 FINRA's Letter at p. 33. Elizabeth M. Murphy, Secretary October 17, 2013 Page 4 In our view, this general response does not even attempt to speak to our concerns. While the current definition may have been worked out over eight years ago with the NYSE and NASAA, neither the NYSE nor NASAA represented or considered the interests of mutual fund underwriters in this process. Indeed, after the current definition was adopted in 2005, we raised concerns with the NASD regarding its impact on mutual fund underwriters, and we sought relief to address these concerns.<sup>9</sup> At the time, we were told informally that, due to the controversy surrounding the definition and the number of years it took for the regulators to reach agreement on it, the NASD was not interested in reopening the rule for further amendment. We were also told that, if the NASD ever considered revisions to the rule, we should express our concerns at that time, which we did in ICI's Letter. However, our concerns appear not to have been given serious consideration by FINRA and we do not believe that either the passage of time since the definition was adopted in 2005 or the controversy surrounding it at that time are adequate responses to our concerns. We therefore urge FINRA to amend the proposal to address our concern. 2. Rule 3110(c), Internal Inspections of Home Offices – ICI's Letter recommended that FINRA (1) better tailor the requirements of Rule 3110(c), relating to internal inspections of members' locations and branch office, to the purpose of such inspections and (2) not require inspections where there is no public purpose to be served by it (e.g., inspections of a home of a mutual fund wholesaler or regional distributor). In response to our first recommendation, we are pleased that FINRA incorporated the Institute's recommendation that would permit FINRA members to document in their inspection procedures that certain activities enumerated in the rule would not be reviewed in connection with each internal inspection because the member does not engage in such activities at that particular location.<sup>10</sup> As regards our second recommendation, FINRA's Letter states that "inspections are a crucial component of detecting and preventing regulatory and compliance problems of associated persons working at unregistered offices. Some unregistered offices also operate as separate business entities under names other than those of the members."<sup>11</sup> 9 See Letter from the undersigned to Mr. Chip Jones, Vice President, Registration and Disclosure, NASD, dated June 21, 2006. In light of the fact that we had been told that the NASD would not revisit the definition of the term "branch office" so soon after it had been adopted, our letter asked the NASD to "clarify" that, under the rule, "personal residences of mutual fund regional distributors and wholesalers that are not held out to the public as offices of the broker-dealer and from which no business with retail customers is conducted are not required to register as branch offices." The NASD never provided the recommended clarification. 10 See Order at pp. 7-8 and proposed FINRA Rule 3110(c)(2)(D). 11 FINRA's Letter at p. 25. Elizabeth M. Murphy, Secretary October 17, 2013 Page 5 This response fails to address our concern with requiring inspections of the home of a mutual fund wholesaler or regional distributor. As discussed in detail in the ICI's Letter, mutual fund wholesalers and regional

distributors typically work from their home and the business they conduct out of that location involves setting up appointments and making sales calls on other FINRA members or financial advisers.<sup>12</sup> Records regarding the activities of the wholesalers or regional distributors are maintained by the underwriter – not in these home locations – and such records are available to FINRA’s examiners. These home locations are not locations where an associated person is conducting a financial business “on the side” or a location that conducts business with retail investors. To treat these locations – and subject them to the same registration and regulatory requirements – as a full-service branch office as FINRA proposes seems inefficient and wholly unnecessary.

3. Rule 3110(b)(2), Supervisory Procedures for Reviewing Transactions – ICI’s Letter recommended 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. Our letter noted that mutual fund underwriters typically do not have or maintain any customer relationships or effect customer transactions. In response to the Institute’s recommendation, FINRA’s Letter states 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).”<sup>13</sup> We agree. However, notwithstanding this, the underwriter’s supervisory procedures under Rule 3110(b)(2) are still required to “include procedures for the review by a registered principal, evidenced in writing, of all transactions relating to the investment banking or securities business of the member.”<sup>14</sup> As a result, as with all of their required supervisory procedures, mutual fund underwriters will 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. It would

