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Outsourcing Law
ALERT
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Proposed FINRA Regulatory Changes Regarding Outsourcing That Require Attention

On March 29, 2011, the Financial Industry Regulatory Authority (FINRA) published for industry comment a proposed rule clarifying the scope of a member firm's obligations and supervisory responsibilities for functions or activities outsourced to a third-party.

The proposed Rule (FINRA Rule 3190 – Third-Party Service Providers) makes clear that:

- when a member firm outsources a function or activity related to its business as a regulated broker-dealer to a third-party service provider, it does not relieve the member firm of its obligation to comply with applicable securities laws and regulations, and FINRA and Municipal Securities Rulemaking Board (MSRB) rules;
- the member firm cannot delegate its **responsibilities** for, or control over, any outsourced functions or activities;
- a member firm must have supervisory procedures, including due diligence measures, to ensure that its arrangements with third-party service providers are reasonably designed to achieve compliance with applicable securities laws and regulations, and FINRA and MSRB rules.

The proposed rule also imposes additional restrictions and obligations that apply solely to a clearing or carrying member firm and its third-party service provider arrangements.

Effect

Proposed Rule 3190 will for the first time memorialize the guidance set forth in NTM 05-48 in the form of an affirmative set of supervisory obligations for which a broker-dealer and its personnel will be held accountable. As a result, failure to comply with the new rule would enable FINRA to more readily cite deficiencies on FINRA exams, which could lead to an increase in disciplinary events and fines for member firms.

We **strongly recommend** that our clients and any other entity that is impacted by the proposed rule take the time to review FINRA's Proposed Rule 3190 and submit comments to FINRA by the **May 13, 2011, deadline**. To help guide you in the process, we have provided some "Practice Pointers" in the second part of this alert where we point out some of the issues and concerns raised by the proposed rule which a member firm or a third-party outsourcer might consider when preparing a response to FINRA.

This part of our Alert provides a detailed description of FINRA's Proposed Rule 3190 along with issues to consider and Practice Pointers that the reader could consider when preparing a response to FINRA.

Changes Impacting All Member Firms Utilizing Outsourcing Services

Under the proposed rule, any member firm (whether an introducing broker or a clearing or carrying firm) utilizing third-party outsourcing arrangements will be subject to the following:

- The term "third-party agreement" now includes both the third-party service provider and sub-vendors utilized by the third-party service provider. Therefore, broker-

dealers must create supervisory systems and written procedures for functions performed by the third-party service provider and its sub-vendors.

- FINRA is now explicitly proposing the following ongoing due diligence requirements for member firms:
  - Member firms must conduct due diligence of both current and prospective third-party service providers and their sub-vendors to whom they outsource broker-dealer functions; and
  - The due diligence procedures must be included in the member firm's supervisory procedures.
- Unless otherwise determined by FINRA to the contrary, affiliates to whom member firms outsource will not be treated any differently than non-affiliate third-parties.
- The proposed rule specifically applies to **all** functions **and** activities related to a member firm's business.

Practice Pointers – Member firms should consider the following questions based on these enhancements to NTM 05-48:

- To the extent that a member firm is required to perform ongoing due diligence of sub-vendors of its third-party service providers, how can it fulfill its obligations if it does not have privity of contract with the sub-vendors? Is review of the third-party service provider's due diligence of their sub-vendors sufficient, or must the member firm actually perform its own due diligence above and beyond the third-party service provider's due diligence of the sub-vendors? In addition, can reliance on the third-party service provider's due diligence satisfy the member firm's new obligation to document the process in its written supervisory procedures?
- How often and how extensively must the member firm perform such ongoing due diligence of sub-vendors? Could it shift to the third-party service provider the burden of periodically informing the member firm of changes to the status of its previous due diligence of the sub-vendor, or will the member firm have an affirmative obligation to obtain that information directly from the sub-vender (which is potentially difficult if the member firm is not in privity with the sub-vender)?
- Under what circumstances is FINRA likely to acknowledge that an affiliate should **not be** considered to be a third-party service provider and therefore subject to proposed Rule 3190? For example, if an affiliate is a "Material Associated Person"[1], would this be sufficient evidence for FINRA that such affiliate is sufficiently known to the member firm that due diligence requirements would either be lightened or dropped?
- To the extent a member firm conducts business activities that are not required to be conducted by a broker-dealer[2] out of its broker-dealer entity, and utilizes third-party service providers, does proposed Rule 3190 apply to such non-securities activities? While traditionally such non-securities activities were not subject to FINRA's jurisdiction, in a different proposed rule regarding supervision, FINRA seems to expand its jurisdiction over **non-securities related matters** by requiring member firms to designate a principal to supervise **every business** the member firm operates, regardless of whether registration as a broker-dealer is required for that activity. Will proposed Rule 3190 similarly subject all of a member firm's businesses to the requirements of proposed Rule 3190 regardless of whether the business is securities related or not?

