Proposed FINRA Rule Seeks to Place Limitations on Outsourcing

Introduction and Background

Introduction

On March 29, 2011, FINRA published Regulatory Notice 11-14 (the “Regulatory Notice”), proposing new FINRA Rule 3190 (the “proposed rule”) regarding outsourcing by FINRA-member broker-dealers.1 In short, the proposed rule would:

- Specify that the outsourcing of functions by a FINRA member does not relieve the member of its regulatory responsibilities for compliance with applicable law and regulation.
- Prohibit FINRA members from delegation of their responsibilities for, or control over, any functions or activities related to the member’s business as a regulated broker-dealer performed by a third-party service provider.
- Require ongoing diligence into the experience and capacity of any third-party service provider and any sub-vendor.
- Require that a member firm that clears or carries customer funds and securities
  - Vest an associated person2 of the member with responsibility for: (1) the movement of customer or proprietary cash or securities; (2) the preparation of net capital or reserve formula computations; and (3) the adoption or execution of compliance or risk management systems.
- Notify FINRA of all outsourcing agreements that are in effect on the proposed rule’s effectiveness date and of all subsequent outsourcing arrangements entered into relating to the member’s business as a regulated broker-dealer.

The comment period terminates on May 13, 2011.

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1 See FINRA Regulatory Notice 11-14, “Third-Party Service Providers” (March 2011) (the “Release”). FINRA Regulatory Notices are available on FINRA’s Internet website: www.finra.org.

2 The term “associated person” is defined in FINRA’s By-Laws as: “(1) a natural person who is registered or has applied for registration under the Rules of the Corporation; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with FINRA under these By-Laws or the Rules of the Corporation; and (3) for purposes of Rule 8210, any other person listed in Schedule A of Form BD of a member […]” (Emphasis added.) Importantly, the term “associated person” does not specify the employment status of the associated person under applicable employer-employee law: an associated person of a broker-dealer is not necessarily an employee of that broker-dealer.
Background: the proposed rule combines existing NASD guidance with a 2005 NYSE proposal to limit outsourcing.

Outsourcing is extremely common in the financial services industry. Certain forms of outsourcing – such as clearance and settlement functions – are so well-established that they are themselves an important and regulated part of the industry. The proposed rule combines two regulatory positions formerly maintained by NASD and NYSE Regulation, which in 2007 merged to become FINRA.

First, in 2005, NASD issued Notice to Members 05-48 reminding NASD members that, (a) in general, any persons conducting activities or functions that require registration under NASD rules are considered associated persons of the member, and (b) outsourcing an activity or function to a third-party service provider does not relieve members of their ultimate responsibility for compliance with applicable law and regulation. Importantly, NASD Notice to Members 05-48 did not place specific limitations on the ability to outsource specific functions.

Second, in late 2004, NYSE Regulation proposed NYSE Rule 340 (“Outsourcing: Due Diligence in the Use of Service Providers”), which rule would have prohibited NYSE member firms from outsourcing among other things: (a) the exercise of supervisory compliance responsibilities; (b) activities that require registration with, or qualification by, the Exchange; (c) control over cash or securities of the member organization and its customers; (d) control over the accuracy and integrity of the books and records of a member organization; and, (e) non-ministerial clearing and custodial services other than those performed pursuant to a clearing agreement.

The proposed rule maintains the principles-based guidance found at NASD Notice to Members 05-48, codifying the general guidance that outsourcing functions to third-party service providers does not relieve the broker-dealer’s obligation to comply with all law and regulation in respect of all of its securities activities. The proposed rule, however, also codifies certain of the proposals embodied in the proposed NYSE rule, namely those that prohibit the outsourcing of specific activities by clearing or carrying firms.

