



May 12, 2011

**VIA ELECTRONIC DELIVERY (pubcom@finra.org)**

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

**Re: FINRA Regulatory Notice 11-14, Third-Party Service Providers**

Dear Ms. Asquith,

This letter is submitted on behalf of the National Society of Compliance Professionals, Inc. (hereafter referred to as the "NSCP")<sup>1</sup> in response to the publication of Regulatory Notice 11-14 (hereafter referred to as the "Notice" or the "Proposal"), which discusses the Financial Industry Regulatory Authority, Inc.'s ("FINRA's") proposed rule 3190, the purpose of which is to clarify the scope of a member firm's obligations and supervisory responsibilities for functions or activities outsourced to a third-party service provider (hereafter referred to as the "Proposed Rule" or the "Rule").<sup>2</sup> We appreciate the opportunity to provide our comments relating to this important proposal.

Our remarks reflect the NSCP's fundamental mission, which is to set the standard for excellence in the securities compliance profession. This commitment is exemplified, among other things, by the time and resources the NSCP, and the industry professionals whose volunteer services it marshals, have devoted in the past three years to the development of a voluntary certification and examination program for compliance professionals.<sup>3</sup>

Our mission is directed at the interests of compliance programs and compliance officers. We accordingly support a regulatory scheme that: (i) promotes practices that support market integrity

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<sup>1</sup> The NSCP is a non-profit membership organization made up of approximately 1800 securities industry professionals committed to developing education initiatives and practical solutions to compliance-related issues.

<sup>2</sup> The Proposed Rule was published by FINRA in Regulatory Notice 11-14 in March 2011.

<sup>3</sup> Persons who complete NSCP's certification program (CSCP) qualify for the "Certified Securities Compliance Professional" designation.

and the interests of investors; (ii) creates clarity as to a firm's obligations to provide a reasonable system of supervision; (iii) promotes requirements that enable compliance officers to create reasonably workable programs; and (iv) avoids requirements or mandated tasks that are more costly or less efficient in realizing a regulator's public policy objectives, thereby increasing the difficulty facing a compliance officer in the discharge of his or her duties.

## **Background**

The National Association of Securities Dealers, Inc. (hereafter referred to as the "NASD") provided its original guidance concerning member firms' obligations with respect to outsourcing arrangements in July 2005 (the "Guidance").<sup>4</sup> The Guidance clarified that firms remain responsible for compliance with all applicable federal securities laws and regulations and self-regulatory rules pertaining to any activity or function outsourced to a third-party service provider. The Guidance provided that members are required to maintain a supervisory system and procedures to ensure qualified personnel monitor these arrangements and that appropriate due diligence is performed prior to, and throughout, the relationship. The Guidance confirmed the approach that had been taken over time with respect to outsourcing arrangements by the NASD and other regulators, including the SEC. We believe the supervision of outsourcing arrangements articulated by the Guidance is sensible and effective in promoting compliance with the securities laws while fostering sound business practices. Firms have operated according to (and have been examined with respect to their compliance with) the Guidance for the past five years.

FINRA now seeks to codify the Guidance through the Proposed Rule. While the NSCP supports this goal in principal, there are certain aspects of the Rule that we do not support. One of our primary concerns relates to the inconsistency of the treatment of persons performing functions that require registration under the Rule with FINRA's recently proposed rule creating a new registration category for "operations professionals."<sup>5</sup> We also believe that the Rule does not give appropriate recognition to outsourcing arrangements with affiliates. Likewise, we find unnecessary and problematic the addition of new restrictions and obligations, not contained in the original Guidance, pertaining to "clearing and carrying" members.

For the reasons discussed in greater detail below, we believe a rule that: (i) clearly assigns responsibility for compliance with applicable FINRA and MSRB rules to the member; (ii) requires the member to perform adequate due diligence over third-party vendors; and (iii) requires the member to establish and maintain procedures to supervise the performance of the outsourced function will enable members to effectively and efficiently achieve compliance with FINRA and MSRB rules. We maintain that FINRA Regulatory Notice 05-48, taken together

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<sup>4</sup> See NASD Notice to Members 05-48, *Members' Responsibilities when Outsourcing Activities to Third-Party Service Providers*, July 2005.

<sup>5</sup> See FINRA Regulatory Notice 10-25, *Registration and Qualification Requirements for Certain Operations Personnel*, May 2010 and SEC Release No. 34-64080; File No. SR-FINRA-2011-013.

with the NASD Rule 3010 supervisory requirements (i.e., the original Guidance), captures these elements. We believe that the Proposed Rule should go no further.

