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RE: New FINRA Rule 3190 Regulating Third-Party Service Providers

Integrated Management Solutions USA LLC ("IMS") is pleased to have the opportunity to comment on FINRA's new Rule 3190 (the "Proposed Rule") regarding the regulation of third-party service providers, including, without limitation, heightened supervisory requirements for clearing and carrying firms. By way of background, IMS is one of the largest providers of financial accounting and compliance consultants to the securities industry, providing such services to about 100 FINRA members. We believe this perspective enables us to assess the impact of the Proposed Rule on FINRA member firms, specifically, but in our role as business experts we are also conscious of the damage that elements of the Proposed Rule will likely cause to a significant number of member firms.

Special recognition for MSRB

We note that FINRA has given special recognition to MSRB, as if to endorse the overly-duplicative environment caused by its existence. We also note that many FINRA member firms are subject to the rules of various other regulatory bodies, e.g., the various securities exchanges, whose rules are perhaps even more important or stringent than those of MSRB. We suggest that

FINRA delete references to MSRB and substitute instead a catchall phrase that encompasses rules of organizations whose rules are subject to the approval of the SEC.[1]

Third-Party Service Providers in General

Much of Proposed Rule 3190(a), (b) and (f)(1)[2] adapt the requirements of NASD Rules 3010 (Supervision) and 3012 (Supervisory Control System) to outsourced functions generally. Our primary concern with this part of the Proposed Rule is its largely undefined, and overbroad, applicability to "…a third-party service provider (including any sub-vendor) [which] perform[s] functions or activities related to the member's business as a regulated broker-dealer…."[3] (Emphasis added.) Thus, as currently formulated, the Proposed Rule would apply to any third-party service provider (including any sub-vendor) performing functions related to a member's regulated activities.[4] The only limitation that FINRA has proposed is the exclusion of those who perform "…ministerial activities…"[5], although bright-line standards do not apply uniformly even

[1] Frankly, we would be much happier with a single rulebook that covered all of the non venue-specific rules governing securities broker-dealer conduct instead of the hodge-podge patchwork consisting of SEC rules, NASD rules, FINRA rules, MSRB rules, and exchange rules. Many of the rules of these organizations represent nothing more than redundant recitations of similar concepts. The burden of duplicative rules was well-documented long ago, before the NASD/NYSE Regulation merger into FINRA.

[2] Proposed Rule 3190(c)-(e) and (f)(2) apply specifically to clearing and carrying members and will be discussed elsewhere in this comment letter.

[3] Proposed Rule 3190(a)(1).

[4] Proposed Supplementary Material .01 (Scope of Third-Party Service Provider) purportedly clarifies that the term "third-party service provider (including any sub-vendor)" includes "…any person controlling, controlled by or under common control with a member firm, unless otherwise determined by FINRA." Does this impose an affirmative obligation on a member to seek such a determination from FINRA? If it does, it belongs in the Proposed Rule, and not as "Supplementary Material." We note, also, that if an affirmative obligation is being proposed, FINRA should provide guidelines for making such determinations, including, without limitation, response times and who FINRA would consider distant enough from the controlled entity to avoid a conflict of interest. Certainly, it could not be the member's outside auditor, which is required to be independent under rules governing its conduct under, but not limited to, PCAOB rules.

[5] Proposed Rule 3190(f)(1).

to such supposedly ministerial services.[6] As currently proposed, we believe this to be unworkable and unrealistic.

For example, members often retain outside counsel and accountants to deal with a broad spectrum of issues "related to" a member's regulated activities. As written, when professionals are retained, the Proposed Rule requires the member to:

> [A] …establish and maintain a supervisory system and written procedures for any functions or activities performed by a third-party service provider (including any sub-vendor) that are reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules[7][; and]
>
> [B] …[conduct] an ongoing due diligence analysis of each current and prospective third-party service provider (including any sub-vendor) to determine, at a minimum, whether:
>
> (1) the third-party service provider (including any sub-vendor) is capable of performing the activities being outsourced; and
> (2) the member can achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules with respect to any functions or activities being outsourced.[8]

Does FINRA really expect a member to have a supervisory system and written procedures in place with respect to when and how to use and supervise third-party professionals? Would a member even be able to conduct effective due diligence over such providers? Even assuming, for argument's sake, that the member is qualified to conduct such a review, the amount of time it

[6] For example, if an overnight courier service is used to deliver securities, is that ministerial? Is a bank that operates a lock-box facility for a broker-dealer simply providing ministerial services? We think not, since the bank is not only holding customer funds and/or securities, it has control and discretion over such assets, including, without limitation, the power to determine whether release conditions have been met. What happens if the bank makes a mistake? Is that the member's responsibility? What about DTCC, which handles billions of dollars worth of securities transactions daily? Are its mistakes the responsibility of the member? In fact, how does a member know that FINRA is properly performing its compliance functions such as enforcing continuing education, fingerprinting and registration requirements? Based on the number of errors our firm has seen over the years in functions effectuated by CRD, for example, we're not convinced that FINRA is necessarily an adequate provider of such services, but since it is the only available option right now, we'll just have to make do.

