



June 25, 2018

By Electronic Mail to [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, DW 20006-1506

**Re: FINRA Regulatory Notice 18-10:  
DriveWealth, LLC Comment on FINRA Rule 4311 (Carrying Agreements)**

Dear Ms. Mitchell:

DriveWealth, LLC<sup>1</sup> appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") Notice to Members 18-10 (the "Notice"), which requests comment on FINRA Rule 4311 and its effectiveness and efficiency in governing carrying agreements within the securities industry.

DriveWealth, LLC supports FINRA's mission of providing effective oversight of the securities industry and applauds FINRA's self-reflection and proactive review of existing rules to gauge their practicality and relevance in an evolving marketplace.

In this letter, we provide comments on several of the questions asked within the Notice, and detail various aspects of FINRA Rule 4311 (the "Rule") and its importance in delineating responsibility among market participants.

### **Summary Position**

Our position is that FINRA Rule 4311 is relevant and should not be altered in any significant way, which would confound or otherwise impose responsibilities on parties not best positioned to carry out the functions of financial entities operating in a diversified marketplace. DriveWealth believes that Rule 4311, whether formally or through principle guidance, could reasonably be extended to cover the relationship between clearing/custodian firms and registered investment advisors, specifically, to address novel issues developing in today's market due to

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<sup>1</sup> DriveWealth, LLC is a registered clearing/carrying broker-dealer whose investment platform provides emerging wealth management and brokerage counterparties with the flexibility to develop products which will meet the growing demand of investment solutions.



technological advancements. The benefits market participants share by defining responsibilities, is apparent in the brokerage industry, and similar benefits could be recognized in the adviser market. Lastly, while we are in favor of the delegation of responsibilities, we do not feel that Rule 4311 should assign responsibilities to clearing firms, and therefore liability, for activities that are not their own. This is not to say that clearing firms do not have a responsibility to monitor and support the ministerial activities of its customers, rather, with the clarity provided by Rule 4311, and with defined responsibilities, each registered entity should be held accountable for their activities as registered counterparties. By clarifying these responsibilities, each counterparty will be incentivized to fully understand and comply with the rules that govern their business, and contractually accept responsibilities for their business activities.

### **Background**

NYSE Rule 382, and FINRA Rule 4311 have been reviewed and refined since becoming effective, but have largely withstood the test of time because the industry finds it useful. Moreover, it played a role in fostering significant innovation and efficiency within the industry by market participants. The importance of these rules is foundational as they appropriately permit the allocation of duties consistent with the expected roles of market participants which has protected investors, spawned numerous smaller innovative brokers/advisers and permitted clearing firms to specialize in back office operations and other ministerial functions, creating industry shaping efficiency.

The framework for the clearance and settlement system was largely developed in the aftermath of the “paper crunch” crisis of 1967–1970, which highlighted the systemic operational risks that swept the industry, as trading volumes increased and ineffective protocols and weak operational constructs stifled growth. The introduction of computers furnished the automation required to process the increased trading volumes, however, the industry required additional guidance to fulfill the efficiencies created by the diversifying marketplace. Throughout the 1970s, and even more so today, technological advancements have produced efficiencies freeing market participants to take on different roles within the industry, culminating in our current market framework, where firms can operate in focused areas of their own election – specializing in their own business with clear insight as to their responsibilities and exposure.

In 1982, the New York Stock Exchange (“NYSE”) recognized this evolving marketplace and understood the benefits of having certain firms be assigned specific responsibilities (to comply with rule, or best practice) to achieve operational efficiencies necessary to keep pace with growing trading volumes. In



this regard, NYSE Rule 382 was truly a landmark rule and clearly introduced the welcomed concept of allocation of duties to market participants and culled specific disclosure requirements for customers. The specification of responsibilities promulgated within the Rule allowed clearing firms to performed necessary ministerial tasks to bolster the capital markets and to reduced duplicative efforts between firms.

### **How has the market changed and how might Rule 4311 apply?**

DriveWealth believes we are amid a material shift in the marketplace, with the rise of investment related personal financial management (“PFM”) services and robotic passive investment. Technology has supported the development of diverse and innovative wealth management products entering the market. Technology has also allowed non-core securities firms, such as credit lenders, credit unions, HSA providers, automated advisers, and others to build brokerage and advisory products. This is the first material shift - new entrants are building, controlling, owning and servicing investment related technology; where in the past, this technology stack has largely been owned, controlled and deployed by the clearing provider, or 3<sup>rd</sup> party vendors who specialize in technology delivery to financial institutions and professionals. We believe this decoupling of technology ownership gives rise to several potential issues that Rule 4311 could address, such a technology management (e.g. if an investment adviser develops its own technology which integrates with a clearing broker’s technology, but for whatever reason fails to manage a piece of their proprietary technology ultimately impacting a broker responsibility, who is ultimately responsible?). Various legal cases hold, and Rule 4311 suggests, that the broker is accountable, even if the issue did not arise from its own doing. To this end, we believe a principle based adjustment is needed to address the management of technology, and give allowances to clearing brokers who in good faith are providing the services they are responsible for providing, while also holding investment advisers and introducing brokers responsible for their own deployment of technology, and associated delivery of information to customers. While technology has offered this rise in new financial products, it also creates some challenges, which we believe if addressed in Rule 4311, would not only clarify expectations, but also create efficiencies, particularly between brokers and advisers.