<sup>12</sup> According to 2011 guidance issued by the SEC’s Office of Compliance Inspections and Examinations and FINRA, in conducting an inspection of its branch offices and other locations, the FINRA member should “engage in a significant percentage of unannounced exams, selected through a combination of risk-based analysis and random selection.” See Regulatory Notice, Branch Office Inspections, FINRA Regulatory Notice 11-54 (November 2011). This would not appear to be possible for mutual fund underwriters conducting inspections of the home offices of mutual fund wholesalers and regional distributors due to the nature of business conducted out of these locations and the fact that the wholesaler or regional distributor typically spends most of his or her time “on the road” making sales calls or visiting with existing fund distributors. Indeed, most of the guidance in Regulatory Notice 11-54 would appear to be inapplicable to these locations.

<sup>13</sup> FINRA’s Letter at pp. 13-14. FINRA’s Letter also notes that, pursuant to proposed Rule 3110.05, mutual fund underwriters may use a risk-based system to conduct the required review.

<sup>14</sup> See FINRA’s proposed Rule 3110(b)(2). Elizabeth M. Murphy, Secretary October 17, 2013 Page 6 seem that a more reasoned approach would be for FINRA’s rules to be internally consistent – i.e., if , because of the type of business the FINRA member conducts, it will not have any customer transactions to review, the member should not be required to include in its supervisory policies a provision governing review of transactions.

4. Rule 3110(b)(6)(C), Supervisory Structures – ICI’s Letter recommended that proposed Rule 3110(b)(6)(C) and its related Supplementary Material permit members, when appropriate, to have a person associated with a mutual fund underwriter supervise a person who determines that supervisor’s compensation or continued employment. ICI’s Letter provided examples that may be unique to a mutual fund complex where an associated person – for limited purposes or periods – may supervise a person who determines the supervisor’s compensation or continued employment. In response to our recommendation, FINRA’s Letter states that “FINRA addressed a similar comment in the rule filing and declined to make any revisions to [the proposed rule]. The exception [in the proposed rule] is

specifically based on a member's inability to comply with the general supervisory requirements because of the members' size or supervisory personnel's position within the firm."<sup>15</sup> A footnote to this discussion in FINRA's Letter notes that the exception in the proposed rule is based, in large part, on the exception in NASD Rule 3012(a)(2)(A)(ii) for FINRA members of limited size or with limited resources.<sup>16</sup> While FINRA may have believed that incorporating the concepts of NASD Rule 3012 into Rule 3110(b)(6)(C) would address our concerns, unfortunately, it does not because our concerns were unrelated to the member's size and resources. Our concern was based on the unique relationships that occur within a mutual fund complex where, for limited purposes or limited periods of time, a registered associated person may wind up supervising a more senior person who may play a role in determining the associated person's compensation or continued employment. ICI's Letter provided examples of how such situations could occur within a fund complex. Also, while ICI's Letter recognized the conflicts of interest that may arise with a more junior person supervising a more senior person, the examples we<sup>15</sup> FINRA's Letter at p. 22. <sup>16</sup> FINRA's Letter at fn. 85. NASD Rule 3012(a)(2)(A)(ii), which is available on FINRA's website at