***The Supervisory Requirements of the Proposed Rule are Inconsistent with the Registration and Examination Requirements Contained in FINRA's Proposed Rule 1230(b)(6) Registration and Qualification Requirements for Certain Operations Personnel.***

We believe that FINRA's position with respect to a firm's obligations to supervise, and take responsibility for, the activities of outsourced service providers is inconsistent with FINRA's recently proposed rule 1230(b)(6) regarding registration and qualification requirements for certain operations personnel, in particular its stated intention to impose the operations professional registration requirement on employees of third-parties. As stated above, for the most part, the Notice is accurate in characterizing the Proposed Rule as reiterating a longstanding FINRA position that firms may not outsource supervisory or regulatory responsibility, and that they remain accountable for the activity that outsourced service providers perform on their behalf. The Notice also states that activities that require registration must be performed by registered associated persons of the members, which was also implied, if not expressly stated, in the Guidance. The Notice goes on to state that firms may not delegate functions that they are required, as a regulatory matter, to perform. Although this appears to go further than prior pronouncements, taken together, all of these positions buttress the argument the NSCP has previously made relating to the proposed registration of operations professionals - that FINRA's registration requirements should not extend to persons outside of a firm.<sup>6</sup> By expressly locating supervision and oversight for all outsourced functions within the member and with registered associated persons of the firm, and prohibiting members from outsourcing that supervision and oversight, the Proposal is stating that the mind and management of regulatory required functions cannot reside with third-parties. This logic fully accomplishes the stated goals of the proposed FINRA operations professional registration requirements if that requirement extends only to firm personnel.

The only way the registration requirements of the outsourcing and operations professional proposals can be reconciled is through the provision, contemplated under the Proposed Rule, that permits employees of service providers to be registered as associated persons of the member. While we would endorse such a structure we suggest that, contrary to the statements made in FINRA's proposed registration of operations professionals filing with the SEC, this should be viewed as a very narrow category of persons, and should not extend in the undefined manner set out in that filing, all the way up the management chain of the outsourced service provider.

Notwithstanding, we question what purpose will be served by requiring service provider employees to be registered. Registration itself will not help facilitate firms' supervision of service providers' employees (e.g., registration will not provide a firm additional authority to

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<sup>6</sup> See NSCP's letters in response to FINRA Regulatory Notice 10-25 at <http://www.nscp.org/media/commentletters/comment-07-30-10.pdf> and to SEC File No. SR-FINRA-2011-013 at <http://www.nscp.org/media/commentletters/comment-04-08-11.pdf>.

discipline, and/or terminate the employment of such persons). Indeed, we maintain that the registration requirement would only serve to “muddy the water” with respect to a member’s regulatory responsibility over the outsourced function as firms may assume that the function is being properly supervised by a registered employee of the service provider.

In addition to the massive burden registration of service provider employees will place on firms, there exists the potential for regulatory confusion with respect to those employees that provide services to multiple firms. If such personnel are required to be registered or are deemed associated persons of a member due to the nature of the services they perform, they will need to be associated persons of each member they serve under the provisions of the Rule. Such multiple-registered persons will be subject to the full panoply of supervisory requirements (e.g., review of personal trading, correspondence and outside business activities) of each firm they support.<sup>7</sup> In addition to the supervisory requirements, efficiently and accurately maintaining these registrations will require a member to have clear and continuous visibility into a service provider’s organization in order to determine which individuals require registration and to properly update registrations in response to changes made at the service provider.<sup>8</sup> This will be extremely burdensome and costly for vendors and members alike and will likely result in increased costs that will be passed along to the investing public. Smaller firms with limited resources will struggle to supervise and manage the increased number of registered persons.<sup>9</sup> Some small service providers may be forced out of business. Regulatory personnel may well question how one individual could be capable of effectively performing a registered function for a multitude of member firms.<sup>10</sup> For all the foregoing reasons, we maintain that the registration requirements should not extend to persons outside of the member. The Proposed Rule should be revised to reflect this.

### **Outsourcing Arrangements with Affiliates Should be Treated in a Manner Similar to Clearing Arrangements Under the Proposed Rule.**

The Supervisory requirements contained in the Proposed Rule make no distinction between service providers that are affiliates of the member and those that are independent third-party service providers. The NSCP does not dispute the concept that outsourcing should not be permitted to be used as a vehicle to escape review or regulatory

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<sup>7</sup> Such a scenario may arise, for example, with respect to employees of the Transaction Auditing Group, Inc. (also known in the industry as “TAG”) which provides best execution reporting services for a substantial number of member firms.

<sup>8</sup> To further complicate matters (and the burden on members), this requirement extends to sub-vendor personnel as well.

<sup>9</sup> Also, it is not unusual for smaller firms to be approved for a limited number of associated persons by FINRA. The required registration of service provider employees may cause smaller firms to exceed its permitted number of associated persons.

