

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-84646; File No. SR-FINRA-2018-039)

November 26, 2018

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change Relating to FINRA Rule 4570 (Custodian of Books and Records)

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“SEA,” “Act” or “Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 15, 2018, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend FINRA Rule 4570 (Custodian of Books and Records) to: (1) provide 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 on the form; (2) clarify the obligations of the designated custodian; and (3) require the designated custodian to consent to act in such a capacity.

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

SEA Rule 17a-4 (Records to be Preserved by Certain Exchange Members, Brokers and Dealers)<sup>3</sup> requires broker-dealers to retain their books and records for specified retention periods.<sup>4</sup> Pursuant to SEA Rule 17a-4(g),<sup>5</sup> a firm that stops doing business as a registered broker-dealer has a continuing obligation to retain its required books and records for the remainder of the specified retention periods. Form BDW requires that a firm that is withdrawing its registration identify and provide the contact information of the person who will have custody of the firm's books and records after the firm has discontinued its business operations. Form BDW also requires that the firm provide the address where the books and records will be located, if different than the custodian's address. In addition, the Form BDW provides that the firm and person signing the form on behalf of the firm must certify that the firm's books and records will be preserved and made available for inspection.

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<sup>3</sup> 17 CFR 240.17a-4.

<sup>4</sup> See also FINRA Rule 4511 (General Requirements).

<sup>5</sup> 17 CFR 240.17a-4(g).

FINRA Rule 4570 currently requires a member to designate as the custodian of its required books and records on the Form BDW a person who is associated with the member at the time the Form BDW is filed.<sup>6</sup> The rule is intended to enhance the ability of FINRA to obtain a firm's required books and records upon dissolution of the firm.<sup>7</sup>

#### Permitting Another Member to Act as the Designated Custodian

FINRA understands that some members have had difficulty in identifying and designating an associated person as the books and records custodian on their Form BDWs when they are in the process of winding down. These members have 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.

To provide greater flexibility to members, FINRA is proposing to amend Rule 4570 to provide a member that is filing a Form BDW the option of designating another FINRA member as the custodian of its books and records on the Form BDW. The proposed rule change would not require members to designate another FINRA member as the custodian of their books and records, but would give them the option to do so, at their discretion. Firms would continue to have the option of designating an associated person as the custodian of their books and records. Further, the proposed rule change would preserve FINRA's ability to obtain the books and

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<sup>6</sup> For purposes of Rule 4570, an associated person is a natural person. See FINRA By-Laws, Article I, paragraph (rr).

<sup>7</sup> FINRA has jurisdiction over, and has the ability to obtain information from, a former associated person of a member for generally two years after: (1) the effective date of the person's termination of registration; (2) the effective date of revocation or cancellation of the person's registration; or (3) in the case of an unregistered person, the date upon which such person ceased to be associated with the member. See FINRA By-Laws, Article V, Section 4 (Retention of Jurisdiction) and FINRA Rule 8210 (Provision of Information and Testimony and Inspection and Copying of Books).

records of a former member because FINRA would continue to have jurisdiction over, and the ability to obtain information from, the member that has agreed to act as custodian.

#### Clarifying the Obligations of the Designated Custodian

In addition to permitting another member to act as the designated custodian, FINRA is proposing to amend Rule 4570 to clarify the obligations of the designated custodian.

Specifically, the proposed rule change would clarify that the custodian designated on the Form BDW, which would be either an associated person or another member, must preserve the books and records on behalf of the member that filed the Form BDW for the remainder of the applicable retention periods and make them available for inspection by FINRA upon request. For example, if a custodian receives a record from a firm that is going out of business that had an original retention period of six years, four years of which have already passed, the custodian must retain that record for the remaining two years and provide it to FINRA upon request.

Further, the proposed rule change would clarify that a custodian is required to preserve and produce a former member's books and records in the same manner in which they were received. This provision is intended to ensure that the custodian does not alter the records after taking possession of them. However, the proposed rule change would provide that a custodian would not be precluded from converting the books and records in its possession into another format acceptable under the Exchange Act (e.g., convert from paper format to an electronic storage media), so long as such records are not altered or deleted during the conversion process.

In addition, the proposed rule change would provide that where a member is acting as custodian, such member would not be required to verify the completeness or accuracy of the books and records that it receives. This exception is limited to members that are acting as custodians because their function is more akin to that of a recordkeeping service. However,

FINRA believes that an associated person who is acting as custodian of a member's books and records is in a position to verify the completeness and accuracy of the member's books and records based on his or her existing relationship with the member.

