



Financial Industry Regulatory Authority

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Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

**Re: File No. SR-FINRA-2011-064 – Response to Comments**

Dear Ms. Murphy:

On November 1, 2011, FINRA filed with the Securities and Exchange Commission (“SEC” or “Commission”) SR-FINRA-2011-064, a proposed rule change to adopt FINRA Rule 4524 (Supplemental FOCUS Information) to require each member, as FINRA shall designate, to file such additional financial or operational schedules or reports as FINRA may deem necessary or appropriate for the protection of investors or in the public interest as a supplement to the FOCUS report. The content of such supplemental schedules or reports, their format, and the timing and frequency of such filings, would be specified in a Regulatory Notice (or similar communication). FINRA would file with the SEC the content of any such Regulatory Notice (or similar communication) issued pursuant to proposed FINRA Rule 4524. As part of the proposed rule change, FINRA is proposing one such schedule, a Supplemental Statement of Income (“SSOI”) as a supplement to the Statement of Income (Loss) page of the FOCUS Report. The Commission published the proposed rule change for comment in the Federal Register on November 14, 2011.<sup>1</sup> The Commission received five comment letters in response to the proposed rule change.<sup>2</sup> This letter responds to those comments.

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<sup>1</sup> Securities Exchange Act Release No. 65700 (November 7, 2011), 76 FR 70523 (November 14, 2011) (Notice of Filing of File No. SR-FINRA-2011-064). The comment period closed on December 5, 2011.

<sup>2</sup> See Letter from Howard Spindel, Senior Managing Director, and Cassondra E. Joseph, Managing Director, Integrated Management Solutions USA LLC, dated December 5, 2011 (“IMS”); letter from Pat Nelson, dated November 30, 2011 (“Nelson”); letter from Nancy Brda, Chief Financial Officer, Newedge USA, LLC, dated December 5, 2011 (“Newedge”); letter from George Hessler, CEO and President, Stock USA Execution Services, Inc., dated November 25, 2011 (“Stock USA”); and letter from Holly H. Smith and Susan S. Krawczyk, Sutherland Asbill

## **New Financial and Operational Reports or Schedules**

Several commenters have concerns with the implementation of possible future reports or schedules.<sup>3</sup> Nelson expresses reservations about commenting on a rule that may require unspecified additional information in the future. Stock USA believes that although FINRA will “publish the content of each Regulatory Notice with the SEC,” it would not be the same as requesting SEC approval. Further, CAI suggests that FINRA should submit any new report or schedule to the SEC in the form of a proposed rule change that solicits public comment and requires SEC approval before it is allowed to be effective. In response to the commenters, FINRA has amended the proposed rule to clarify that FINRA shall file with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (“Exchange Act”) the content of any Regulatory Notice (or similar communication) issued pursuant to the proposed rule. Further, if such content contains material substantive changes, FINRA will file it for comment with the SEC pursuant to Section 19(b) of the Exchange Act. As such, commenters will have an opportunity to express any concerns to the SEC with respect to any request for such additional substantive information made pursuant to the proposed rule.

## **Reporting Threshold**

The proposed SSOI is intended to capture more granular detail of a firm’s revenue and expense information. The proposed SSOI contains a *de minimis* exception for providing details of revenue and expenses for certain designated sections, e.g., commissions. If a member’s total dollar amount for a designated section is \$5,000 or less for the reporting period, the member would only be required to enter the total dollar amount to complete this section. A number of commenters suggest that the *de minimis* exception should include a percentage threshold for gross revenue.<sup>4</sup> IMS and Newedge believe that there would be no value to FINRA in obtaining information relating to business lines that are a small percentage of a broker-dealer’s revenue or expenses. In addition to a percentage threshold, Stock USA suggests raising the *de minimis* exception to \$25,000. Similarly, CAI believes that the \$5,000 threshold is impractically low and that a suitable threshold should reflect the revenues of the firm as a whole. After careful consideration, FINRA has amended the SSOI and instructions to include as a component to the *de minimis* exception for certain designated sections a percentage of gross revenue threshold. Thus, if the aggregate amount for the designated section is less than the greater of \$5,000 or 5% of the firm’s total revenue or total expense, as applicable, for the reporting period, a member would only be required to enter the aggregate amount to

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& Brennan LLP, on behalf of the Committee of Annuity Insurers, dated December 5, 2011 (“CAI”).

<sup>3</sup> CAI, Nelson and Stock USA.