<sup>10</sup> Also, some states do not permit individuals to be registered with more than one firm. If the registration requirement is not removed from the Proposed Rule, FINRA will need to provide guidance to member firms on this point.

responsibility/accountability simply because the outsourced party is an affiliate (presumably, this is FINRA's intent). The Proposal needs to recognize, however, some clear and critical differences between outsourcing to arms-length third parties and outsourcing to affiliates. This is especially evident under the Dodd-Frank Wall Street Reform and Consumer Protection Act and in the aftermath of the financial services crisis, which underscored the economic interdependence of affiliated financial services entities and reinforced the role of prudential regulation at the holding company level, typically by a regulator other than the SEC.<sup>11</sup>

The NSCP believes that at least two areas of difference between affiliate and third-party outsourcing arrangements must be considered. First, in determining the level of due diligence appropriate for supervising an outsourcing arrangement, the level of familiarity and interaction between affiliate groups should be recognized, and deference accorded to regulatory oversight of the affiliate by financial regulators other than FINRA. In this regard, it is noteworthy that the Proposed Rule substantially reduces, if not eliminates, due diligence obligations on a non-clearing broker-dealer that outsources activities to a clearing firm, yet maintains such obligations with respect to activities outsourced to a regulated affiliate. This logic is counterintuitive. The reality is that a firm will typically have far greater familiarity with the systems, personnel and activities of an affiliate that performs outsourced functions for it than those of a third-party clearing firm. While it is the case that the clearing firm is itself regulated by FINRA, and as a result hopefully performing its activities in compliance with applicable regulatory standards, the same can also generally be said for an affiliate whose activities are subject to oversight by a banking or other regulator. FINRA should afford deference to the oversight of a bank regulator or other oversight authority, in much the same way as the banking regulators accord deference to the SEC and FINRA with respect to the activities of a broker-dealer. Accordingly, we believe that the exception to the requirements of the Rule contained in section 3190(f) should be revised to include affiliated entities subject to regulatory oversight by financial regulators other than FINRA.

Second, it must be acknowledged that, for those members (including most of the larger firms) that are part of consolidated financial services companies, integration or coordination of certain functions of the broker-dealer into the parent bank or holding company is often dictated, not just by the parent, but by the prudential umbrella regulator of the financial holding company. Typically, under these arrangements the personnel who manage or supervise activities for a firm also manage or supervise those activities for banking or other affiliates of a member. Indeed, such personnel may be part of the senior management team of an affiliate (e.g., bank) or affiliate holding company. Any personnel dedicated to a member firm's activities will typically be subordinate to the parent holding company's managers. This structure makes it awkward, if not impossible, to describe firm personnel as supervising or managing the outsourced service. The reporting relationships are in fact reversed -- it is the affiliates (e.g., bank's) personnel who are overseeing the personnel performing the member functions (who organizationally may be employees of the firm, the bank, or the holding company).

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<sup>11</sup> FINRA, of course, has no authority to regulate non-broker-dealer entities.

A telling example often occurs in the credit risk area. It is not only sensible from a business perspective to have a centralized credit risk function managed at the enterprise level, the prudential umbrella regulator of a bank or holding company generally demands it. To state that a firm's margin/credit/finance managers should be required to supervise the credit managers at the bank or holding company level defies common sense and enterprise financial prudence. Indeed, it is not unlikely that the umbrella regulator would deem such a structure to be completely unacceptable. While one way out of this dilemma would be to require the enterprise credit manager to register as an associated person of the member, such an alternative would be inappropriately intrusive and almost certain to be unacceptable both internally within the organization and for the umbrella bank regulator. This issue is even more acute for firms owned by foreign banks, where senior managers of centralized functions are likely to be both employees of the parent bank or bank holding company, and who also reside abroad.

We believe that the appropriate resolution to this issue would be to require that the member have managers that oversee the firm's activities, and the manner in which that function is integrated into the larger financial company's activities, but recognize that it is appropriate to defer to the oversight and management of the enterprise-wide function by the enterprise's prudential umbrella regulator (domestic or foreign). We suggest that an addition to the supplementary material would be an effective way to incorporate this concept into the Rule.

**The Due Diligence Requirements, Particularly with Respect to Sub-Vendors, are Burdensome and Unfair.**

Section 3190(b) of the Proposed Rule requires that members' supervisory procedures relating to outsourcing arrangements include ongoing due diligence analysis of service providers (including any sub-vendors). Although the due diligence obligation was part of the original Guidance, the Proposed Rule imposes a more formal structure. The obligation to perform due diligence on sub-vendors is new. We believe that the specific inclusion of sub-vendors is unnecessary and will create a whole new level of required due diligence where none may be necessary. This will result in additional cost, expense and time that some firms will be unable to provide.