Changes Impacting Clearing or Carrying Firms Utilizing Outsourcing Services

Restrictions Applicable to Certain Clearing or Carrying Member Firms' Activities

At Loeb & Loeb's Outsourcing Seminar in October 2010, Grace Vogel, Executive Vice President, Member Relations of FINRA announced that FINRA would issue a proposed rule on third-party service providers. (We provided a summary of the seminar in our November 2010 Alert.) Ms. Vogel explained that a proposed rule would contain an outright prohibition against clearing or carrying firms outsourcing the following functions:

- the movement of customer or proprietary cash or securities;
- the preparation of the net capital and customer protection computations; and
- the implementation and maintenance of compliance and risk management systems.

In proposed Rule 3190, FINRA places **restrictions** on a clearing or carrying member firm's activities in these three areas, **but has stopped short** of an outright prohibition of such activities. Specifically, FINRA is requiring that these activities be performed by persons or entities which become "Associated Persons"[3] of the clearing or carrying firm (and "Registered Persons"[4] where the activity requires licensing and registration) subject to the **direct control and supervision** of the member firm.

Practice Pointer – Although not expressly stated in proposed Rule 3190, one practical approach that a member firm might consider for complying with this aspect of proposed Rule 3190 would be to require that the third-party service provider's personnel who are responsible for these types of activities become "Associated Persons" of the member firm and therefore become subject to the clearing or carrying member firm's supervisory control system.

As it relates to the movement of funds and securities, FINRA is proposing in its supplementary materials to proposed Rule 3190 an alternative to the above approach. It is providing that a third-party service provider may post entries to the clearing or carrying member firm's ledgers if the clearing or carrying member firm reviews each posting prior to the close of business on the day following the posting. FINRA goes on to clarify that a clearing or carrying member firm may comply with the prompt supervisory review requirement by substantiation of financial balances and spot-check reviews of individual entries.

As it relates to the preparation of net capital and customer protection computations, FINRA is proposing that the performance of underlying calculations in aid of the preparation of the net capital and customer protection computations would be ministerial functions that could be performed directly by a third-party service provider if the member firm's Associated Person reviews and understands net capital and customer protection computations and has the ability to explain the rationale behind the third-party's calculations to FINRA.

Similarly, as it relates to the implementation and maintenance of compliance and risk management systems, the proposed rule would allow a third party service provider to perform basic calculating, logging and maintaining of lists that are preparatory to creating related books and records, as well as review of output from compliance and risk management systems. However, analysis and/or conclusions based upon the data from compliance and risk management systems would have to be performed by an Associated Person of the member firm.

Practice Pointer – Under all three scenarios, member firms should consider whether these compromise positions being proffered by FINRA are practical. Member firms might also consider whether there are other more practical solutions that they could propose to achieve FINRA's objective of preventing potential harm that could result from possible non-compliance by a clearing or carrying member firm's third-party service provider with the federal securities laws, FINRA and MSRB rules.

Oversight of Third-Party Service Providers by Clearing or Carrying Member Firms

Proposed Rule 3190 would require (i) that a clearing or carrying member firm include in its supervisory procedures additional procedures that would enable the member firm to take prompt corrective action where necessary to achieve compliance with applicable securities laws, and (ii) that the clearing or carrying member firm approve transfers of duties by a third-party service provider to its sub-vendors.

Notification Prior to Entering into an Outsourcing Arrangement by Clearing or Carrying Member Firms

At Loeb & Loeb's Outsourcing Seminar, Ms. Vogel predicted that the proposed rule would most likely require prior notification of such arrangements to FINRA. In fact, as published, in the proposed rule FINRA has backed off of this position in favor of a 30 calendar day post notification requirement.

The notification must include:

- the functions being outsourced;
- the identity and location of the third-party service provider and any sub-vendors;
- a description of any affiliation between the clearing or carrying member firm and the third-party service provider.

Practice Pointer – FINRA does not suggest in proposed Rule 3190 that the clearing or carrying member firm has an ongoing obligation to update FINRA of changes to the information previously provided. Clarification by FINRA of this point should be sought.

Practice Pointer – In addition, under proposed Rule 3190, FINRA does not explain why it is proposing that the above data be provided to FINRA. For example, it would make sense for FINRA to request information on a third-party service provider's regulatory status or affiliation to the clearing or carrying member firm if FINRA were to use this information to impose lesser due diligence requirements on the clearing or carrying member firm.

Finally, FINRA suggests that although proposed Rule 3190 does not itself require a clearing or carrying member firm to submit prospective outsourcing arrangements to FINRA for review, a clearing or carrying member firm might wish to do so on its own accord.

Practice Pointer – If this suggestion becomes final, our experience suggests that this "offer" from FINRA will likely be followed by many clearing or carrying member firms. If this becomes an adopted practice, it may create negative implications for any clearing or carrying member firm that does not submit its agreements to FINRA for review.

Loeb & Loeb's outsourcing and financial services groups will be happy to assist in the preparation and filing of your comments. Contact Stephen Cohen at 212.407.4279, scohen@loeb.com or Akiba Stern at 212.407.4235, astern@loeb.com.

Endnotes

[1] As the term is used in Rule 17h-1T under the Securities Exchange Act of 1934.

[2] Examples of these activities would include investment advisory, commodities, real estate or certain insurance activities.

[3] As the term is used in FINRA's By Laws Article 1 (gg).

[4] As the term is contemplated under FINRA Rule 1031.