[http://finra.complinet.com/en/display/display.html?rbid=2403&record\\_id=4400&element\\_id=3722&highlight=3012#r4400](http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4400&element_id=3722&highlight=3012#r4400), provides as follows: (ii) "Limited Size and Resources" Exception. If a member is so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the reviews pursuant to (i) above (e.g., a member has only one office or an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), the reviews may be conducted by a principal who is sufficiently knowledgeable of the member's supervisory control procedures, provided that the reviews are in compliance with (i) to the extent practicable. Elizabeth M. Murphy, Secretary October 17, 2013 Page 7 provided would not seem to raise such concerns. ICI's Letter also noted that the rule expressly requires any member relying on its limited exception to document both how the supervisory arrangement comports with the rule's requirements and how the member's supervisory procedures are not "reduced in any manner, due to the conflicts of interest that may be present" as a result of the arrangement.<sup>17</sup> 5. Rule 3110(b)(4), Review of Communications – ICI's Letter recommended that Rule 3110(b)(4) and its related Supplementary Material, which will govern the review of correspondence and internal communications, (1) better define which internal communications are considered to relate to the member's business and must be reviewed and (2) provide members greater flexibility in their use of electronic review systems or lexicon-based screening tools. The Institute's first recommendation was that FINRA revise Rule 3110(b)(4) and its related Supplementary Material to provide greater certainty that not all internal communications related to a member's investment banking or securities business are required to be reviewed. Our recommendation was intended to respond to our concern that Rule 3110(b)(4) could be read to require a review of all internal communications, except those that are of a purely personal nature. Therefore, we were pleased to see that FINRA's Letter acknowledged that proposed FINRA Rule 3110.06 "does not require the review of every internal communication." We continue to believe, however, that despite the clarification provided in FINRA's Letter,<sup>18</sup> the rule text and related Supplementary Material are ambiguous (both of which FINRA refused to amend). Because both FINRA examiners and members refer to the rule text and its related Supplementary Material (and not the FINRA Letter) for compliance purposes, we again urge FINRA to amend these provisions along the lines we recommended in our earlier letter.<sup>19</sup> The Institute's second recommendation related to FINRA's rule providing sufficient flexibility to enable members to use electronic systems and lexicon-based tools to review and screen communications, such as email. ICI's Letter discussed the importance of FINRA's members being able <sup>17</sup> See proposed Rule 3110(b)(6)(C)(ii). <sup>18</sup> The guidance provided in FINRA's

Letter includes the following: [I]f 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 such activities, provided that its supervisory procedures acknowledge that factor as part of the member's determination that its procedures were reasonably designed to achieve compliance with all applicable federal securities laws and FINRA rules. FINRA's Letter at p. 16. 19 ICI's Letter at p. 14 (recommending that FINRA make clear that a firm may use risk based principles to determine which review of any internal communications is necessary). Elizabeth M. Murphy, Secretary October 17, 2013 Page 8 to utilize such tools, particularly in light of the ever-increasing use of electronic communications. The letter expressed concerns with FINRA imposing documentation standards on the use of such tools that are so rigorous so as to unintentionally preclude their use.<sup>20</sup> In response, FINRA's Letter notes that, "with respect to communications reviewed by electronic surveillance tools that (sic) are not selected for further review, 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."<sup>21</sup> Notwithstanding this limited flexibility, we remain concerned that the text of the rule's Supplementary Material expressly requires a member using such a tool to "clearly identify the reviewer, the internal communication or correspondence with the public that was reviewed, the date of the review, and the actions taken by the member as a result of any significant regulatory issues identified during the review. Merely opening a communication is not a sufficient review."<sup>22</sup> Based on this language, it appears that, if a member uses a tool to review or screen communications, it must ensure that the tool is capable of recording all of this required information for every communication electronically scanned or reviewed.<sup>23</sup> Because of the questionable value of this information for regulatory purposes, ICI's Letter recommended that FINRA's rule be revised to permit the use of such tools "so long as a member creates and maintains records demonstrating that it has controls in place that are reasonably designed to ensure that the reviewing tool screens communications subject to review and is operating as intended. Thereafter, when the system is operational, the member should only be required to maintain records documenting the review of those communication that have generated review alerts . . . ."<sup>24</sup> We continue to believe that our recommended approach will provide FINRA with the information it needs to document members' compliance with their review responsibilities without impeding members' necessary reliance on such tools. <sup>20</sup> ICI's Letter at p. 16. <sup>21</sup> FINRA's Letter at p. 17. <sup>22</sup> See FINRA's proposed Supplementary Material .07. <sup>23</sup> For example, assume a member uses a lexicon-based tool to search for the word "guarantee" in any of the members' electronic communications. Instead of just keeping a record of each communication that the member found that included this term, proposed Rule 3110.07 would require the member to keep a record that includes, among other pieces of information, each electronic communication that was reviewed that did not contain this word. <sup>24</sup> ICI's Letter at p. 16. Elizabeth M. Murphy, Secretary October 17, 2013 Page 9 6. Rule 3110(d), Transaction Review and Investigation – ICI's Letter recommended that the provisions in proposed Rule 3110(d), which would govern a member's review and investigation of "covered accounts" be revised to (1) narrow the scope of those accounts that must be identified and monitored; (2) exclude mutual fund underwriting from the definition of "investment banking services"; and (3) incorporate NYSE guidance into the Rule's Supplementary Material. Taking our recommendations in order, we are pleased that, with respect to our first recommendation, FINRA narrowed the definition of "covered accounts" to be more in line with the NYSE's rule that was incorporated into the FINRA rule. We support the narrowing of this definition. With respect to our second recommendation, we continue to be concerned that FINRA has decided to define the term "investment banking services" to include mutual fund

