Financial Industry Regulatory Authority

2017 FINRA Annual Conference

Washington, DC | May 16 – 18, 2017

Outside Business Activities and Private Securities Transactions
Tuesday, May 16
3:00 p.m. – 4:00 p.m.

Outside business activities (OBAs) and private securities transactions (PSTs) are regulatory and examination priorities, as they can both result in conflicts of interest that firms must understand and mitigate. Join industry practitioners and FINRA staff as they cover conflicts arising from OBAs and PSTs, and the key requirements of supervising such activities. Panelists also discuss common deficiencies found during examinations, and share effective practices for designing and implementing supervisory systems and controls to mitigate the risks associated with OBAs and PSTs.

Moderator:
William St. Louis
Vice President and District Director
FINRA New York and Long Island District Offices

Panelists:
Mari Buechner
President and Chief Executive Officer
Coordinated Capital Securities, Inc.

Edward Sullivan
Executive Director, National Field Risk and Supervision
Morgan Stanley

Justin Triolo
Associate District Director
FINRA New York District Office

Outside Business Activities and Private Securities Transactions Panelist Bios:

Moderator:

William St. Louis is District Director of FINRA's New York and Long Island offices and manages the sales practice examination and surveillance staff in those offices. Prior to assuming this role in June 2014, he was the Regional Enforcement Chief Counsel for FINRA's North Region where he managed Enforcement staff in FINRA's New Jersey, Boston, and Philadelphia offices. He joined the company in 1998 and spent several years in a variety of Enforcement roles in New York including service as a Deputy Regional Chief Counsel. Mr. St. Louis earned a B.A. from Baruch College and a law degree from New York University School of Law. Prior to law school he worked in the Compliance Department of a regional broker-dealer.

Panelists:

Mari J. Buechner is President and Chief Executive Officer of Coordinated Capital Securities, Inc. (CCS). With more than 20 years of industry experience, Ms. Buechner has comprehensive executive management expertise in compliance, finance, marketing, operations, service and technology. In 2008, Ms. Buechner was elected to serve on the FINRA Board of Governors and is a past member of FINRA's Small Firm Advisory Board and the FINRA District 8 Committee. Ms. Buechner currently serves on the FINRA Independent Dealer/Insurance Affiliate Committee and volunteers her time to work on various ad hoc committees and educational programs. She has been recognized as one of the "Top 50 Women in Wealth Management" (Wealth Manager, April 2009) and formerly served as Chairman of the Board for the Financial Services Institute. Ms. Buechner graduated from the University of Wisconsin-Madison with a bachelor's degree in finance and marketing.

Edward G. Sullivan is Executive Director in National Field Risk & Supervision at Morgan Stanley where he is focused on the development and implementation of controls for the Wealth Management field organization. Mr. Sullivan came to Morgan Stanley in October 2016 with almost 20 years of experience in a variety of roles, most recently with UBS where he was the Head of Field Compliance. Prior to joining UBS, he spent time as a Broker-Dealer consultant at KPMG, a sales practice examiner at the former NYSE, and began his career as a Financial Consultant with Merrill Lynch. Mr. Sullivan has presented at various industry education conferences including SIFMA and the FINRA Compliance Outreach Program for Broker-Dealers.

Justin Triolo is Associate District Director with FINRA's District 10 New York office and has been with FINRA since April 2004. In his role, Mr. Triolo manages approximately 25 staff members, including Examination Managers and Examiners, who are responsible for conducting cycle and branch office examinations of member firms. Mr. Triolo started his career in Regulation as an Examiner with the Sales Practice Review Unit of NYSE Regulation. Prior to joining FINRA, Mr. Triolo was a Senior Analyst for Novations, and responsible for quality assurance testing, curriculum development and training for the Competitive Positions Group of the NYSE. Mr. Triolo has a Bachelor of Arts degree from Gettysburg College.

