Ridge

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

RE: Comment on Proposed FINRA Rule 3190 Presented in FINRA Regulatory Notice 11-14

Dear Ms. Asquith:

Ridge Clearing & Outsourcing Solutions, Inc. ("Ridge") appreciates the opportunity to comment on FINRA Regulatory Notice 11-14 (the "Notice"), which proposes new FINRA Rule 3190 (the "Proposed Rule"). Ridge is a registered broker-dealer that provides, among other services, operations support for broker-dealers. Our clients include some of the industry's most prominent financial service providers.

The Proposed Rule is intended to clarify a member firm's obligations and supervisory responsibilities regarding its outsourcing arrangements, and to impose additional restrictions and obligations that would apply solely to clearing and carrying member firms and their third-party service provider arrangements. Ridge generally supports the approach of the Proposed Rule, including, in particular, permitting a clearing member firm to use a third-party to post to its books and records, provided the clearing member firm conducts a spot-check review of such postings prior to the close of the business day following the postings.[1]

Ridge also generally supports the Proposed Rule's heightened requirements for movements of cash or securities, including that the authority and responsibility for such movements remain with a person associated with the clearing member firm. Ridge requests, however, that the Staff make clear that such heightened requirements would not prohibit a clearing member firm from outsourcing the clerical act of pushing a button, at the direction

[1] Notice at 5.

and under the supervision and control of the member firm, to effect such movements of cash or securities. An employee at a third-party service provider who acts upon specific instructions of the clearing member firm in performing a function that is subject to appropriate control and supervision by the clearing member firm, is not vested with the authority and responsibility for the resulting movement of cash or securities. Accordingly, that employee should not be required to be an associated person of the clearing member firm. The act of pushing a button (much like the performance of a system, itself) should be deemed a ministerial activity within the exception provided in sub-section (f) of the Proposed Rule, as long as the authority and responsibility for the underlying function remains with an associated person of the clearing member firm.

In reliance on existing regulatory guidance[2], clearing member firms that currently outsource operations support functions to Ridge have developed many effective controls to maintain their authority and responsibility over those functions, including the movements of cash and securities, whether or not the button to move cash or securities happens to be pushed by a person associated with the firm. Ridge, in fact, requires that its outsourcing clients, consistent with the regulatory guidance, establish detailed procedures, including written supervisory procedures, setting forth in detail the manner in which they will exercise comprehensive supervision and control over Ridge. Ridge's contracts give these clients the "tools" to exercise such supervision and control, including, for example, a clearly defined scope of services, service level agreements, an independent SAS 70 audit, governance structure, client-driven audit and inspection rights, exception reports and the sharing in liability for our errors. Further, Ridge's systems are designed to facilitate the clearing member firm's supervision and control, and in many cases, Ridge gives clients real-time insight into the performance of the outsourced activities and the ability to override Ridge's actions. Our clients have established extensive systems of internal control in reliance on existing regulatory guidance, and the additional requirements of the Proposed Rule discussed herein could be disruptive and costly to each of them.

Should the Staff, however, adopt an interpretation of the Proposed Rule that would generally require that all tasks involved in the movement of cash or securities be performed by an associated person of the clearing member firm--a position that we would consider unwarranted--Ridge believes that there should be an exception allowing for outsourcing performance of ministerial tasks relating to the movement of cash and securities to a third-party service provider that is a registered broker-dealer. Such an exception would follow the example of many other regulations under which a member firm may allocate key functions to a third-party, provided that the party is a registered broker-dealer.

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[2] *See* NASD Notice to Members 05-48 (April 2005) ("NTM 05-48") and FINRA Office of General Counsel Interpretive Memorandum, dated August 15, 2006.

DISCUSSION

I. Support for Spot-Check Review

Ridge supports the approach in the Proposed Rule (Supplementary Material .02), which permits a clearing member firm to perform a spot-check review of postings to its books and records by a third-party service provider prior to the close of the business day following the posting. Ridge agrees with the Staff's conclusion that this approach, in contrast to requiring the actual prior sign-off on each individual entry, achieves the efficiencies of outsourcing. Clearing firms will be able to reduce overhead costs, increase speed and flexibility and achieve operational/structural efficiencies, while protecting the integrity of the carrying member firm's books and records. Ridge finds the subsequent spot-check review approach to be a realistic, workable and practical solution that reflects how business is conducted today.