underwriting. As discussed in detail in ICI's Letter, the business of a mutual fund underwriter is significantly and substantively different from the business of investment banking. Moreover, according to FINRA, the "primary purpose" of this rule is to prevent insider trading by those members that provide investment banking services, and it is targeted to those firms "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."<sup>25</sup> While we do not dispute the need for FINRA's heightened concern regarding insider trading by persons within firms that offer investment banking services, the activities of a mutual fund underwriter do not raise these concerns. Rather than addressing the misfit of this proposed rule to mutual fund underwriters, FINRA's Letter instead tries to minimize its impact on such persons by explaining that "[t]he only additional requirement of those firms that engage in 'investment banking services' is that they report information regarding their internal investigations to FINRA."<sup>26</sup> It further states, in direct response to concerns expressed with this provision by the ICI and the Securities Industry and Financial Markets Association ("SIFMA"), "neither commenter has 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."<sup>27</sup> Contrary to FINRA's statement, however, ICI's Letter did offer such an explanation: Our concern with including mutual fund underwriters in the scope of this new requirement is exacerbated by FINRA's statements in the Release that, if the rule's application to mutual fund

25 Release at p. 75-76. 26 If FINRA believes such enhanced reporting is not at all burdensome, all FINRA members that do not provide investment banking services should be treated as investment banking firms for purposes of this rule and mutual fund underwriters should not be singled out for such treatment. 27 FINRA's Letter at p. 32. Elizabeth M. Murphy, Secretary October 17, 2013 Page 10 underwriters is misplaced, it should not be of concern to such firms because they may never need to submit the required reports. This response wholly overlooks the costs and burdens associated with adopting and implementing the policies and procedures and systems that must be put in place to ensure compliance with the rule even if they never trigger the filing of a report. 28 FINRA's response to ICI's Letter appears to disregard our concerns and, consequently, underestimate 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. Our third recommendation was intended to address our concern with the manner in which FINRA has incorporated NYSE Rule 342.21 into Rule 3110(d). In particular, FINRA's rule appears to impose more extensive investigation and reporting requirements on members than those imposed by the NYSE's rule. While FINRA has assuaged part of our concern by revising the rule's definition of "covered account" (discussed above) to better align it with the NYSE's rule, FINRA has not yet incorporated the NYSE's longstanding guidance governing the rule's implementation into its proposal. In the absence of this incorporation, we remain concerned that, as stated in ICI's Letter, "even those NYSE members that have been subject to the NYSE's rule may find their reporting requirements . . . significantly increased under FINRA Rule 3110(d). To avoid this result, we recommend that FINRA add Supplementary Material under Rule 3110(d) that is consistent with NYSE Information Memo 06- 06." 29 FINRA's Letter does not address this recommendation. 7. Rule 3120, Supervisory Controls - ICI's Letter recommended that the \$200 million gross revenue threshold that FINRA proposes to trigger additional reporting obligations on certain

