Richard J. O'Brien
Chief Compliance Officer
National Financial Services LLC
200 Seaport Boulevard, Boston MA 02210
617.563.6986 richard.j.o'brien@fmr.com

June 22, 2018

Via Electronic Mail (pubcom@finra.org)

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
Financial Industry Regulatory Authority
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-10 | FINRA Requests Comment on the Effectiveness and Efficiency of Its Carrying Agreements Rule (FINRA Rule 4311)

Dear Ms. Mitchell:

National Financial Services, LLC[1] ("NFS" or the "Firm") appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") Regulatory Notice 18-10, in connection with FINRA's retrospective review of its carrying agreements rule, Rule 4311.[2] As an active member of FINRA's recently established Clearing Firms Advisory Committee, and a participant on FINRA's inaugural Clearing Firms Roundtable, NFS welcomes FINRA's evaluation of the effectiveness and efficiency of Rule 4311. Before responding to specific questions that FINRA has posed in the Regulatory Notice, we provide some background information regarding NFS and the fully disclosed clearing business in general. We believe this background information will help provide context to the Firm's comments.

[1] NFS, a Fidelity Investments company, is an SEC-registered clearing and carrying broker-dealer and FINRA member. As such, NFS acts as the custodian for cash and securities for: (i) customers of its affiliated retail introducing broker-dealer Fidelity Brokerage Services LLC ("FBS"); (ii) customers of unaffiliated introducing broker-dealers and investment advisors; and (iii) its direct institutional customers. Fidelity Investments is a leading provider of investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services.

[2] FINRA Regulatory Notice 18-10, Retrospective Rule Review; FINRA Requests Comment on the Effectiveness and Efficiency of Its Carrying Agreements Rule (March 23, 2018). The Clearing Firm Committee of the Securities Industry and Financial Market Association ("SIFMA"), of which NFS is a member, also has submitted a comment letter regarding Rule 4311, with which NFS agrees. NFS submits this letter to supplement the SIFMA letter on specific issues.

Background

NFS clears transactions on a fully disclosed basis for over 200 "introducing" broker-dealer firms ("introducing firm"). As a clearing broker-dealer ("clearing firm"), NFS provides "back office" processing (clearance and settlement) and custody services to affiliated and non-affiliated introducing firms pursuant to fully disclosed clearing agreements which are filed with, and approved by, FINRA pursuant to Rule 4311. Because many introducing firms do not have the resources, net capital, personnel or expertise to clear and settle their own trades and custody customer assets, introducing firms often contract with a clearing firm (such as NFS) to perform their back office and administrative functions. These functions include, but are not limited to, clearing and settling securities trades for customers of introducing firms, extending margin, and maintaining custody of customer funds and securities. As a result, the vast majority of introducing firms registered with the Securities and Exchange Commission ("SEC") enter into contractual arrangements with a fully disclosed clearing firm.

The clearing business plays a vital role in the securities markets. Without the services of clearing firms, the speed and efficiency of the modern day securities market would simply not be possible. Many introducing firms, and in particular smaller firms, could not enter or remain in the securities business because of substantial costs and capital requirements associated with self-clearing.[3] Among other items, these costs and requirements include having sufficient capital; maintaining membership and compliance with the rules of the various securities exchanges, clearing agencies, and securities depositories needed to engage in this business; and bearing the cost of the fixed overhead technology and personnel expenses associated with clearance, settlement, and custody. The significant resources and regulatory requirements associated with the clearing business make it a heavily regulated business that requires significant capital and operational expenses on the part of the firms providing these services. In addition, the expansion of potential clearing firm liability (as discussed below) has increased risks and costs to the clearing industry, such that the number of clearing firms available to provide services to unaffiliated firms has significantly decreased over the years (due to mergers, sales or otherwise), and new firms are not entering this business.