II. Need to Clarify that Proposed Rule 3190(c) Does Not Prohibit Outsourcing

Ridge fully agrees with the Staff's view of the critical importance at a clearing member firm of the movement of cash and securities and the need to protect customer funds and securities from errors, fraud, and other violative conduct by unauthorized persons. Ridge believes, however, that there is a need to clarify that Proposed Rule 3190(c) would not prohibit a clearing member firm from outsourcing purely ministerial, non-discretionary tasks, such as button pushing involved in the movement of funds and securities.

The Notice states that the Proposed Rule requires "persons responsible for the handling, transfer or disposition of cash or securities as they enter and flow from the firm be associated persons of the member firm."[3] Proposed Rule 3190(f)(1), however, appropriately excepts from the provisions of the Rule, "ministerial activities performed on behalf of a member," unless otherwise prohibited. Ridge urges the Staff to clarify that this ministerial exception would permit the outsourcing of certain functions relating to the movement of customer or proprietary cash or securities where those functions involve purely ministerial activities. This clarification follows logically from availability of the general ministerial exception. Moreover, it would be entirely consistent with the approach taken in the other sections of Proposed Rule 3190(c), where heightened requirements are also imposed.

Specifically, while Proposed Rule 3190(c)(2) requires a clearing member firm to vest an associated person of the firm with the authority and responsibility for the preparation for net capital and reserve formula computations, the Notice recognizes that the "performance of calculations in aid of the preparation of these computations" are purely ministerial functions that can be performed by a third-party service provider.[4] Similarly, while Proposed Rule

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[3] Notice at 5.

[4] *Id.*

3190(c)(3) requires a clearing member firm to vest an associated person with the authority and responsibility for the adoption or execution of compliance or risk management systems, the Notice permits the performance by a third-party service provider of "basic calculations logging or maintaining lists that are preparatory to creating books and records and review of output from these systems."[5] In other words, the same ministerial exception should apply to all the sections of Proposed Rule 3190(c).

In particular, Ridge requests the Staff to make clear that Proposed Rule 3190(c)(1) does not prohibit a clearing member firm from outsourcing the pushing of a button to move cash or securities. A primary benefit of outsourcing is the efficiency achieved by having a third-party perform the clerical task of pushing buttons. The mere physical act of button pushing does not involve any exercise of discretion or judgment. Imposing a requirement that such a physical act can only be performed by an associated person of the clearing member firm would deny that firm the acknowledged benefits of outsourcing. Ridge believes that member firms have a strong track record demonstrating effective controls that allow them to maintain full authority and responsibility for movements of cash and securities, notwithstanding that ministerial tasks are not performed by associated persons.

The spot-check review is one example of such a control. Ridge's clearing member firm clients have successfully implemented many additional controls, including: (i) detailed procedures and instruction manuals for the outsourced tasks, essentially eliminating exercise of judgment or discretion on the part of the service provider; (ii) written supervisory procedures specifying the persons at the firm who will supervise the outsourced tasks, how the tasks are supervised, and documenting performance of supervisory responsibilities; (iii) systematic controls, including regular surveillance, exception reports, and access to books and records; (iv) contractual protections, such as service level agreements (including extensive reporting requirements and penalties), a clearly defined scope of support, an independent SAS 70 report, extensive governance requirements, customer ability to take corrective action, customer rights to approve subcontractors, audit and inspection rights, liabilities, indemnities, and remedies; (v) firm-wide policies and procedures applicable to outsourcing engagements, including governance committees and procedures, standards to be applied in selecting service providers performing initial and ongoing due diligence of service providers; and (vi) actual performance of due diligence of the service provider. Ridge currently has in place a number of outsourcing arrangements that incorporate such controls. Ridge believes, based on its experience and the feedback it receives from its clearing member firm clients, that such controls are very effective. Ridge's clients are subjected to annual audits by FINRA. To our knowledge, no issue has ever been raised in these audits regarding the adequacy of clients' controls over any of the outsourced functions (including the movement of cash or securities). Ridge receives high service scores from its clients, has never paid a penalty for failing to meet a service level obligation, and meets SAS 70 audit standards. It would be very costly and

