

May 2, 2011

VIA ELECTRONIC MAIL (pubcom@finra.org)

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

Re: **FINRA Regulatory Notice 11-14 and Proposed Rule 3190**
Regarding Third-Party Service Providers

Dear Ms. Asquith:

We are submitting this comment letter on proposed FINRA Rule 3190, as set forth in FINRA Regulatory Notice 11-14 (March 2011)(the “Proposal”). The Proposal is designed to clarify a member firm’s obligations and supervisory responsibilities regarding outsourcing arrangements.

We are writing on behalf of our client, a FINRA member firm that wishes to remain anonymous (the “Client”). The Client is a U.S.-based broker-dealer registered with the Securities and Exchange Commission (the “SEC”) and is a subsidiary of a foreign financial institution. Although the Client acknowledges the benefit of regulatory guidance related to outsourcing, it has apprehensions about many aspects of the Proposal.

In particular, the Client is concerned about the following: (a) possible unintended consequences that could result from the Proposal, such as discouraging outsourcing that is beneficial to clients; (b) whether a new rule is necessary, as opposed to additional regulatory guidance; (c) the scope and nature of the new requirements and the lack of clarity regarding whether the Proposal supersedes prior FINRA guidance in all respects and, if not, which parts of prior guidance continue to apply; (d) the lack of consideration for how the new requirements should apply to providers located outside the United States; and (e) the timing and nature of the notice requirements. Each of these concerns is set forth in more detail below.

A. Benefits of Outsourcing

Member firms have been relying on third-party service providers to perform various functions on their behalf for many years. The firms’ customers benefit from this outsourcing in a number of ways. Outsourcing can permit firms to enhance the service they provide to customers, improve efficiency and effectiveness, reduce costs, benefit from expertise and specialization and take advantage of economies of scale. These benefits, in

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turn, can be passed on to clients in the form of enhanced and faster service, lower pricing and the like.

Because of the benefits offered by outsourcing, it is critical that FINRA not take positions that unnecessarily discourage outsourcing. An overly restrictive rule is likely to have a number of negative consequences. It can discourage outsourcing even when it can be shown that reliance on third parties is more efficient and cost effective, it can stifle innovation, it can undercut the development of better and more effective delivery of products and services to customers and it can disrupt relationships that have served firms and their clients well for many years.

B. Guidance Versus a Rule

Over the years, various financial institution regulators have wrestled with how best to balance the need to protect investors against the benefits offered by outsourcing.¹ FINRA and its predecessors have published guidance on multiple occasions, including FINRA Notice to Members 05-48 (April 2005), *Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers* ("FINRA 2005 Guidance").² The New York Stock Exchange (the "NYSE") also filed a rule change proposal with the SEC relating to outsourcing, but later withdrew the proposal.³

The Client questions whether a new FINRA rule is actually necessary. In the section of the Proposal captioned "Background and Discussion," FINRA does not identify any specific problem related to outsourcing by member firms. FINRA states simply that it "has continued to receive inquiries regarding outsourcing and the scope of the guidance, including, among other things, requests to identify specific functions that a clearing or carrying member firm may outsource to a third-party service provider and the appropriateness of any member firm outsourcing activities to a third-party service provider that is not registered as a broker-dealer."

¹ See, e.g., *Outsourcing in Financial Services*, the Joint Forum of the Basel Committee on Banking Supervision (February 2005), formed under the aegis of the Basel Committee on Banking Supervision, the International Association of Securities Commissions ("IOSCO") and the International Association of Insurance Supervisors (the "Joint Forum Report"); and *Principles of Outsourcing of Financial Services for Market Intermediaries*, IOSCO Technical Committee (February 2005) (the "IOSCO Report").

² See also FINRA Office of General Counsel Interpretive Memorandum (August 15, 2006), *A Member's Responsibilities Regarding the Outsourcing of Certain Activities*.

³ Proposed Rule 340 would have required appropriate procedures for the outsourcing of services and functions by member organizations. See NYSE Rule Change Proposal, SR-NYSE-2005-22, filed with the SEC on March 16, 2005 and, after two amendments, subsequently withdrawn prior to SEC approval.

If the only problem that FINRA is seeking to address is that it continues to receive inquiries from firms about outsourcing, it can resolve that concern with additional guidance. It does not need an entirely new rule to provide guidance. If FINRA's goal is to address other problems besides continued inquiries, it should specify those problems and explain why a new rule is necessary to address those problems and the extent to which it is necessary.