The framework underlying Rule 4311 (and its predecessor rules NYSE 382 and NASD 3230) was intended in part to address the so-called "Paper Crisis" of the 1960s and 1970s. An underlying understanding with respect to this framework, under which smaller firms could enter the securities business, was that in exchange for performing routine and ministerial functions on behalf of introducing firms, clearing firms were supposed to be free from liability or regulatory responsibility for acts or omissions of introducing firms. Under a more traditional model, all end customer-facing or "front office" responsibilities under clearing agreements are allocated exclusively to the introducing firm, including account opening, due diligence, suitability and supervision of accounts, account activity, and registered representatives. Because the relevant

[3] *See, e.g.*, Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, Vol.48, No.3, THE BUSINESS LAWYER, 841-868 (May 1993).

front office duties are formally allocated to the introducing firm and confirmed in a written agreement approved by FINRA, the clearing firm is relieved of these front office duties.[4]

This concept is reflected in the longstanding legal principle in the securities industry that clearing firms generally do not have a fiduciary relationship with customers of introducing firms because of their limited roles with those customers.[5] This limited customer-facing role generally shields clearing firms from liability to the end customers of its introducing firms. The SEC has summarized this concept as follows:

> In the typical fully disclosed [clearing] relationship between a customer, an introducing firm and a clearing firm, the clearing firm's contact with the customer is limited to transmitting confirmations, account statements and other correspondence such as proxy statements or Regulation T notifications. The introducing firm is responsible for accepting customer orders and other trading instructions. Under these circumstances, the clearing firm's primary (and frequently only) source of information about the customer is the introducing firm. Typically, the customer agreement between the clearing firm and the customer will authorize the clearing firm to accept instructions and orders from the introducing firm for the customer's account without inquiry or investigation, unless the clearing firm receives prior written notice from the customer to the contrary.[6]

NFS fully supports this long-standing legal principle, which provides a basis for many of our responses and comments below.

1. *Is the rule effective in ensuring clear allocation of responsibilities between parties to a carrying agreement? If not, why not? Are there additional responsibilities that the rule should specifically require to be allocated? Are there responsibilities that the rule should not permit to be allocated? Why*?

NFS believes that FINRA Rule 4311 generally has been effective in providing latitude to introducing firms and clearing firms to allocate responsibilities among themselves in instances where the rule is silent on the allocation of a function. While this allocation of responsibilities

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[4] *See* NYSE Information Memo 82-18 (Mar. 5, 1982).

[5] *See*, e.g., Goldstein v. CIBC World Mkts. Corp., 776 N.Y.S.2d 12, 14 (1st Dep't 2004); Strategic Income Fund L.L.C. v. Spear, Leeds & Kellogg Corp., 305 F.3d 1293, 1296 n.12 (11th Cir. 2002) ("In drafting Count IV, counsel was certainly mindful of the general rule that clearing firms have no fiduciary relationship with the customers of introducing brokers"); McDaniel v. Bear, Stearns & Co., Inc., 196 F. Supp. 2d 343, 352 (S.D.N.Y. 2002) ("It is well-settled that, when a clearing firm acts merely as a clearing agent, it owes no fiduciary duty to the customers of its introducing broker and cannot be held liable for the acts of an introducing firm."); Connolly v. Havens, 763 F.Supp. 6, 10 (S.D.N.Y.1991) ("It is well-established that a clearing firm ... does not have a fiduciary relationship with the customers ... of the introducing broker with which it has contracted to perform clearing services.").

[6] *See In re* Bear, Stearns Secs. Corp., Exchange Act Release No. 41,707, 54 S.E.C. 224, 232 (1999).

may be clear to the firms involved, FINRA's views on the allocation of responsibilities between introducing and clearing firms may be different, and this difference of opinion often manifests itself during regulatory examinations, most frequently in the context of new regulatory requirements for which there is little to no guidance regarding appropriate allocations. Lack of regulatory guidance on allocations of responsibilities between clearing firms and introducing firms can sometimes result in FINRA examination staff taking the misguided view that a clearing firm (i) has *de facto* responsibility for functions that are not expressly allocated to it in a clearing agreement, and (ii) is responsible for performing regulatory and compliance oversight of the introducing firms with whom they do business.