[7] Proposed Rule 3190(a)(2).

[8] Proposed Rule 3190(b).

would take would likely be staggering, particularly since such reviews are required to be ongoing and FINRA has provided no guidance on the parameters of such a process. It is also, quite simply, absurd.

Generally, a member seeks professional advice and assistance to help it determine its obligations so that it can "…achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules…[,]" not the other way around. Moreover, members rely on their professionals to determine what constitutes such compliance, with the Proposed Rule again reversing the parties' expectations. The same would hold true for CPA firms retained by a member to conduct an annual audit, which must include a review by the CPA of the broker-dealer's adequacy and competency.[9] How would the broker-dealer confirm that the CPA firm is doing its job correctly? Is the broker-dealer responsible for, and even competent to determine, whether the CPA firm meets FINRA's undefined "standards?"

What FINRA is seeking to mandate is a circular argument comparable to the age-old chicken and egg conundrum. Instead, FINRA should articulate general principles of competency and supervisory expectations in a Regulatory Notice, such as was done in NtM 05-48, instead of in a rule that raises more questions than it solves and imposes cost burdens without commensurate benefits. Such a Regulatory Notice should provide guidance to members to do the best they can to ensure that whichever vendors/sub-vendors they use are competent, or as already required by NASD Rule 3010(a), to design supervisory procedures "…reasonably designed to achieve compliance with applicable securities laws and regulations." A member should not need to study or document why the member believes that Federal Express, Paychex, ADP, DTCC, clearing firms, etc. are competent, especially when the member is not competent to formulate such judgments with any degree of certainty.

[9] See SEC Rule 17a-5(g).

Another example is the outsourcing of IT and communications activities. These were expressly discussed in NtM 05-48, which concluded that "…a member may never contract its supervisory and compliance activities away from its direct control." (Emphasis added.) Although FINRA has wisely moved away from a "direct control" requirement, the burden FINRA now seeks to impose would fall disproportionately on small- and medium-sized firms, which represent the vast bulk of FINRA member firms and which currently, of necessity, rely on such third-party service providers to fulfill their regulatory obligations. These firms do not have the time, resources, competency or personnel to conduct ongoing due diligence and supervisory functions as described in the Proposed Rule. Yet another example is the current duplicative OATS and TRACE reporting requirements for members, even if such services are also provided by a regulated member for a fee charged to the member that is the beneficiary of the services. The securities industry has suffered greatly through FINRA's overly-exuberant enforcement of the notion that with respect to reporting requirements, a member firm may not delegate its responsibilities even to another FINRA-regulated member firm. The Proposed Rule is too similar to those reporting rules in that it effectively provides FINRA with additional fertile ground to discipline member firms, even well-run ones.

Perhaps FINRA should instead, as a service to its members, fund a certification program to identify qualified third-party service providers of certain specific functions?[10] Of course, members will end up paying for such certification, further squeezing an already overburdened industry.

Another problem is that the Proposed Rule does not distinguish between regulated and unregulated third-party service providers (and sub-vendors). A general determination of

[10] We would hope that any of the vendors available through FINRA's affinity programs would already be pre-vetted and automatically deemed acceptable.

competency, coupled with spot-check substantiation of results, should suffice for regulated providers (including those licensed as professionals under state law). Member firms that contract with unregulated – or otherwise unlicensed – entities or individuals (which simply means they are not engaged in services for which they receive transaction-based compensation) would benefit from a FINRA-sponsored certification program.

As a service to FINRA and the members, we provide below a partial list of third-party service vendors/sub-vendors whose competency would need to be vetted under the Proposed Rule:

- Payroll services
- ATS firms
- Floor brokers
- Outside counsel
- Independent auditors
- Tax return preparers
- Outside Financial and Operations Principals
- DTCC
- Banks
- Central Registration Depository
- Overnight delivery services
- U.S. Post Office
- Regulatory consultants
- AML examiners
- IT providers

- Internet Service Providers
- Execution platform providers
- Algorithmic trading systems analysts and programmers
- Service bureaus
- Etc.

In fact, the list is endless. The Proposed Rule cannot be applied to the real world.

