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December 22, 2010

VIA ELECTRONIC MAIL

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2010-061--Comments to Proposed FINRA Rule 4311

Dear Ms. Murphy:

We appreciate the opportunity to comment on Proposed FINRA Rule 4311 governing the requirements applicable to Financial Industry Regulatory Authority ("FINRA") members when entering into agreements for the carrying of customer accounts. We represent a number of Canadian financial services firms with U.S. broker-dealer affiliates who are FINRA members in connection with this comment letter, listed in **Exhibit A**, attached hereto. These and many other U.S. broker-dealer affiliates of Canadian investment dealers were established to conduct brokerage business involving Canadian securities for U.S. institutional customers and to effect cross-border corporate finance transactions involving Canadian securities. The U.S. broker-dealers typically have service agreements in place between them and their Canadian affiliates, in which the Canadian affiliates agree to assist the U.S. broker-dealers in their back-office operations, particularly with regard to settlement services and related administrative functions. We are writing this comment letter because we believe that Proposed FINRA Rule 4311 could potentially have unnecessary consequences for the current cross-border operations in place between many U.S. broker-dealers and their Canadian affiliates. The same issues could also apply to other international securities firms as well.

Proposed FINRA Rule 4311(a)(1) prohibits a FINRA member, unless otherwise permitted by FINRA, from entering into an agreement with a carrying firm for the carrying of its customer accounts on an omnibus or fully disclosed basis unless the carrying firm is a FINRA member firm. The other provisions of Proposed FINRA Rule 4311 outline additional requirements that a carrying firm must follow, including, among other things, submitting any agreement for carrying accounts, whether on an omnibus or fully disclosed basis to FINRA for approval; conducting appropriate due diligence with respect to any new introducing firm relationship; and requiring that each carrying agreement in which accounts are to be carried on a fully disclosed basis, specify the responsibilities of each party to the agreement.

We note, however, that FINRA has not provided a definition of the term "carrying broker" in its rule proposal. While we do not believe that the typical relationships established between U.S. broker-dealers and their Canadian affiliates are, or should be considered, carrying relationships, we are concerned that confusion could be created by the arrangements in place between these U.S. broker-dealers and their Canadian affiliates. We therefore ask that Proposed FINRA Rule 4311 be clarified to explicitly exclude such arrangements from the requirements of Proposed FINRA Rule 4311.

As noted above, many Canadian-affiliated U.S. broker-dealers use their Canadian affiliates to assist with U.S. clearing and settlement services and related administrative functions on their behalf. Some affiliated companies are Canadian clearing firms that can directly provide these services to their U.S. broker-dealer affiliates. Others are participants in Canadian marketplaces but are introducing firms to Canadian clearing firms. In the latter case, the Canadian affiliates have separate service agreements with Canadian clearing firms to complete the U.S. transactions. Canadian clearing firms are participants in CDS Clearing and Depository Services Inc. ("CDS"). CDS is a participant in the Depository Trust Company (the "DTC") and the National Securities Clearing Corporation (the "NSCC"). Canadian clearing firms are permitted to become CDS-sponsored direct participants in DTC and NSCC, with their own clearing numbers, and are thereby able to efficiently complete cross-border transactions between CDS and DTC/NSCC.

The arrangements between the U.S. broker-dealers and their Canadian affiliates are permissible under present rules and do not present the Canadian affiliates with a broker-dealer registration requirement in the United States. This is so because many of our U.S. broker-dealer clients are "self-clearing" firms that rely on an exemption from the Securities and Exchange Commission's (the "SEC") Customer Protection Rule under Rule 15c3-3(k)(2)(i), and the transactions between parent and subsidiary are broker-to-broker transactions that comply with Rule 15a-6(a)(4)(i) under the Securities Exchange Act of 1934 (the "Exchange Act"). The service agreements between the U.S. broker-dealers and their Canadian affiliates document the relationship between the two firms and define their respective responsibilities in a manner consistent with the U.S. broker-dealers' full regulatory responsibility as self-clearing firms. Customers have no confusion regarding this relationship since they transact only with the U.S. broker-dealers and their registered personnel, they receive research only from the U.S. broker-dealers or as permitted by Rule 15a-6 with notice requiring that transactions be effected only through the U.S. broker-dealers, and all confirmations and statements are issued by the U.S. registered broker-dealers. In addition, these firms typically limit their transactions to institutional investors for whom delivery versus payment/receipt versus payment ("DVP/RVP") transactions are the norm, and who readily understand these arrangements. In the case of fails, the U.S. broker-dealers take all required net capital charges and are responsible for completing such transactions.

Under these arrangements, the U.S. broker-dealers are typically not required to comply with the full parameters of Rule 15c3-3 because they conduct their institutional brokerage business under the Rule 15c3-3(k)(2)(i) exemption.[1] Under the (k)(2)(i) exemption, no customer securities or funds may be held beyond settlement date and transactions are effected so that delivery of securities takes place only against payment by the customer.[2]

However, the concern arises under Proposed FINRA Rule 4311 whether U.S. broker-dealers that have service agreements in place with their Canadian parent companies will be able to continue to rely on the exemption set forth in subparagraph (k)(2)(i) of Rule 15c3-3. We submit that these arrangements should not be affected by FINRA's rule proposal because neither the Canadian affiliates nor the U.S. broker-dealers should be considered to be carrying brokers for DVP/RVP transactions with institutional investors. These arrangements have been permitted by the SEC and FINRA for many years and should not be lightly done away with in the absence of compelling evidence that U.S. institutions have been disadvantaged or funds and securities are at risk of loss.

Because the U.S. broker-dealers relying on the (k)(2)(i) exemption clear the relevant transactions on a DVP/RVP basis, these U.S. broker-dealers are appropriately characterized as "clearing firms," but not as "carrying firms."[3] Under these arrangements, the Canadian affiliates should not be considered to be either "clearing firms" or "carrying firms." Although the Canadian affiliates assist their U.S. broker-dealer affiliates with clearing and settlement functions, the relationships between the U.S. broker-dealers and their Canadian affiliates are not that of introducing brokers/carrying brokers and the service agreements between the U.S. broker-dealers and the Canadian affiliates do not create such relationships.[4] Rather, the relationships

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[1] *See* RMK International Securities, Inc., SEC No-Action Letter (January 29, 1991) and Dominion Securities, Inc., SEC No-Action Letter (December 7, 1978).

[2] In the event that customer funds are received prior to the time required to complete a transaction (e.g., funds are delivered by a customer before settlement date), the U.S. broker-dealers utilize a special bank account for the exclusive benefit of their customers, as required by Rule 15c3-3(f). If the funds are not capable of being immediately applied to a customer settlement obligation, they are required to be returned to the customer by noon the next day.

[3] *See* SEC Release No. 34-31511 (November 24, 1992).

[4] To reinforce the foregoing characterization, the service agreements typically state that:

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resemble typical correspondent relationships between U.S. broker-dealers and foreign securities dealers.

In SEC Release No. 34-31511, the SEC characterized an introducing broker relationship as one in which the carrying firm takes responsibility for the proper dispensation of funds or securities between the trade date and settlement date (among other things). In such arrangements, the carrying firm also holds any customer funds and securities following the trade date. In contrast, in the arrangements described above between U.S. broker-dealers and their Canadian affiliates, it is the exception that any funds or securities are held by the U.S. broker-dealers in advance of settlement, and then only through the use of a special (k)(2)(i) account, and the Canadian affiliates never hold or carry any accounts for such customers.

The SEC has also previously made distinctions between clearing and carrying firms. This distinction is recognized in Rule 15c3-1 under the Exchange Act (the "Net Capital Rule"). Rule 15c3-1(a)(2)(ii) has a special minimum requirement for (k)(2)(i) firms of $100,000, substantially higher than the minimum for introducing firms that actually receive, but do not hold customer securities of $50,000 set forth in Rule 15c3-1(a)(2)(iv). However, a firm that carries customer accounts and receives and holds customer funds or securities is subject to a minimum net capital of $250,000 under Rule 15c3-1(a)(2)(i). Firms that operate under the (k)(2)(i) exemption, that clear and settle on a DVP/RVP basis and are subject to a $100,000 requirement, is in sharp contrast to a carrying firm or an introducing firm.

Many foreign-owned, FINRA member firms, particularly Canadian-owned firms, operate pursuant to the Rule 15c3-3(k)(2)(i) exemption with the approval of the SEC and FINRA District offices and we see no reason why such arrangements should need to be modified. However, in the proposing release to Proposed FINRA Rule 4311, the SEC stated that FINRA has specified that all requirements that apply to a FINRA member that clears or carries customer accounts also applies to any FINRA member that, operating pursuant to the exemptive provisions of Rule 15c3-3(k)(2)(i), either clears customer transactions pursuant to such exemptive provisions or

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> [U.S. broker-dealer] is a self-clearing firm executing transactions on a delivery-versus-payment basis, and the [Canadian parent company] will act solely as [U.S. broker-dealer]'s broker and settlement agent in completing such transactions. [U.S. broker-dealer] does not hold any customer securities or other property on behalf of [U.S. broker-dealer]'s customers, and does not carry margin accounts on their behalf. [U.S. broker-dealer] relies upon the exemption provided in subparagraph (k)(2)(i) of Rule 15c3-3, the [SEC's] "Customer Protection Rule." None of [U.S. broker-dealer]'s customer accounts are introduced to or carried by the [Canadian parent company].