Finally, FINRA is proposing to amend Rule 4570 to require that where a FINRA member has agreed to act as custodian of the books and records of another member that has filed a Form BDW, the member acting as custodian must: (1) treat such books and records as if they were its own books and records; and (2) arrange upon its dissolution for such books and records to continue to be retained for the remainder of the applicable retention periods under FINRA and Exchange Act rules in the same manner as its own books and records consistent with Rule 4570. FINRA believes that by clarifying the obligations of the custodian, the proposed rule change would facilitate compliance with the obligations under SEA Rule 17a-4(g) and Form BDW.

#### Requiring the Consent of the Designated Custodian

FINRA has become aware of situations where the person named as the custodian on the Form BDW was not aware that the member was designating the person as a custodian. To address this issue, the proposed rule change would require a member to obtain the affirmative, written or verbal, consent of the custodian of books and records identified on the firm's Form BDW. In addition, the proposed rule change would require a member that is withdrawing its registration to inform its custodian of the obligations under FINRA and Exchange Act rules, including FINRA Rule 4570, prior to obtaining the custodian's consent.

The proposed rule change would also require the designated custodian to represent to FINRA, in a method prescribed by FINRA, that the custodian: (1) has consented to act in the capacity of a custodian; (2) understands the responsibilities of a custodian; and (3) agrees to

provide the books and records of the member for which it is acting as custodian to FINRA upon request during the course of the required retention periods.

The proposed rule change would impact all members, including members that have elected to be treated as capital acquisition brokers (“CABs”) and are subject to the CAB Rules. CAB Rule 457 subjects all CABs to FINRA Rule 4570. Accordingly, the proposed rule change to FINRA Rule 4570 would also impact CABs.

If the Commission approves the proposed rule change, FINRA will announce the effective date of the proposed rule change in a Regulatory Notice to be published no later than 60 days following Commission approval. The effective date will be no later than 120 days following publication of the Regulatory Notice announcing Commission approval.

## 2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>8</sup> which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. FINRA believes that the proposed rule change would facilitate compliance with FINRA and SEC recordkeeping requirements. Specifically, the proposed rule change would provide a member the flexibility to select another member as its custodian, which would enhance FINRA’s ability to obtain the member’s required books and records upon the member’s dissolution. This is because FINRA’s jurisdiction over former associated persons is more limited than its jurisdiction over current members. The proposed rule change would also clarify the obligations of the designated

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<sup>8</sup> 15 U.S.C. 78o-3(b)(6).

custodian and require the designated custodian's consent, which would enhance the ability of designated custodians to carry out their recordkeeping responsibilities.

B. Self-Regulatory Organization's Statement on Burden on Competition

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.

Economic Impact Assessment

FINRA has undertaken an economic impact assessment, as set forth below, to further analyze the regulatory need for the proposed rule change, its potential economic impacts, including anticipated costs, benefits, and distributional and competitive effects, relative to the current baseline, and the alternatives FINRA considered in assessing how best to meet its regulatory objective.

Regulatory Need

FINRA Rule 4570 is intended to ensure that a firm's books and records are properly retained and accessible for the remainder of the applicable retention periods after the firm withdraws its registration with FINRA. However, certain aspects of the rule as currently written limit a firm's ability to identify a willing custodian and reduce the likelihood that books and records are properly retained and accessible following a firm's termination of registration.

Economic Baseline

The economic baseline for the proposed rule change is the number of firms that withdraw from the industry and thus file a Form BDW, and would therefore have to identify a custodian. In the past five years, approximately 1,100 firms filed a Form BDW, terminating their registration with FINRA. The firms had a median age of 14 years, and a median firm size of five associated persons and \$240,000 in total assets, at the time they filed their Form BDW. The

number of firms filing a Form BDW annually has largely remained constant over the last five years.<sup>9</sup>

### Economic Impact

The proposed rule change would primarily affect firms filing a Form BDW, customers of those firms, designated custodians, and investors generally.

### Benefits

Currently, firms that file a Form BDW may only designate an associated person as the custodian of their books and records. By allowing such firms to designate another member as their custodian, the proposed rule change may reduce search costs associated with identifying a willing custodian. Search costs can be significant for firms filing a Form BDW as there are many other obligations that must also be addressed as a firm prepares to leave the industry. These obligations can make it difficult for a firm to identify an associated person who is willing, and able, to carry out the custodial responsibilities as the firm is in the process of winding down.

FINRA believes that introducing-only firms with established relationships with clearing firms may be most likely to benefit from the additional flexibility provided in the proposed rule change.<sup>10</sup> The clearing firm will already have possession of at least part of the introducing firm's books and records and, if willing to act in such a capacity, could therefore more easily maintain custody of all of the introducing firm's records along with its own books and records. The value of this flexibility would depend upon the willingness of the clearing firm to take on these

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<sup>9</sup> Annually since 2013, FINRA has received a low of 212 withdrawal requests (2014) and a high of 234 withdrawal requests (2013), and an average of 220 withdrawal requests per year.