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[5] *Id.*

unjust to require clients to undo these arrangements, particularly when Ridge and its clearing member firm clients tailored them in good faith relying on longstanding regulatory guidance.[6]

The appropriateness of an exception for ministerial activities relating to the three functions of Proposed Rule 3190(c) is widely recognized. For example, under FINRA's Ops Plus Proposal, which would create a new registration category for "Operations Professionals," the registration requirements of that proposal would not apply to persons who are engaged solely in clerical or ministerial activities in any of the covered functions, which include "[c]ollection, maintenance, re-investment (i.e., sweeps) and disbursement of funds", "receipt and delivery of securities and funds, account transfers", and "[p]osting entries to the books and records of a member in connection with the [other] covered functions."[7] Further, the SEC has concluded that "clerical and ministerial" activities specifically include, among others, "bookkeeping and record keeping, performing calculations, and data processing functions."[8]

III. Alternative Proposed Exception to Rule 3190(c)

As indicated above, Ridge strongly believes that the Proposed Rule should not be interpreted to require that all tasks involved in the movement of cash and securities be performed by an associated person. Should the Staff, however, adopt a contrary interpretation that would require ministerial tasks like button pushing be performed by associated persons, Ridge would urge the Staff to adopt an exception to the Proposed Rule allowing a clearing member firm to outsource those tasks to a third-party service provider, that is a registered broker-dealer.

Such an exception would follow the many examples of regulations that allow a broker-dealer to allocate performance of a function (including functions that may involve significant risk) to another regulated broker-dealer, provided that the broker-dealer allocating performance retains the ultimate responsibility for regulatory compliance of those functions. Examples of functions which a broker-dealer may allocate to another registered broker-dealer, where the outsourcing firm maintains full responsibility for regulatory compliance, include:

1. **Trade Reporting.** Under FINRA Rule 6380B(g), a Trade Reporting Facility Participant member firm may agree to allow another member firm to report and lock-in trades on its behalf, if both firms have completed a "give up agreement," as specified by FINRA, and submitted the agreement to the FINRA/NYSE Trade

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[6] Prior outsourcing guidance, including NTM 05-48 and NYSE Proposed Rule 340, would allow a clearing member firm to outsource to a third party-service provider ministerial tasks relating to movements of cash or securities.

[7] Registration and Qualification Requirements for Certain Operations Personnel, Regulatory Notice 10-25, at 3 (May 2010).

[8] SEC Release No. 34-44291, note 179 (May 11, 2001).

Reporting Facility. The member with the reporting obligation remains responsible for the transaction submitted on its behalf.

2. **Market Access.** Under Exchange Act Rule 15c3-5, a broker-dealer providing market access can allocate, by written contract, control over specific regulatory risk management controls and supervisory procedures to a customer that is another registered broker-dealer. Paragraph (d)(2) of the Rule, however, makes clear that any such allocation of control does not relieve the broker-dealer providing market access from any obligation under the Rule, including the overall responsibility to establish, document and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of market access. Thus, the broker-dealer providing market access remains ultimately responsible for the performance of any regulatory risk management control or supervisory procedure, including those allocated to a broker-dealer customer.

3. **Notices Under Regulation M.** FINRA Rule 5190 allows a broker-dealer member of a syndicate to allocate to another broker-dealer member, by written agreement, responsibility for providing written notice to FINRA of distributions of securities subject to Regulation M. Responsibility for submitting a notice of engaging in penalty bids and syndicate covering transactions can be similarly allocated to another member by written agreement.

A broker-dealer outsourcing to a FINRA-regulated entity provides significant protections that are not present when outsourcing to non-members. Ridge believes that these protections should make it possible to outsource ministerial tasks relating to movements of cash or securities to another registered broker-dealer. A member firm outsourcing to another member offers all of the protections afforded by the supervisory structure of one regulated entity, but also affords the additional supervisory oversight of the regulated service provider. Both member firms would continue to supervise their associated persons, but there would now be two firms with responsibility for compliance, with the outsourcing broker-dealer retaining full responsibility for compliance of the functions it outsources, and the regulated service provider having responsibility for compliance of the functions it performs. Outsourcing to a registered broker-dealer would also offer the added benefit of regulatory oversight of the service provider by FINRA.