holds customer funds in a bank account established thereunder. FINRA has previously made similar statements regarding FINRA members that rely on the (k)(2)(i) exemption in relation to the new consolidated financial responsibility rules.[5] Comment letters were submitted in response to the financial responsibility rules wherein, among other things, firms questioned why FINRA members operating under the (k)(2)(i) exemptive provisions would be subject to the same rules as clearing/carrying firms when the operational and financial risks generated by the activities were significantly different. For instance, it was noted that firms that rely on (k)(2)(i) should not be subject to the same rules as clearing/carrying firms since (k)(2)(i) firms do not engage in clearing/carrying activities and instead must "promptly" forward funds and securities by noon of the next business day following receipt. To the extent such firms actually hold customer funds in a special account under (k)(2)(i), which is rare, the amounts held and the duration of the holding is not comparable to amounts held by traditional clearing/carrying firms.[6] However, in response to such comments, FINRA stated that firms that operate pursuant to the Rule 15c3-3(k)(2)(i) exemption receive customer funds for the purpose of settling customer transactions and such firms perform a clearing function, irrespective of how short the period they may hold customer funds. Accordingly, FINRA believed that firms that operate pursuant to the Rule 15c3-3(k)(2)(i) exemption should, as a matter of investor protection, be subject to all requirements set forth in the new financial responsibility rules that apply to carrying and clearing firms.[7]

Although FINRA's position, outlined with respect to the financial responsibility rules and reiterated in relation to Proposed FINRA Rule 4311, ignores the considerable differences in investor protection risks between clearing/carrying firms and (k)(2)(i) firms and inappropriately treats these firms the same for purposes of investor protection requirements in the rules, such statements do serve as support for the longstanding position that firms engaged in a DVP/RVP business can rely on the (k)(2)(i) exemption while maintaining a self-clearing status. In addition, however a U.S. broker-dealer operating under the (k)(2)(i) exemption is characterized for purposes of Proposed FINRA Rule 4311, the clearing and settlement services arrangement between a U.S. broker-dealer operating under the (k)(2)(i) exemption and its Canadian affiliate is not a carrying relationship and FINRA's rule proposal should not be permitted to change this fundamental understanding within the securities industry. Since the effect of overlapping regulation renders it practically impossible for the Canadian affiliates to register as broker-

[5] *See* 74 FR 58334 (November 12, 2009). *See also* FINRA Rules 4110.02, 4120.03 and 4521.01.

[6] *See, e.g.*, letter submitted by Sutherland Asbill & Brennan LLP on behalf of the Committee of Annuity Insurers (June 13, 2008); letter submitted by ING Advisors Network (June 13, 2008); and letter from Stephen R. Kinkade (June 13, 2008).

[7] *See* Letter from Adam Arkel, Assistant General Counsel of FINRA to Elizabeth Murphy, Secretary of the SEC (April 14, 2009).

dealers with the SEC and to become FINRA members, the effect of the FINRA proposal if applied to these cases, would be to require the introduction of a third party U.S. clearing firm as an intermediary between the U.S. broker-dealer and its Canadian affiliate. Since the Canadian affiliate will still execute and complete transactions in Canadian markets, albeit for this U.S. clearing firm, all that has been accomplished is additional cost and unnecessary additional transaction legs. This would be an unnecessary setback in cross-border securities processing not justified by any demonstrated risk.

Proposed FINRA Rule 4311 raises specific concerns for broker-dealers operating on a DVP/RVP basis under the (k)(2)(i) exemption from Rule 15c3-3. However, it raises similar issues for U.S. broker-dealers and their Canadian affiliates whose cross-border clearing arrangements are structured as omnibus accounts. In standard omnibus arrangements, omnibus clearing firms carry in a single account the positions of introduced customer transactions of introducing brokers. Generally, the omnibus clearing firms are not given any identifying information about the beneficial owners of the assets contained in the omnibus accounts. Rather, the omnibus clearing firms treat the intermediary broker-dealers as their sole customers. In omnibus clearing arrangements, omnibus clearing firms generally perform clearance, settlement, execution and custody pursuant to omnibus clearing agreements with the introducing brokers. The introducing brokers remain legally responsible for custody, clearing, capital requirements, reserve deposits, and books and records. The omnibus clearing firms contractually perform certain of these functions for the introducing brokers as servicing agents.

Rule 15c3-3 provides no exemption or special treatment for omnibus arrangements. Therefore, U.S. broker-dealers operating on an omnibus basis are fully subject to the requirements of Rule 15c3-3 and typically designate the omnibus accounts at the Canadian affiliates as approved foreign control locations under Rule 15c3-3(c)(4) even though all transactions remain DVP/RVP. However, even if the Canadian affiliates are able to hold the U.S. broker-dealers' customer securities pending completion of DVP/RVP transactions due to their classification as satisfactory control locations, the relationships between the U.S. broker-dealers and the Canadian affiliates should still not be deemed to be carrying relationships for purposes of Proposed FINRA Rule 4311. Under this type of arrangement, the customer securities are still under the control of the U.S. broker-dealers, and the U.S. broker-dealers are completely responsible for their customers' securities even if Canadian-based personnel of the affiliates perform execution and settlement services pursuant to service arrangements involving Canadian securities executed and cleared in Canada. Omnibus arrangements of this kind were permitted by New York Stock Exchange rules for many years.

In the Canadian context, omnibus arrangements are typically used by firms that have a limited number of transactions for U.S. customers since the record-keeping for omnibus accounts has not been highly automated. Firms with larger numbers of transactions have more commonly relied on the (k)(2)(i) structure described above. Neither approach has demonstrated any risk in DVP/RVP transactions for institutional investors. These are practically the least risky of all transaction types and do not justify a heavy regulatory hand.

The SEC has stated that the purpose of Proposed FINRA Rule 4311 is to ensure that certain functions and responsibilities are clearly allocated to either an introducing or carrying firm, consistent with requirements of the self-regulatory organization's and SEC's financial responsibility and other rules and regulations, as applicable. However, under the service agreements between the U.S. broker-dealers and their Canadian affiliates, regardless of whether the U.S. broker-dealers are operating on a Rule 15c3-3(k)(2)(i) or fully-computing basis, the U.S. broker-dealers retain ultimate responsibility for all functions that the Canadian affiliates perform on the U.S. broker-dealers' behalf. In addition, the service agreements reinforce the exclusive relationship between the U.S. broker-dealers and their customers and provide that no obligations or relationships are established between the Canadian affiliates and the U.S. broker-dealers' customers. Therefore, the cross-border clearing and settlement arrangements between the U.S. broker-dealers and their Canadian affiliates should not need to be modified in response to Proposed FINRA Rule 4311 because the allocation of responsibilities is already clear.

In addition, the SEC stated that the proposed rules would, in combination with the new consolidated financial responsibility rules, enhance FINRA's authority to execute effectively its financial and operational surveillance and examination programs. However, we believe that FINRA is already able to execute its financial and operational surveillance and examination programs of U.S. broker-dealers that operate using the cross-border clearance and settlement arrangements described above. These arrangements have worked efficiently without problems or risks to U.S. customers for many years and should not be required to be altered based on Proposed FINRA Rule 4311. FINRA also has effective information sharing arrangements in place with its Canadian counterpart -- the Investment Industry Regulatory Organization of Canada ("IIROC"), and indeed, on occasion, has coordinated examinations with IIROC. FINRA routinely conducts examinations of its members in Canada at their Canadian offices. FINRA has access to all the information it needs to carry a highly effective examination program for the firms involved in these activities. We are unaware of any instance in which FINRA's examinations of such Canadian cross-border business have been impeded to the slightest degree.

If the Canadian affiliates are deemed to be carrying brokers based on these cross-border clearance and settlement arrangements, the U.S. broker-dealers will be required to terminate these arrangements with their affiliates. Terminating these arrangements would be both inefficient and an incredible waste of resources. The cross-border clearance and settlement arrangements described above are particularly appropriate in the case of these Canadian based financial firms since the securities traded for U.S. customers are listed on Canadian marketplaces and clear and settle through CDS (in conjunction with the use of the sponsored accounts Canadian clearing firms have with DTC and NSCC). Given that (1) the securities involved are primarily Canadian issues, (2) the affiliates are members of the Canadian markets and CDS and have direct sponsored accounts with DTC and/or NSCC, and (3) custody is also held to a large degree by U.S. institutional investors in Canada, the use of Canadian affiliates to act as settlement agents in these transactions promotes efficient and secure cross-border clearance and settlement.

Because of the widespread ramifications that FINRA's rule proposal could have on the cross-border clearing and settlement arrangements that are currently in place between many U.S. broker-dealers and their Canadian affiliates, we believe that FINRA should clarify that such cross-border clearance and settlement arrangements operating under the (k)(2)(i) exemption to Rule 15c3-3 and as fully computing broker-dealers under Rule 15c3-3 do not need to be modified in order to comply with Proposed FINRA Rule 4311. This type of clarification would avoid upsetting the highly efficient cross-border arrangements presently in effect.

Finally, if FINRA intends the concept of carrying to include the (k)(2)(i) and omnibus arrangements described above, we do not believe that its statement concerning the basis for the rule change or burden on competition have been adequate to give fair notice to affected parties as the impact on the arrangements we have described. There is no weighing of the rule change in relation to the arrangements presently employed in these cross-border arrangements and no meaningful discussion of any potential harm that may have been found under current arrangements. The issues we have raised in this comment letter are not new to FINRA and yet find no discussion in this release. For a discussion of these issues, we have attached as **Exhibit B** (without the accompanying exhibits) our memorandum sent to the SEC staff and FINRA last May. These issues have been the subject of discussion since that time, but the policy considerations have been sidestepped in this proposal.

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Thank you for providing us with the opportunity to provide comments on Proposed FINRA Rule 4311. We would be pleased to discuss any comments herein, or provide the SEC with any additional assistance as it proceeds with the rule proposal. Please do not hesitate to contact me at (212) 715-1130 if you have any questions.

Very truly yours,

D. Grant Vingoe

cc: Michael Macchiaroli, Securities and Exchange Commission
Mark Attar, Securities and Exchange Commission
Leigh Bothe, Securities and Exchange Commission
Yui Chan, Financial Industry Regulatory Authority

Exhibit A

This submission is made on behalf of the following firms:

Cormark Securities Inc.

