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Fidelity INVESTMENTS

BY OVERNIGHT MAIL

February 5, 2019

Mr. Robert W. Errett
Deputy Secretary
Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: File Number SR-FINRA-2018-039, Proposed Changes to FINRA Rule 4570 (Custodian of Books and Records)

Dear Mr. Errett:

National Financial Services LLC[1] ("NFS") submits this letter in connection with FINRA's proposed changes to FINRA Rule 4570 (File No. SR-2018-039) to highlight a few significant concerns that NFS has to the proposed rule change.

The crux of the proposed rule change is to allow a member that is filing a Form BDW (Uniform Request for Broker-Dealer Withdrawal) the option of designating another FINRA member as the custodian of its books and records (referred to herein as the "4570 custodian"). While the proposed rule change does not explicitly name clearing firms as the other FINRA member that can be designated, FINRA provides several specific examples of how it believes clearing firms can reasonably take on this obligation. FINRA posits that "FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act."[2] NFS respectfully submits that the proposed rule would not result in the desired effect of having clearing firms readily agree to be designated as the 4570 custodian because it would place undue financial and operational burdens on clearing firms, as detailed below.

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[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; (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 Proposed Changes to FINRA Rule 4570 (File No. SR-2018-039) at 9.

I. CLEARING FIRMS ARE NOT LIKELY TO CONSENT TO BE DESIGNATED AS THE 4570 CUSTODIAN.

NFS has reviewed the proposed rule with interest and has concluded that it is not likely to consent to being designated as the 4570 custodian due to the onerous impact such designation would have on NFS' operational and financial resources. We believe other fully disclosed clearing firms would have the same concerns.

A. There are Far Fewer Existing Clearing Firms Than FINRA Statistics Suggest.

In suggesting that clearing firms would be logical FINRA members to be designated as 4570 custodians, FINRA states that there are currently 1479 active introducing-only firms, 112 active clearing firms and that of the firms that have filed BDWs in the past 5 years, 39% have been introducing-only firms.[3] Based on those statistics, one might reasonably deduce that the burden on the 112 clearing firms to take on the post-BDW custodial responsibilities would not be onerous. Although FINRA does not indicate what firms are included in that count, we believe that number is misleading because it includes firms that self-clear. In fact, NFS believes that there are currently less than 20 fully disclosed clearing firms in business, as compared to approximately 125 fully disclosed clearing firms in 1998, a staggering 85% decrease in the past 20 years.[4] Given the small number of existing fully disclosed clearing firms that could act as 4570 custodians, we respectfully disagree with FINRA's belief that the resulting burden on competition would be reasonable and appropriate. For this reason, we believe that clearing firms would not agree to be designated as 4570 custodians.

B. The Proposed Rule Change Would Impose Substantial Operational and Financial Burdens on Clearing Firms.

If clearing firms agreed to be designated as 4570 custodians, the added responsibility would require a considerable amount of work to comply with the proposed rule. In fact, the associated operational process and costs of taking on the role of the custodian are far more complex and deep than FINRA contemplates. FINRA assumes that because a clearing firm maintains some of an introducing firm's books and records, it "could therefore more easily maintain custody of all the introducing firm's records along with its own books and records."[5] However, the required exercise would consist of substantially more than simply taking in a new set of records. At a minimum, the clearing firm would need to perform a detailed review and analysis of: (1) what records it already has at its disposal, (2) whether the format and content of those records are any different from the records the introducing broker-dealer is required to maintain, (3) the types of

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[3] *Id.* at 10-11.

[4] Bresiger, G., "*Survival of the Smartest: What Clearing and Self-Clearing Brokers Must Do to Survive and How You Know It Isn't Worth the Effort*", 26 Clearing Quarterly Directory, p. 44, June 2013.

[5] *Id.* at 11.

records being provided by the withdrawing introducing broker, (4) the location of those records and whether any third-party service providers are being used by the withdrawing introducing broker, (5) the applicable retention periods, (6) whether it can maintain the records being transferred to it in the same format they are transferred in, and if not, how they will transfer them without altering or deleting them in the process (as would be required under the proposed rule), and (7) whether the transferred format can be appropriately indexed and stored for later retrieval. This would be a time-consuming and labor-intensive undertaking for clearing firms to perform.