<sup>4</sup> CAI, IMS, Newedge and Stock USA.

complete the section. Additionally, FINRA has added a *de minimis* exception for the revenue from sale of insurance based products section on the SSOI.<sup>5</sup> Finally, FINRA has clarified language on the SSOI and instructions regarding the reporting thresholds for other expenses and other revenue.

### **Filing Time Frame**

The proposal would require the proposed SSOI to be filed within 17 business days after the end of the calendar quarter, consistent with the time frame allowed for the filing of the FOCUS reports. Newedge believes that given the significant amount of work already involved in preparing a FOCUS report, and considering the additional amount of work that will be required in preparing the SSOI, firms should be provided with an additional three to five business days after filing their FOCUS report to file the SSOI. FINRA recognizes the new report will involve an additional amount of work for members and believes that it is reasonable to give members an additional three business days to file the SSOI. Therefore, FINRA has amended the proposal to require the SSOI to be filed within 20 business days after the end of the calendar quarter.

### **SSOI Instructions**

The proposed SSOI contains instructions that include guidance, clarifications and definitions with respect to certain line items. Newedge believes that certain product categories should be defined more precisely to avoid the potential for duplicative or inconsistent reporting by members. Newedge suggests that the categories of “commodities,” “foreign exchange,” “derivatives other than listed or unlisted options,” “corporate debt,” “US Government and Agency” securities and “asset backed securities” be further clarified. In response to the commenter, for certain revenue items, where specific and/or detailed instructions are not provided on the SSOI, FINRA expects firms to report the revenue item in accordance with the definition and/or methodology used for the preparation of the FOCUS report.<sup>6</sup> Further, FINRA believes that the instructions to the SSOI contain sufficient clarity regarding “corporate debt,” “US Government and Agency” securities and “asset backed securities”; however, FINRA has clarified the instructions with respect to “foreign exchange.” FINRA has also added instructions regarding non-securities insurance based products. Further, FINRA notes that the term “derivatives other than listed or unlisted options” does not appear in the proposed SSOI.

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<sup>5</sup> The SSOI and instructions have been amended to reflect the new *de minimis* exception for revenue from sale of insurance based products by dividing Section 2 into two sections; revenue from sale of investment company shares is now Section 2 and revenue from sale of insurance based products is now Section 3. Each section after Section 3 has been renumbered to reflect this change.

<sup>6</sup> For example, the category “commodities revenue” comes directly from the FOCUS Report Part II and Part IIA and should be reported consistent with what the firm reports for this revenue item on the FOCUS Report.

### **Small Firm Concerns**

IMS believes that smaller broker-dealers should have a less detailed SSOI report than larger broker-dealers. Stock USA suggests that small broker-dealers generally do not have the sophisticated systems that break down each item of revenue or expense by product or segment, nor should they be required to have such systems. As FINRA stated in the rule filing, the required information is important to identify regulatory risk and trends, irrespective of firm size. Moreover, FINRA reiterates that many of the line items will not apply to smaller firms with limited product offerings. And, as mentioned above, the proposed SSOI is being amended to broaden the scope of a *de minimis* exception. Thus, the form generally will be much less complicated and time consuming for smaller firms and should not require sophisticated systems to generate the information.

### **Exemption from SSOI**

CAI believes that an exemption from the SSOI should be crafted for those members that do not engage in risky business lines and who provide financial information that is already transparent. CAI cites as examples mutual fund wholesalers and variable annuity principal underwriters and wholesalers that, in CAI's view, do not present the type of risk that the SSOI contemplates. FINRA – without adopting the commenter's risk characterizations with respect to its examples – does not agree that such an exemption is appropriate and believes that the required information is important to identify revenue sources, enable FINRA to segment firms and identify regulatory risk and trends, irrespective of the business model of the member or whether a particular business segment or product line has raised recent regulatory concerns. Further, FINRA notes that the revenue streams of variable annuity principal underwriters and wholesalers are not transparent from the FOCUS report as it currently exists. Additionally, FINRA notes that many of the line items will not apply to firms with limited product offerings, such as mutual fund wholesalers and variable annuity principal underwriters and wholesalers.