Desjardins Securities International Inc.

Dundee Securities Inc.

Griffiths McBurney Corp.

Maple Securities U.S.A. Inc.

National Bank of Canada Financial Inc.

NBF Securities USA Corp.

Peters & Co. Equities Inc.

PI Financial (US) Corp.

Salman Partners (USA) Inc.

TD Securities

ARNOLD & PORTER LLP

Memorandum

To: Mark Attar
Leigh Bothe
Division of Trading and Markets
Securities and Exchange Commission

Cc: Michael A. Macchiaroli
Division of Trading and Markets
Securities and Exchange Commission

Yui Chan
Risk Oversight & Operational Regulation
Financial Industry Regulatory Authority

From: Arnold & Porter LLP

Date: May 28, 2010

Re: **U.S.-Canadian Cross-Border Clearance and Settlement Arrangements**

Introduction

We represent a number Canadian-based clients with U.S. broker-dealer affiliates, listed in **Exhibit A** hereof (collectively, the Committee on U.S.-Canadian Cross-Border Clearance and Settlement Arrangements ("Committee")), who have asked us to make submissions to you on their behalf regarding issues arising in connection with U.S.-Canadian cross-border clearance and settlement arrangements. Several of these firms have recently been informed by the Financial Industry Regulatory Authority ("FINRA") and its Canadian counterpart, the Investment Industry Regulatory Organization of Canada ("IIROC"), that their existing U.S.-Canadian cross-border clearing arrangements may have to significantly change as a result of certain U.S. regulatory concerns that have been identified by FINRA and, apparently, the U.S. Securities and Exchange Commission ("SEC") during their recent review of these arrangements. Beyond the firms that we represent, these concerns apply to many other firms involved in cross-border transactions who have similar arrangements in place.

As we understand it, the principal areas of concern for FINRA and the SEC are that: (1) the arrangements may be impermissible introducing/carrying arrangements with unregistered foreign firms, notwithstanding the fact that the U.S. broker-dealers' are self-clearing broker-dealers that rely on the (k)(2)(i) exemption under Rule 15c3-3 (the "Customer Protection Rule") of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as well as established interpretations permitting foreign parent companies to act as settlement agents for their subsidiaries without establishing customer relationships with the subsidiaries' U.S. customers; and (2) the arrangements may involve impermissible outsourcing of customer protection functions to unregistered foreign firms. In this regard, FINRA has suggested that the cross-border clearance and settlement relationships between the U.S. broker-dealers and their Canadian parent companies must be restructured as omnibus introducing/carrying relationships. We understand that written guidance on some of the concerns is presently being formulated, but that there remains uncertainty concerning the precise direction of this guidance.

As indicated in Grant Vingoe's email to the SEC staff dated April 16, 2010, various issues and related questions have surfaced as a result of the discussions between Committee members, FINRA and IIROC about their concerns, which are common to most Canadian affiliated U.S. broker-dealers, and should be dealt with before costly changes are implemented. This memorandum is intended to: (1) describe in detail the pertinent aspects of the U.S.-Canadian cross-border clearance and settlement arrangements currently in place; (2) explain how these arrangements are viewed in Canada; and (3) outline various issues and questions for the SEC to consider with FINRA in response to their evolving views of the U.S.-Canadian cross-border clearance and settlement arrangements.

We understand the SEC staff is viewing these issues as policy matters, which will be discussed at its next quarterly meeting with FINRA that is scheduled to take place in early June. In this regard, the affected U.S. broker-dealers should not need to make costly and complex contractual, systems and other operational changes until the issues discussed herein are addressed by FINRA and the SEC, and written guidance is published. In addition, FINRA should not be treating these matters as deficiencies with the suggestion that repeat violations will be found unless immediate corrective action is taken by the FINRA members involved. We emphasize that these are clearly matters of policy discussion, requiring clarity, and should not be viewed as present deficiencies. It is also our understanding that paragraph (k)(2)(i) under Rule 15c3-3 remains a valid and available exemption for firms conducting delivery-versus-payment or receipt-versus-payment ("DVP/RVP") business.

We trust that the issues analyzed in this memorandum will be assessed in light of the very cooperative relationship that exists between Canadian and U.S. securities regulators, as evidenced by the memorandum of understanding between the SEC and Canadian securities commissions as well as the close working relationship between FINRA and IIROC.[1] We also trust that FINRA and SEC staff will bear in mind that the

[1] See also the joint news release issued by FINRA and IIROC on July 27, 2009 entitled, IIROC, FINRA Announce Cooperation Agreement" available at:

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Canadian securities industry weathered the financial crisis without firm failures or any significant operational problems in the areas under discussion.

Summary Conclusions

Based on the issues and facts known to us, we believe that:

- The U.S.-Canadian cross-border clearance and settlement arrangements should continue on the basis that (k)(2)(i) is a viable and useful exemption from the Customer Protection Rule for cross-border DVP/RVP business.

- The concerns raised by FINRA are inconsistent with existing guidance, rules and longstanding practice regarding reliance on (k)(2)(i) for DVP/RVP business.

- There is no sound reason to believe that a change in the current structure is warranted or would result in added protections to the clearance and settlement process and/or U.S. customers. The existing structure is consistent with the availability of SIPC coverage. It also promotes more effective surveillance activities by the affected firms and their affiliates.

- Requiring U.S. broker-dealers to establish omnibus clearing arrangements with their Canadian parent companies would create unnecessary manual processes, since automated solutions for transactions in significant volumes are not immediately available, and will not provide added contractual or regulatory benefits. Omnibus arrangements should be voluntary rather than mandated.

- Any changes to current practices will result in material financial, operational, and compliance consequences for Canadian firms engaged in U.S.-Canadian cross-border servicing arrangements, as well as other international firms conducting DVP/RVP business in reliance on (k)(2)(i).

- The U.S.-Canadian cross-border clearance and settlement arrangements are a permissible method of outsourcing that comply with FINRA regulatory guidance.

- The (k)(2)(i) and outsourcing issues discussed herein should be treated by FINRA and the SEC as matters of policy only. In this regard, we respectfully request that the SEC advise FINRA to refrain from imposing any deadlines to enforce compliance with its views in this area until further consideration is given to the issues and clear guidance is provided. Any other result would

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http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=987181955420425AA48CE1438DCF430A&Language=en.

unfairly disadvantage Canadian-based firms with U.S. broker-dealers relying on the current structure.

- We also seek clarity concerning the net capital treatment of foreign securities held in custody by the Canadian parent entities of U.S. broker-dealers and the conditions that may apply to allow these positions to be treated as allowable notwithstanding custody by an affiliated firm.

Background

A. U.S.-Canadian Cross-Border Clearance and Settlement Arrangements

Many U.S. broker-dealer affiliates of Canadian investment dealers were established with the approval of FINRA and the SEC to conduct DVP/RVP brokerage business involving Canadian securities for U.S. institutional customers and to effect cross-border corporate finance transactions involving Canadian securities. These arrangements were designed to satisfy U.S. institutional demand for Canadian securities primarily to ensure: (1) U.S. regulatory jurisdiction over these U.S. broker-dealer entities and their personnel engaged in brokerage activities with U.S. institutional customers; (2) sales practice and conduct compliance by these firms; and (3) financial and operational compliance by such firms appropriate to DVP/RVP business with secure and efficient clearance and settlement. The U.S. broker-dealers conduct their brokerage business as self-clearing brokers, clearing transactions on a DVP/RVP or cash-on-delivery ("COD") basis. These U.S. broker-dealers use their Canadian parent entities to perform defined settlement services and related administrative functions on their behalf pursuant to service agreements.[2]

Some parent companies are Canadian clearing firms that can directly provide these services to their broker-dealer subsidiaries. Others are participants in Canadian marketplaces, but are introducing firms to Canadian clearing organizations. In the latter case, the Canadian parent firms have separate service agreements with Canadian clearing firms to clear the U.S. transactions. The Canadian clearing firms are participants in the Canadian Depository for Securities ("CDS"). They thereby have the capability to receive and deliver Canadian securities, as well as the ability to receive and deliver U.S. securities through CDS's links to the National Securities Clearing Corporation ("NSCC") in the United States.

A number of U.S. investors have retained Canadian-based custodians to hold their Canadian securities for ease of subsequent transactions since U.S. custodians are not members of CDS and often do not hold Canadian dollar assets. In these situations, the Canadian clearing firms settle directly to other CDS participants. In other cases, especially involving securities that are inter-listed on Canadian and U.S. markets, the Canadian clearing firms settle via CDS's southbound service directly with custodians

[2] A form of service agreement is attached as **Exhibit B**.

who are NSCC participants, satisfying the U.S. broker-dealers' settlement obligations. This can be accomplished since CDS is a branch for these purposes of the NSCC.

The U.S. broker-dealers use their Canadian affiliates to perform U.S. settlement services and related administrative functions on their behalf, notwithstanding that the Canadian affiliates are not registered clearing firms in the United States. This is because the U.S. broker-dealers are "self-clearing" firms under this arrangement and broker-to-broker transactions between the U.S. broker-dealers and their Canadian affiliates comply with Rule 15a-6(a)(4)(i) under the Exchange Act. Some FINRA findings we have seen confuse this issue and consider the arrangement to be a Rule 15a-6 chaperoning arrangement under Rule 15a-6(a)(3). This is not the case. Rule 15a-6 is only relevant to the extent that it provides an exemption for U.S. broker-dealers to effect broker-to-broker transactions to effect and settle Canadian securities transactions with their parent companies without subjecting the parent companies to broker-dealer registration by virtue of these transactions.

The service agreements between the U.S. broker-dealers and their Canadian parent companies document the relationship between the two firms and define their respective responsibilities, but do not in any way absolve the U.S. broker-dealers from full regulatory responsibility as self-clearing firms. The service agreements have no effect upon the obligations between the U.S. broker-dealers and their customers and create no obligations or relationships between the Canadian affiliates and the U.S. broker-dealers' customers.