<sup>10</sup> Note that there are many firms that use clearing firms for some but not all of their transactions. The value of the additional flexibility decreases as the percentage of an introducing firm's records with any one clearing firm decreases.



custodial obligations after the introducing firm has left the industry. Any factor impacting the provision of clearing services more generally would likely also impact the likelihood that a clearing firm would be willing to take on the custodial responsibilities. Currently, there are approximately 1,479 active introducing-only firms and 112 active clearing firms.<sup>11</sup>

FINRA also believes that if a firm that is filing a Form BDW chooses another member as its custodian, it would enhance the ability of FINRA to obtain the books and records of the firm. This is because FINRA's jurisdiction over former associated persons is more limited than its jurisdiction over current members.<sup>12</sup> As noted below, FINRA's ability to obtain the books and records of a former firm more easily and readily would also benefit customers of the firm and investors more generally.

FINRA has become aware of situations where a document request was made to a custodian only to find that the custodian had stopped paying for the document storage or otherwise no longer had access to the books and records of the former firm. This makes books and records unavailable for use by FINRA staff, may inhibit the ability of FINRA staff to conduct its work and could lead to the imposition of sanctions on the custodian. Further, without access to the books and records of a former firm, customers who bring a claim against the firm may be limited in their ability to obtain restitution. Finally, FINRA and other regulators may be more limited in their ability to pursue a disciplinary action against the former firm or an associated person of the firm, possibly increasing risk to investors generally. By clarifying custodians' obligations, the proposed rule change aims to improve custodians' understanding of

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<sup>11</sup> Of the 1,100 firms that withdrew from the industry over the last five years, we can affirmatively identify that 432 (39%) were introducing-only firms.

<sup>12</sup> FINRA has jurisdiction over, and has the ability to obtain information from, a former associated person generally for two years. See FINRA By-Laws, Article V, Section 4 (Retention of Jurisdiction) and FINRA Rule 8210 (Provision of Information and Testimony and Inspection and Copying of Books).

the time and monetary commitment and the potential sanctions that could be imposed on them should they not comply with their obligations.

Further, FINRA has come across instances where the custodian was unaware that they were named as the custodian of a former firm's books and records and did not have access to them. By requiring the custodian's affirmative consent and representation to FINRA, the proposed rule change would eliminate such situations. Similar to the benefits associated with clarifying the obligations of custodians, the custodian's consent and representation to FINRA would also increase the likelihood that a former firm's books and records would be properly retained and accessible.

#### Costs

The costs associated with the proposed rule change would likely depend on whether the designated custodian is an associated person or another member. The proposed rule change would give a firm that is filing a Form BDW the additional option of designating another member, rather than an associated person, as its custodian. Therefore, the expansion of the categories of eligible custodians should impose no new burdens on firms that continue to designate associated persons as their custodians. Introducing firms that designate their clearing firms as custodians, subject to their consent, may incur additional costs associated with clearing services.

Firms that designate members as their custodians, subject to their consent, may incur costs associated with record-keeping services provided by such members. For instance, a member that agrees to act as custodian is likely to incur operational and technology costs associated with integrating the former member's books and records into its record-keeping systems. Moreover, the proposed rule change could result in a change in how custodianship of

books and records by firms leaving the industry is paid for and managed. For instance, clearing firms might adapt their business models to integrate the costs of custodial services into clearing agreements at the outset of the clearing relationship. This would potentially lead to an industry-wide increase in the costs of clearing agreements, regardless of any custodial undertaking by the clearing firms. However, considering the small number of firms that file Form BDW per year, FINRA believes that this is a low probability outcome.<sup>13</sup> Further, the competitive dynamics of procuring clearing services may preclude this outcome, as firms that raise their fees may lose clients.

The clarification of a custodian's obligations does not add any new direct burdens, but it could make it harder for firms to identify a custodian willing to agree to the obligations. Likewise, the affirmative consent requirement and the requirement to provide a representation to FINRA may make it more difficult for firms to find a willing custodian. However, given the importance to FINRA and investors of proper custody of books and records, FINRA believes that these additional burdens are warranted.

#### Alternatives Considered

FINRA considered whether to amend Rule 4570 to require a firm that is going out of business to be only able to designate another member as its custodian. While such a requirement would further enhance FINRA's ability to obtain the books and records of former firms, FINRA determined that a firm that is leaving the industry and that is experiencing financial or operational difficulties may find it difficult to find another member that is willing to act as custodian. Further, FINRA continues to evaluate the viability that FINRA make itself available as an alternative custodian for members' records after withdrawal.

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<sup>13</sup> On average, 220 firms have filed a Form BDW each year over the last five years. This represents about five percent of all active firms.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2018-039 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2018-039. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change.

Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2018-039 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>14</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>14</sup> 17 CFR 200.30-3(a)(12).