While we understand that amending Rule 4311 whenever a new regulatory requirement is enacted would not be feasible, we believe that guidance and interpretations connected with a rule requirement that incorporates the impact or implications specific to the clearing and/or the introducing firms and that discuss possible (but not required) means by which introducing firms and clearing firms can allocate responsibilities could help alleviate the concerns mentioned above. We recommend that FINRA provide such guidance in the rule filings that FINRA submits to the SEC under Rule 19b-4 of the Securities Exchange Act of 1934 or in Regulatory Notices that accompany announcements of SEC approved FINRA rules and rule changes. Less optimally, FINRA could also include this guidance in FAQs that often accompany new rule requirements, once a rule has been approved and finalized.

An example of a new rule requirement that benefited from clarity concerning clearing firm and introducing firm obligations can be found in the post-rulemaking FAQs issued for FINRA's recent revisions to FINRA Rule 2232 to require mark-up/mark-down disclosure on confirmation statements to retail customers for corporate and agency bonds. During the rulemaking process, clearing firms often communicated to FINRA that they would not be in a position to provide information necessary for introducing firm to comply with the rule. In FAQ's issued after the final rule was published, FINRA clarified that introducing firms "bear the ultimate responsibility for compliance" with the rule.[7] This guidance was helpful, although it could have been more helpful if it was issued earlier in the rulemaking process, such as in connection with the final rule.

An example of a new rule requirement that did not benefit from this guidance is the new margin requirements for "covered agency transactions" under amended FINRA Rule 4210. While the amended rule made clear the circumstances under which margin must be collected in connection with covered agency transactions; it did not take into consideration the various counterparties that could be associated with such transactions in a clearing context, including the limited agency role of clearing firms and that clearing firms may not actually be the counterparty

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[7] *See* FINRA Fixed Income Confirmation Disclosure: Frequently Asked Questions, FAQ 1.9 (2018), http://www.finra.org/industry/faq-fixed-income-confirmation-disclosure-frequently-asked-questions-faq (In arrangements involving clearing dealers and introducing or correspondent dealers, who is responsible for mark-up disclosure?")

to a transaction. Although FINRA published FAQs[8] and a Regulatory Notice[9] regarding the new requirements under FINRA Rule 4210, it did not provide meaningful guidance that included the perspective of clearing firms regarding the way the margin collection requirements would impact clearing arrangements outside of language that clearing firms and introducing firms could allocate functions among themselves.[10] Thus, in addition to guidance that includes a clearing firm point of view on new rule requirements, it may also be helpful for FINRA to initiate discussions with clearing firms, such as NFS, in order to understand how new regulatory requirements could impact clearing arrangements. In doing so, potential issues may be mitigated for clearing firms and introducing firms prior to a rule's adoption and/or the issuance of FAQs. We believe that this consultation process should be relatively easy, given FINRA's newly established Clearing Firms Advisory Committee.

While there may be additional responsibilities that may be specifically allocated, we believe that these are topics for further discussion.

2. *Has the rule served its intended purposes? To what extent have the original purposes of and need for the rule been affected by subsequent changes to the markets, the delivery of financial services, the applicable regulatory framework or other considerations? Are there alternative ways to achieve the goals of the rule that FINRA should consider?*

To the extent Rule 4311 was intended to address the "Paper Crisis," it has met, and continues to meet, its intended purpose. However, to the extent the rule was designed to require on-going allocation of new responsibilities, it has been less than fully successful for the reasons outlined in our response to question #1 above.

Further, to the extent the rule was premised on an understanding that clearing firms would not be held responsible for the acts and omissions of introducing firms, claimants' counsel has sought to erode that understanding over time. Though the limited liability of clearing firms has generally been established by the courts and under long-standing legal precedent, the current FINRA arbitration rules (as amended in 2009) provide very few grounds upon which a clearing

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[8] Frequently Asked Questions & Guidance Covered Agency Transactions Under FINRA Rule 4210, FINRA (Sept. 15, 2017, as updated May 2, 2018), at https://www.finra.org/sites/default/files/faq_coveredtransactions_rule4210.pdf; and Frequently Asked Questions Regarding Exchange Act Rules 15c3-1 and 15c3-3 in Connection with Covered Agency Transactions under FINRA Rule 4210, FINRA (Sept. 5, 2017), http://www.finra.org/sites/default/files/faq_coveredtransactions_sec.pdf.

