



June 22, 2018

**Via Electronic Mail ([pubcom@finra.org](mailto:pubcom@finra.org))**

Ms. Jennifer Piorko Mitchell  
Office of the Corporate Secretary  
Financial Industry Regulatory Authority  
1735 K Street, NW  
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-10 | FINRA Requests Comment on the Effectiveness and Efficiency of Its Carrying Agreements Rule (FINRA Rule 4311)

Dear Ms. Mitchell:

The Clearing Firms Committee (“Committee”) of the Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup> submits this letter to the Financial Industry Regulatory Authority, Inc. (“FINRA”) in response to FINRA’s request for comment on the effectiveness and efficiency of its carrying agreements rule, FINRA Rule 4311 (“Rule 4311”).<sup>2</sup> The Committee appreciates the opportunity to provide FINRA with insights whenever it undertakes a review of existing rule requirements, and applauds FINRA’s initiative to evaluate the current state of its clearing arrangement oversight. As an overall observation, the Committee notes that while the four corners of Rule 4311 are generally black and white, the application of the rule by FINRA examiners, and the reference to the rule in the context of other rule interpretations and guidance, has colored Rule 4311 gray in many cases.

While the purpose of this letter is to provide FINRA with general observations regarding the experiences of our clearing firm members with the application of Rule 4311, this letter is also meant to initiate a multi-faceted dialogue with FINRA regarding Rule 4311. In recognition of the central role that clearing arrangements have in the securities markets, we believe that a series of in-depth, follow-up discussions with FINRA are vital in order to provide FINRA with a holistic understanding of the impact that its oversight has on clearing firms and the introducing firms that

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<sup>1</sup> SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over \$2.5 trillion for businesses and municipalities in the U.S., serving clients with over \$20 trillion in assets and managing more than \$67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

<sup>2</sup> FINRA Regulatory Notice 18-10, Retrospective Rule Review; FINRA Requests Comment on the Effectiveness and Efficiency of Its Carrying Agreements Rule (March 23, 2018).

use their services. In the interim, below we provide some initial observations on how Rule 4311 has been applied that we anticipate will result in further dialogue with FINRA regarding the rule.

**1. *Is the rule effective in ensuring clear allocation of responsibilities between parties to a carrying agreement? If not, why not? Are there additional responsibilities that the rule should specifically require to be allocated? Are there responsibilities that the rule should not permit to be allocated? Why?***

As a general matter, FINRA Rule 4311 has been effective in providing introducing firms and clearing firms the flexibility to allocate responsibilities among themselves. This has particularly been the case in situations where Rule 4311 does not specifically impose requirements that must be allocated, or when new regulatory requirements are such that introducing firms and clearing firms must determine among themselves the most appropriate and effective means of allocating new responsibilities.

At the same time, however, issues regarding the allocation of responsibility often manifest themselves during regulatory inquiries of both types of firms. With respect to clearing firms, they often experience situations where FINRA examination staff take the view that clearing firms (i) have *de facto* responsibility for issues that are not expressly allocated in a clearing agreement and (ii) are responsible for performing regulatory and compliance oversight of the introducing firms with which they do business in a manner that serves as a proxy to FINRA's oversight responsibilities. For instance, while FINRA Rule 4311(c)(2) states that carrying firms are responsible for the safeguarding of funds and securities for the purposes of Rule 15c3-3 of the Exchange Act, paragraph (c)(1) indicates that the clearing firm and the introducing firm can allocate responsibilities regarding the receipt and delivery of funds and securities. FINRA examination staff appear to read into these provisions a requirement that clearing firms take extra measures to ensure that an introducing firm's instructions and customer authorizations that impact the receipt and delivery of funds and securities are valid notwithstanding that a clearing agreement may allocate these responsibilities to the introducing firm. This position, taken to an extreme, has gone so far as to suggest that a clearing firm is responsible for reimbursing an introducing firm's customer when an introducing firm makes mistakes in connection with a function specifically allocated to that introducing firm.