The U.S. broker-dealers conduct their institutional brokerage business within the scope of the exemption set forth in subparagraph (k)(2)(i) of Rule 15c3-3 under the Exchange Act. No customer securities or funds are held beyond settlement date. Transactions are effected so that delivery of securities takes place only against payment by the customer (e.g., simultaneously). No margin accounts are offered. The U.S. broker-dealers confirm all transactions to their U.S. customers and take all required charges in connections with fail transactions.

In accordance with the (k)(2)(i) exemption and the positions of the SEC staff in various no-action letters, the U.S. broker-dealers are exempt from the requirements of Rule 15c3-3.[3] In the event that customer funds are received prior to the time required to complete a transaction (e.g., funds are delivered by a customer before settlement date), the U.S. broker-dealers utilize a special bank account for the exclusive benefit of the U.S. broker-dealers' customers, as required by Rule 15c3-3(f). If the funds are not capable of being immediately applied to a customer settlement obligation, they are required to be returned to the customer by noon the next day.

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[3] *See*, RMK International Securities, Inc., SEC No-Action Letter (January 29, 1991) and Dominion Securities, Inc., SEC No-Action Letter (December 7, 1978), both of which are attached as **Exhibits D and E**, respectively.

Because the U.S. broker-dealers clear the relevant transactions on a DVP/RVP basis in accordance with Rule 15c3-3(k)(2)(i), these U.S. broker-dealers are characterized as "clearing firms," but not as "carrying firms" pursuant to SEC Release No. 34-31511 (November 24, 1992), attached as **Exhibit C**, for purposes of Rule 15c3-1 under the Exchange Act.

The relationships between the U.S. broker-dealers and their Canadian parent companies are not that of introducing brokers/carrying brokers, and the service agreements do not create such relationships.[4] In Release No. 34-31511, the SEC characterizes an introducing broker relationship as one in which the carrying firm takes responsibility for the proper dispensation of funds or securities between the trade date and settlement date (among other things). In such arrangements, the carrying firm also holds any customer funds and securities following the trade date. In contrast, in the arrangements under discussion, it is the exception that any funds or securities are held by the U.S. broker-dealer in advance of settlement and then only through the use of the special (k)(2)(i) account and the Canadian parent companies never carry any accounts for such customers.

The distinction between clearing and carrying firms is recognized in Rule 15c3-1 under the Exchange Act (the "Net Capital Rule"). Rule 15c3-1(a)(2)(ii) has a special minimum requirement for (k)(2)(i) firms of $100,000, substantially higher than the minimum for introducing firms that actually receive, but do not hold customer securities of $50,000 set forth in Rule 15c3-1(a)(2)(iv). However a firm that carries customer accounts and receives and holds customer funds or securities is subject to a minimum of $250,000 under Rule 15c3-1(a)(2)(i). Clearly, (k)(2)(i) firms clear and settle on a DVP/RVP basis and are subject to a $100,000 requirement, which is in sharp contrast to a carrying firm or an introducing firm. Over the years, during the new membership process, FINRA has somewhat inconsistently required either $100,000 or $250,000. We have usually counseled U.S. broker-dealers not to argue about a $250,000 requirement, not because it was accurate, but because it provided a cushion for charges that would be incurred in the case of fails. A $250,000 requirement also facilitated the use of the Alternative Method under the Net Capital Rule by some firms.

In view of the foregoing, the service agreements are not "Clearing Agreements" or "Carrying Agreements," and the parties did not intend to create such arrangements.[5]

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[4] For example, the service agreements typically provide that "the services to be provided…are merely administrative in nature and all obligations to pay for securities purchased [by] and to deliver securities sold to [U.S. broker-dealer]'s customers rests with [U.S. broker-dealer] and not with the [Canadian parent company]."

[5] To reinforce the foregoing characterization, the service agreements typically state that:

> [U.S. broker-dealer] is a self-clearing firm executing transactions on a delivery-versus-payment basis, and the [Canadian parent company] will act solely as [U.S. broker-dealer]'s broker and settlement agent in completing such transactions. [U.S. broker-dealer] does not hold any customer securities or other property on behalf of [U.S. broker-dealer]'s customers, and does not carry margin accounts on their behalf. [U.S. broker-dealer] relies upon the exemption provided in subparagraph (k)(2)(i) of

Footnote continued on next page

The relationships resemble typical correspondent relationships between U.S. broker-dealers and foreign securities dealers. Since the Canadian parent companies' contractual relationships do not extend beyond their U.S. broker-dealer affiliates, the Canadian dealers are exempt from registration as broker-dealers in the United States pursuant to Rule 15a-6 under the Exchange Act. Customers have no confusion regarding this relationship since they transact only with the U.S. broker-dealers and their registered personnel, they receive research only from the U.S. broker-dealers or as permitted by Rule 15a-6 with notice requiring that transactions be effected only through the U.S. broker-dealers, and all confirmations and statements are issued by the U.S. registered broker-dealers. These firms typically limit their transactions to institutional investors for whom DVP/RVP transactions are the norm, and who readily understand these arrangements.

Many foreign-owned, FINRA member firms, particularly Canadian-owned firms, operate on the foregoing basis with the approval of the SEC and FINRA District offices. In this regard, we have had numerous conversations with FINRA examiners and SEC staff over the years and have provided similar information supporting these operational structures, which were allowed to be implemented.

Some FINRA examiners have asserted in examination findings that under the arrangements we have described, Securities Investor Protection Corporation ("SIPC") coverage is not available to U.S. customers since transactions are effected *for* U.S. customers by non-U.S. firms based on a misunderstanding of the nature of the arrangements and a mistaken belief that these are Rule 15a-6 chaperoned arrangements. This is simply not the case since U.S. customers are transacting only with U.S. broker-dealers and have no contractual relationship with the foreign firms. If there were insolvencies of the U.S. firms that interrupted settlements, the obligations to the customers for which protection would apply would be solely that of the U.S. broker-dealers. SIPC coverage does not apply to transactions with "a foreign subsidiary of a member of SIPC."[6] In the (k)(2)(i) arrangements under discussion, U.S. customers only effect transactions with the U.S. broker-dealer and coverage should therefore apply. SIPC coverage is certainly appropriate since these firms are presently paying SIPC fees to afford such protection to their customers.

FINRA's examination findings regarding SIPC coverage go so far as to assert that firms whose activities are organized in the manner under discussion should include a statement on their confirmations that SIPC coverage does not apply. Such a far-reaching requirement, affecting the rights of U.S. customers, should not be imposed pending clarity concerning the issues under discussion.

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Rule 15c3-3, the [SEC]'s "Customer Protection Rule." None of [U.S. broker-dealer]'s customer accounts are introduced to or carried by the [Canadian parent company].

[6] *See*, Section 78lll(2)(A) of the Securities Investor Protection Act.

B. Canada's Treatment of U.S.-Canadian Cross-Border Clearance and Settlement Arrangements

IIROC's handling of the U.S.-Canadian cross-border clearance and settlement arrangements in Canada has reflected differences in defined terms under IIROC's by-laws as compared to the U.S. rules and regulations we have discussed. From a Canadian standpoint, for ease of processing, it is common for Canadian parent companies performing services under these cross-border clearance and settlement arrangements to have account ranges on their books and records for their U.S. broker-dealer affiliates that identify each account for which they would settle on a DVP/RVP basis. From a U.S. standpoint, this identification is an administrative convenience helping to ensure effective, timely settlement and does not indicate a customer relationship between the U.S. customers and the Canadian firms. Nonetheless, the staff of IIROC, from a purely Canadian standpoint, has viewed the arrangements as potentially satisfying the Canadian definition of an introducing/carrying arrangement because the identity of U.S. customers are known to the Canadian parent companies, and thus, Canadian Investor Protection Fund ("CIPF") coverage (the equivalent of SIPC) may be implicated.

Notwithstanding the terminology differences, IIROC has, without exception, granted exemptions from its introducing/carrying by-laws to permit these arrangements in the circumstances described above, which are supported by letters from FINRA (and formerly, the NASD) stating that the arrangements were permissible. For new FINRA members, that assurance came in the form of the new member application describing the way settlement would occur and FINRA approval. This evidence of approval was based on an understanding that there was a difference in how these arrangements were defined under U.S. and Canadian rules, combined with an acceptance on both sides that these arrangements were permissible and consistent with investor protection.

We understand that the SEC has requested that IIROC not issue any further exemptions from its rules to permit these structures and that some firms operating this way have been informed by IIROC that FINRA may require them to alter their way of doing business. It is this development that has prompted enormous concern among Committee members, and is the impetus for our submission of this memorandum to the SEC.

Issues & Questions

A. DVP/RVP Clearance and Settlement Structure

1. Continuance of the U.S.-Canadian Cross-Border Clearance and Settlement Arrangements in Reliance on Rule 15c3-3(k)(2)(i) and Related Guidance

The first essential question arising from FINRA's and the SEC's changing views is whether the U.S.-Canadian cross-border clearance and settlement arrangements, which are supported by paragraph (k)(2)(i) of Rule 15c3-3, certain SEC no-action letters described above, and longstanding practice, can continue in the same or substantially similar form.

U.S. broker-dealer firms have properly relied on the exemption from the Customer Protection Rule in paragraph (k)(2)(i) and are properly regarded as self-clearing on a DVP/RVP basis, but not "carrying" since they do not hold customer property or securities, consistent with their (k)(2)(i) status and their requirement to "promptly" forward all funds and securities. Given that (1) the securities involved are primarily Canadian issues, (2) the parent companies are members of the Canadian markets and CDS, and (3) custody is held to a large degree by U.S. institutional investors in Canada, the Canadian parent companies must logically act as the settlement agents in these arrangements.