[9] Covered Agency Transactions, FINRA, Regulatory Notice 16-31 (Aug. 2016).

[10] Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; *Notice of Filing of a Proposed Rule Change To Amend FINRA Rule 4210 (Margin Requirements) To Establish Margin Requirements for the TBA Market*, Exchange Act Release No. 76148 (Oct. 14, 2015), 80 Fed. Reg. 63603, 63619 (Oct. 20, 2015) ("FINRA notes that Rule 4311 permits firms to allocate responsibilities under carrying agreements so that, for instance, an introducing firm could calculate margin and make margin calls, provided, however, that the carrying firm is responsible for the safeguarding of funds and securities for the purposes of SEA Rule 15c3-3").

firm can file a pre-hearing motion to dismiss.[11] As a result, clearing firms are forced to expend significant time and resources defending arbitrations that are based on allegations against an introducing firm in connection with functions that have been exclusively allocated to the introducing firm under a clearing agreement (*e.g.*, sales practices, suitability, and customer account approvals). This is the case even in instances where the claims are fully devoid of allegations of knowledge or participation on the part of the clearing firm.

NFS believes that the increase in the scope of potential clearing firm liability (1) undercuts the overall effectiveness of FINRA Rule 4311, which is intended to allocate responsibilities and liabilities between clearing firms and introducing firms, and (2) is inconsistent with prior regulatory guidance, which stated that where the relevant responsibilities are formally allocated to one party under the clearing agreement approved by the regulators, the other party to the clearing agreement is relieved of those duties.[12]

The scope of resources expended to reinforce this understanding of limited liability of clearing firms has unnecessarily expanded due to the clearing firm being viewed as a "deep pocket" particularly when the introducing firm responsible for the misconduct goes out of business (*e.g.*, files a Form BDW) and leaves thousands of orphaned end customer accounts on the clearing firm platform. More specifically, the proliferation of litigation against clearing firms by claimants who seek to hold the clearing firm vicariously liable for the alleged acts or omissions of introducing firms simply by virtue of carrying those firms' accounts has had, and will continue to have, a negative impact on the fully disclosed clearing business, thereby harming the industry and end customers. This is particularly the case with respect to arbitrations where clearing firms are named as a party solely because they provide clearance and settlement services to the introducing firm involved.

Because the means to address clearing firm liability is outside the scope of this Regulatory Notice, NFS is interested in starting a dialogue with FINRA on the scenarios described above. We believe that there are a number of ways to achieve a more equitable balance across firms consistent with the regulatory premises underlying Rule 4311 and its predecessors. This might include, for example, a reiteration by FINRA of the regulatory expectations regarding the allocation of responsibilities between firms (and the consequences thereof), or the use of a safe harbor for clearing firms.[13] We welcome discussing this and other approaches with FINRA.

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[11] In 2009, FINRA amended its arbitration rules to "discourage" pre-hearing motions to dismiss, and expressly limited pre-hearing motions to dismiss, to one of three scenarios: (1) prior settlements and releases; (2) movant is not associated with the account, security or conduct at issue; or (3) res judicata/collateral estoppel. See FINRA Rule 12504.

[12] *See* NYSE Information Memo *supra* note 4.

[13] This would not be the first time FINRA provided some sort of safe harbor guidance. For example, based on concerns raised by the SIFMA Clearing Firms Committee in 2011 in response to the then proposed amendments to FINRA Rule 2340 (Customer Account Statements) and the inability of clearing firms to determine the reliability of valuations received from third parties for certain alternative investments , FINRA eventually codified a safe harbor for clearing firms to follow in connection with their posting of the estimated value of a DPP or REIT on the account

3. What has been your experience with implementation of the rule, including any ambiguities in the rule or challenges to complying with it?

