

SIFMA Compliance & Legal Division Monthly Luncheon held December 18, 2007
Marc Menchel, Executive Vice President and General Counsel for Regulation and Grace
Vogel, Executive Vice President, Member Regulation, FINRA
Discussion Panel Led by
Gerald Baker, Executive Director of SIFMA/CL

Marc Menchel led with a discussion of where FINRA is at in the Rule Book process. Marc noted there is a lot of work to do. Initially it was thought that FINRA could build off the NYSE Rule Harmonization efforts and omnibus filings. As part of the process consideration is being given to developing principle based regulations. Marc noted that FINRA is working closely with smaller ad hoc industry groups and other constituents and has developed a principle overlay to the rules which they recently sent to the SEC. As part of that effort, FINRA is considering fashioning institutional carve outs based on dollar thresholds and types of institutions for certain rules such as best execution and mark up rules.

Grace Vogel noted that FINRA has looked at a number of rules identified from the work done in the Rule Harmonization process and have looked to rescind NYSE rules if they were more burdensome and where there were related NASD rules. Commenting on potential for redundancies in NYSE book because of overlapping conduct rules applicable to the NYSE floor, Grace noted that there will continue to be rules in the NYSE rule book governing conduct of firms in regard to their floor activities. Under agreement, overlapping conduct rules will be enforced by FINRA. Grace noted that they are looking to identify rules that need to be rewritten totally because the rules are either too prescriptive or no longer make sense. Examples of rules in these categories may be the research rules, communications with public and internal supervision. Instead, FINRA will work to draft principle based rules that are less prescriptive than what exists now. Some of the principles being considered that Marc and Grace referenced were fair dealing, just and equitable principles of trade, fair treatment of customers, avoidance of fraud and manipulations, suitability, fair communications with the public, resolution of conflicts of interest, registration and training.

Marc noted that the idea of principles is that they will be used as a guide for the employment of prosecutorial discretion in the enforcement of SRO rules and the federal securities laws. Enforcement will look back to the principle and consider how much harm or damage to the principle has been done and use that as a factor in determining whether any enforcement response is warranted and at what level. This will also be a guiding light to further principle based regulation and allow us to have a rule set that is flexible and elastic enough such that new rules do not need to be written each time a problem arises (as was the case, for example, with the research rules). Also, principle based rules allow for tiering - natural tiering should take place through principles.

In response to concerns raised in the enforcement of principle based rules, i.e., that more cases can be brought based on violation of "principles" and the risk of creating "rules by enforcement", Marc and Grace noted that the intent of the overlay of principles is not to create more enforcement actions. Rather, the intent is to invoke more thought by the

regulator, in analyzing potentially violative conduct with regard, as to the nature and severity of the offense of such conduct to the applicable principles. Marc acknowledged that there is tension in the industry between principle based and prescriptive rules – that the industry flip flops between both – it wants principles but also wants prescriptive rules. Principles impose on the regulator its own judgment as to whether the firm is carrying out the spirit of the principle, which is the intent of having principles. The test will be “colorable reasonable judgment”. It will be a challenge for FINRA to train examiners to think about the principle and “spirit of the rule”

Marc noted that certain other rules (the 4-6000 and 9000 series) would move into the FINRA rules book without modification but subject to modification as events warrant in the normal course of time. FINRA would then focus on the 1-3000 series rules. Marc noted that they are prioritizing and bringing the action plan to the FINRA board. They will work to reorganize the rule book conceptually, e.g., the financial operation supervisory rules will be together and reference the overriding principles. Therefore, a prescriptive rule can fall within more than one principle.

Grace concluded with a discussion of the unified examination program of FINOP and Sales Practice groups. Grace noted that in 2008, these groups will come in together (rather than giving firms a choice as in past). The focus will be on a 1, 2 or 4 year exam cycle – e.g., for an institutional firm, exams can be done every year for one reason (e.g., FINOP) and every 4 years for another reason (e.g. sales practice.) FINRA will give 30 days advance notice of commencement of the examination and there will be one administrative lead for FINOP /Sales Practices and one document request made. There are three different types of Branch Exams from a risk modeling standpoint. Branch Office reviews will be done as part of the main office review (other than for-cause exams). Initial kick off meetings will be scheduled. Every exam will be risked based (not every issue will be looked at) using information from past experience with the firm to tailor examinations. Grace also noted that there will continue to be sweep examinations which are often done when new rules are enacted, e.g., Reg. SHO sweep examinations. Sweep examinations will also continue on an ad hoc, unplanned basis in response to events in the market place. The intent of sweep examinations is often to share best practices and play those best practices back to firms.