As indicated earlier, the Canadian parent companies have no contractual relationship with U.S. customers and act solely as service providers to their U.S. broker-dealer affiliates to execute and settle the U.S. transactions. This would occur with any non-affiliated brokers in other jurisdictions since omnibus arrangements are not the norm. The service agreements specifically provide that the Canadian parent companies act solely as executing brokers and settlement agents for the U.S. broker-dealer affiliates in completing transactions. Since the U.S. broker-dealers are self-clearing, they are solely responsible to the U.S. customers to complete all transactions and are required to take capital charges for any fails, and customers should have the benefit of SIPC coverage in these circumstances.

It appears that undue weight is being placed by FINRA and the SEC on the introducing/carrying terminology used by IIROC for purposes of compliance with Canadian rules and regulations, even though these arrangements are affirmatively not introducing/carrying arrangements from a U.S. regulatory standpoint (and should not be treated as such) and have always been permitted by IIROC notwithstanding its terminology. The origin of this Canadian terminological issue lies with an appropriately conservative view of the possible extension of CIPF coverage to these accounts based on CIPF rules and certainly not a view that the full range of Canadian conduct and operational rules apply in respect of such accounts. Exemptions confirming this have been uniformly granted by IIROC.

Both FINRA and the SEC have supported reliance on the (k)(2)(i) exemption in DVP/RVP clearance and settlement structures for years, and we see no reason why this exemption and related guidance should be rescinded now. First, the DVP/RVP clearance and settlement structures were approved by FINRA as part of the new membership application process for many firms. Detailed disclosures to FINRA describing the DVP/RVP structure were provided within the business plans, written supervisory procedures and in the Form BDs of the U.S. broker-dealers. Second, in addition to the SEC no-action letters mentioned above, there have been numerous conversations and correspondence with FINRA and SEC staff over the years in order to provide comfort in connection with on-site examinations. This would sometimes arise since FINRA had not, at the time, developed a specific examination module applicable to firms that were self-clearing but not carrying under (k)(2)(i). FINRA examiners recognized that this was an internal issue effecting its examination program unrelated to the appropriateness of these arrangements. In response to examination concerns, the service arrangements were modified and language was approved by FINRA examiners to address such matters as fails, books and records and allocation of expenses.

In 2006, we received informal advice from Mr. David Hwa of the SEC's former Division of Market Regulation, after consultations with others in his group, including Mr. Macchiaroli, clarifying several issues related to the resale of restricted securities initially placed with U.S. institutional investors in private placements and subsequently sold pursuant to Rule 904 of Regulation S on Canadian stock exchanges. In this regard, SEC staff confirmed that the (k)(2)(i) exemption from Rule 15c3-3 is available to firms that are self-clearing on a DVP/RVP basis, and that the occurrence of fails-to-deliver arising from processing delays resulting from the need to remove restrictive legends will not alter the availability of such exemption. The SEC staff also agreed to relief from proprietary haircuts for fails-to-deliver on Rule 904 resale transactions effected though a U.S. broker-dealer's Canadian parent company, provided that the U.S. broker-dealer takes a daily mark to market charge and enters into an agreement with the Canadian parent company under which the Canadian parent would not enforce the fail owed to it by the U.S. broker-dealer in its broker-to-broker transaction.

We also point to the FOCUS reports filed by substantially all FINRA-member firms that include a section entitled "Exemptive Provisions," which allows firms to claim a Rule 15c3-3 exemption using any of four alternatives, including (k)(2)(i). As noted above, the Net Capital Rule itself has a specific minimum requirement of $100,000 applicable to (k)(2)(i) scenarios as well.

References to (k)(2)(i) in recent FINRA and SEC rulemaking and guidance also suggest an acknowledgment by regulators that the exemption continues to be valid and very useful to firms engaging in DVP/RVP business. Specifically, in FINRA Regulatory Notice 08-56, FINRA announced the publication of "Consolidated Interpretations of SEC Rules Governing Financial Responsibility, Customer Protection and Books and Records." FINRA consolidated former NASD and New York Stock Exchange ("NYSE") interpretations of the SEC's financial and operations rules (including Rule 15c3-3) and created a single resource for interpretations.[7] Several interpretations relate to and support the notion that broker-dealers continue to rely on (k)(2)(i).

On November 4, 2009, the SEC approved FINRA's proposed rule changes to adopt a new set of financial responsibility rules for its "Consolidated Rulebook."[8] FINRA Rules 4110, 4120, 4130, 4140 and 4521 are the new consolidated rules governing financial responsibility that are based in part on, and replace, provisions in the NASD and Incorporated NYSE rules. Generally, the rules establish criteria promoting the permanence of members' capital, require the review and approval of certain material

[7] *See,* FINRA Interpretations of Financial and Operations Rules available at: http://www.finra.org/Industry/Regulation/Guidance/FOR/.

[8] *See,* Exchange Act Release No. 60933 (November 4, 2009), 74 FR 58334 (November 12, 2009) (Order Granting Approval to Proposed Rule Change; File No. SR-FINRA-2008-067) ("Approval Order").

financial transactions, and establish criteria intended to identify members approaching financial difficulty and to monitor their financial and operational condition. The new rules incorporate many existing provisions from NASD and Incorporated NYSE rules that govern financial responsibility, but streamline and reorganize those provisions. A notable difference in the new rules is that FINRA has tiered many provisions so that they apply only to those members that clear or carry customer accounts. On this point, FINRA specifically provides that all requirements in the new consolidated rules that apply to firms clearing/carrying customer accounts also apply to firms that are operating pursuant to the exemptive provisions of (k)(2)(i) and either clear customer transactions pursuant to such exemption or hold customer funds in a bank account established thereunder.[9] On the one hand, these new rules arguably ignore considerable profile differences between clearing/carrying and (k)(2)(i) firms and treat these firms the same for purposes of investor protection requirements in the rules.[10] However, the new rules also serve as support for the longstanding position that firms engaged in a DVP/RVP business can rely on the (k)(2)(i) exemption while maintaining a self-clearing status.

2. Restructuring the DVP/RVP Clearance and Settlement Arrangements as Omnibus Accounts

Following from the (k)(2)(i) issue is whether the U.S.-Canadian cross-border clearing arrangements discussed herein need to be restructured as omnibus accounts (as suggested by FINRA staff).

It is our belief that typical securities omnibus account arrangements provide no additional customer protection or regulatory benefit over the current DVP/RVP clearance and settlement arrangements. In standard omnibus arrangements, omnibus clearing firms carry in a single account the positions of introduced customer transactions of introducing brokers. Generally, the omnibus clearing firms are not given any identifying information

[9] *See,* FINRA Rules 4110.02, 4120.03 and 4521.01. *See also,* Approval Order, note 9, at 74 FR 58334. In response to comment letters received concerning treatment of (k)(2)(i) firms, FINRA noted that firms that operate pursuant to the (k)(2)(i) exemption receive customer funds for the purpose of settling customer transactions and perform a clearing function, irrespective of how short the period they may hold customer funds.

[10] As part of FINRA Regulatory Notice 08-23, whereby FINRA requested comment on FINRA Rules 4110, 4120, 4130, 4140 and 4521, a distinction between clearing/carrying firms and non-clearing/carrying firms was made. In that Notice, FINRA stated that certain of its proposed rule provisions would apply only to those firms that clear/carry customer accounts or operate pursuant to (k)(2)(i). In response to Notice 08-23, comment letters were submitted wherein, among other things, firms questioned why (k)(2)(i) firms would be subject to the same rules as clearing/carrying firms when the operational and financial risks generated by the activities are significantly different. For instance, firms that rely on the (k)(2)(i) exemption should not be subject to the same rules as clearing/carrying firms since (k)(2)(i) firms do not engage in clearing/carrying activities and instead must "promptly" forward funds and securities by noon of the next business day following receipt. To the extent that such firms actually hold customer funds in a special account under (k)(2)(i), which is rare, the amounts held and the duration of the holding is incomparable to the amounts held by traditional clearing/carrying firms. *See, e.g.,* letter submitted by Sutherland Asbill & Brennan LLP on behalf of the Committee of Annuity Insurers (June 13, 2008); letter submitted by ING Advisors Network (June 13, 2008); and letter from Stephen R. Kinkade (June 13, 2008).

about the beneficial owners of the assets contained in the omnibus accounts. Rather, the omnibus clearing firms treat the intermediary broker-dealers as their sole customers. In omnibus clearing arrangements, omnibus clearing firms generally perform clearance, settlement, execution and custody pursuant to omnibus clearing agreements with the introducing brokers. The introducing brokers remain legally responsible for custody, clearing, capital requirements, reserve deposits, and books and records. The omnibus clearing firms contractually perform certain of these functions for the introducing brokers as servicing agents.

Other similarities exist with respect to FINRA regulatory oversight of the two types of arrangements. Omnibus clearing agreements require review and approval by FINRA. Under the existing DVP/RVP clearance and settlement structure, all (k)(2)(i) service arrangements similarly require review by FINRA under guidance for expense sharing arrangements. As indicated above, FINRA's new financial responsibility and operational requirements subject clearing/carrying firms (including omnibus clearing/carrying firms) and (k)(2)(i) firms to the same requirements. Thus, from FINRA's perspective, there is nothing to gain from having these arrangements restructured as omnibus accounts.