Before imposing an entirely new rule on members and possibly causing disruption of existing relationships, FINRA should also address the following matters: (a) whether any other securities, banking or insurance regulators, or any other regulators of financial institutions, have proposed or adopted rules regarding outsourcing, as opposed to only publishing guidance, such as the Joint Forum Report or IOSCO Report; (b) how these rules, if any, differ from the Proposal; and (c) why any identified differences between the Proposal and such other rules or guidance are justified in the case of FINRA member firms. If no other financial regulator has adopted rules, FINRA should explain why a new rule for member firms is warranted when other regulators have not taken this more drastic step.

In comparison to formal rules, regulatory guidance can more readily be updated and changed to reflect any unintended consequences that result from the position taken or other developments. To amend FINRA rules requires more process and formality, including, in most cases, the need for public comment and SEC approval, both of which generally result in a rule change taking longer to be put into effect than simply publishing revised guidance.

C. Scope and Nature of the Proposal

Even if FINRA determines that it is necessary to adopt a new rule rather than simply publish additional guidance, the Client believes that the scope and nature of the Proposal is too broad. The Client acknowledges that ultimate responsibility for supervision of outsourced activities lies with the broker-dealer and that firms cannot delegate that responsibility to third-party service providers. However, to address this concern, FINRA need only clarify that qualified principals of the member firm must take ultimate responsibility for the supervision and control of outsourced activities and services. To ensure that outsourcing is subject to proper firm oversight, FINRA merely needs to require that firms adopt and implement appropriate written policies and supervisory procedures, including due diligence measures. These measures could apply at each stage of outsourcing, including the selection of the vendor, approval of the arrangement, ongoing oversight over the provision of services and termination of the relationship. The Client believes that the elements of the Proposal that go beyond requiring these measures are unwarranted.

The Client also believes that the Proposal fails to account for prior guidance. The Proposal does not address whether it supersedes FINRA 2005 Guidance and other

interpretive positions or which parts of the prior guidance survive. In particular, there appear to be differences between the Proposal and FINRA 2005 Guidance related to the following:

1. The outsourced functions or activities that are covered (*e.g.*, those “related to the member’s business as a regulated broker-dealer” or those that, if performed directly by members, would be required to be “the subject of a supervisory system and written supervisory procedures pursuant to Rule 3010”);
2. The extent to which the Proposal applies to outsourcing to a firm’s affiliates; in particular, the exclusions or different treatment that should apply when outsourcing to affiliates with respect to requirements for contracts, diligence, supervision and monitoring, as well as the impact of the affiliate being subject to regulation by FINRA or by other regulators either within or outside the United States; and
3. The extent to which activities that require qualification and registration under FINRA rules can be outsourced at all and, if so, whether the person performing the activity becomes an “associated person” of the member, as well as whether the Proposal applies at all to a person who is already registered with the member and subject to the firm’s supervision and control.

FINRA should explain and clarify these differences between the Proposal and FINRA 2005 Guidance. The scope of the Proposal should be narrowed and not seek to stretch beyond what it needs to cover in order to protect customers. This can be accomplished by requiring that firms ensure that outsourcing is subject to proper firm oversight and that firms adopt and implement appropriate written policies and supervisory procedures, including due diligence measures. Rather than being prescriptive, the rule should be more principle-based and allow for more flexibility so that the benefits of outsourcing can be continued to be realized by firms and passed on to client.

D. Application to Providers Located Outside the United States

FINRA does not distinguish in the Proposal between member firms outsourcing to third-party service providers located in the United States and providers located outside the United States. A number of unique issues exist with respect to non-U.S. service providers. For example, these vendors may be subject to the laws or regulations of their home jurisdiction, and such laws or regulations may conflict with aspects of the Proposal. Such a conflict could make it difficult for the member firm to engage or continue to use the non-U.S. provider, perhaps eliminating the best service option for the U.S. broker-dealer. FINRA should consider including a provision that would recognize or give deference to existing guidance or regulation in the home jurisdiction of the vendor.

Requiring firms to treat persons outside the United States who perform covered activities as associated persons also raises other problems for U.S. broker-dealers. Having an associated person in another jurisdiction could mean that the U.S. broker-dealer has a branch office in that jurisdiction. This, in turn, could subject the U.S. broker-dealer to regulation by the local authorities in that jurisdiction, depending on the corporate structure of the broker-dealer and any parent organization. It could also result in the U.S. broker-dealer be deemed to be “doing business” in, and therefore subject to being taxed by, that jurisdiction.

All of these issues unique to using third-party service providers located outside the United States pose problems to U.S. broker-dealers. The issues result in U.S. firms being placed at a competitive disadvantage against foreign-regulated firms. A firm that is not subject to FINRA’s jurisdiction would be free to choose the vendor that offers the best product, service or price or that makes the firm more efficient or effective than other vendors, whereas the U.S. firm might be restricted from using such vendor and need to settle for sub-optimal providers. This could be especially problematic for the U.S. arm of a global firm where the parent organization requires or at least expects the U.S. subsidiary or branch to outsource certain activities or services to the parent or affiliates.