Another example where FINRA examination staff appear to impose additional requirements on clearing firms is with respect to various self-regulatory organization ("SRO") rules<sup>3</sup> that require a broker-dealer to determine whether a customer is an employee of the SRO, and if so, to take certain additional measures. Although the opening and approval of accounts is often allocated to introducing firms per Rule 4311(c)(1)(A), and introducing firms are in the best position to know their customers for purpose of FINRA Rule 2090 and the customer identification program rule in 31 C.F.R. §1023.220, clearing firms often encounter FINRA examination staff making the determination that the clearing firm is responsible for this aspect of the SRO Employee Rules.

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<sup>3</sup> See, e.g., FINRA Rule 2070(a); New York Stock Exchange Rule 407(a); Nasdaq Stock Market Rule 2070A(a); Investors' Exchange LLC, Rule 6.180(a); Chicago Stock Exchange, Article 8, Rule 6; Chicago Board Options Exchange Rule 9.17; BOX Options Exchange Rule 4120 ("SRO Employee Rules").

The large options position reporting (“LOPR”) rule is another example of FINRA examination staff imposing obligations on clearing firms even though information necessary to comply with certain LOPR obligations sits with the introducing firms. Specifically, because the introducing firms have the customer-facing relationship, clearing firms often do not have the information to report accounts that are “acting in concert.” Nevertheless, FINRA examination staff often expect that the clearing firms will have such information.

Because we believe that the issues mentioned above represent a relatively small sample of issues under Rule 4311, we welcome the opportunity for further dialogue with FINRA on ways to address these and other concerns, such as through dedicated forums, engagement with clearing firms prior to the development of proposed regulatory requirements, and other avenues.

***2. Has the rule served its intended purposes? To what extent have the original purposes of and need for the rule been affected by subsequent changes to the markets, the delivery of financial services, the applicable regulatory framework or other considerations? Are there alternative ways to achieve the goals of the rule that FINRA should consider?***

FINRA Rule 4311 has generally served its intended purpose of providing a framework for allocating responsibilities between clearing firms and introducing firms. That said, changes in the markets, in the way that financial services are delivered, and in the applicable regulatory framework have caused clearing firms and introducing firms to reevaluate the allocation of responsibilities.

An example, where clearing firms and introducing firms have struggled in determining appropriate allocations among themselves involves new technological developments that ultimately present some sort of risk to both types of firms. For instance, cyber fraud, hacking, network security, and information technology security represent areas that are not entirely amenable to allocation, since both parties to a clearing arrangement would need to have adequate protections in place. However, the lack of clear regulatory requirements in this space often results in FINRA examination staff expecting that clearing firms will require certain information technology security standards of introducing firms.

We also note that there has been confusion on the part of introducing firms regarding their books and records obligations under Rules 17a-3 and 17a-4 of the Exchange Act, and FINRA Rule 4511. Although all broker-dealers have independent recordkeeping obligations, often times introducing firms (and in some cases FINRA staff) take the view that clearing firms also serve as a service bureau for the maintenance of the introducing firm’s records even though the clearing agreements do not call for such an allocation, and the processes outlined in Rule 17a-4(f) and (i) required of the introducing firm have not been satisfied. While these comments regarding recordkeeping requirements are meant to be illustrative, we also note that there have been and will continue to be issues around “write-once, read-many” or WORM record keeping requirements that are beyond the scope of this letter. In this regard, we refer FINRA to an SEC rulemaking petition submitted by various trade associations asking that the SEC adopt a principles-based recordkeeping approach

for broker-dealers similar to the Commodity Futures Trading Commission's approach for entities under its jurisdiction.<sup>4</sup>

As previously mentioned, while we believe that this retrospective presents a great opportunity to address interpretive and implementation issues that have arisen over the years, and we look forward to working through these issues in follow-up discussions with the FINRA staff, the examples outlined above are meant to be illustrative rather than an exhaustive list of all such issues that arise in clearing arrangements. We do believe, however, that having a mechanism whereby FINRA consults with clearing firms at the initial stages of proposed rulemakings and/or the issuance of FINRA interpretive guidance that are reasonably likely to impact clearing arrangements can further the goals that FINRA Rule 4311 is intended to achieve. In addition, forums with FINRA where firms can regularly communicate issues that they are experiencing would help level-set expectations for all parties to a clearing arrangement so as to avoid subsequent issues arising during an examination that may not be communicated to other similarly situated firms in a timely manner. Two types of forums that seem promising for these purposes are the recently conducted FINRA Clearing Firm Roundtable and the newly enacted Clearing Firm Advisory Committee. These types of forums could permit more granular discussions regarding, for example, FINRA's rulemaking initiatives or changing internal FINRA perspectives.