Technology has and will continue to mold the marketplace in areas that Rule 4311 will govern. While it is understood Rule 4311 is a broker rule, DriveWealth believes there are many benefits to be gained if this rule were also to contemplate broker-adviser relationships, particularly considering the growing number of advisers being approved by the Commission. By adding SEC registered investment advisers,

formally or through guidance, the efficiencies will mirror the benefits we observed in the brokerage industry.

## **II Rule 4311 is both Prescriptive and Principle based**

The principle based component of Rule 4311 calls for a delegation and allocation of duties and responsibilities. The responsibilities can be broken down into sales/advisory related and operational classifications. In the sales practice areas, the introducing firm/adviser entity is directly in contact and responsible for ensuring supervision, suitability and monitoring the activity of the account. The clearing firm takes on the heavy lifting protecting assets, record keeping, reporting, etc. Both introducing and clearing firms perform functions that are logical and natural. Amendments have been made to the original NYSE 382 that have strengthened exposure. Added were topics on how to handle introducing customer complaints and requirements to list provided compliance oriented reports. Additionally, clearing firms serve a roles with respect to AML, senior investors and IRS issues.

## **III Technology and FINRA/Introducing Roles**

Technology and regulation continues to advance. Currently, we see considerable digital resources replacing functions previously held by middle office/level positions, such as the branch manager. The flattening of the supervisory structure from human to machine has been taking place for several years. While human supervisors will never be fully replaced, we believe the future of big data and algorithms (behavioral or otherwise) incorporating artificial intelligence will be a pillar of supervision. The introducing firm, using tools of its own or made available by the clearing firm vendor would continue to support quality supervision and ensure sales/advisory compliance.

## **IV ANSWERS TO THE FINRA QUESTIONS**

- 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?**

We feel that Rule 4311 is effective in that it permits logical allocation of responsibilities between registered counterparties and its effectiveness is demonstrated by the fact that the rule has remained substantially unchanged since inception, with modest revisions to account for the changes in the industry over

time. Considering more recent additions to the FINRA Rule book, an example would be allowing registered counterparties to assign responsibilities covered under FINRA Rules 2165 and 4512. Practically speaking, a clearing firm and introducing firm (or adviser) should reasonably be able to assign responsibilities regarding the various facets of these rules.

We do not believe that Rule 4311 should be used to unreasonably extend responsibilities (and liability) to clearing firms, it reasonably should not be responsible for. Another example might be in the event a SEC Registered Investment Adviser were to defraud an investor, in a way that is not obvious, nor apparent to the clearing firm through reasonable surveillance efforts.

**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?**

The Rule has served its purpose, and all market participants and customers are better off due to the clarity and principles the Rule sets forth. When considering topics like technology management, cybersecurity and other areas that are not as clearly discernable from the registration categories of entities, FINRA should allow firms to reasonably add to counterparty specific responsibilities that may arise.

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

The benefit of clearly identifying and assigning responsibilities to market participants allows for a workable framework and easy implementation of the Rule. The clarity provided within the rule, and subsequent additions, cure otherwise ambiguous situations.

**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?**

We find the process to be efficient. Given that carrying agreements are largely the same across similar counterparties, it might make sense to have firms who have submitted previous carrying agreements to FINRA to be allowed, at FINRA's discretion, be limited to the submission of the correspondent questionnaire, in lieu of the full agreement. The questions in the questionnaire should give FINRA ample information to assess the size and risk of the relationship, and compare it to the



firm's financial and other information – which FINRA receives through FOCUS filings. Using this information FINRA can elect to follow-up to sample agreements, as it does in other areas of its examination program. In line with other comments herein, it may also be of some value to follow the same procedure for financial service agreements between clearing firms and advisers.