From an SEC regulatory standpoint, however, omnibus clearing arrangements, which find their origins in NYSE member regulation rules, have an ambiguous status. Omnibus clearing arrangements are inconsistent with (k)(2)(i) since positions are "carried" on an omnibus basis. Rule 15c3-3 provides no exemption or special treatment for omnibus arrangements. Therefore, it appears that firms would have to designate the omnibus accounts at the Canadian parent companies as approved foreign control locations even though all transactions remain DVP/RVP and such firms would be fully subject to Rule 15c3-3, basically writing the (k)(2)(i) exemption out of existence and imposing regulatory burdens inconsistent with DVP/RVP transactions of the kind under consideration. Similarly, there is no reference in the Net Capital Rule to omnibus clearing arrangements, and the concept of an introducing broker does not cover such omnibus arrangements with foreign firms. The application of a $250,000 minimum standard seems disproportionate as well, especially since any customer property coming into the U.S. broker-dealers' possession must be locked up in special accounts and returned promptly. There is also no reference to omnibus accounts in the FOCUS reports filed with FINRA. In one of the few non-NYSE references, Regulation T refers to omnibus credit accounts, but this is inapplicable to accounts maintained at foreign firms.

Until recently, there has been very few FINRA rules or guidance referring to omnibus accounts specifically. In January 2009, FINRA requested comment on proposed new FINRA Rules 4150, 4311, 4522 and 4523 in its continuous effort to develop a new set of financial responsibility and related operations rules for the Consolidated Rulebook.[11] Proposed FINRA Rule 4311 is based on NASD Rule 3230 and NYSE Rule 382, which govern the requirements applicable to firms when entering into agreements

[11] *See,* FINRA Regulatory Notice 09-03.

for the clearing/carrying of customer accounts. One distinction for FINRA-only member firms is the specific language in new FINRA Rule 4311 referring to accounts introduced to clearing/carrying firms (including foreign entities) on an omnibus basis. This language was drawn from previous NYSE rules. FINRA's new focus on omnibus accounts is likely due to NYSE influence in the financial and operations area at FINRA. There has been a longstanding perception that NYSE examiners have been most familiar with carrying firms and have not been as familiar with (k)(2)(i) structures for DVP/RVP business. This is apparent in FINRA's recent financial and operations rule adoptions and proposals, which refer to omnibus accounts specifically and essentially ignore the very different business models of clearing/carrying firms and (k)(2)(i) firms and treat them the same for regulatory purposes. It would be unreasonable to require FINRA-only member firms that have been relying on (k)(2)(i) for years to change their structure to resemble omnibus arrangements on this basis. In any case, FINRA's new focus on omnibus account arrangements does not and cannot rescind the SEC's (k)(2)(i) exemption and related no-action letters.

We also note that FINRA's potential requirement for the use of omnibus account arrangements between U.S. broker-dealers and their Canadian parent companies is inconsistent with its own recent guidance on master accounts and sub-accounts. Recent FINRA guidance on master accounts and sub-accounts seems to limit the use of omnibus accounts and requires that individual customer account relationships be established by firms that have actual or inquiry notice that an account has different beneficial ownership.[12] In the operational area, FINRA appears to be promoting the use of omnibus accounts, while in the sales conduct and securities law compliance areas, seeking to limit their use. Based on the perspective in this FINRA guidance, it would promote compliance efforts if the Canadian parent companies knew the identities of individual U.S. customers for settlement purposes since such identification would enhance surveillance of activities by these account holders by the U.S. firms and their parent companies acting in a coordinated manner. The use of omnibus accounts shield identity and make compliance efforts more difficult. On the other hand, no meaningful additional customer protection is afforded by a move to omnibus accounts.

Any change to the existing DVP/RVP clearance and settlement structure will have significant financial, compliance, and operational consequences for the U.S. broker-dealers utilizing the existing structure even though the Canadian parent companies will still be acting as executing firms and settlement agents for all Canadian securities. U.S. broker-dealers utilizing the current structure may be subject to higher net capital requirements, must meet all of the requirements of Rule 15c3-3 for safekeeping customer funds and securities, and must maintain books and records of a fully computing, clearing/carrying firm. In addition, transactions in omnibus accounts will require extra processing legs and will need to be double booked by both the U.S. broker-dealers and their Canadian parent companies - resulting in four transaction records reflecting buy and sell transactions between the U.S. broker-dealers and U.S. customers, as well as buy and

[12] *See,* FINRA Regulatory Notice 10-18.

sell transactions between the U.S. broker-dealers and Canadian parent companies in the omnibus accounts. These extra records would, at present, have to be created and reconciled manually, which would be extremely difficult with a significant number of transactions. Under the existing arrangement, the DVP/RVP transactions are booked to reflect one transaction as between the U.S. broker dealers and their customers, with the Canadian parent companies acting as settlement agents of the U.S. broker-dealers and the resulting records being incorporated into the U.S. firms' books and records. In omnibus arrangements, the U.S. broker-dealers still must rely on their parent companies' access to CDS to effect settlement, but unnecessary, duplicative, manually produced, transaction records will need to be generated. These changes will require unnecessary and very significant system and operational adjustments in order to accommodate large volumes of trading for U.S. customers in Canadian securities.

3. NSCC Membership

Another issue that should be addressed is whether, if the existing U.S.-Canadian cross-border clearance and settlement structure is permitted to continue, the U.S. broker-dealer affiliates would need to become clearing members of NSCC in order to have the status of a (k)(2)(i) self-clearing firm on a DVP/RVP basis involving Canadian securities.

This has not been required to date since Canadian parent companies can complete these transactions for their U.S. broker-dealer affiliates through CDS either directly to Canadian custodians for U.S. institutional investors or to U.S. custodians through CDS, which is a branch of NSCC.

Many firms utilizing the existing structure have no direct connection with NSCC since their U.S. institutional customers use Canadian custodians to hold their Canadian securities positions, so that NSCC participants would have to use correspondents in any event to settle with Canadian custodians. In cases in which institutional customers use U.S. based custodians, NSCC membership by U.S. firms would just add an extra processing leg in trades involving Canadian securities since the trades would have to initially clear to the U.S. broker-dealers before settling to the U.S. custodians for U.S. institutional customers. To the extent that the U.S. broker-dealers had to introduce these accounts to U.S. clearing firms rather than becoming direct NSCC participants, these U.S. clearing firms would be extracting fees while not providing any meaningful role in transactions in foreign securities executed and cleared in Canada.

The CDS southbound service has worked effectively for over 30 years without the need for this extra step. A brief summary of the regulatory status of CDS in the United States is provided in **Exhibit F**.

The Committee seeks confirmation from the SEC that U.S. broker-dealers can continue to rely on the Rule 15c3-3(k)(2)(i) exemption without restructuring such arrangements as omnibus accounts, and without requiring the U.S. broker-dealers to become members of NSCC.

B. Outsourcing

1. Outsourcing Arrangements for U.S. Broker-Dealers Operating Under the Rule 15c3-3(k)(2)(i) Exemption

During the course of recent regulatory examinations for some U.S. broker-dealers operating with U.S.-Canadian cross-border clearance and settlement arrangements, FINRA has questioned whether these arrangements constitute permissible outsourcing arrangements, without requiring registration of personnel of the Canadian parent companies, other than personnel at the supervisory level, such as a Financial and Operations Principal ("FINOP"), who are often dually registered with the Canadian and U.S. Firms. However, the cross-border clearance and settlement arrangements in place are similar to other back-office outsourcing arrangements that U.S. regulators have acknowledged and accepted for many years. Many U.S. broker-dealers are increasingly contracting with third-party service providers to perform activities and functions related to their operations that the U.S. broker-dealers would otherwise perform themselves and the service arrangements between U.S. broker-dealers operating under the (k)(2)(i) exemption and their Canadian parent companies is one such example.

FINRA has stated that although U.S. broker-dealers cannot contract away their supervisory and compliance activities from their direct control, U.S. broker-dealers are not precluded from outsourcing certain activities that support the performance of their supervisory and compliance responsibilities. While FINRA has published guidance on outsourcing, it appears that FINRA has purposefully not stated what functions may or may not be outsourced or provided opinions regarding the appropriateness of a U.S. broker-dealer outsourcing any particular function to a third-party service provider as long as the activity does not require qualification or registration with the U.S. broker-dealer and the U.S. broker-dealer maintains ultimate responsibility for its supervisory and compliance activities.[13]

This flexible, principles-based approach to the activities that should and should not be outsourced is appropriate because outsourcing policies should take into account the particular broker-dealer's ability to establish effective supervision and controls that are tailored to the specific circumstances of each outsourcing arrangement. If U.S. broker-dealers are able to properly supervise and monitor the third-party service providers, they should be permitted to outsource such activities as long as the ultimate responsibility for such activities remains with the U.S. broker-dealers.

U.S. broker-dealers have outsourced a number of their important operational and compliance functions that have been accepted by U.S. securities regulators, including: (1) various mission critical functions; (2) traditional clearing arrangements; and (3) back-office functions. For example, in NYSE Information Memo 05-80, the NYSE acknowledged that U.S. broker-dealers could outsource mission critical systems. In that notice, "mission critical systems" were defined to mean "any system that is necessary,

[13] *See,* http://www.finra.org/Industry/Regulation/Guidance/InterpretiveLetters/P017175.

depending on the nature of a member's or member organizations' business, to ensure prompt and accurate processing of securities transactions, including order taking, entry, execution, comparison, allocation, clearance and settlement of securities transactions, the maintenance of customer accounts, access to customer accounts and the delivery of funds and securities." Under the existing cross-border clearance and settlement arrangements between U.S. broker-dealers and their Canadian parent companies, the personnel of Canadian parent companies, fulfilling the parent's contractual role as an executing firm and settlement agent for its affiliate in foreign markets, assist their affiliates with critical functions, primarily execution services, DVP/RVP deliveries for the broker-dealer and the generation of transaction records under the supervision of the FINRA member.

As discussed earlier, the U.S. broker-dealers engaged in these cross-border arrangements supervise the settlement process, address fails-to-deliver and ensure that they take the required net capital charges so that they are continuously in net capital compliance. In addition, the U.S. broker-dealers have registered personnel who are designated to oversee and monitor all of their Canadian parent companies' employees involved in assisting with the U.S. broker-dealers' clearance and settlement functions.