As mentioned above, in NFS' experience, FINRA examination staff often take the view that clearing firms (i) have *de facto* responsibility for functions that are not expressly allocated in a clearing agreement and (ii) are responsible for performing regulatory and compliance oversight of the introducing firms with whom they do business. Because of this, resources that could otherwise be expended to improve efficiencies and the experiences of introducing brokers and their customers are instead redirected to respond to the expanded expectations of FINRA examination staff. As reflected throughout this letter, the efficiencies of the clearing business can be greatly enhanced through thoughtful consideration on the part of FINRA regarding how new regulatory requirements or changing FINRA policy perspectives actually impact the clearing business to help clarify expectations prior to an examination cycle. Moreover, it would be helpful for FINRA to reiterate that introducing firms have independent regulatory and supervisory obligations for which the clearing firm is not, and has never been, responsible.

4. What has been your experience with FINRA's approval process for carrying agreements and changes to carrying agreements? What modifications to the process, if any, would be appropriate? Why?

NFS' experience with respect to FINRA's approval process generally has been positive. In particular, the Firm has a favorable view of the 10-day approval process for agreements where the clearing firm is using an approved template agreement.

5. The rule sets forth specified requirements with respect to the furnishing of reports by the carrying firm to the introducing firm. Are these requirements effective? What modifications, if any, would be appropriate? Why?

As reflected in SIFMA's comment letter, we also believe that paragraph (h) of Rule 4311 is unnecessary and should be eliminated based upon, among other things, the fact that introducing firms are made aware of the tools and data that are continuously available to them from their clearing firm, typically through the clearing firm's intranet site and ongoing dialog between firms. Introducing firms can use those tools and information to determine the controls they believe are necessary, in order to appropriately supervise their business.

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statement. FINRA 2340(c)(1) (effective in 2016) states that the clearing firm shall include the estimated value on the account statement as long as it is "developed in a manner reasonably designed to ensure that it is reliable". The rule itself then provides two alternative valuation methodologies that it deems reliable: net investment or appraised value. See FINRA 2340 (c)(1) ("[a] per share estimated value for a DPP or REIT security will be deemed to have been developed in a manner reasonably designed to ensure that it is reliable if the [clearing firm] member uses one of the following per share estimated value methodologies"). This safe harbor has brought much needed clarity to the industry vis-a-vis third-party pricing.

While clearing firms currently provide introducing firms with notice regarding the availability of pre-formatted reports as contemplated by Rule 4311(h), the clearing business and its associated technologies have matured since the time that the operative provisions of Rule 4311(h) were first developed. While the rule articulates that clearing firms are under no obligation to provide any reports, some clearing firms such as NFS provide introducing firms with a wide assortment of tools and data sets that can be used to help introducing firms with their supervisory responsibilities. Introducing firms are made aware of the availability of these tools and data sets when they access NFS' platform. We believe that this continuous access makes the requirement to send an annual notice regarding the availability of reports now obsolete.

6. ***To what extent does the rule impact the availability of clearing services to small firms? How could the rule or FINRA's approval process be changed to help small firms obtain access to clearing consistent with investor protection?***

As a general matter, NFS does not believe that Rule 4311 in and of itself adversely impacts the availability of clearing services to small firms. However, the extra resources that clearing firms expend to address certain unannounced expectations on the part of FINRA examiners and to defend against arbitration claims, coupled with capital demands, can factor into a clearing firm's risk assessment as to whether to provide services to certain smaller firms. In this regard, we note that Rule 4311 correctly requires the clearing firm to conduct "financial, operational, credit and reputational risk" due diligence prior to accepting a new firm onto its platform.[14]

7. ***What are the challenges for small firms in coordinating with clearing firms to respond to regulatory inquiries or to assist their customers? How could these challenges be addressed by FINRA consistent with investor protection? Are there uniform templates or formats that could be used to increase the efficiency of such coordination?***

As mentioned above and consistent with SIFMA's comment letter, we believe that eliminating outdated provisions, such as 4311(h), and providing increased flexibility to permit the transfer of data elements rather than static pre-formatted reports can increase efficiencies in the way that clearing firms and introducing firms coordinate with each other. From a procedural standpoint, we believe that it would be useful for FINRA to jointly develop with firms a uniform approach to requesting information, including through the use of templates or specific formats. These small changes can help smaller introducing firms more efficiently allocate their limited regulatory resources and reduce the numerous different types of reports that clearing firms create to accommodate FINRA examination staff requests to introducing firms.