Clearing and Carrying Firms

First, we believe that the supervisory rules governing clearing firms (Rule 3230 - approved by the SEC, but with an effective date not yet determined) and carrying firms (Rule 4311 – also approved by the SEC, but with an effective date not yet determined) should be sufficient as relates to members' supervision of third-party vendors and sub-vendors. Those rules already mandate the inclusion of the respective functions and responsibilities of each party to clearing and carrying agreements and could readily incorporate FINRA supervisory obligations. A member needing guidance with respect to such specialized agreements governing what, for most members, are essential operations is not likely to look for such guidance in a general rule addressing third-party vendors.

Second, the Proposed Rule would impose additional management and supervisory responsibilities on clearing and carrying members without a clear assessment by FINRA as to whether such additional controls are necessary and/or effective. Such firms, under the Proposed Rule, are expected to "…vest an associated person of the member with the authority and responsibility for:

(1) the movement of customer or proprietary cash or securities;

(2) the preparation of net capital or reserve formula computations; and

(3) the adoption or execution of compliance or risk management systems."[11]

Yet arguably, these burdens as articulated in the Proposed Rule are no different from the burdens already imposed by existing NASD/FINRA or SEC rules.[12] We certainly don't need redundant rules!

Clearing and carrying member firms are also now being ordered to perform the obvious, namely "…to take prompt corrective action where necessary to achieve compliance with applicable securities laws and regulations and with applicable FINRA and MSRB rules[.][13] Enlightened self-interest and the risk of reputational damage would likely be a far more realistic deterrent to such firms.

Two notification and approval requirements have also been added. If a third-party service provider transfers any duties to a sub-vendor, the clearing or carrying member for which such services have been subcontracted must approve the transfer. Actually, we believe there is value in this requirement, but no guidance is provided by FINRA for its implementation. No timing provisions for approval are provided and, of course, the clearing or carrying firm is expected not only to perform due diligence but also maintain a supervisory system and written procedures with respect to a sub-vendor with which it is not in contractual privity. Taken to an extreme, if a vendor transfers certain duties from one of its employees, officers or other associated persons to another such person, it has effectively chosen a new sub-vendor. How could the vendors operate efficiently if their customers - FINRA members - had control over their operations? And such control presumes that the vendors only have a single customer for

[11] Proposed Rule 3190(c).
[12] See, in particular, NASD Rule 1022(b)(2) which requires the designation of a registration-qualified chief financial officer who is responsible for a myriad of important functions.
[13] Proposed Rule 3190(d)(1).

which the approval process would need to be effective. Obviously, some of their FINRA-member customers might be happy with a new sub-vendor while others would be quite displeased with the change. These are costs that should reasonably be built into a clearing or carrying agreement, but since the firm is not likely to know of such a transfer to a sub-vendor when negotiating for its services with a member firm, clearing or carrying member firms are likely to pre-emptively increase their prices protectively. Again, another spiraling cost burden disproportionately borne by smaller- and mid-sized firms.

Finally, clearing and carrying firms are required to notify FINRA within thirty (30) calendar days after entering into any outsourcing agreement, stating the terms and conditions of the arrangement.[14] But this is a rule without a remedy. FINRA has no veto power over such agreements and has not provided any indication as to what it intends to do with the information provided. Its only guidance is that clearing and carrying firms are expected to review their existing outsourcing arrangements for compliance with the Proposed Rule. This rule, too, appears needlessly to increase costs without corresponding benefits.

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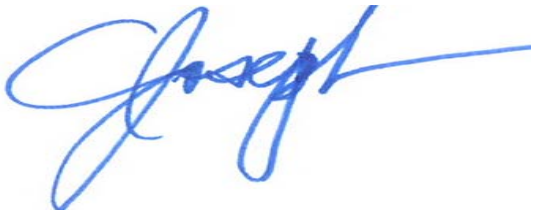
In sum, FINRA is attempting, once again, to micromanage its members – this time, in a situation where the economics that generate the need to outsource also dictate that members identify and work with third-party service providers that deliver practical and effective business solutions. The Proposed Rule should never be adopted. Instead, FINRA should review and update, if necessary, its current Regulatory Notices on the subject. This approach would allow FINRA to respond more quickly to emerging developments and fine-tune actual problems; that process would be much more efficient than any rule vetted through the rule-making process.

[14] Proposed Rule 3190(e).

Thank you for the opportunity to comment on this matter. Should you have any further questions, feel free to call Howard Spindel at 212-897-1688 or Cassondra Joseph at 212-897-1687, or by e-mail at **hspindel@intman.com or cjoseph@intman.com,** respectively.

Very truly yours,



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