28 ICI's Letter at p. 19 (footnote omitted). In support of our recommendation that application of the rule to mutual fund underwriters is not necessary in the public interest, ICI's Letter also discusses SEC Rule 17j-1 under the Investment Company Act of 1940: Importantly SEC Rule 17j-1(c) expressly requires both

the fund 'and each investment adviser and principal underwriter of the Fund [to] adopt a written code of ethics containing provisions reasonably necessary to prevent its Access Persons' from engaging in unlawful actions involving the fund. As defined in the rule, the term 'access person' would include 'any director, officer, or general partner of a principal underwriter who, in the ordinary course of business, makes, participates in or obtains information regarding the purchase or sale of covered securities of the Fund . . . .' ICI's Letter at fn. 37. 29 ICI's Letter at p. 21. NYSE Memo 06-06, which is excerpted in ICI's Letter, provides valuable guidance regarding the implementation of NYSE Rule 342.12. See ICI's Letter at pp. 20-21. Elizabeth M. Murphy, Secretary October 17, 2013 Page 11 FINRA members be revised to recognize the unique business and capital structure of mutual fund underwriters. ICI's Letter discussed in detail how it is not uncommon for mutual fund underwriters to appear to have \$200 million or more in gross revenues for limited period of time - i.e., between the time the underwriter receives 12b-1 payments from the fund and the time such sums are paid to the fund's retail distributors. In light of this unique circumstance, ICI's Letter recommended that FINRA either carve limited purpose broker-dealers out of this additional reporting requirement or exclude from the rule's definition of "gross revenue" any revenue the underwriter receives as a payment from the fund pursuant to Rule 12b-1 under the Investment Company Act of 1940 that the underwriter pays to a fund intermediary within 3 months of its receipt. Either alternative would have addressed our concerns with the proposed rule failing to take into account the unique business—and revenue stream - of mutual fund underwriters. To its credit, FINRA did attempt to address the Institute's concern with Rule 3120. It did so by revising the rule - not as recommended by the Institute - but by limiting the additional information that must be reported by those members with \$200 million or more in gross revenues to information listed in the rule<sup>30</sup> but only "to the extent applicable to the member's business." While we appreciate FINRA's attempt to address our concerns, its solution relates to the contents of the reports and not the trigger in the rule (i.e., the member's gross revenues) that requires that the reports be supplemented with additional information. Accordingly, we again strongly recommend that FINRA revise Rule 3120 as recommended in ICI's Letter to recognize the unique revenue streams flowing through mutual fund underwriters to retail distributors and revise the rule to avoid these pass-through revenues be counted as the member's gross revenue, thereby triggering the rule's additional reporting requirements. ■

■ ■ ■ From FINRA's Letter, it appears that FINRA has, in large part, dismissed our substantive concerns with FINRA's proposal and our recommendations to address those concerns without compromising investor protection. Consequently, FINRA has failed to (1) give adequate consideration to the serious concerns raised with the proposal by the Institute and others; (2) appropriately tailor the proposed rules in order to avoid a "one-size-fits-all" approach to regulation; and (3) properly consider the costs and burdens each new requirement in its proposal will impose on its members and whether 30 The additional information would consist of a tabulation of reports pertaining to customer complaints and internal investigations made to FINRA during the preceding year and a discussion of the member's compliance efforts for the previous year in each of the following areas: (1) trading and market activities; (2) investment banking activities; (3) antifraud and sales practices; (4) financial and operations; (5) supervision; and (6) anti-money laundering. Elizabeth M. Murphy, Secretary October 17, 2013 Page 12 these costs will be outweighed by the rules' benefits. For all of these reasons, as well as the reasons discussed above and in ICI's Letter, we strongly recommend that the Commission disapprove FINRA's proposal until such time as it is significantly amended to address these concerns in a meaningful way. We appreciate the opportunity to provide these comments and the Commission's consideration of them. If you have any questions, please contact the undersigned at (202)326-5825. Sincerely, /s/ Tamara K. Salmon Senior Associate Counsel Attachment



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