Outside Business Activities and Private Securities Transactions

FINRA

Panelists

- **Moderator**
  - **William St. Louis, Vice President and District Director, FINRA New York and Long Island District Offices**
- **Panelists**
  - **Mari Buechner, President and Chief Executive Officer, Coordinated Capital Securities, Inc.**
  - **Edward Sullivan, Executive Director, National Field Risk and Supervision, Morgan Stanley**
  - **Justin Triolo, Associate District Director, FINRA New York District Office**

To Access Polling

- Under the “Schedule” icon on the home screen,
- Select the day,
- Choose the Outside Business Activities and Private Securities Transactions session,
- Click on the polling icon: 

Polling Question 1

1. How many registered individuals does your firm have?
   a. Less than 10
   b. 11 to 50
   c. 51-150
   d. 150 – 299
   e. More than 299

Polling Question 2

1. Is your sales force compensated as:
   a. Independent Contractors via 1099
   b. Employees via W-2

Outside Business Activities – The Rule

- **FINRA Rule 3270**

  "No registered person may be an employee, independent contractor, sole proprietor, officer, director, or partner of another person, or be compensated, or have the reasonable expectation of compensation, from any other person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member, in such form as specified by the member. Passive investments and activities subject to the requirements of Rule 3280 shall be exempted from this requirement."

Outside Business Activities – Overview

The rule requires:

- **Registered individuals must provide prior written notice to the Firm**
- **Firm must assess/evaluate (See Rule 3270.01)**
  - Will the proposed activity interfere with, or compromise, the registered individual's responsibilities?
  - Will the proposed activity be viewed as part of the firm's business by customers or members of the public?
  - Is it an Outside Business Activity or a Private Securities Transaction?
- **Firm can prohibit the activity or place conditions**
- **Firm must keep records of its compliance with its obligations**

Outside Business Activities – A Few Considerations

- Lack of compensation does not negate the requirement
  - Prior Written Notice required if you'll be ". . . an employee, independent contractor, sole proprietor, officer, director, or partner of another person, or be compensated, or have the reasonable expectation of compensation . ."
- The Rule only applies to registered persons – Firm can impose its own requirements on non-registered individuals
- No duty to supervise activity, however firm should assess whether activity has evolved post approval
- Prior written notice must be in the manner specified by firm
- Form U4 disclosure obligations – See the "Other Business" question
- Passive investments and activities subject to Rule 3280 are exempt

Private Securities Transactions – Rule 3280(b)

- **FINRA Rule 3280**

  "Prior to participating in any private securities transaction, an associated person shall provide written notice . . . describing in detail the proposed transaction and the person's proposed role therein and stating whether he or she has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice."

Private Securities Transactions – Overview

- Associated persons (“APs”) must provide prior written notice
- If the AP has received or may receive selling compensation, the Firm:
  - must provide written approval or disapproval of the proposed transaction(s); and
  - has recordkeeping and supervisory obligations if it approves the transaction.
  - [If the Firm disapproves the transaction, the associated person cannot participate in the transaction in any manner.]

Private Securities Transactions – Overview (cont'd)

- **If the AP has not and will not receive any selling compensation, the Firm:**
  - **must provide prompt written acknowledgement of the AP's notice; and**
  - **can, in its discretion, impose specified conditions on the AP's participation in the transaction(s).**

PSTs – A Few Considerations

- Applies to all APs (Registered and Non-Registered)
- Written Notice: Must be submitted before the PST begins to move forward – cannot be submitted simultaneously or after the completion of the transaction.
- Participating "in any manner" in a private securities transaction
  - Referrals may qualify
  - Facilitating an investment, e.g., processing paperwork, transmitting funds
  - Recommending an investment
- With limited exceptions, an AP's personal investment can be a PST – See Rule 3280(e)(1)

Outside Business Activities – Is this an OBA or PST?

Your firm hired John and Joe to perform investment banking business through your firm. They have an approved d/b/a (ABC Corp.) they use for this work. You find out through a third party that ABC has consulting agreements for advisory services it performs and that ABC and John and Joe receive at least $200,000 a year from this business. Later you find out that ABC also has an affiliate (XYZ LLC) that has an agreement with another company to purchase IPO allocations.

Is ABC's consulting business an additional OBA? What about XYZ, is that an OBA for John and Joe. Or a PST? Or neither?

