

VIA ELECTRONIC MAIL

May 13, 2011

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

RE: Regulatory Notice 11-14 – Third-Party Service Providers

Dear Ms. Asquith:

On March 29, 2011, the Financial Industry Regulatory Authority (FINRA) published Regulatory Notice 11-14¹ (RN 11-14) requesting comment on a proposed FINRA Rule governing obligations and supervisory responsibilities regarding outsourcing arrangements (Proposed Rule). The Financial Services Institute (FSI)² welcomes this opportunity to comment on the Proposed Rule. We appreciate FINRA's efforts to enact rules related third-party service providers that codify established FINRA guidance. In fact, we understand that independent broker-dealers are already complying with the spirit of the Proposed Rule. As a result, we are supportive of FINRA's objectives in offering the Proposed Rule.

However, we do have concerns with certain aspects of the Proposed Rule. Specifically, we would like additional prescriptive guidance related to subsections (a) and (b) of the Proposed Rule. We also urge FINRA to make the Proposed Rule clearer, less ambiguous, and more precise by breaking it into two separate rules - one for clearing firms, and one for all broker-dealers. Additionally, we believe that subsection (b) should recognize the important distinction between an affiliated and non-affiliated third-party service provider. Finally, we would like additional guidance related to the due diligence of subvendors when there is no privity of contract between the member and the subvendor. These concerns are described and discussed in more detail below.

Background on FSI Members

FSI represents independent broker-dealers (IBD) and the independent financial advisors that affiliate with them. The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered

¹ See FINRA Regulatory Notice 11-14, available at

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123398.pdf>.

² The Financial Services Institute is an advocacy organization for the financial services industry – the only one of its kind – FSI is the voice of independent broker-dealers and independent financial advisors in Washington, D.C. Established in January 2004, FSI's mission is to create a healthier regulatory environment for their members through aggressive and effective advocacy, education and public awareness. FSI represents more than 125 independent broker-dealers and more than 16,000 independent financial advisors, reaching more than 15 million households. FSI is headquartered in Atlanta, GA with an office in Washington, D.C.

investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees, of their affiliated broker-dealer firm.³ These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically “main street America” – it is, in fact, almost part of the “charter” of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.⁴ Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients’ investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI’s mission is to ensure our members operate in a regulatory environment that is fair and balanced. FSI’s advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

Comments on the Proposed Rule

As stated above, we appreciate FINRA’s efforts to enact rules that codify established guidance on third-party service providers. However, we have concerns related to certain aspects of the Proposed Rule. Specifically, we would like additional guidance related to subsections (a) and (b) of Proposed Rule 3190. We also believe that the Proposed Rule would be easier to interpret if it were broken out into two separate rules - one for clearing firms, and one for all member firms. Additionally, we believe that subsection (b) should reflect the important distinction between an affiliated and non-affiliated third-party services provider of a member firm. Finally, we would like additional guidance related to due diligence of subvenders when there is no privity of contract between the member and the subvendor. These concerns are addressed in more detail below.

- **Prescriptive Guidance Needed** – Subsections (a) and (b) of Proposed Rule 3190 set forth principal based regulation that is outcome-focused rather than detailed rules that prescribe how the outcome should be achieved. We compliment FINRA on taking this approach and deferring to member firms on how to achieve compliance with the desired outcome of the Proposed Rule – increased supervision of third-party services providers. However, given the prescriptive and rules based approach that FINRA has taken in the

³ Cerulli Associates at <http://www.cerulli.com/>.

⁴ These “centers of influence” may include lawyers, accountants, human resources managers, or other trusted advisors.

past in developing the FINRA Rulebook, we believe that there is the possibility for regulatory challenges related to a firm's attempts to comply with the Proposed Rule.

As FINRA attempts to transition to principal based regulation, we believe that it would be helpful to provide member firms with additional guidance or examples of how to achieve compliance with the Proposed Rule. This guidance does not need to be contained in the Proposed Rules; rather it can be included in supplementary material to the Proposed Rule, or in another suitable location. We believe that providing these examples will alleviate fears of members and will ensure that they are properly supervising third-party service provider. Accordingly, we encourage FINRA to adopt a principles based approach, but urge FINRA to provide examples of how to achieve compliance with the Proposed Rule.

- **Two Separate Rules** – As currently written, Proposed Rule FINRA Rule 3190 has six subparts (a – f), and is titled “Use of Third-Party Service Providers.” Subsection (a), is titled General Requirements, subsection (b) is titled Due Diligence Analysis of Third-Party Service Providers, and subsection (f) is titled Exceptions. These three subsections appear to have universal application to all FINRA member firms, regardless of their clientele or business model. Subsection (c) is titled Restrictions Applicable to Clearing or Carrying Members, subsection (d) is titled Oversight of Third-Party Services Providers by Clearing or Carrying Members, and subsection (e) is titled Notification by Clearing or Carrying Members. These three subsections appear to have limited application to clearing and carrying FINRA members.

In light of the limited application of subsection (c – e) of Proposed FINRA Rule 3190, we urge FINRA to create two separate rules, rather than one rule that has provisions that are inapplicable to the majority of FINRA's membership. We believe that this approach will create greater clarity for broker-dealers. Moreover, it will reduce potential ambiguities in the application of Proposed FINRA Rule 3190.

- **Affiliated and Non-Affiliated Due Diligence** – Subsection (b) of the Proposed Rule provides:

“[t]he [supervisory systems and written] procedures required by paragraph (a)(2) shall include an **ongoing due diligence analysis of each current and prospective third-party service provider** (including any subvendor) to determine, at a minimum, whether: (1) the third-party service provider (including any sub-vendor) is capable of performing the activities being outsourced; and (2) the member can achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules with respect to any functions or activities being outsourced.” (Emphasis added)

The Proposed Rule does not reflect the important distinction between affiliated and non-affiliated third-party service providers. We urge FINRA to note in Supplementary Material to the Proposed Rule that the greater transparency and free information flow broker-dealers are likely to experience with an affiliated third-party service provider is a factor that can be considered in developing appropriate supervisory systems.

- **Due Diligence on Subvendors** – As mentioned above, Subsection (b) of the Proposed Rule provides:

“[t]he [supervisory systems and written] procedures required by paragraph (a)(2) shall include an ongoing due diligence analysis of each current and prospective third-party service provider_ **(including any subvendor)** to determine, at a minimum, whether: (1) the third-party service provider (including any sub-vendor) is capable of performing the activities being outsourced; and (2) the member can achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules with respect to any functions or activities being outsourced.” (Emphasis added)

Although the Proposed Rule sets forth the obligation for member firms to conduct due diligence on all third-party service providers, the Proposed Rule does not address the practical situation where members are not in privity of contract with a subvendor. For example, if an introducing broker-dealer enters into a Clearing Agreement with a clearing firm, and the clearing firm entered into an agreement with vendor to conduct a function within the clearing firm, what are the obligations between the introducing broker-dealer and the vendor? In these situations, the subvendor is under no obligation to comply with the introducing broker-dealer request for due diligence information.

We believe that members will benefit from additional guidance related to a member’s reliance on the review of the third-party service provider’s due diligence file of their subvendors. We urge FINRA to set forth this guidance in the Proposed Rule and expressly state that a firm can rely on its third-party service provider due diligence files to satisfy the due diligence obligations of the Proposed Rule as they relate to subvendors.

Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to work with you to on the Proposed Rule related to Third-Party Service Providers.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 770 980-8487.