***3. What has been your experience with implementation of the rule, including any ambiguities in the rule or challenges to complying with it?***

As previously mentioned, ambiguities in the rule's application are varied and broad in scope, and can often arise in connection with new SEC and FINRA rulemaking or interpretations. Rather than catalogue these issues here, we believe that an alternative way to discuss these ambiguities is through regular forums between FINRA and clearing firms.

***4. What has been your experience with FINRA's approval process for carrying agreements and changes to carrying agreements? What modifications to the process, if any, would be appropriate? Why?***

Overall, clearing firms have viewed the approval process for carrying agreements favorably. In particular, clearing firms have responded positively to the 10-day approval process for new clearing relationships with introducing firms when using a clearing firm's pre-approved template.

***5. The rule sets forth specified requirements with respect to the furnishing of reports by the carrying firm to the introducing firm. Are these requirements effective? What modifications, if any, would be appropriate? Why?***

We believe that paragraph (h) of Rule 4311 is unnecessary and should be eliminated in light of current processes that clearing firms and introducing firms use to implement their respective controls and supervise their businesses. Clearing firms continuously make available to introducing

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<sup>4</sup> See Petition for Rulemaking to Amend Exchange Act Rule 17a-4(f) from SIFMA, the Financial Services Roundtable, Futures Industry Association, International Swaps and Derivatives Association, and the Financial Services Institute dated Nov. 14, 2017, available at <https://www.sifma.org/resources/submissions/sec-electronics-recordkeeping-requirements/>.

firms various supervisory resources in the normal course of business through the clearing firm's platform and advise introducing firms of these resources beginning at the onboarding phase and on a regular basis thereafter. Further, while clearing firms do currently provide introducing firms with notice regarding the availability of pre-formatted reports as contemplated by Rule 4311(h), the clearing business and its associated technologies have matured since the time that the operative provisions of Rule 4311(h) were first developed. While the rule is clear that clearing firms are under no obligation to provide any reports, some clearing firms provide introducing firms with a wider assortment of tools, both detective, as in the case of exception reports and real-time alerts, and preventive, as in the case of rules engines and data sets that can be used to help introducing firms with their supervisory and regulatory responsibilities. For example, some clearing firms provide introducing firms with tools by which they can download relevant raw data for the purpose of creating their own reports for internal use, to respond to regulatory inquiries, or to use as part of their supervisory processes. Many clearing firms also provide introducing firms with tools which allow them to conduct a supervisory review prior to the processing of a transaction. Frequently, clearing firms provide on-line methods that allow introducing firms to access such information through intranets, search engines, and other methods. For these reasons, we believe that the need for the rigid notice of exception reports and other requirements set forth in paragraph (h) are no longer aligned with how clearing and introducing firms work together on these items, and the way information is delivered to introducing firms.

***6. To what extent does the rule impact the availability of clearing services to small firms? How could the rule or FINRA's approval process be changed to help small firms obtain access to clearing consistent with investor protection?***

While business and risk considerations may come into play for clearing firms when determining whether to onboard a particular introducing firm, the Committee does not believe that the rule, by itself, necessarily impacts the availability of clearing services to small firms. Separately, SIFMA surveyed members of the SIFMA Private Client Small Firms Committee ("Small Firms Committee") on this particular question. The responding members of the Small Firms Committee did not identify any concerns other than requesting more clarification regarding indirect participants to clearing arrangements.

***7. What are the challenges for small firms in coordinating with clearing firms to respond to regulatory inquiries or to assist their customers? How could these challenges be addressed by FINRA consistent with investor protection? Are there uniform templates or formats that could be used to increase the efficiency of such coordination?***

In our experience, smaller firms often face challenges when responding to FINRA regulatory requests for information because of the formats in which FINRA seeks this information. From a procedural perspective, we believe that it would be useful for FINRA, in coordinating with firms, to request information in a uniform manner, including through the use of templates or specific formats. We believe that these small changes can help firms more efficiently allocate their limited resources to more pressing business and compliance matters rather than devoting resources to, for example, re-formatting reports received from a clearing firm, or having the clearing firm create numerous different formats, in order to meet specific formatting requests for different introducing firms from FINRA staff.