3 See NASD Rule 3230 (“Clearing Agreements”) and Incorporated NYSE Rule 382 (“Carrying Agreements”). See also pending FINRA Rule 4311 (“Carrying Agreements”) and SEC Adopting Release 34-63375, “Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change to Adopt Rules Governing Guarantees, Carrying Agreements, Security Counts and Supervision of General Ledger Accounts in the Consolidated FINRA Rulebook” (November 24, 2010). NASD rules, Incorporated NYSE rules, and pending FINRA rules are available on FINRA’s Internet website, www.finra.org. SEC Releases are available on the SEC’s Internet website, www.sec.gov. Similarly, there are many firms – including certain large and well-known firms – that do not maintain an employer-employee relationship with their registered representatives, instead adopting the established and recognized “independent contractor model”.


Summary of Proposed Rule 3190

Definition of “third-party service provider” includes affiliates

The term “third-party service provider” is not defined in the proposed rule. However, in accordance with Supplementary Material .01, the proposed rule does apply to service arrangements with a parent or affiliate. Supplementary Material .01 states that a third-party service provider includes a sub-vendor or service provider who is any person controlling, controlled by or under common control with a FINRA member, unless otherwise determined by FINRA.7

Although the proposed rule’s obligations and responsibilities generally apply to sub-vendors, in addition to third-party service providers, for ease of reading this publication refers only to third-party service providers, except where the application to sub-vendors would alter the nature of members’ obligation.

Responsibilities for outsourced functions

Proposed rule 3190(a)(1) provides that the use by a FINRA member of a third-party service provider to perform functions or activities related to the member’s business as a regulated broker-dealer8 does not relieve the member of its obligation to comply with applicable securities laws and regulations and with applicable FINRA and MSRB rules. The section also provides that no member may delegate its responsibilities for, or control over, any functions or activities performed by a third-party service provider.

Proposed rule 3190(f) sets forth two types of outsourcing arrangements to which the proposed rule does not apply. Outsourcing arrangements with respect to ministerial activities are excepted from the proposed rule, unless they are otherwise prohibited by applicable securities laws and regulations or applicable FINRA or MSRB rules. In addition, the proposed rule does not apply to activities performed pursuant to a carrying agreement approved under FINRA Rule 4131.

Supervision and diligence of third-party service providers

Proposed rule 3190(a)(2) requires members to establish and maintain a supervisory system and written procedures for any functions or activities performed by a third-party service provider (including any sub-vendor), which must be reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules.

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7 See Supplementary Material .01. The term “control” means: (i) beneficial ownership of 10 percent or more of the outstanding common equity of an entity, including any right to receive such securities within 60 days of the member’s participation in the public offering; (ii) the right to 10% or more of the distributable profits or losses of an entity that is a partnership, including any right to receive an interest in such distributable profits or losses within 60 days of the member’s participation in the public offering; (iii) beneficial ownership of 10% or more of the outstanding subordinated debt of an entity, including any right to receive such subordinated debt within 60 days of the member’s participation in the public offering; (iv) beneficial ownership of 10% or more of the outstanding preferred equity of an entity, including any right to receive such preferred equity within 60 days of the member’s participation in the public offering; or (v) the power to direct or cause the direction of the management or policies of an entity.

8 In Notice to Members 05-48, NASD noted that its requirements with respect to outsourced functions only applied to “covered activities”: the activities and functions that, if performed directly by members, would be required to be the subject of a supervisory system and written supervisory procedures. The notice cited examples of covered activities: order taking, handling of customer funds and securities, and supervisory responsibilities under NASD Rules 3010 and 3012. The proposed rule, however, does not refer to covered activities, and refers instead to the member’s outsourcing of “a function or activity related to its business as a regulated broker-dealer.” It is not clear whether the proposed rule’s difference in terminology means that the proposed rule will differ in scope from NASD Notice to Members 05-48.
Those procedures must include an ongoing due diligence analysis of current and prospective third-party service providers to determine, at a minimum, (1) whether the third-party service provider (including any sub-vendor) is capable of performing the activities being outsourced, and (2) whether the member can achieve compliance with applicable FINRA and MSRB rules for the functions being outsourced.9

Restrictions on outsourcing by clearing or carrying members

In addition to the requirements noted above, which apply to all FINRA members, the proposed rule provides for additional restrictions and obligations for clearing or carrying members.10 Proposed rule 3190(c) requires a clearing or carrying member firm to vest an associated person of the firm with authority and responsibility for the following activities:

- The movement of customer or proprietary cash or securities;
- The preparation of net capital or reserve formula computations; and
- The adoption or execution of compliance or risk management systems.