Outside Business Activities – Examples

- **Examples of OBAs:**
  - RR working for, or on the board of, a start-up company
  - RR with insurance license selling life settlements outside of the firm
  - RR providing accounting services or pension plan consulting services
  - RR acting as a real estate broker
  - RR referring member firm customers to a mortgage broker and receiving a fee
  - RR working outside the firm as an educator
  - RR is treasurer of local country club
  - RR on board of religious institution or civic organization

Outside Business Activities – Evaluating OBAs

- **Possible questions when evaluating OBAs:**
  - **What information is currently on the registered person's Form U4?**
  - **Will the proposed activity be viewed by customers or public as part of Firm's business? Does it pose a conflict?**
  - **Could the activity be considered a private securities transaction?**
  - **Is the business securities or investment related?**
  - **Is the business affiliated with a public company?**
  - **Is the business related to an issuer?**

Outside Business Activities – Evaluating OBAs (cont'd)

- **Additional possible questions when evaluating OBAs:**
  - **Will the RR devote significant time to the business?**
  - **Does the OBA share office space with the Firm? Will non-fingerprinted OBA employees have access to firm records?**
  - **What email address is being used?**
  - **Is there check-writing, trading authority / custody or control?**
  - **Any changes contemplated in the OBA that would impact a future assessment?**

Outside Business Activities – Approval & Controls

- **Should specific conditions or limitations be imposed?**
  - No involvement with Firm's customers in operation of OBA
  - No raising capital, offering securities
  - Periodic attestations regarding compliance with conditions
  - No custody / control over assets
  - No web presence for registered person
  - Cannot operate from Firm's premises
  - Limitation son how the registered person presents himself in OBA marketing
- **Firms may prohibit OBAs**

Examples of Common Deficiencies – OBAs and PSTs

- Registered individuals failing to disclose OBAs to their firms
- Associated persons failing to disclose PSTs to their firms
- Procedures that don't sufficiently detail the who, what, when and how of OBA/PST processes and approval
- Disclosure forms not containing sufficient details as to the activities
- Firms not adequately determining whether disclosed OBAs should be treated as PSTs under FINRA Rule 3280

Examples of Common Deficiencies (cont'd)

- Firms not adequately memorializing review, assessment and approval of OBAs/PSTs
- Firm's list of OBAs does not align with Form U4 disclosures
- Timely disclosure on the Form U4
- Firms not properly supervising PSTs on an ongoing basis
- Firms not properly detecting, retaining, and/or reviewing firm related e-mail correspondence sent/received through an OBA e-mail address
- Failure to record PSTs on the Firm's books

Some Best Practices

- Ongoing training to individuals/principals regarding applicable regulations, guidance, and the Firm's controls
- Using FINRA OBA/PST related disciplinary actions in training
- Annual attestations to disclose all OBAs/PSTs
- Periodic reminders regarding responsibilities to maintain accurate Form U4s and disclosure of OBAs/PSTs prior to engaging in them
- Review for undisclosed OBAs/PSTs – Independent internet searches and looking for lifestyle flags – is production in line?

Financial Industry Regulatory Authority

2017 FINRA Annual Conference

Washington, DC | May 16 – 18, 2017

Outside Business Activities and Private Securities Transactions
Tuesday, May 16
3:00 p.m. – 4:00 p.m.

Resources

FINRA Notices

- FINRA *Regulatory Notice 16-12, Pension Income Stream Products – FINRA Provides Guidance on Firm Responsibilities for Sales of Pension Income Stream Products* (April 2016)

  www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-12.pdf

- Notice To Members 01-79, *Selling Away and Outside Business Activities – NASD Reminds Members of Their Responsibilities Regarding Private Securities Transactions Involving Notes and Other Securities and Outside Business Activities* (December 2011)

  www.finra.org/sites/default/files/NoticeDocument/p003677.pdf

- Notice To Members 96-33, *NASD Clarifies Rules Governing RR/IAs* (May 1996)

  www.finra.org/sites/default/files/NoticeDocument/p013792.pdf

FOR ILLUSTRATION PURPOSES ONLY

2017 Annual Compliance Confirmation

Name of Registered Rep:	JOHN BROWN
Branch Type/Supervisor/Records Keeper:	OSJ/MAGGIE SMITH/MAGGIE SMITH
Disclosed Professional Designation(s):	CFP

	CCS-Linked	Outside Business	Personal
Email	JBROWN@CCSEMAIL.COM	JBROWN@SMITHINSURANCE.COM	JB1968@GMAIL.COM
Website	SMITHFINANCIAL.COM		
Facebook	YES		YES
Linked-In	YES		
Twitter			
Social Other			

Disclosed Personal Electronic Devices:	IPAD (APPROVED 2-18-14) IPHONE (APPROVED 9-6-10)

Consolidated Account Reporting:	SELF-CREATED (APPROVED 6-10-15) RISK-ALYZE (APPROVED 10-24-16)

Disclosed Outside Accounts:	SCOTTTRADE #1234-7788, E-TRADE #5467-8723

Disclosed Outside Business Activity:

NAME OF BUSINESS	DESCRIPTION	YOUR POSITION	# HOURS/M-F
SMITH INSURANCE COMPANY	LIFE INSURANCE AND FIXED ANNUITIES	INSURANCE AGENT	20
STARBUCKS	COFFEE SHOP	PART-TIME BARRISTA	0
BROWN DOWNTOWN	DJ	OWNER	5

SIGNATURE PAGE:

By signing below, I confirm that I have disclosed all Outside Business Activities, Private Securities Transactions, Outside Accounts, Professional Designations and electronic forms of Communication used to conduct CCS-related business, outside business or personal to CCS and that these activities are accurately disclosed on page one of this confirmation. If any of the information is inaccurate I have indicated the changes in this confirmation.

By signing below, I agree to the terms of the CCS Independent Contractor Agreement.

By signing below, I hereby affirm that I agree to the following Form U-4 pre-dispute arbitration clause:

1. You are agreeing to arbitrate any dispute, claim or controversy that may arise between you and your firm, or a customer, or any other person, that is required to be arbitrated under the rules of the self-regulatory organizations with which you are registered or registering. This means you are giving up the right to sue a member, customer, or another associated person in court, including the right to a trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed.
2. A claim alleging employment discrimination, including a sexual harassment claim, in violation of a statute is not required to be arbitrated under FINRA rules. Such a claim may be arbitrated at FINRA only if the parties have agreed to arbitrate it, either before or after the dispute arose. The rules of other arbitration forums may be different.
3. A dispute arising under a whistleblower statute that prohibits the use of predispute arbitration agreements is not required to be arbitrated under FINRA rules. Such a dispute may be arbitrated only if the parties have agreed to arbitrate it after the dispute arose.
4. Arbitration awards are generally final and binding; a party's ability to have a court reverse or modify an arbitration award is very limited.
5. The ability of the parties to obtain documents, witness statements and other discovery is generally more limited in arbitration than in court proceedings.
6. The arbitrators do not have to explain the reason(s) for their award unless, in an eligible case, a joint request for an explained decision has been submitted by all parties to the panel at least 20 days prior to the first scheduled hearing date.
7. The panel of arbitrators may include arbitrators who were or are affiliated with the securities industry, or public arbitrators, as provided by the rules of the arbitration forum in which a claim is filed.
8. The rules of some arbitration forums may impose time limits for bringing a claim in arbitration. In some cases, a claim that is ineligible for arbitration may be brought in court.

«REPRESENTATIVE» Signature:		Date:
CCS Compliance Department:		Date:

Branch Examination – Outside Business Activity

Review Annual Compliance Confirmation (ACC):

FOR UN-ANNOUNCED EXAMS, COMPLETE DURING INTERVIEW ON-SITE

Have any RR's reporting to the Branch disclosed outside business activity?	☐ No – complete OBA training below ☐ Yes – see ACC
Are there any changes to outside business activity?	☐ No – complete OBA training below ☐ Yes - notify compliance ☐ Yes – update ACC
After providing the additional training below, does the RR need to disclose or update an outside activity?	☐ No ☐ Yes -notify compliance
Do any changes require a U4 update?	☐ No ☐ Yes - notify licensing and registration ☐ N/A

Pre-Audit Review

Do disclosed OBA's align with the RR's CRD (U4) Record?	☐ No - notify licensing and registration ☐ Yes
Email Review: Was there any evidence of undisclosed outside business activity?	☐ No ☐ Yes – notify compliance
Google Search: **attach results* Was there any evidence of undisclosed outside business activity?	☐ No ☐ Yes – notify compliance

On-Site Review:

In reviewing customer correspondence and communications (i.e. correspondence addressed to a different business, separate business cards, manner of which the phone is answered, etc.), was there any evidence of undisclosed outside business activity?	☐ No ☐ Yes – notify compliance
In the review and approval of checks received and forwarded blotter were there any checks that are not made payable to the clearing firm or a fund company, that may be a red flag for undisclosed outside business activity?	☐ No ☐ Yes – notify compliance
In reviewing retail communications at the Branch, including social media or websites, was there any evidence of undisclosed outside business activities?	☐ No ☐ Yes – notify compliance

BRANCH INTERVIEW/INSPECTION (OUTSIDE BUSINESS ACTIVITIES):

☐ ☐ ☐ 

Describe any changes to outside business activities disclosed to CCS:
☐ None ☐ Described below

