



Cornell University
Law School

Lawyers in the Best Sense

WILLIAM A. JACOBSON
Associate Clinical Professor of Law

657 Myron Taylor Hall
Ithaca, New York 14853-4901
T: (607) 255-1243
F: (607) 255-3264
E: wja23@cornell.edu

May 10, 2011

(Via Email: pubcom@finra.org)

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

**RE: Regulatory Notice 11-14
Proposed New FINRA Rule 3190 (Use of Third-Party Service Providers)**

Dear Ms. Asquith,

The Cornell Law Securities Clinic ("the Clinic") welcomes the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") proposed FINRA Rule 3190 ("Rule Proposal"). The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see <http://securities.lawschool.cornell.edu/>.

The Rule Proposal provides that member firms are not relieved of their obligations to comply with all applicable securities laws and regulations and industry rules when they outsource activities or functions to third party service providers. The Rule Proposal mandates that member firms maintain a supervisory system for outsourced functions and activities, including conducting ongoing due diligence to ensure that third-party service providers are capable of performing the outsourced activities and that members firms can achieve compliance with applicable securities laws and regulations and FINRA and Municipal Securities Rulemaking Board ("MSRB") rules. The Rule Proposal contains special restrictions and oversight and notification requirements applicable only to clearing or carrying members.

The Clinic strongly supports the Rule Proposal. Currently, no FINRA rules clearly address the issue of firms outsourcing activities and functions to third-party service providers. The closest FINRA has come to issuing any substantive guidance on the issue of outsourcing is *Notice to Members 05-48* ("NtM 05-48"). *NtM 05-48* informed firms that a member who outsources activities as "part of its business structure" must make certain,



under NASD Rule 3010, that the member's supervisory system and written procedures include procedures regarding its outsourcing practices designed to ensure compliance with applicable securities laws and regulations and FINRA rules.¹ NASD Rule 3010 itself makes no mention of outsourcing arrangements. Rule 3010 requires only that members establish a supervisory system and written supervisory procedures that are appropriately tailored to members' business structures.²

Two cases from recent years of firms failing to adequately supervise third-party service providers under Rule 3010 highlight the necessity of the Rule Proposal. In 2010, FINRA fined PlanMember Securities Corporation for failing to have *any* supervisory system in place to monitor a third-party vendor's breakpoint determination for the firm's mutual fund customers.³ Similarly, FINRA fined Citibank Global Securities, UBS Securities, and Deutsche Bank Securities in 2009 for failing to adequately supervise the outsourcing of communications with customers about the sale of securities in the initial public offering of Vonage, LLC in May 2006.⁴ Although the firms had some supervisory procedures in place, the inadequacy of those procedures was of such a magnitude that when the outsourcing firm sent out an incorrect communication to customers, none of the firms knew what information had been communicated to their customers or how many customers received incorrect communications.

Collectively, these two cases demonstrate the problems that result from having no specific rules for firms to follow regarding the nature of their obligation to supervise third-party service providers or the type of supervisory systems and procedures they should have in place. The Rule Proposal solves both of these deficiencies. Proposed Rule 3190(a)(1) makes clear that member firms cannot use outsourcing, under any circumstances, as an excuse to relieve themselves of their obligation to comply with federal securities laws and regulations and industry rules. Nor may firms, under the Rule Proposal, delegate away their responsibilities for or control over functions and activities performed by third-parties or delegate away their responsibilities for or control over outsourced functions and activities, as

¹ See National Association of Securities Dealers, *NtM 05-48, Members' Responsibilities When Outsourcing Responsibility to Third-Party Service Providers* (July 2005), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014735.pdf>.

² NASD Rule 3010(a)-(b); see also National Association of Securities Dealers, *NtM 99-45* (June 1999), available at <http://www1.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p004311.pdf>.

³ FINRA, *Disciplinary and Other FINRA Actions 11* (June 2010), <http://www.finra.org/web/groups/industry/@ip/@enf/@da/documents/disciplinaryactions/p121625.pdf>.

⁴ FINRA, *FINRA Fines Citigroup Global Markets, UBS and Deutsche Bank \$425,000, Orders Customer Restitution for Supervisory Failures in Vonage IPO*, Sept. 22, 2009, <http://www.finra.org/Newsroom/NewsReleases/2009/P120014>.

PlanMember Securities and the firms involved in the Vonage initial public offering seemed to do.

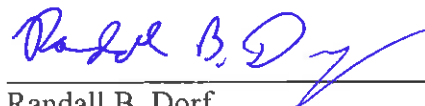
Regarding supervisory systems and procedures, the Rule Proposal puts firms on notice that they need to closely monitor and account for the activities performed on their behalf by outside entities. The Rule Proposal provides firms with a clear mandate that they must institute a supervisory system with written procedures for *any* outsourced activity or function, much as firms must for their own internal activities under NASD Rule 3010. These procedures include a detailed ongoing due diligence competent requiring firms to continuously assess the ability of third-party service providers to perform or prospectively perform an outsourced activity and the firm's own ability to achieve compliance with all applicable laws, regulations, and rules. The combination of supervisory and written procedures with an explicit requirement to perform ongoing due diligence should prevent firms from shirking their responsibilities as the firms in the two above cases did.

At a time when member firms are increasingly relying on outside entities to perform a variety of activities and functions related to their business operations, the need to ensure that member firms adequately supervise and are accountable for the work performed for them by outside entities is readily apparent. The continual failure of firms to provide adequate supervision under the existing rules and guidance mandates the need for new rule that specifically and clearly addresses members' responsibilities regarding outsourcing arrangements. Thus, the Clinic strongly urges FINRA to promptly file the Rule Proposal with the SEC.

Respectfully Submitted,



William A. Jacobson, Esq.
Associate Clinical Professor of Law
Director, Cornell Securities Law Clinic



Randall B. Dorf
Cornell Law School, Class of 2012