While clearing firms retain information pertaining to the brokerage accounts on their platforms, that information is often retained in a format that is different than that required to be kept under the introducing firm's books and records obligations. For example, introducing firms are required to maintain suitability information as part of their customer account records, but clearing firms are not. In addition, introducing firms maintain many types of books and records that are beyond the purview of clearing firms, such as employee information, evidence of supervision, order blotters, general ledgers, accounting records, copies of communications with end customers, to name a few.

FINRA's proposed requirement for a 4570 custodian to treat the withdrawing firm's books and records as if they were its own[6] would add to a clearing firm's existing complex and voluminous record storage practice. As it is, NFS' record retention schedules are extensive and contain 66 categories of broker dealer records with 21 different retention periods (7 are flat time frames, 14 are time frames based on an event trigger, e.g., account closure plus six years). NFS currently manages 1.6 petabytes (that is 15 zeros) of data in WORM storage, which has been described as "...costly, outmoded, and inefficient storage containers used exclusively to meet the 17a rule's requirements."[7]

To take on the books and records for numerous defunct introducing broker-dealers would add an overly burdensome amount of work to the responsibilities of clearing firms, requiring sizable additional technology and human resources, not to mention the costs of paying for the additional storage space.

C. The Proposed Rule Change Would Subject Clearing Firms to Increased Regulatory Inquiries and Litigation.

Clearing firms already regularly find themselves the recipients of regulatory inquiries and production requests because they are seen as a central repository for documents and data related to introducing firms – despite the fact that introducing firms have their own supervisory and regulatory responsibilities and maintain their own books and records. On average, NFS responds to approximately 1,500 regulatory requests a year. A natural consequence of being designated

[6] *Id.* at 7.

[7] Petition for Rulemaking to Amend Exchange Act Rule 17a-4(f), U.S. Securities And Exchange Commission (2017), https://www.sec.gov/rules/petitions/2017/petn4-713.pdf.

the custodian of a BDW firm's books and records is not only receiving additional regulatory requests but also becoming the subject of litigation – as a party, as a recipient of discovery requests, as a recipient of litigation holds that may force a modification of retention periods – all of which in turn would lead to more resources being expended by the clearing firm. One challenge of having books and records stored in WORM-compliant formats is that they are not conducive to data analysis, thereby limiting the clearing firm's ability to satisfy inquiries/requests that require data analysis. Furthermore, to the extent an end customer with a grievance decides to pursue litigation after their introducing broker-dealer has filed a BDW, the end customer may see the clearing firm/custodian of the introducing firm's records as the logical defendant. The proposed rule would therefore add a significant regulatory and litigation burden on clearing firms.

D. Clearing Firms Would be Left to Bear the Financial Cost.

FINRA recognizes that there will be a cost to maintain these records in the manner proposed. However, it assumes that if a clearing firm becomes the 4570 custodian, the additional costs would be borne by the introducing broker. It suggests that a clearing firm might integrate the costs of the custodial services into its clearing agreements at the outset of the clearing relationship, but then states that an industry-wide increase in costs of clearing agreements is a low probability outcome, noting the "competitive dynamics of procuring clearing services may preclude this outcome, as firms that raise their fees may lose clients."[8] FINRA offers no other views or suggestions on how clearing firms could realistically get paid for agreeing to take on these custodial services.

NFS agrees with FINRA that it is not practical to expect correspondent clients to pay for the additional costs. First, clearing firms will have little leverage to force such an additional cost on existing correspondents on their platforms. Second, introducing broker-dealers, like most other business entities, are looking to reduce costs and increase efficiency and it is unlikely that they would agree to pay in advance for a service that would be necessary only in a worst-case scenario, which they do not believe will ever occur. Because it is unlikely to be able to recoup its costs – either upfront or at the time an introducing firm goes out of business – NFS is unlikely to agree to take on the costs and burdens of acting as a 4570 custodian.