One responding member of the Small Firms Committee indicated that its clearing firm is very responsive to the small firm's requests for regulatory inquiries, going to so far to ask that the small firm identify "regulatory" requests in order to give them priority. That small firm further stated, however, that as requests need to go into the clearing firm's queue, turnaround times for requested materials can be an issue, which may require a small firm to make such regulatory-related requests early in the examination process when such requests are typically made. This small firm further stated that depending on the information requested by FINRA examination staff, compiling the respective data in an automated report and organizing it into FINRA's desired format within the prescribed request window can be challenging. The small firm also stated that the challenges small firms face with data requests could be greatly resolved if FINRA were to standardize its routine data requests nationwide. These standard data file templates could be provided to all clearing firms so that introducing firms could quickly and easily access them for routine retrieval and production. Many of these problems and delays can be fully resolved if FINRA, in consultation with clearing firms, were to standardize data file requests.

In addition, another small firm indicated that clearing firms should have extensive knowledge and understanding of FINRA rules and be prepared to be as cooperative as possible in assisting with responding to regulatory requirements. This firm further stated that any challenges faced by small firms can be resolved if FINRA were to understand the requirements of a small firm and implement targeted rules addressing their needs.

***8. With respect to "intermediary" or "piggyback" clearing, does the rule and approval process provide sufficient flexibility and clarity to establish such clearing arrangements? What, if any, changes should be made to the rule and process to accommodate such arrangements consistent with investor protection?***

The Committee recognizes that intermediary or "piggy-backing" arrangements is a way smaller firms can access the services of clearing firms. In this regard, while the documentation and processes that clearing firms, introducing firms, and piggybacking firms use for these arrangements is well established, we believe that there would be an increased willingness on the part of clearing firms to consider taking on these arrangements from a risk perspective, if FINRA codified that the primary introducing firm has due diligence and supervisory responsibilities for the arrangement. Doing so can help alleviate some potential inefficiencies and risk concerns that some clearing firms may experience when considering whether to enter into these types of arrangements.

Of the responding firms from the Small Firms Committee, one stated that the piggybacking arrangements were not a problem for them. The other, however, indicated that Rule 4311 was vague on these types of arrangements, and as such, the rule and approval process do not provide sufficient flexibility and clarity to establish such clearing arrangements. On this note, this firm further stated that these concerns could be alleviated by clarifying and designing the rule to accommodate these types of relationships.

**9. *What have been the economic impacts, including costs and benefits, arising from FINRA's rule? Have the economic impacts been in line with expectations described in the rulemaking? To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models? Has the rule led to any negative unintended consequences?***

This question is difficult to answer absent a specific proposal from FINRA because any economic data points at this juncture would be purely speculative. As such, we believe that this question is better addressed through a different forum in which FINRA and firms can discuss issues or concerns with specificity, including any related economic impacts.

**10. *Can FINRA make the rule, interpretations or attendant administrative processes more efficient and effective? If so, how?***

As mentioned above, one of the most significant steps that FINRA could take to increase the efficiency and effectiveness of FINRA Rule 4311 would be to initiate a dialogue with clearing firms before significantly developing the operative provisions of any rules, interpretations, or FAQs that could directly or indirectly impact the operations and risk models of clearing firms. We acknowledge and welcome FINRA's outreach to the industry and the recent formation of the Clearing Firm Advisory Committee. We are optimistic that through these activities, FINRA can become aware of any potential implementation issues at an earlier stage of the rulemaking process, avoid delays in implementing the desired rulemaking, and avoid inadvertently causing significant and unintended operational challenges for clearing firms.