☐ ☐ ☐ 

Describe any noted exceptions to firm procedures for outside business activity during the email review or google search:
☐ None ☐ Described below

☐ ☐ ☐ 

Describe any noted exceptions to firm procedures for outside business activity during review of retail and on-line communications and any marketing materials made available to the public or to customers at the Branch:
☐ None ☐ Described below

☐ ☐ ☐ 

Describe any noted exceptions to firm procedures in the review of Branch books and records (branch's checks received and forwarded blotter, correspondence, client files, complaint file, etc.)
☐ None ☐ Described below

TRAINING REQUIREMENT *check here* ☐ to confirm training was provided

Outside Activities requiring prior notification

- Serving in the *specific* role of an employee, independent contractor, sole proprietor, officer, director, or partner in which you will NOT be compensation or expect compensation.
- Serving in the *specific* role of an employee, independent contractor, sole proprietor, officer, director, or partner in which you will be compensated or expect compensation.
- Serving in in *any role in any OBA* in which you will be compensated or expect compensation.

Activities Not Considered as Outside Business Activities

- Serving in the *any* role *other than* an employee, independent contractor, sole proprietor, officer, director, or partner in which you will NOT be compensation or expect compensation. (examples: unpaid volunteer work, Little League Coach, Homeowners Association Board Member, etc.)

Prior Notification

RR must receive prior approval from CCS before engaging in the proposed activity. RR's must submit the OBA Form to Compliance for Review.

Changes to Previously Disclosed OBA's

It is the RR's responsibility to inform CCS any time there is a material change in disclosed outside business activities. These changes include number of hours per week spent on activity, change in title or responsibility, change in location where activity is conducted, change in compensation, and termination of an outside activity. These changes may result in an amendment to the RR's Form U-4 and may require review and approval by CCS, depending the change.

RR's are required to confirm any disclosed outside activities annually on the Annual Compliance Confirmation.

Private Securities Transactions

Review ACC provided by Rep:

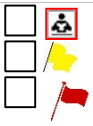
FOR UN-ANNOUNCED EXAMS, COMPLETE DURING INTERVIEW ON-SITE

Have any RR's reporting to the Branch disclosed private securities transactions to CCS?	☐ No – complete PST training below ☐ Yes – see ACC
Are there any changes to disclosed private securities transactions?	☐ No – complete PST training below ☐ Yes -notify compliance ☐ Yes – update ACC
After providing additional training, does the RR need to disclose or update a private securities transaction?	☐ No ☐ Yes -notify compliance

Pre-Audit Review:

Review firm records, are there any previously disclosed private securities transaction that are no longer active?	☐ No ☐ Yes – Describe in next section
Review firm records for disclosed OBA's at Branch. Are there any OBA's that require additional review to ensure they are not a private securities transaction?	☐ No ☐ Yes – Describe:

BRANCH INTERVIEW/INSPECTION (PRIVATE SECURITIES TRANSACTIONS):



Describe any changes to private securities transactions disclosed to CCS:

☐ None ☐ Described below

In conducting your review and interview, is there any evidence of

1. undisclosed private securities transactions
2. inactive private securities transactions that are active
3. OBA's that may be a private securities transaction

☐ None ☐ Described below

TRAINING REQUIREMENT *check here* ☐ to confirm training was provided

Private Securities Transactions:

The definition of a private securities transactions is quite broad and literally covers "any" securities transaction outside of CCS.

Prior Notification:

It is the RR's responsibility to provide prior written notice (Private Securities Transaction Form) to CCS before undertaking or engaging in a private securities transaction. Prior notification is required whether you will be compensated (or expect compensation) or you will not.

This includes private securities transactions for the RR's own account.

Compensation is defined as "Selling compensation" under the rule. Selling Compensation is any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security.

RR's are prohibited from undertaking or engaging in any disclosed private securities transaction until CCS has provided written notification that the activity is approved or the activity is approved subject to any specified conditions. If denied, CCS will provide written notice and you are not allowed to undertake or engage in the activity.

Changes to Previously Disclosed Private Securities Transactions

It is the RR's responsibility to inform CCS any time there is a material change in disclosed private securities transactions including the dissolution of a previously disclosed private securities transaction.

RR's are required to confirm any disclosed private securities transactions annually on the Annual Compliance Confirmation.