In the Regulatory Notice, FINRA provided guidance on ways firms can permissibly use third-party service providers in connection with the above responsibilities. Supplementary Material .02 notes that the provisions of 3190(c)(1), requiring an associated person to be assigned responsibility for movement of customer cash and securities, do not preclude a designated third-party service provider from posting items to a member’s books or records, provided that the member reviews each posting prior to the close of the business day following the posting. FINRA noted that it generally would permit the prompt supervisory review required by Supplementary Material .02 to be performed via substantiation of financial balances and spot-check reviews of individual entries, rather than an actual sign-off on each entry.

With respect to the requirement that an associated person be responsible for preparation of net capital or reserve formula computations, FINRA noted that calculations in aid of the preparation of these computations would be a ministerial function that, pursuant to proposed rule 3190(f)(1), could be performed by a third-party service provider.

With respect to the adoption or execution of compliance or risk management systems, the proposed rule does not prohibit a firm from using a third-party service provider as part of the member firm’s compliance and risk management activities, provided the member firm adopts such services and systems in a manner consistent with regulatory requirements, retains control over their implementation and use within the firm, and independently determines that they achieve compliance with the applicable securities laws and FINRA and MSRB rules. Further, basic calculations, logging or maintaining lists that are preparatory to creating related books and records and review of output from these systems could be performed by a

9 Proposed rule 3190(b).
10 We note that FINRA’s rules generally deem clearing or carrying members to be those members that clear or carry customer accounts, and that certain FINRA rules also generally require firms that operate pursuant to the exemption from Exchange Act Rule 15c3-3(k)(2)(i) to be subject to the same restrictions as clearing or carrying member firm. See, for example, our client publication dated February 4, 2010, “FINRA Adopts Changes to Financial Responsibility Rules for Carrying or Clearing Members; Creates Additional Obligations for Members Exempt Under Rule 15c3-3(k)(2)(i),” available at http://www.shearman.com/fina-adopts-changes-to-financial-responsibility-rules-for-carrying-or-clearing-members-creates-additional-obligations-for-members-exempt-under-rule-15c3-3k2i-02-04-2010/. The Regulatory Notice does not define “clearing or carrying member,” and we also note that FINRA has not issued any guidance indicating that firms operating pursuant to 15c3-3(k)(2)(i) will be treated as a clearing or carrying member for purposes of the proposed rule.
third-party service provider; however, any analysis or conclusions based upon the data would have to be performed by an associated person of the firm.

The supervisory procedures regarding third-party providers of a clearing or carrying member firm must include procedures that:

- Enable the member to take prompt corrective action where necessary to achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules; and,
- Require any transfer of duties by a third-party service provider to a sub-vendor to be approved by the member.

Notice to FINRA of outsourcing activities

Under proposed rule 3190(e), clearing or carrying member firms also are subject to certain notifications requirements with respect to their use of third-party service providers. A clearing or carrying member entering into an outsourcing agreement relating to its business as a regulated broker-dealer must notify FINRA within 30 calendar days after the date the member enters into the agreement.

In addition, should the proposed rule become effective, clearing or carrying member firms will be required to notify FINRA of all its existing outsourcing arrangements relating to its business as a regulated broker-dealer.

The notifications must include: (1) the function or functions being performed by the third-party service provider (including any sub-vendor, if known), and (2) the identity and location of the third-party service provider (including any sub-vendor, if known).

Conclusion

Outsourcing is an important and common aspect of the global financial industry that increasingly relies on specialization and automation. In this regard, the proposed rule represents the increasing level of regulatory interest in the inner workings of FINRA member firms and the importance that FINRA attributes to robust compliance and comprehensive controls and procedures to achieve the purposes underlying FINRA interpretive guidance. For clearing and carrying firms, the proposed rule will, if adopted, require a comprehensive, and, for some firms, costly review of all third-party service provider arrangements – including those with affiliates – in order to arrange for compliance.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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