***In addition to comments responsive to these questions, FINRA invites comment on any other aspects of the rule that commenters wish to address.***

As we consider the impact of Rule 4311, we would be remiss if we did not express that FINRA's prior change to its arbitration rules limiting the ability for clearing firms to be dismissed from arbitrations where claimants' counsel seeks to hold clearing firms vicariously liable for the acts/omissions of introducing firms simply by virtue of carrying their accounts. This adversely impacts the risk model of the clearing business, thereby harming the industry and the end customers. Current FINRA arbitration rules prohibit the clearing firm from filing a pre-hearing motion to dismiss except under rare circumstances. These rules force clearing firms to expend resources and time defending arbitrations based on allegations which implicate only obligations exclusively allocated to the introducing firms under the clearing agreement pursuant to Rule 4311. We believe this liability undercuts the overall effectiveness of Rule 4311, which is intended to clearly allocate responsibilities between a clearing firm and introducing firm. We are hopeful that as part of this retrospective review, we can further work with FINRA on a means to address the concerns raised by this FINRA arbitration rule and its impact on Rule 4311.

In addition to our comments above, we also would like to mention that while FINRA Rule 4311 and related interpretations are focused on the allocation of responsibilities in connection with entering into and maintaining an ongoing clearing arrangement, the rule provides less clarity when it comes to a clearing arrangement's end-of-life phase. This occurs when an introducing firm ceases doing business, changes clearing firms, or change structures (e.g., from a broker-dealer to

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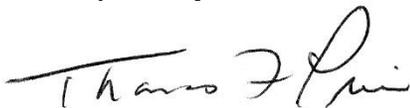
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an investment adviser). One of the significant issues is orphaned accounts.<sup>5</sup> Orphaned accounts are customer accounts that are “orphaned” and left at a clearing firm after the introducing firm responsible for servicing the account has severed its relationship with the clearing firm. These accounts become the responsibility of the clearing firm and the account holders no longer have access to the services of an investment professional. This limits the ability of the account holder to access the securities markets. There are a number of reasons that an account can become orphaned. These include: (1) the introducing firm’s new clearing firm rejecting certain types of assets or specific accounts; (2) the new clearing firm may not accept certain account types; and (3) accounts may remain with a clearing firm due to the action or inaction of a client as it relates to a request to move that customer’s account. We believe FINRA should consider whether additional amendments to the rule should be implemented that address the responsibilities of the introducing firm and potential new options that clearing firms have with respect to orphaned accounts. Measures could include giving clearing firms the flexibility to transfer these orphaned accounts via negative consent to another broker-dealer on its platform with qualified and licensed staff able to provide account holders with service and access to their account as well as the trading markets. As with other more granular issues mentioned above, this topic is probably best addressed through additional conversations with FINRA in another forum.

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SIFMA appreciates the opportunity to provide insights to FINRA as it evaluates FINRA Rule 4311, and we would be happy to discuss these comments in greater detail with the FINRA and its Staff. If you have any questions, please contact me (at 212.313.1260 or [tprice@sifma.org](mailto:tprice@sifma.org)) or William Leahey (at 212. 313.1127 or [wleahey@sifma.org](mailto:wleahey@sifma.org)).

Respectfully submitted,



Thomas F. Price  
*Managing Director*  
Operations, Technology & BCP

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<sup>5</sup> SIFMA notes that there is a material difference between an “orphaned” account and an “abandoned” account in common usage. Generally, firms use the term “abandoned” to classify an account for the purposes of state unclaimed property laws. All 50 states and the District of Columbia have adopted unclaimed property laws that require the reporting and remittance (“escheatment”) of various types of intangible property (generally, any obligation to pay money to another person) after such property has remained unclaimed by the owner for a specified period of time (generally, three to five years after the property becomes due and payable to the owner). If a state’s unclaimed property laws apply to a certain type of property, then the “holder” of that property has certain obligations, including (i) to attempt to return the property to the rightful owner (this is called “due diligence”); and (ii) if the owner cannot be located, to report and remit the property to the state. For further information, please see SIFMA’s 2015 Whitepaper on Unclaimed Property here: <http://www.sifma.org/issues/item.aspx?id=8589952727>.

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cc: Kris Dailey, FINRA, Vice President, Risk Oversight & Operational Regulation (ROOR)  
Adam Arkel, FINRA, Associate General Counsel, Office of General Counsel