Considering the burdens posed by the proposed rule, NFS believes that it is unlikely any clearing firm would readily agree to be designated as a 4570 custodian. While the proposed rule requires consent of the designated custodian, it is probable that clearing firms will be subjected to pressure to take on the role "for the public good." If it is impractical to believe that clearing firms will be able to get paid for this substantial obligation, it is unfair to put that burden on

[8] FINRA Proposed Changes to FINRA Rule 4570, *supra* at 13-14.

them.[9] Moreover, the proposed rule may also have an unintended result of making it more likely that a clearing firm will refuse clients who do not have a strong capital base – out of fear that the firm will go bankrupt and the clearing firm will be required to retain their books and records for FINRA. This could have an impact on new entrants to the market and poses a burden on competition.

II. IF THE SEC ADOPTS THE PROPOSED RULE, ADDITIONAL LIMITATIONS SHOULD ALSO BE ADOPTED.

In the event the Commission approves the proposed change to allow a withdrawing firm to designate another FINRA member as custodian of its books and records, NFS proposes the following modifications to the proposed rule.

A. The Rule Should Require Written Consent.

The current proposal would require the firm to obtain the affirmative, written or verbal consent of the person identified as custodian on the firm's Form BDW. To avoid any confusion of role or consent, the rule should require that the designated custodian consent in writing to take on the role. Verbal consent alone should not be binding under any circumstances.

B. Designated Custodians Should Be Granted Limitation of Liability.

At a minimum, designated custodians including clearing firms must be granted limitations on liability under the rule with respect to recordkeeping or related deficiencies that are attributable back to the withdrawn broker-dealer. Though FINRA mentions that a member acting as custodian should not be required to verify the completeness or accuracy of the books and records that it receives,[10] we believe that does not go far enough to protect clearing firms from potential liability in regulatory matters and litigation.

C. The SEC Should Consider Enacting a Rule to Provide for a Comprehensive and Orderly Process for Unwinding a Broker-Dealer.

In connection with challenges associated with introducing firms withdrawing from the brokerage business, FINRA should consider how best to provide for a comprehensive and orderly process for unwinding a broker-dealer. Such a rule should take into account all aspects of the withdrawal,

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[9] The Commission should consider the possibility of having FINRA become the custodian of the books and records of a firm going out of business. Much of the concern underlying FINRA's proposed rule is its own inability to access the books and records of a former firm. That concern would be eliminated if FINRA maintained the books and records itself, and the burden could be minimized by FINRA maintaining only those types of records it deems most critical. FINRA could then spread the costs of storage across the industry, rather than expecting individual clearing firms to bear the cost.

[10] *Id.* at 6-7.

including orphaned customer accounts as well as books and records. There are currently no rules that detail the timing of a communication to the end customer of the introducing firm's intent to file a Form BDW – or what information must be communicated. Our experience in this area *is* that once news of an introducing firm's filing of a Form BDW (or intention to file) becomes known inside the introducing firm, that firm's representatives work to transfer out the customer accounts that they want to keep. The remaining accounts that they have no interest in continuing to service (low balance accounts or accounts which may have some form of restrictions) are left "orphaned" in the custody of the clearing firm, with very limited trading and service options. Moreover, there appears to be little substantive regulatory review of the Form BDW Process. When a firm exits the business, the Form BDW filing is accepted by the SEC, and the Forms U-5 of the principals are processed by FINRA. We believe that it would be beneficial to introducing firms, clearing firms, and most importantly investors, if FINRA and the SEC undertook a comprehensive review of the Form BDW process to ensure fairness and consistency for end customers, and to minimize the impact of "orphaned accounts" to investors and to clearing firms.

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NFS appreciates the opportunity to bring these issues to your attention and would be happy to discuss these issues with you.

Sincerely,

Richard J. O'Brien
Senior Vice President, Compliance
Chief Compliance Officer, NFS

cc: The Honorable Jay Clayton, Chairman
The Honorable Robert J. Jackson, Jr., Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad Roisman, Commissioner

Mr. Brett Redfearn, Director, Division of Trading and Markets
Mr. John Roeser, Associate Director, Division of Trading and Markets
Mr. David Shillman, Associate Director, Division of Trading and Markets
Mr. Robert Cook, President and CEO, FINRA
Mr. Robert Colby, Chief Legal Officer, FINRA