Financial Industry Regulatory Authority

February 26, 2019

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. SR-FINRA-2018-039 (Proposed Rule Change Relating to FINRA Rule 4570 (Custodian of Books and Records)) – Response to Comments

Dear Mr. Fields:

This letter is being submitted by Financial Industry Regulatory Authority, Inc. ("FINRA") in response to comments submitted to the U.S. Securities and Exchange Commission (the "Commission" or "SEC") regarding the above referenced rule filing.[1] The Commission received one comment letter in response to the Proposal.[2] NFS focused its comments on the impact of the Proposal to clearing firms, asserting that assumption of the role of custodian would impose substantial operational and financial burdens on such firms. Consequently, NFS stated that it is not likely to consent to being designated as a Rule 4570 custodian. NFS contended that other fully disclosed clearing firms would have the same concerns and therefore the Proposal would not achieve its desired effect.

FINRA addressed many of NFS's concerns in the Proposal but will underscore and clarify a few points here.[3] Foremost, the Proposal would have no impact on clearing firms or any other firms or individuals that choose not to consent to becoming a Rule 4570 custodian for another firm. FINRA acknowledged that a member that chooses to assume the role of custodian would likely "incur operational and technology costs associated with integrating the former member's books and records into its record-

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1 *See* Securities Exchange Act Release No. 84646 (November 26, 2018), 83 FR 61689 (November 30, 2018) (Notice of Filing of File No. SR-FINRA-2018-039) ("Proposal").

2 *See* Letter from Richard J. O'Brien, Senior Vice President, Compliance, National Financial Services LLC, to Robert W. Errett, Deputy Secretary, SEC, dated February 5, 2019 ("NFS").

3 *See* Proposal, 83 FR 61689, 61691-92.

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keeping systems."[4] The Proposal also indicated that members may seek to recover these costs; however, it may not be possible due to competitive forces in the marketplace.[5] FINRA expects that a member would weigh the extent of the burden and ability to recover costs in determining whether to consent to become a custodian of books and records.

FINRA developed the Proposal in response to feedback from some members that expressed difficulty in identifying and designating an associated person as the books and records custodian on their Form BDW when they are in the process of winding down. These members indicated that other members are willing to function as custodians for purposes of FINRA Rule 4570, but they cannot do so currently because of the limitations in the rule. The Proposal is therefore intended to provide greater flexibility to these members as they are winding down their business. FINRA vetted the Proposal with several of its advisory committees representing a cross-section of FINRA membership, including the Clearing Firm Advisory Committee. These committees raised some questions and concerns in the event that a firm consents to be designated a custodian, but ultimately each committee supported the Proposal going forward, given its optional nature. Moreover, FINRA has addressed in the Proposal the key concerns (e.g., clarifying, as discussed below, that a designated custodian would not be liable for incomplete records it receives).

While NFS acknowledged that the proposal requires the consent of the designated custodian, it nonetheless asserted that clearing firms "will be subjected to pressure to take on the role 'for the public good'" and that it would be unfair to impose the associated burdens on such firms without being paid. FINRA notes that NFS provided no basis for its contention that it will be "pressured" to take on the custodial role without compensation. FINRA believes that market forces will determine whether a third-party will consent to acting as custodian for another member and the terms of any compensation in connection with assuming the obligations attendant to such designation.

FINRA wishes to clarify one aspect of its economic impact analysis challenged by NFS. The Proposal indicated that introducing-only firms with established relationships with clearing firms may be most likely to benefit from the additional flexibility provided in the Proposal, since the clearing firm will already have possession of at least part of the introducing firm's books and records.[6] NFS believes that the clearing firms numbers contained in the Proposal were misleading when it indicated that there were 112 clearing

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4 *See* Proposal, 83 FR 61689, 61692.

5 *See* Proposal, 83 FR 61689, 61691-92.

6 *See* Proposal, 83 FR 61689, 61691.

firms, because NFS believes that there are less than 20 fully disclosed clearing firms and therefore the rule change will have a greater impact on these clearing firms. Based on current information derived from Form BD, there are approximately 99 active FINRA members that are referenced as the clearing firm for another member and 1,479 active introducing-only firms.[7] Of these clearing firms, 25 clearing firms have references to "fully disclosed" in the description of the clearing arrangement. Additionally we can affirmatively identify that 432 (39%) of the 1,100 broker-dealers that withdrew from the industry over the last five years have been introducing only firms.

Additionally, NFS recommended that if the Proposal is adopted that it should include the following changes: (1) require that the member receive written consent from the custodian to avoid any confusion; (2) provide limitations on liability for the custodian with respect to recordkeeping deficiencies; and (3) that the SEC should consider enacting rules to provide for a more comprehensive and orderly process for winding down a broker-dealer.

The Proposal currently includes the requirement that the members filing the Form BDW receive written or oral consent from the custodian and that the custodian file a written confirmation with FINRA that the custodian agrees to act as a custodian and understands the obligations under the rule. There is nothing under the Proposal preventing a clearing firm from having an internal policy that would require written consent be given to a member winding down its business in order to establish the required consent. However, the Proposal included the option for oral consent because FINRA understands that sometimes firms wind down business operations under expedited circumstances that may make obtaining written consent impractical.

In addition, FINRA recognizes that members acting as custodians may not be in a position to verify the completeness or accuracy of the books and records they receive. In the Proposal, FINRA compared members acting as custodians to record-keeping services that are not obligated to perform a completeness check on the records.[8] The Proposal does not contemplate that a member acting as a custodian would be liable for deficiencies in the records that it receives.[9] However, any limitations on liability that would affect the maintenance, preservation or availability of the records received by the custodian would be contrary to the purpose of the rule, which is to ensure that even after a member ceases doing business that its records are available for regulatory use.

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7 The information regarding active clearing firms is derived from Form BD, Item 8c. An alternative definition is provided by Form BD Item 6, which results in a set of 115 active clearing firms.

8 *See* Proposal, 83 FR 61689, 61690.

9 *See id.*

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FINRA believes that the foregoing responds to the material issues raised by the commenter to the Proposal. If you have any questions, please contact the undersigned at [redacted].

Sincerely,

/s/ Julia Bogolin

Julia Bogolin
Counsel