### **Exemption from Operational Page Reporting**

The proposed SSOI includes a new Operational Page that would collect additional information from certain members with respect to participation in unregistered offerings during the reporting period. Only members whose revenue from unregistered offerings exceeds 10% of total revenue for the reporting period would be required to complete the Operational Page. If a member is required to complete the Operational Page for a given quarter, the member is required to report information only with respect to its five largest unregistered offerings (in terms of the aggregate dollar amount of securities sold) for self or affiliate offerings, and the five largest unregistered offerings other than self or affiliate offerings. CAI suggests there is an inconsistency between the proposed Operational Page and certain FINRA offering rules. CAI believes that offerings that are exempted from FINRA offering rules should not be subject to the Operational Page; specifically, CAI

points out that FINRA Rule 5110 (Corporate Financing Rule – Underwriting Terms and Arrangements) exempts ten different types of offerings from the rule.

The commenter fails to recognize that the proposed Operational Page serves a different purpose than FINRA Rule 5110. The Operational Page of the proposed SSOI is intended to provide FINRA with greater transparency as to the source of the revenues associated with unregistered offerings when such revenues are a material percentage of a firm's overall revenues, whereas FINRA Rule 5110 regulates the underwriting terms and arrangements of most public offerings of securities sold through FINRA members. While not subject to FINRA Rule 5110, information about the exempted offerings cited by CAI would provide a stronger understanding regarding the types of unregistered offerings that generate significant revenue for members.<sup>7</sup>

### **Reporting Issues**

IMS believes that FINRA should give more consideration to member practices and procedures with respect to their books and records. IMS states that firms organize revenue data based on internal definitions of business lines and to comply with generally accepted accounting principles (“GAAP”). IMS believes that FINRA's emphasis on reporting by product lines contradicts well-established revenue reporting rules and procedures under GAAP. Further, IMS believes that FINRA is artificially forcing firms to differentiate income generated by investments from that of trading by requiring that revenue be reported by how the income might be taxed. Finally, IMS finds inconsistent that FINRA is proposing to capture trading income data for more than a dozen separate categories but then provides only one line for capital gains or losses related to longer-term investments.

FINRA disagrees that the proposal is at odds with member practices. The SSOI is similar to the FOCUS Report in that it requires members to break-out revenues based on product line and distinguishes between trading and investment gains. Additionally, requesting information to be reported by product line is not inconsistent with GAAP. Further, the instructions to the SSOI require that all revenue and expense items must be reported in accordance with GAAP. With respect to breaking-out trading revenue data compared to investment capital gains or losses, FINRA believes that more granular detail for trading revenue is warranted because the regulatory risks associated with trading

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<sup>7</sup> FINRA has found significant problems in several recent examinations and investigations. These problems include fraud and sales practice abuses in Regulation D offerings. See Regulatory Notice 10-22 (April 2010) (Regulation D Offerings); see also FINRA Press Release, FINRA Sanctions Eight Firms and 10 Individuals for Selling Interests in Troubled Private Placements, Including Medical Capital, Provident Royalties and DBSI, Without Conducting a Reasonable Investigation (November 29, 2011).

activities differ from the regulatory risks associated with longer-term investment activities.

### **Alternatives to Schedule**

IMS and Nelson believe that FINRA should consider alternatives to the SSOI. IMS suggests that a joint task force consisting of FINRA and other regulators should be convened to produce a meaningful revised FOCUS Report. Nelson inquires if FINRA has given any thought as to other ways to gather SSOI information. As stated in the rule filing, FINRA has considered a number of alternatives and believes that the proposed SSOI is the most effective and timely way to obtain the additional detail of revenues earned or expenses incurred by product or other more specific categories. Additionally, FINRA notes that it consulted with its advisory committees in connection with the development of the proposed SSOI.

### **Implementation Date**

FINRA stated in the rule filing that the implementation date of the proposed schedule will be no sooner than 180 days, and no later than 365 days, following Commission approval of the proposed rule change. CAI suggests that a compliance effective date of no sooner than 365 days following the SEC's approval would be appropriate because members not already collecting this information will require much more time than larger firms to implement the operational and systems changes the SSOI necessitates. FINRA disagrees with the commenter and believes that the proposed time frame strikes the proper balance of ensuring FINRA receives timely information while giving members sufficient time to file the first proposed SSOI.

### **Self-Regulatory Organization ("SRO") Rulemaking**

Several commenters express concern that FINRA did not conduct a cost-benefit analysis in connection with the rule proposal.<sup>8</sup> Stock USA believes that FINRA failed to make a justification about "how the proposed rule will be used to enhance its meeting of both the economic and protective provisions of Section 15A(b)(6) of the Exchange Act" and failed to balance the burdens with the benefits of implementation. Additionally, CAI believes that the absence of specific cost estimates is inconsistent with the Exchange Act requirements. Further, CAI requests that FINRA discuss the legal authority upon which it is relying to adopt the SSOI and address the role the SSOI would play with respect to a broker-dealer's annual audits.

