UNIVERSITY OF MIAMI
SCHOOL of LAW

Investor Rights Clinic
1311 Miller Drive, Suite A312
Coral Gables, FL 33146

Phone: 305-284-8234
Fax: 305-284-9368

April 27, 2018

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

Re: Regulatory Notice 18-08 | FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities ("OBAs") and Private Securities Transactions ("PSTs")

Dear Ms. Mitchell:

The University of Miami School of Law Investor Rights Clinic ("IRC") appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") proposed new rule addressing the outside business activities and private securities transactions of registered persons. The proposed rule (FINRA Rule 3290) would replace current FINRA Rules 3270 and 3280 that require firms to assess and, with respect to PSTs, supervise the outside activities of their associated persons. Regulatory Notice 18-08 explains that Rule 3290 seeks to "reduce unnecessary burdens while strengthening investor protection" by narrowing and clarifying the scope of these obligations.

I. Overview

As the only *pro bono* organization in Florida assisting investors of modest means, the IRC has witnessed the somber aftermath of poorly supervised OBAs and PSTs. While the IRC recognizes the need to respond to changing business practices by adapting regulatory requirements, we are concerned that the new rule does not adequately protect investors from the misconduct frequently associated with PSTs.

The average IRC client is a retiree that suffered investment losses due to opportunistic broker misconduct, but whose claims are too small for them to find legal representation. To our clients, these losses reflected a lifetime of saving for retirement. Importantly, many of our clients do not receive copies of their account opening applications and customer agreements with their financial professionals' brokerage firms. Additionally, most of our clients do not understand how to interpret their account statements, and all of our clients believed that the individuals managing their brokerage or IRA accounts would act in their best interests. Based on our experience, many retail investors—especially those with limited or no prior investment experience—are particularly vulnerable to their brokers' misconduct involving products "sold away" from the firm.

II. Supervision of Private Securities Transactions

The proposed rule would require member firms, following notice of a registered person's investment-related activity, to conduct a risk assessment and approve or disapprove of the activity. A member's supervisory obligation is then limited to overseeing the registered person's compliance with any conditions or limitations the member imposes. The member is not required to supervise the underlying activity. This is problematic because, under this framework, firms may not identify any "red flags" during their initial risk assessment, and approve an activity that later evolves into a Ponzi scheme. Associated persons intending to commit fraud will find comfort knowing that their activities will not be supervised following the initial assessment.

The IRC is also concerned that the proposed rule will incentivize member firms to forgo placing limitations on PSTs, as doing so would trigger supervisory responsibilities. Alternatively, members may adopt a policy of "disapproving" outside activities to absolve themselves of supervisory obligations altogether. Presumably, if a particular activity is not approved and the associated person engages in the activity anyway, the new rule would arguably provide cover to the member firm for the broker's PSTs that resulted in losses to investors. The firm would naturally terminate the broker for engaging in unapproved activities, but thereafter have a strong argument that it is not liable for its failure to supervise the broker in connection with the activity it did not approve. In our experience, investors are most harmed by OBAs and PSTs that have ***not*** been approved, but which could have been uncovered had the firm reasonably exercised its supervisory obligations under existing rules.

Indeed, the IRC is currently representing an elderly retiree who lost her entire 401(k) savings from undisclosed, outside activities. Our client was in her mid-sixties when her tax preparer, a registered representative and investment adviser, advised her to rollover her 401(k) to an IRA that he would manage. Instead of opening an IRA for his client at the member firm with which he was associated, he transferred her life savings to an unregistered investment advisor in exchange for a "kickback." The unregistered investment advisor decimated our client's entire savings in little more than a year by excessively trading foreign currency futures on an online trading platform. In defending against our client's claims, the member firm has taken the position that because the broker did not disclose these activities, it did not fail to supervise the broker's OBAs and PSTs. Rule 3290 would shield this firm and others from liability—presumably even where supervisory personnel take an "ostrich" approach to addressing undisclosed PSTs and OBAs.

Instead, member firms should be obligated to identify undisclosed OBA's and PSTs, particularly where the conduct should have been apparent to supervisory personnel, as well as implement reasonable measures to ensure that registered persons are not actively engaging in transactions or activities the member has expressly disapproved. This provides an extra layer of investor protection where the firm is not notified of a PST, since the most egregious transactions are often undisclosed to the firm. Moreover, clarifying that firms cannot adopt a "willful blindness" approach to supervising PSTs would not increase their obligations under current laws, as federal courts already adhere to this principle.[1]

III. Supervision of Investment Adviser Activities

The proposed rule would further eliminate a member's obligation to supervise a registered person's Investment Adviser ("IA") activities conducted at a non-affiliated firm. These activities

[1] *Harrison v. Dean Witter Reynolds, Inc.*, 79 F.3d 609 (7th Cir. 1996) (Although the claimant was not a customer of the firm, the court determined that a reasonable jury could find the firm was reckless in not detecting its employee's Ponzi scheme, and that the firm ignored obvious warning signs that the employee was engaged in misconduct).

are not immune from abuse and misconduct. The typical scenario involves a registered person establishing the customer's account at, or referring the client's account to, an unaffiliated, dually registered broker-dealer/IA. Frequently, this occurs without the customer's knowledge.

Of course, the IA would face regulatory scrutiny for any subsequent misconduct. However, the goal of FINRA's supervisory rules is not to address misconduct after investors have suffered, but instead to identify and prevent misconduct from occurring in the first place. Consequently, we do not believe the proposed rule appropriately addresses investor protection concerns, despite the existence of separate obligations under the IA regulatory regime.

Instead of requiring the member firm to supervise the IA's activities, the firm could be obligated to provide certain notifications and disclosures to the IA's clients indicating that the IA conducts outside activities independent of the firm. This might mitigate the risk of an investor being misled into opening an account at an entity they erroneously assumed was the member firm.

IV. "Investment-Related"

The IRC recognizes that modern technologies have led to an increase in the number of part-time, "freelance" workers, and similarly recognizes that supervision of all OBAs is no longer practical.[2] Thus, we support FINRA's proposal to limit supervision requirements to investment-related activities.

However, though we agree that a registered person driving part-time for Uber does not pose a threat to investors, we ask that FINRA confirm the scope of "investment-related." Specifically, the IRC requests assurance that the rule would extend to the referral context, where a registered person refers his customer to a third party in exchange for compensation, and the third party recommends the investments at issue.[3]

V. Conclusion

The IRC is committed to protecting retail investors, particularly those most vulnerable to the abuse and fraud that accompanies OBAs and PSTs. While we recognize FINRA's desire to strike a balance between investor protection and current business practices, we urge FINRA to incorporate language that better protects investors. Again, we thank FINRA for the opportunity to comment on this proposal.

Respectfully submitted,

Lauren Van Buren

Lauren Van Buren
Legal Intern, Investor Rights Clinic

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[2] A 2017 study conducted by Edelman Intelligence found that 36 percent of the United States workforce is now freelancing. A "freelancer" was defined as an individual who has "engaged in supplemental, temporary, project- or contract-based work within the past 12 months." *Freelancing in America 2017*, UPWORK, https://www.upwork.com/i/freelancing-in-america/2017/ (last visited April 4, 2018).

[3] This is of particular concern given the increasing number of initial coin offerings, many of which offer additional "coins" in exchange for referrals.