The activities performed by the Canadian parent are far more confined than the outsourcing implicit in introducing/carrying agreements in which the customer relationship is shared and customer responsibilities allocated.

U.S. securities regulators have also acknowledged that many U.S. broker-dealers outsource their back-office functions. In FINRA's 2010 List of Exam Priorities, FINRA contemplated its member firms outsourcing key operating functions, including back-office securities processing activities.[14] U.S. broker-dealers often outsource their back-office functions to affiliated entities who are better able to perform such support functions. Through specialized expertise that the affiliated entities develop, they become more efficient in performing such functions than if the U.S. broker-dealers had to do them on their own. This is especially important for U.S. broker-dealers engaged in cross-border clearance and settlement arrangements where the U.S. broker-dealers are part of a much larger international organization and the U.S. broker-dealers have the limited purpose of effecting institutional brokerage transactions on a DVP/RVP basis involving foreign securities.

The arrangements under discussion comply with specific outsourcing guidance provided by FINRA. FINRA Regulatory Notice 05-48 provides guidance on FINRA members' responsibilities when outsourcing activities to third-party service providers. This notice stresses two points: (1) any parties conducting activities or functions that require registration under FINRA rules will be considered associated persons of the U.S. broker-dealers, absent the service providers separately being registered as broker-dealers and such arrangements having been contemplated by FINRA Rules or applicable federal securities laws or regulations; and (2) outsourcing activities or functions to third parties

[14] *See*, 2010 FINRA Examination Priorities Letter (March 2010) available at: http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p121004.pdf.

does not relieve U.S. broker-dealers of their ultimate responsibility for compliance with applicable federal securities laws and regulations and FINRA rules regarding the outsourced activities or functions.

The back-office clearance and settlement functions that the employees of Canadian parent companies perform for their U.S. broker-dealer affiliates do not require registration. Even when U.S. broker-dealers perform their back-office functions internally, the employees responsible for such back-office functions are typically not registered persons. NASD Rule 1031 requires that all "representatives" of a U.S. broker-dealer must be registered with that U.S. broker-dealer. The Canadian employees of the parent companies are not considered "representatives" of the U.S. broker-dealers and therefore, are not required to be registered as such. "Representatives" are defined as "persons associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions." The employees of the Canadian parent companies that are engaged in back-office functions for the U.S. broker-dealers are not "associated persons" of the U.S. broker-dealers and therefore are not representatives who are required to be registered.

NASD Rule 1011(b) defines an "associated person" to mean, in material part: (1) a natural person registered under NASD Rules; (2) a sole proprietor, or any partner, officer, director, branch manager of the broker-dealer, or any person occupying a similar status or performing similar functions; (3) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the broker-dealer; (4) any employee of the broker-dealer, except any person whose functions are solely clerical or ministerial; (5) any person directly or indirectly controlling the broker-dealer whether or not such person is registered or exempt from registration under the FINRA By-Laws or NASD Rules; or (6) any person engaged in investment banking or securities business controlled directly or indirectly by the broker-dealer whether such person is registered or exempt from registration under the FINRA By-Laws or NASD Rules.

The employees of the Canadian parent companies are not natural persons registered under NASD rules, partners, directors, officers or other employees of the U.S. broker-dealers. Based on FINRA's definition, the only reason why the Canadian parent companies' employees could conceivably be considered to be "associated persons" of the U.S. broker-dealers would be if they controlled or were controlled by the U.S. broker-dealers. The SEC's Uniform Application for Broker Dealer Regulation ("Form BD") defines the term "control" to mean "the power, directly or indirectly to direct the management or policies of a company whether through ownership of securities, by contract, or otherwise."[15] Although the U.S. broker-dealers supervise and monitor the

[15] Form BD also states that any person that (i) is a director, general partner or officer exercising executive responsibility (or having similar status or functions), (ii) directly or indirectly has the right to vote 25% or more of a class of voting securities, or (iii) in the case of a partnership, has the right to receive upon dissolution, or has contributed, 25% or more of the capital, is presumed to have control.

outsourced functions performed by their Canadian parent companies since those activities affect the U.S. firms' responsibilities to their customers, their books and records, their net capital and their compliance with the conditions of the (k)(2)(i) exemption, the U.S. broker-dealers do not control the day-to-day operations of the Canadian employees. Further, the tasks performed by the Canadian personnel for the U.S. broker-dealers are clerical and ministerial in nature. The actual responsibility lies with the U.S. broker-dealer's principals and they use the Canadian back-office to perform mechanical functions under their supervision. The service agreements between the U.S. broker-dealers and the Canadian parent companies typically reinforce this point by stating that "the services to be provided...are merely administrative in nature and all obligations to pay for securities purchased [by] and to deliver securities sold to [U.S. broker-dealer]'s customers rests with [U.S. broker-dealer] and not with the [Canadian parent company.]"

It is hard to imagine a regulatory environment where this type of outsourcing would not be permitted. The alternative, as applied to global firms, would be to require registration by the regulatory authorities in many relevant jurisdictions over the back-office personnel in the firm's home country, rather than registration by the responsible supervisors for each registrant in each jurisdiction.

FINRA has specifically stated within the context of outsourcing, that it does not view third-party vendors as associated persons of the member if they solely provide services such as trade execution and reporting systems or automated data services in connection with back-office functions that, in turn, are utilized by registered or other associated persons of the member. The functions performed by the Canadian parent companies are similar to these types of services and are closely supervised by registered persons of the U.S. broker-dealers who are responsible for such services. In addition, the Canadian personnel are employed by the Canadian parent companies who are registered investment dealers in Canada and are members of IIROC. Therefore, the Canadian personnel are also subject to stringent requirements under Canadian securities regulatory requirements.

In accordance with the FINRA guidance, the U.S. broker-dealers also maintain ultimate responsibility for compliance with all applicable federal securities laws and regulations and FINRA rules regarding their outsourced back-office functions. Under the U.S.-Canadian cross-border settlement arrangements, the U.S. broker-dealers are fully responsible for all aspects of the U.S. broker-dealers' operations and the U.S. broker-dealers have registered employees who are responsible for overseeing the clearance and settlement process.

As contemplated in FINRA Regulatory Notice 05-48, the U.S. broker-dealers must have written procedures designating how the services performed by the Canadian parent companies will be monitored. The U.S. broker-dealers must review and discuss business continuity plans with their Canadian parent companies. In addition, the U.S. broker-dealers must conduct due diligence to ensure that their Canadian parent companies can adequately perform the necessary services. Because the U.S. broker-dealers are affiliates of their parent third-party service providers, the U.S. broker-dealers are typically very familiar with the capabilities, operations and management of the

Canadian parent companies and therefore can ensure that their Canadian parent companies are able to perform the designated tasks.

Additionally, the U.S. broker-dealers have a continuing responsibility to oversee and monitor the services that are outsourced to the Canadian parent companies. Again, because of the affiliate relationship between the U.S. broker-dealers and their Canadian parent companies, the U.S. broker-dealers are able to closely monitor the outsourced functions. Although the U.S. broker-dealers and the Canadian parent companies are separate and distinct entities, the U.S. broker-dealers' familiarity with the Canadian parent companies' operations and employees, and dually registered supervisory personnel, enable the U.S. broker-dealers to fully monitor the Canadian parent companies' activities. In addition, the U.S. broker-dealers must have designated employees who are responsible for overseeing the outsourced activities. The registered employees of the U.S. broker-dealers are required to monitor the outsourcing arrangements to ensure compliance with applicable rules, to ensure that shared information is kept confidential and to continually assess the Canadian parent companies' performance, accuracy and quality of work produced. The U.S. broker-dealers are also required to conduct regular reviews of the Canadian parent companies, typically through normal business operations, designated meetings, and the testing and review of the Canadian parent companies' processes and procedures.

Also, as contemplated in FINRA Regulatory Notice 05-48, the U.S. broker-dealers are required to ensure that FINRA and all other applicable regulators have the same complete access to the Canadian parent companies' operations that are used for the U.S. broker-dealers clearance and settlement functions, as would be the case if the covered activities were performed directly by the U.S. broker-dealers.

As discussed earlier, it has been suggested that the U.S. broker-dealers establish omnibus clearing arrangements between the U.S. broker-dealers and their Canadian parent companies. If an omnibus account was established, the actual functions that the Canadian parent companies would perform would not change. The Canadian parent companies would still assist in the performance of the back-office functions of the U.S. broker-dealers, which would be highly supervised by the U.S. broker-dealers. Therefore, the analysis of whether the settlement arrangements constitute permissible outsourcing arrangements would not change.

It has also been suggested that the U.S.-Canadian clearance and settlement arrangements may be impermissible outsourcing arrangements because the Canadian parent companies are not registered as U.S. broker-dealers. However, the Canadian parent companies are not required to be registered as U.S. broker-dealers because these arrangements are strictly between the U.S. broker-dealers and their Canadian parent companies and do not in any way involve the U.S. broker-dealers' customers. Therefore, the arrangements are considered to be broker-to-broker transactions, which are permissible under Rule 15a-6(a)(4)(i) of the Exchange Act.

On May 26, 2010, in FINRA Regulatory Notice 10-25, FINRA solicited comment concerning a rule proposal that extends registration requirements to certain supervisory employees engaged in back-office functions.

Under the proposed rule, an individual that serves in a discretionary, oversight or quality control capacity with respect to certain back-office functions would be required to register as an Operations Professional. Specifically, the following persons associated with a FINRA member would be required to register as an Operations Professional:

- Senior management with responsibility over defined covered functions;
- Supervisors, managers or other persons responsible for approving or authorizing work in direct furtherance of the covered functions, including work of other persons in the covered functions; and
- Persons with the authority or discretion to commit the FINRA member's capital in direct furtherance of the covered functions or to commit the FINRA member to any contract or agreement (written or oral) in direct furtherance of the covered functions (including, *e.g.*, a person who has the discretion to commit the firm to any contract or agreement involving securities lending or borrowing activities).