FINRA has complied with all rulemaking obligations imposed by the Exchange Act. Pursuant to Section 19(b)(1) of the Exchange Act, FINRA submitted to the Commission a "concise general statement of the basis and purpose" of the proposed rule.

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<sup>8</sup> CAI, Nelson, Newedge and Stock USA.

The proposed rule is consistent with Section 15A(b)(6) of the Exchange Act and is “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.” FINRA believes that the proposed rule and proposed SSOI will further strengthen FINRA’s ability to protect investors through a more informed understanding of the drivers of members’ business that can be used for more targeted examinations and to understand trends in those drivers that may portend greater risk to the firm and the protection of customer assets. In addition, the proposed rule does not create a “burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.”<sup>9</sup> The burden of completing the SSOI is outweighed by FINRA’s enhanced ability to protect investors by having a more detailed understanding of members’ sources of revenue and expense drivers. There is nothing in Section 15A, Section 19, or elsewhere in the Exchange Act that requires FINRA to engage in a cost-benefit analysis in its rulemaking of the type suggested by the commenters nor is there a concomitant responsibility on the part of the SEC in approving SRO rule proposals. Nonetheless, FINRA has carefully crafted the proposal to achieve its intended and necessary regulatory purpose while minimizing the burden on firms and is always responsive to burden concerns raised throughout the rulemaking process with respect to any proposal including the instant one. In this regard, FINRA presented the proposal to the public and solicited comments prior to submitting the proposed rule change to the Commission.<sup>10</sup> Additionally, as stated above, FINRA consulted with its advisory committees in connection with the development of the proposed SSOI.

FINRA reviewed the comments and made appropriate changes. For example, in response to comments on the initial Regulatory Notice, FINRA included a *de minimis* exception that will make the form less time consuming for many smaller firms. In addition, FINRA amended the SSOI by making the requested tax information less burdensome, allowing flexibility regarding the reporting of dividends and interest for principal trades and allowing revenue from unit investment trusts that are open-end companies to be included with revenue from investment company shares. Moreover, recognizing that certain information requested by the proposed SSOI may be confusing to members, FINRA developed instructions that include guidance, clarification and definitions with respect to certain line items.

And, as further detailed above, FINRA has proposed additional changes after careful consideration of comments raised in response to the publication of the revised proposal in the Federal Register. In particular, FINRA has amended the proposal by clarifying that FINRA shall file with the SEC pursuant to Section 19(b) of the Exchange Act the content of any Regulatory Notice (or similar communication) issued pursuant to the proposed rule, broadening the scope of the *de minimis* exception for certain designated sections by including as a component a percentage of gross revenue (or expense, as

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<sup>9</sup> See Section 15A(b)(9) of the Exchange Act.

<sup>10</sup> See Regulatory Notice 10-33 (July 2010).

appropriate) threshold, providing firms with an additional three business days after filing their FOCUS report to file the SSOI and clarifying the instructions with respect to certain product lines on the SSOI to avoid inconsistent or duplicative reporting by members.

Finally, with regard to the role the SSOI would play with respect to a broker-dealer's annual audits, the SSOI is not one of the reports required to be audited under Exchange Act Rule 17a-5. FINRA does not expect or require the SSOI be audited unless the auditor believes there is a need to review; however, total revenue and total expenses on the proposed SSOI should equal total revenue and total expenses on the FOCUS report.

### **Comment Period**

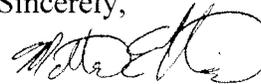
CAI states that the twenty-one day comment period did not allow members sufficient time to properly estimate the costs associated with the operational and systems changes needed to complete the SSOI and requested that members should be permitted more time to comment. The length of a comment period is determined by the SEC and therefore outside the scope of this response.

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FINRA believes that the foregoing, along with the discussion in the rule filing, fully responds to the issues raised by the commenters. FINRA emphasizes that the proposed rule change would provide FINRA a means and process to obtain greater transparency into a member's business activities and to better illuminate industry trends, allowing for more focused and effective examinations.

If you have any questions, please contact me at (202) 728-8156.

Sincerely,



Matthew E. Vitek  
Counsel