**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 Rule 4311 can better define the responsibilities and the quality of reports provided to counterparties. In lieu of assigning liability to clearing firms, require clearing firms to provide better information to its counterparties so that they can better manage their business. As big data, analytics, machine learning, etc. become a staple in the industry, the quality of reports should naturally improve – providing introductory parties access and the ability to self-manage their business, and compliance. The importance of this is to ensure the clearing firms are making these reports available to counterparties, at a reasonable cost, so that the brokers or advisers that clear through them, have the tools to supervise and manage their own business. If left to the introducing broker, or adviser to decide which available reports to receive, the default is typically to the least expensive set of reports which minimally cover the supervisory efforts of the introductory party.

We are sure FINRA uncovers this situation during its examinations in a variety of areas such as suitability, AML and others. An example of an additional report covered under Rule 4311 might require clearing firms to provide reports based on age, and activity, so that an introducing party has the tools to better identify elder harm.

DriveWealth believes that the direction of reporting should move to real-time interactive tools, whose thresholds are set and monitored by the introducing party. The thresholds and other facets established by the introducing party should match the introducing party's customer base and activities and the introducing party should be wholly responsible for this as the clearing entity is not best positioned to identify changes in the introductory parties' business.

We do not find issue with the stated requirement. DriveWealth has gone farther by giving its counterparties access to their data so that the introducing firm can create exception reports that are specific to its business, as needed. An additional ancillary benefit is that correspondents will be able to pull commonly requested materials for

FINRA examinations, without having to have the clearing firm pull the data requested in an ad-hoc basis.

**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?**

This is a very challenging question, because the macro view of the securities marketplace and its participants is driven by risk and cost. Over the past 10-15 years there has been a mass consolidation of clearing services, limiting competition. Competition is fundamental in determining the pricing and services offered by clearing firms and directly impacts the price all clearing firms charge. Indeed, in the last 2 years, we have seen a decrease in commissions charged by many of the largest securities providers in the industry. These decreased charges to customers was caused by new market entrants, who charge significantly lower fees/commissions to their customer to engage in securities activities.

What FINRA must realize is that technology is driving costs down, and newer entrants are using this technology to create efficiencies across the clearing broker. It is paramount that FINRA understands that any changes to Rule 4311 that place additional burden or liability on the clearing firm, will likely lead to a further consolidation of the clearing sector, and a less competitive market. This will lead to a reduction in the number of clearing firms, by making it cost prohibitive for new entrants and push existing firms to further consolidate, which will directly reduce the number of affordable clearing options for smaller firms. We believe this underscores our position that Rule 4311 should be used to assign reasonable allocation of duties, and not unduly allocate responsibilities to the clearing sector. We believe that promoting better data collection techniques, analysis and reporting tools, is a reasonable solution to this question. Better information and transparency provided to all introductory parties, small and large, will help support the responsibilities of the counterparties and promote investor protection.

**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?**

Further to our comments to question # 5 and 6, DriveWealth believes the industry has a data problem. Too many firms, have too much unstructured data, that they simply cannot provide back to their counterparties. DriveWealth believes that



providing the data to the counterparty is a fundamental role of the clearing firm, so that small firms can access their information in real-time (or close to real-time) to monitor their business and customer activities – this is a better solution than creating additional liability on the clearing broker. Also, small firms will be able to click one button and download all information for all their customers, in a matter of minutes, not weeks, which is a typical turnaround for a purchase and sales blotter. There simply is no reason that manual ad-hoc SQL queries must be run to provide a small firm with its own trading activity, customer information, money movement blotter, or the like. This information should be at the introducing firm’s finger tips, and it is this same information, that the clearing firm provides the small firm in the form of real-time panels, and reports, so that they can own and manage their business.

### **Conclusion**

Technology has brought efficient expansion, which has allowed interested market participants relatively few barriers to engage in brokerage or advisory business. These products are largely API driven, which makes the integration of systems relatively seamless, providing a fertile landscape for new market participants. This has led to the creation of several technology driven firms, with the ability to create long-term investment products, which service both existing and underserved groups of investors. Many of these new products promote responsible investing methods, enabling investors to save and invest, in a cost-effective way, in broad based and/or index tracking instruments; which compared to the interest rate environment, is an attractive option for existing investors, and the public.

Comparing returns for banking products and broad-based equity indexes demonstrates that not being able to participate (if one chooses to), is a material opportunity cost expensed to underserved groups, which smaller firms typically cater to. DriveWealth believes the rise of efficient and harmonious technologies is an effective solution to ensure services are available to all groups of people, or, the opportunity lost by not being able to access reasonable long-term investment products is substantial. And since most of these advancements are occurring in the non-traditional brokerage and advisory spaces, the scope of Rule 4311 could reasonably define or redefine the allocated responsibilities between brokers and advisers, and promote technological solutions to add transparency while reasonably holding a regulated entity accountable for their activities.

Sincerely,

Mark Bulger  
Chief Compliance Officer, DriveWealth, LLC