Regulatory Notice 18-10

Retrospective Rule Review

FINRA Requests Comment on the Effectiveness and Efficiency of Its Carrying Agreements Rule

Comment Period Expires: May 23, 2018

March 23, 2018

Notice Type
- Request for Comment

Suggested Routing
- Compliance
- Legal
- Operations
- Regulatory Reporting
- Senior Management

Key Topics
- Capital Compliance
- Carrying Agreements
- Financial Responsibility
- Operational Rules

Referenced Rules & Notices
- FINRA Rule 4311
- Regulatory Notice 11-26
- SEA Rule 15c3-3

Summary

FINRA is conducting a retrospective review of the rule governing carrying agreements to assess its effectiveness and efficiency. This *Notice* outlines the general retrospective rule review process and seeks responses to several questions related to firms' experiences with this specific rule.

Questions regarding this *Notice* should be directed to:

- Kris Dailey, Vice President, Risk Oversight & Operational Regulation (ROOR), at (646) 315-8434 or *Kris.Dailey@finra.org*; or
- Adam Arkel, Associate General Counsel, Office of General Counsel, at (202) 728-6961 or *Adam.Arkel@finra.org*.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by May 23, 2018.

Comments must be submitted through one of the following methods:

- Emailing comments to *pubcom@finra.org*; or
- Mailing comments in hard copy to:

  Jennifer Piorko Mitchell
  Office of the Corporate Secretary
  FINRA
  1735 K Street, NW
  Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.[1]

Background & Discussion

FINRA believes that it is appropriate, after a reasonable period of time, to look back at its significant rulemaking to determine whether a FINRA rule or rule set[2] is meeting its intended investor-protection objectives by reasonably efficient means. FINRA further believes that a retrospective review should include a review not only of the substance and application of a rule or rule set, but also FINRA's processes to administer the rules. FINRA intends to select relevant rules and to conduct retrospective rule reviews on an ongoing basis to ensure that its rules remain relevant and appropriately designed to achieve their objectives, particularly in light of environmental, industry and market changes.

In conducting the review, FINRA staff will follow a similar process to previous retrospective rule reviews. In general, the review process consists of an assessment and action phase. During the assessment phase, FINRA will evaluate the efficacy and efficiency of the rule or rule set as currently implemented, including FINRA's internal administrative processes. FINRA will seek input from affected parties and experts, including its advisory committees, subject-matter experts inside and outside of the organization, and other stakeholders, including industry members, investors, interested groups and the public. FINRA staff will assess issues including the existence of duplicative, inconsistent or ineffective regulatory obligations; whether market or other conditions have changed to suggest there are ways to improve the efficiency or effectiveness of a regulatory obligation without loss of investor protections; and potential gaps in the regulatory framework. Upon completion of this assessment, FINRA staff will consider appropriate next steps, which may include some or all of the following: modifications to the rule, updated or additional guidance, administrative changes or technology improvements, or additional research or information gathering.

The action phase will then follow. To the extent action involves modification of rules, FINRA will separately engage in its usual rulemaking process to propose amendments to the rules based on the findings. This process will include input from FINRA's advisory committees and an opportunity for comment on specific proposed revisions in a *Regulatory Notice* or rule filing with the SEC, or both.

Request for Comment

FINRA has identified FINRA Rule 4311 (Carrying Agreements) for review. The rule, which governs requirements applicable to members when entering into agreements for the carrying of customer accounts, was approved by the SEC in 2011 and is the consolidated successor to former NASD Rule 3230, Incorporated NYSE Rule 382 and corresponding interpretations (the predecessor rules).[3] Broadly, based on the predecessor rules, current Rule 4311 prohibits a member, unless otherwise permitted by FINRA, from entering into an agreement for the carrying, on an omnibus or fully disclosed basis, of any customer account in which securities transactions can be effected unless the agreement is with a carrying firm that is a FINRA member. Among other things, the rule requires that each

carrying agreement must identify and bind every direct and indirect recipient of clearing services as a party to the agreement. The rule also requires that the carrying firm shall submit to FINRA for prior approval any agreement for the carrying of accounts, whether on an omnibus or fully disclosed basis, before such agreement may become effective. The carrying firm is also required to submit to FINRA for prior approval any material changes to an approved carrying agreement before such changes may become effective. Under the rule, each carrying agreement in which accounts are to be carried on a fully disclosed basis must specify the responsibilities of each party to the agreement, including certain responsibilities as set forth in the rule. Further, Rule 4311, like the predecessor rules, allows FINRA members to allocate between themselves responsibility for each of the functions enumerated therein. Allocation between the parties to the agreement can effectively assign responsibility for rule compliance to one (or more, if applicable) of the other parties. Thus, a smaller firm can, for example, maintain relationships with its customers and take responsibility for opening accounts and accepting orders from its customers, while the carrying firm takes responsibility for the extension of credit, the receipt and delivery of funds and securities and safeguarding funds and securities for purposes of SEA Rule 15c3-3, without exposing a firm to potential liability for a function allocated to another firm.

Additionally, the rule includes requirements that address such areas as notification to be submitted to FINRA when a new introducing firm is added to a carrying agreement; the carrying firm's due diligence with respect to new introducing firm relationships; notification to customers with respect to the existence of the carrying agreement; the furnishing of written customer complaints and specified reports, such as exception reports, to the introducing firm; books and records requirements as to reports requested by and furnished to the introducing firm; and requirements as to maintenance and identification of proprietary and customer accounts.

FINRA seeks answers to the following questions with respect to this 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?
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?
3. What has been your experience with implementation of the rule, including any ambiguities in the rule or challenges to complying with it?

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

In addition to comments responsive to these questions, FINRA invites comment on any other aspects of the rule that commenters wish to address. FINRA further requests any data or evidence in support of comments. While the purpose of this *Notice* is to obtain input as to whether or not the current rule is effective and efficient, FINRA also welcomes specific suggestions as to how the rule should be changed. As discussed above, FINRA will separately consider during the action phase specific changes to the rule.

Endnotes

1. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.

2. A rule set is a group of rules identified by FINRA staff to contain a similar subject, characteristics or objectives.

3. *See* Securities Exchange Act Release No. 63999 (March 1, 2011), 76 FR 12380 (March 7, 2011) (Order Granting Approval to Proposed Rule Change; File No. SR-FINRA-2010-061); *see also Regulatory Notice 11-26* (May 2011) (announcing the SEC's approval of FINRA Rule 4311, among other consolidated financial responsibility and related operational rules).

   The current FINRA rulebook consists of: (1) FINRA Rules; (2) NASD Rules; and (3) rules incorporated from NYSE ("Incorporated NYSE Rules"). While the NASD Rules generally apply to all FINRA members, the Incorporated NYSE Rules apply only to those members of FINRA that are also members of the NYSE. The FINRA Rules apply to all FINRA members, unless such rules have a more limited application by their terms. For more information about the rulebook consolidation process, *see Information Notice 3/12/08* (Rulebook Consolidation Process).