Requiring that all tasks relating to the movement of customer or proprietary cash or securities only be performed by associated persons of the clearing or carrying member firm presumes that such tasks are best performed by the firm itself. Clearly, this is not always the case. The opportunity of a clearing firm member to select a service provider that has developed a special competency through performing a function for many member firms is a principal reason such firms choose to outsource. The importance of protecting customer funds and securities is precisely the reason to permit clearing member firms to outsource the

performance of the function to a highly experienced registered broker-dealer with advanced systems and controls.

In the same way proposed Supplementary Rule .02 allows for following-day review of posting items to a member's books and records, an exception that allows outsourcing movements of cash or securities to another registered broker-dealer could be subject to prompt review by the outsourcing broker-dealer. The exception could also be subject to a requirement that the outsourcing broker-dealer provide prior notice to FINRA and demonstrate its due diligence on the ability of the regulated service provider to perform the outsourced functions.

A. Shared Employee Arrangements are Awkward and Inefficient

An interpretation of the Proposed Rule that requires clearing firms to "vest an associated person of the member firm" with performing all movements of cash or securities means that a clearing or carrying member firm that seeks to outsource these functions would have no realistic way of doing so without effecting a shared employee arrangement. Such arrangements are impractical and ineffective at best at meeting the efficiency goals of outsourcing recognized by the Staff in the Notice. Moreover, they present potential conflicts.

Supervision is more difficult under a shared employee arrangement because the shared employee wears multiple hats. It is difficult for a shared employee to determine which hat he or she is wearing at any given time and which supervisor is overseeing which task. It is also expensive and duplicative for firms to maintain shared employee status. For example, each firm will need to provide the shared employee with human resources, payroll, computer access, and training in its unique corporate policies. Requiring all movements of cash or securities to be performed by a person associated with the clearing member firm becomes even more complicated when one experienced shared employee at the service provider may perform the same function for ten different clearing member firms. Under the Proposed Rule, that one person would be required to be associated with all ten firms, as well as the service provider. Traditional outsourcing to one entity is far more efficient and reliable.

Further, the shared employee may find it difficult to reconcile the duty of loyalty and confidentiality the employee owes to each firm with which he or she is associated. The arrangement may also raise outside business activity issues under FINRA Rule 3270. For example, each member firm would need to consider whether the shared employee's activities for the other employer(s) will interfere with or otherwise compromise the registered person's responsibilities to the member and/or the member's customers; or be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered.[9]

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[9] FINRA Rule 3270

B. Previous Guidance Recognizes Clear Benefit of Outsourcing to a Regulated Entity

The withdrawn Proposed NYSE Rule 340 would have allowed a broker-dealer, subject to a heightened standard of due diligence, to outsource "core activities," defined as those activities that are deemed material to the broker-dealer's functioning as such. The "core activities" expressly included "the delivery, handling and safeguarding of funds and securities," and "the creation of original books and records."[10] Because these functions and activities were deemed to be central to a broker-dealer's business, Proposed Rule 340 required that any outsourcing broker-dealer provide prior notice to the regulating body and meet a heightened standard of due diligence with respect to the service provider. The level of required scrutiny would have been determined, in part, by the type of entity that would be acting as service provider. Significantly, Proposed Rule 340 exempted from both the prior notification requirement and the prescribed general due diligence requirement those outsourcing arrangements pursuant to which a registered broker-dealer would be the service provider. It sensibly recognized that outsourcing to a registered broker-dealer should be accorded preferential treatment. The Proposed Rule should follow the same approach if the Staff is not prepared to confirm the availability of the exception in Proposed Rule 3190(f)(1) to ministerial activities relating to the movement of cash or securities.

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Ridge is grateful for this opportunity to comment on the Proposed Rule and welcomes a continued dialogue with FINRA on this important subject. Please feel free to contact me at 516-472-5008 or via e-mail at Adam.Behar@ridgeclearing.com.

Very truly yours,

Adam Behar
General Counsel

cc: Grace Vogel, Executive Vice President, Member Regulation, FINRA
Patricia M. Albrecht, Associate General Counsel, FINRA
Joseph Barra, President, Ridge Clearing & Outsourcing Solutions, Inc.

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[10] SEC Form 19b-4 of Proposed Rule 340 (March 16, 2005) at 6.