FINRA should consider the unique problems raised by providers located outside the United States and include appropriate exemptions in any new outsourcing rule that it adopts.

E. Notice Requirement

The Proposal requires that a clearing or carrying member notify FINRA within 30 days after entering into any outsourcing agreement with a third-party service provider to perform any functions or activities related to the firm’s business as a registered broker-dealer that is permitted to be outsourced. The Proposal sets out specific information that must be included in the notice, including the functions to be performed, the identity and location of the provider, the provider’s regulator, if any, and any affiliation between the provider and the firm, and requires firms to keep copies of both the notice and the outsourcing agreement in accordance with the SEC’s record retention rule.

The Client notes that many outsourced arrangements are not memorialized in “classic” contracts. This is particularly true for services and activities outsourced to affiliates, where – because of the common ownership of the firm and the affiliated service provider -- the terms may be less than arms’ length, based on simple service level agreements or similar informal documentation. FINRA should account in any new rule for less formal arrangements among affiliates.

In other contexts, U.S. securities regulators have recognized the value of giving U.S. investors access to foreign markets and foreign broker-dealers. For example, under SEC Rule 15a-6, the SEC strikes a workable balance between protecting U.S. investors, on the one hand, and allowing the free flow of information and services from abroad, on the other hand. This carefully constructed balance has worked well over the years to allocate responsibilities between the U.S. and foreign broker-dealer in a way that allows U.S. investors to continue to receive information and services from what is often believed to be the best source. The Client believes that FINRA should consider comparable exceptions for outsourcing to providers located outside the United States. Specifically, the Proposal should not conflict with SEC Rule 15a-6 arrangements wherein foreign affiliates are already providing select outsourced functions. The functions performed by such affiliates should be included in the Section (f) exceptions.

Another unique problem relating to non-U.S. providers are differences between the United States and other jurisdictions with respect to privacy laws. For example, the European Union ("EU") takes a highly restrictive approach to the processing and movement of personal data. Under the EU's Data Protection Directive,⁴ personal data (*i.e.*, information relating to an identifiable natural person) can only be processed (*e.g.*, collected, recorded, retrieved, used or disseminated) if the enumerated conditions on transparency, legitimate purpose and proportionality are met and can only be transmitted to a country outside the EU if such country provides an adequate level of protection for the data.

The United States has no single data protection law comparable to the EU's Data Protection Directive. Instead, it takes a "sectoral approach" to data protection and relies on a combination of legislation, regulation and self-regulation, whereby it adopts legislation on an *ad hoc* basis when certain sectors or circumstances justify it.

The Proposal could cause a dilemma for firms using vendors in the EU or other jurisdictions with comparable privacy laws. If a firm must treat a person performing covered activities as its associated person, the firm will need to obtain that person's personal data, which may trigger a violation of the applicable data protection laws. If so, the member firm may be blocked from obtaining that information and, therefore, may be prevented from using that vendor. The firm might face the unsatisfactory choice of: (a) foregoing the benefits of the outsourced activity or service altogether; (b) engaging a less desirable vendor in the United States or another jurisdiction not subject to such data protection laws; or (c) incurring the expense of hiring and training staff and buying or building the software, systems or functionality to perform the services in-house without needing to resort to outsourcing.

⁴ Directive 95/46/EC (Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31995L0046:EN:HTML>).

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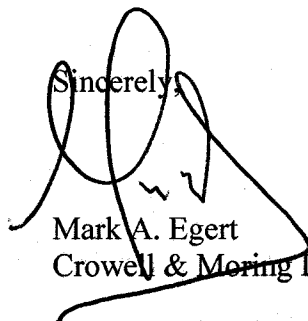
The Proposal also requires that, within three months of its effective date, a clearing or carrying firm will be required to notify FINRA of all outsourcing arrangements in effect as of the effective date of the rule. The Client believes that this requirement should only apply to activities or functions related to the firm's business as a regulated clearing or carrying member and not more broadly to activities related to the firm's business as a regulated broker-dealer.

The Client feels that a three-month time period to notify FINRA of all such outsourcing arrangements with third-party service providers is too short and should be lengthened to at least six or nine months, especially given that this is an entirely new requirement. FINRA needs to allow firms sufficient time to comply with the new requirements, as virtually all existing relationships will need to be investigated relating to the use of any and all sub-vendors, new contract terms may need to be negotiated and new contracts may need to be executed.

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Should you have any comments or questions on the foregoing, please do not hesitate to contact the undersigned at 212-895-4219.

Sincerely,



Mark A. Egert
Crowell & Moring LLP