We also believe that the formal structure as currently set forth in the Rule will unfairly disadvantage larger consolidated financial services firms who typically have multiple business lines that may have separate relationships with vendors. The vendors may well provide services both to the member and its affiliates. In order to effectively comply with the requirements of the Rule, large firms will be forced to centralize the administration of their outsourcing relationships to coordinate the management and supervision of service providers, at potentially great expense. Smaller firms with fewer business lines and service provider relationships will find it easier to manage outsourced relationships without the need to centralize. We believe that the due diligence requirements as set forth in the original Guidance are clear and provide both large and small firms the flexibility to effectively manage and supervise outsourcing relationships as they see fit and that the additional requirements of the Proposed Rule (including those relating to sub-vendors) are not necessary and should be removed from the Rule.

**The Additional Restrictions and Obligations Applicable to Clearing and Carrying Firms Are Unnecessary and Should be Removed from the Proposed Rule.**

Three sections of the Rule, 3190(c), (d) and (e), impose additional requirements and restrictions on clearing and carrying firms that were not part of the original Guidance. As stated above, and for the reasons discussed below, we believe that these additional requirements are not necessary. As previously stated, assuming a member firm: (i) conducts proper due diligence prior to entering into an arrangement with a third-party service provider; (ii) has in place a clearly defined agreement; and (iii) has procedures related to the oversight and monitoring of the service provider, all of which are mandated under the original Guidance, we believe that the additional restrictions and obligations contained in sections (c), (d) and (e) of the Rule are simply not necessary and should be removed from the Proposed Rule.

**The Provisions of the Proposed Rule that Mandate Firms to Have Procedures that Require a Member to Approve Transfer of Duties to a Sub-Vendor and that Enable a Member to Take Prompt Corrective Action to Achieve Compliance are Unnecessary and will be Extremely Costly and Burdensome.**

Section 3190(d) of the Rule requires clearing and carrying members to have procedures in place that: (i) enable the member to take prompt corrective action with respect to activities performed by service providers to achieve compliance with applicable rules; and (ii) require member approval of the transfer of duties by the service provider to a sub-vendor. While the Notice states that the Rule “does not necessarily require a clearing or carrying member firm to alter any contracts with its third-party service providers,” it is clear that these additional requirements will obligate firms to review and possibly renegotiate their agreements with service providers in order to comply with the provision. It is highly unlikely, for example, that a vendor will permit a firm to approve (or disapprove of) any transfer of duties to a sub-vendor absent a contractual obligation to do so. The review and renegotiation of service provider contracts will be extremely burdensome and unfair to smaller firms in particular, who have fewer resources. Furthermore, the inclusion of sub-vendor approval provisions will seriously impede a service provider’s ability to efficiently conduct their business. We believe this requirement is unnecessary. As previously stated, FINRA’s objective of ensuring appropriate supervision of outsourced functions would be achieved by the codification of the original Guidance.

**The Requirement that Clearing and Carrying Firms Notify FINRA of Outsourcing Agreements and Arrangements is Burdensome and Unnecessary.**

Section 3190(e) of the Proposed Rule requires clearing and carrying firms to notify FINRA within 30 days after entering into an outsourcing agreement. Clearing and carrying firms must also notify FINRA of all existing outsourcing arrangements within three months of the effective date of the Rule. FINRA provides no explanation, whatsoever, as to why this data is necessary or what it plans to do with the information. This requirement will place a tremendous burden on clearing and carrying members, especially smaller firms with limited resources. We believe that this requirement is unnecessary and burdensome and should be removed from the Rule. This is

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especially true given that FINRA has alternative means to collect this information through its examination and market surveillance functions.

## Conclusion

In summary, for the reasons stated above, we believe that FINRA's overall objectives of providing clarity to members and addressing risks related to outsourcing arrangements would be achieved by a rule that is substantially more narrow and defined than the Rule as currently proposed. We urge FINRA to consider our recommendations, i.e., clarify the registration requirements, recognize the status of outsourced functions to affiliates, eliminate the additional restrictions and obligations relating to clearing and carrying firms and limit the Proposed Rule to a codification of FINRA's original Guidance contained in Notice to Members 05-48 and NASD Rule 3010. The NSCP appreciates the opportunity to provide its comments on the Proposal and hopes FINRA finds them constructive and useful.

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Thank you for your attention to these comments. Questions regarding the foregoing should be directed to the undersigned at 860.672.0843.

Very Truly Yours,

A handwritten signature in black ink, appearing to read 'Joan Hinchman', with a long horizontal line extending to the right.

Joan Hinchman  
Executive Director, President and CEO

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