The following are identified by FINRA as covered functions:

- Development and approval of pricing models used for valuations;
- Trade confirmation, account statements, settlement, margin;
- Stock loan/securities lending;
- Prime brokerage (services to other broker-dealers and financial institutions);
- Client on-boarding (customer account data and document maintenance);
- Capturing of business requirements for sales and trading systems and any other systems related to the covered functions, and validation that these systems meet such business requirements;
- With respect to the covered functions, defining and approving business security requirements and policies for information technology (including, but not limited to, systems and data);
- Defining information entitlement policy in connection with the covered functions;
- Financial Controller (including general ledger);

- Collection, maintenance, re-investment (*i.e.*, sweeps) and disbursement of funds;
- Bank, custody, depository and firm account management and reconciliation;
- Segregation, possession and control, fail control, buy ins;
- Receipt and delivery of securities and funds, account transfers;
- Financial regulatory reporting; and
- Posting entries to the books and records of a firm in connection with the covered functions.

FINRA has stated informally that the idea behind the new registration category is not to require everyone in the back-office to become registered. Rather, FINRA intends to include only supervisors of such back-office functions, regardless of who employs them, to register as Operations Professionals. Because the U.S. broker-dealers are responsible for closely monitoring and supervising the Canadian parent companies' back-office support functions, and since supervisory personnel are often presently dually registered with the Canadian and U.S. firms, we do not anticipate that it would be necessary under the proposed rule as it stands for large numbers of the Canadian parent companies' personnel to become registered with the U.S. broker-dealers. As discussed earlier, all supervisory functions are currently, and will continue to be performed by U.S. broker-dealers' registered employees. Employees of the U.S. broker-dealers who are responsible for supervising the services performed by the Canadian parent companies may be required to become registered as Operations Professionals but such registration should not be required of the employees of the Canadian parent companies. A broader view of this registration requirement, before even the first comment letter has been received and SEC approval obtained, should not be used to make longstanding (k)(2)(i) servicing arrangements practically unavailable by insisting that the Canadian back-office be fully integrated into the U.S. firm.

2. Outsourcing Arrangements for Fully-Computing U.S. Broker-Dealers

Additional outsourcing issues arise in connection with Rule 15c3-3 fully-computing firms that operate using the same cross-border clearance and settlement arrangements as U.S. broker-dealers operating under the (k)(2)(i) exemption. As discussed earlier, over the years, certain regulatory examiners who were unfamiliar with U.S. broker-dealers operating under the (k)(2)(i) exemption have raised concerns about the permissibility of the U.S. broker-dealers' clearing and settlement arrangements with their Canadian parent companies. This tended to happen because examiners found it difficult to separate self-clearing firms from carrying firms. As a result, some U.S. broker-dealers who were relying on the (k)(2)(i) exemption chose to become fully computing broker-dealers under Rule 15c3-3.

The regulators seemed to be particularly concerned that because the U.S. broker-dealers can end up carrying customer positions when fails-to-deliver arise, the (k)(2)(i) exemption might not be available. However, the SEC has accepted that some fails are inevitable and they do not disqualify U.S. broker-dealers from operating on this basis. As discussed earlier, in 2006, the SEC staff confirmed that the (k)(2)(i) exemption is available to firms that are self-clearing on a DVP/RVP basis and that the occurrence of fails-to-deliver arising from processing delays resulting from the need to remove restrictive legends would not alter the availability of such exemption.

Nonetheless, in response to these regulatory examinations, some U.S. broker-dealers have chosen to become fully computing firms under Rule 15c3-3. Aside from complying within the full scope of Rule 15c3-3, the fully computing broker-dealers still operate in the same manner as those broker-dealers relying on the (k)(2)(i) exemption. However, because some U.S. broker-dealers continue to operate under the (k)(2)(i) exemption and other U.S. broker-dealers are fully computing, an inconsistency has developed in the way U.S. broker-dealers with similar clearance and settlement arrangements comply with the Customer Protection Rule.

The U.S. broker-dealers who are fully computing are entitled to carry customer accounts under Rule 15c3-3. Since the U.S. broker-dealers are not set up to carry customer funds or securities, several U.S. broker-dealers have applied to the SEC and received permission to have their Canadian parent companies designated as a satisfactory control location under Rule 15c3-3(c)(4). However, even if the Canadian parent companies are able to hold the U.S. broker-dealers' customer securities due to their classification as satisfactory control locations, the customer securities are still deemed to be under the control of the U.S. broker-dealers based on the definition in Rule 15c3-3 and the U.S. broker-dealers are ultimately responsible for their customers' securities.

Therefore, the same analysis performed for U.S. broker-dealers operating under the (k)(2)(i) exemption, should also apply for fully-computing U.S. broker-dealers in determining that the clearance and settlement arrangement constitutes a permissible outsourcing arrangement. The U.S. broker-dealers are not managing the day-to-day responsibilities of the Canadian personnel and the functions of the Canadian personnel are still largely ministerial and clerical. Nonetheless, it could be argued that for a fully-computing broker-dealer, the Canadian personnel are more directly involved in the investment banking and securities business of the U.S. broker-dealers because the Canadian parent companies are entitled to hold customer securities.

In addition, some Canadian-affiliated fully-computing U.S. broker-dealers have used their fully-computing status to accommodate very limited non-institutional customer activity to trade and hold securities arising from Canadian corporate finance transactions for friends and family of the issuers involved. In this situation, the Canadian parent companies have also been approved as satisfactory control locations under Rule 15c3-3. However, if it is determined that U.S. broker-dealers can no longer outsource their back-office functions to their Canadian parent companies while they are fully-computing U.S. broker-dealers, some fully-computing U.S. broker-dealers may wish to consider changing their status and relying on the (k)(2)(i) exemption. Furthermore, even if the clearance and settlement arrangements between U.S. broker-dealers and their Canadian parent companies are deemed appropriate for fully-computing U.S. broker-dealers (as well as for U.S. broker-dealers acting under the (k)(2)(i) exemption), the U.S. broker-dealers may still wish to consider switching back to operating under the (k)(2)(i) exemption since it is more consistent with their actual business operations.

Assuming that the SEC agrees that the existing cross-border clearance and settlement structure can continue, the Committee asks for confirmation that the existing third party services arrangements for (k)(2)(i) firms are appropriate forms of outsourcing, and also seeks guidance regarding the permissibility of outsourcing arrangements for fully-computing broker-dealers.

C. Proprietary Trading

Apart from the institutional DVP/RVP transactions discussed herein, there are some U.S. broker-dealer affiliates of Canadian investment dealers that also engage in proprietary trading and clear such transactions through their Canadian parents using its CDS southbound service, and maintain custody of such securities at their parent companies. International securities firms would naturally expect to hold at least their foreign securities through their parent clearing firms rather than at U.S.-based competitors. We understand that this has been allowed by the SEC at least on a case-by-case basis for some international firms without treating the positions as non-allowable for net capital purposes, notwithstanding that they are held at an affiliate and in the name of the affiliate at CDS. For Canadian securities transactions, it appears that such correspondent clearing arrangements involving Canadian securities should be permissible.

The Canadian parent companies use (or are themselves) established clearing organizations and participants of CDS. It is not possible for the U.S. broker-dealers to have their proprietary positions held at CDS in their own legal name since the U.S. broker-dealers are not direct participants of CDS. The proprietary positions are held at CDS in the same manner as any other customer securities - in the name of the Canadian clearing organizations. The broker-to-broker relationship between the U.S. broker-dealers and their Canadian parent companies is supported by Rule 15a-6(a)(4)(i) and enables the U.S. broker-dealers to utilize their parent companies' participation in CDS to clear and settle proprietary transactions in Canadian securities.

The fact that CDS holds the proprietary positions in the participant's name (and not the name of the U.S. broker-dealer) has no relevance to the U.S. broker-dealers' control of the securities under Rule 15c3-3 under the Exchange Act (since these are not customer securities) or to the customer protection concerns raised above. This issue only comes into play with respect to proprietary positions of the U.S. broker-dealers.

With respect to Canadian securities, it would be unfair to require international firms to hold such securities at U.S.-based broker-dealers, which would ultimately hold them at clearing organizations in Canada or a competitor anyway. Similarly, it would be an awkward and inconsistent result if customer securities could be held at the Canadian parent companies as approved foreign control locations, but U.S. broker-dealers could not hold their proprietary positions in the same manner without being treated as non-allowable. Of course, such proprietary positions should be required to be free of liens to the same extent as customer securities to be considered to be marketable for net capital purposes.

The Committee seeks clarity on the SEC's process for determining when international firms can treat proprietary positions in foreign securities held at parent companies as allowable for net capital purposes.

Conclusion

For the reasons stated herein, we believe that the U.S.-Canadian cross-border clearance and settlement arrangements should continue to operate on the basis that the Rule 15c3-3(k)(2)(i) exemption is a viable exemption for cross-border DVP/RVP business. There has not been any history of problems arising from the use of such U.S.-Canadian cross-border clearance and settlement arrangements and therefore requiring a change in practice seems unwarranted. Furthermore, the U.S.-Canadian cross-border clearance and settlement arrangements comply with recent regulatory policies, including the outsourcing guidance provided by FINRA. Any changes to current practices will result in material financial, operational and compliance consequences for Canadian firms engaged in cross-border servicing arrangements without any added customer protection or regulatory benefit. The Committee seeks clarity from the SEC regarding whether these practices can continue in the same form that they have for many years and asks that the SEC advise FINRA not to take any action on these matters until further consideration is given to the issues we have raised.

We thank you for allowing us to submit this memorandum. We are available to meet with you to discuss all of these issues at your convenience.

Please do not hesitate to contact Grant Vingoe (212-715-1130) or Barri Bogner (212-715-1329) regarding these matters.