8. ***With respect to "intermediary" or "piggyback" clearing, does the rule and approval process provide sufficient flexibility and clarity to establish such clearing arrangements?***

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[14] FINRA Rule 4311(b)(4).

What, if any, changes should be made to the rule and process to accommodate such arrangements consistent with investor protection?

Like SIFMA, NFS recognizes that intermediary or "piggy-backing" arrangements can give smaller introducing firms access to clearance and settlement services. However, we recommend that FINRA memorialize a requirement stating that the primary introducing firm has a due diligence responsibility in terms of its review of the secondary firm and supervisory responsibilities for the arrangement. In particular, the primary introducing firm should be responsible for evaluating the proposed business of the piggy-backing firm using a risk-based approach, determining whether the piggy-backing introducing firm has the financial wherewithal to engage in the securities business, and otherwise evaluating the piggy-backing introducing firm and its personnel much like an introducing firm would conduct due diligence on a private placement issuer, for example. Doing so can help alleviate some potential inefficiencies and risk concerns that some clearing firms may experience when considering whether to enter into these types of arrangements.

9. ***What have been the economic impacts, including costs and benefits, arising from FINRA's rule? Have the economic impacts been in line with expectations described in the rulemaking? To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models? Has the rule led to any negative unintended consequences?***

As mentioned above, the clearing business is a capital-intensive business with significant fixed overhead costs and requires efficient processes. Clearing firms such as NFS often have to unnecessarily expend resources to address frivolous arbitration claims, reformat or build reports in multiple different ways for introducing firms to respond to FINRA requests, or respond to unfounded expectations on the part of FINRA examiners. These are resources that could otherwise be used to improve the services provided to introducing firms at more efficient costs, which should ultimately benefit introducing firms' customers.

10. ***Can FINRA make the rule, interpretations or attendant administrative processes more efficient and effective? If so, how?***

As mentioned above, FINRA has an opportunity to provide more meaningful guidance regarding the impact that new regulatory requirements have on clearing arrangements by obtaining the views of clearing and introducing firms and incorporating those views, as applicable, in Rule 19b-4 filings, Regulatory Notices, and FAQs. Further, FINRA could address many operational concerns through dialogue to clearing firms, such as through FINRA's new Clearing Firm Advisory Committee, before developing new rule proposals in order to properly assess the impact that such requirements will have on the clearing business.

In addition to comments responsive to these questions, FINRA invites comment on any other aspects of the rule that commenters wish to address.

Consistent with SIFMA's comment letter, we also would like to mention that while FINRA Rule 4311 and related interpretations are focused on the allocation of responsibilities in connection with entering into and maintaining an ongoing clearing arrangement, the rule provides less clarity when it comes to a clearing arrangement's end-of-life cycle. There are no express responsibilities imposed on introducing firms when their customer accounts are not converted to a new clearing firm, such as based on an investment type not supported by their new clearing firm or when they file a Form BDW that results in the clearing firm having orphaned accounts on its books for extended amounts of time. This lack of clarity results in, among other things, an increased number of orphaned accounts on the clearing firm's books and disruptions in the provision of certain account services (*e.g.*, new purchases) to customers. We believe that FINRA should consider whether possible amendments to the rule should be implemented that address the processes that clearing firms confront when, for example, an introducing firm exits the securities business on a voluntary or involuntary basis, or elects to convert to a different clearing firm.

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NFS appreciates the opportunity to provide feedback to FINRA as it evaluates FINRA Rule 4311. We would be happy to discuss these comments in detail with the FINRA and its staff.

Sincerely,

Richard J. O'Brien

cc:

Mr. Robert Cook, President and Chief Executive Officer, FINRA

Mr. Robert Colby, Chief Legal Officer, FINRA