



Highlights from Regulatory Initiatives – Outsourcing Panel

Loeb & Loeb LLP held its annual program, Outsourcing in Financial Services, on Jan. 23, 2013. Grace Vogel, Executive Vice President of the Financial Industry Regulatory Authority (FINRA), and Michael Macchiaroli, Associate Director for the Division of Trading and Markets of the Securities and Exchange Commission, discussed regulatory developments related to outsourcing of financial services by broker-dealers.

The panel opened with a major scoop when Ms. Vogel announced that FINRA is rethinking the scope of its proposed rule on outsourcing (FINRA Rule 3190) because of concerns at FINRA and the SEC that the Rule, as proposed, would extend broker-dealer regulation too far into the operations of industry service providers. Ms. Vogel hinted that the revisions to the proposed rule will reflect a more balanced approach to weighing regulatory concerns against industry practice. Loeb & Loeb will monitor the issuance of the revised rule, which FINRA expects to circulate for comment later this year, and will issue a client alert on the revisions.

The panelists also discussed their views on the extent to which outsourcing of various broker-dealer functions might be permitted or regulated, with customer asset protection being of primary importance. The prevailing view was that client-facing activities, such as account openings, might be outsourced, provided that the broker-dealer retains control over specific actions, including approval of the account and the receipt, handling, and recording of customer cash and securities. Risk management and customer suitability functions could not be outsourced, however. The panelists noted that their organizations' approach differed from that taken by the Canadian regulator, IIROC, which recently proposed rules and guidance concerning outsourcing arrangements used by Canadian broker-dealers.

The panelists encouraged the audience to ensure that the broker-dealer and service vendors understand their respective responsibilities, and suggested that to maintain accountability, outsourcing arrangements should be documented in written contracts that include performance metrics. As a best practice, members should submit their agreements to FINRA for review before execution.

On the topic of data storage in the cloud, Mr. Macchiaroli reminded the broker-dealer community that electronic records must be non-erasable and non-rewritable in order to comply with the record retention rules set forth in SEC Rule 17a-4. He warned that data storage in facilities located outside the United States may be unsuitable, if ready access to the records cannot be assured, and contract provisions that prevent access by the regulators due to broker-dealer nonpayment or other default may also be unacceptable. FINRA expects to issue a regulatory notice in the next 60 days reminding broker-dealers of their responsibilities under Rule 17a-4 when using cloud computing, and suggesting that cloud providers deliver SAS 70 audit letters annually to broker-dealers.

In terms of industry practices, FINRA is seeing migration from outsourcing to offshoring, which provides broker-dealers with greater control over their operations. Firm culture also reduces compliance problems, relative to outsourcing arrangements. Time-zone considerations bear increasingly on offshoring deployments.

Ms. Vogel concluded the panel discussion by reminding the audience that all individuals who perform functions on behalf of a broker-dealer that require registration as a Series 99

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operations principal must register with the broker-dealer, regardless of whether they are employed by a third-party service provider.

If you have any questions or wish to discuss the information in this alert, please contact [Kenneth Adler](#), [Stephen Cohen](#) or [David Fischer](#).

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