Regulatory Notice 16-12

Pension Income Stream Products

FINRA Provides Guidance on Firm Responsibilities for Sales of Pension Income Stream Products

April 2016

Notice Type
- Guidance

Suggested Routing
- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics
- Pension Income Streams
- Principal Review
- Sales Practices
- Suitability
- Supervision

Referenced Rules & Notices
- FINRA Rule 3110
- FINRA Rule 3270
- FINRA Rule 3280

Executive Summary

This *Notice* addresses the responsibilities of firms to supervise the sale of pension income stream products by their associated persons.

Questions regarding this *Notice* should be directed to:

- James S. Wrona, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8270 or *jim.wrona@finra.org*;
- Afshin Atabaki, Associate General Counsel, OGC, at (202) 728-8902 or *afshin.atabaki@finra.org*; and
- Jeanette Wingler, Assistant General Counsel, OGC, at (202) 728-8013 or *jeanette.wingler@finra.org*.

Background and Discussion

Pension income stream products typically involve an up-front lump sum payment to a pensioner in exchange for the rights to the pensioner's future pension income payments.[1] This *Notice* discusses the characteristics of and investor protection issues presented by pension income stream products, as well as the legal status of these products. In addition, this *Notice* addresses the responsibilities of firms in supervising the sale of pension income stream products.

Pension Income Stream Products

Contracts for pension income stream products involve at least three parties: the pensioner selling the rights to his or her future pension income payments, the investor who pays the up-front lump sum amount to acquire the rights to the pensioner's future payments, and a pension purchasing company, sometimes referred to as a factoring company or pension advance company, that facilitates the sale. Pension income stream products are marketed and advertised to the general public. Moreover, pension purchasing companies may use firms and their associated persons to sell these products to investors. In this event, the sales are subject to applicable FINRA rules.

A typical transaction involves the pension purchasing company collecting information about and evaluating the pensioner and his or her pension. An associated person of a firm may be involved in soliciting investors for the products. The pension purchasing company estimates the lump sum amount that the pensioner will receive from the investor and the monthly amounts that the pensioner will pay to the investor in return.

To facilitate the transfer of funds, the pension purchasing company may establish a bank account or escrow account from which the pensioner receives the lump sum amount and in which the pensioner deposits the future monthly payment amounts. In addition, the investor may deposit the lump sum amount into, and receive the monthly payments from, that same bank or escrow account. A pensioner may also be required to obtain a life insurance policy to cover the outstanding balance due on the contract in the event of the pensioner's death before full payment of the amount due to the investor under the contract.[2] The pension purchasing company's fees, any life insurance policy premiums and any other applicable fees or commissions, including commissions received by an associated person, are deducted from the lump sum amount paid to the pensioner.

Federal laws prohibit the assignment of particular pension benefits.[3] As such, a pensioner does not typically directly assign future pension payments to an investor and instead is bound to make the future payments to the investor only by contract. Because a pensioner may stop making monthly payments at any time, leaving the investor with only a breach of contract claim, the pension purchasing company may also engage in post-sale efforts to ensure payment by the pensioner of the amounts due to the investor. Post-sale efforts by the company may include offering to advance payments to the investor until issues can be resolved, purchasing the product back from the investor, less any payments received by the investor, or engaging the services of a law firm to attempt remediation.

Investor Protection Issues Presented by Pension Income Stream Products

Pension income stream products are complex, and they potentially present a number of investor protection issues. While the expected yields for pension income stream products may initially seem like an attractive option for investors, investors may not fully understand the issues presented by the products. For example, investors may pay significant commissions (*e.g.*, 7 percent or higher) to purchase the products. In addition, the products are generally illiquid, meaning an investor needing funds may not be able to sell the product or may be able to sell the product only at a loss. Furthermore, as noted above, because federal laws prohibit the assignment of particular pension benefits,[4] a pensioner does not typically directly assign future pension payments to an investor and instead is bound to make the future payments to the investor only by contract. As a result, if a pensioner stops making monthly payments at any time, an investor may be left with only a breach of contract claim. Notwithstanding these and other risks, a U.S. Government Accountability Office (GAO) report indicates that some pension income stream products are marketed as "safe" investments that pay more than other fixed-rate investments without the "downside risks" of stocks, bonds and mutual funds, and use terms that incorrectly imply that the products are backed by the federal government.[5]

The products also may be problematic for pensioners. For instance, pension purchasing companies may not clearly disclose the costs and terms of the product, including associated fees or the real difference between the lump sum that will be paid to the pensioner versus the value of the future income stream the pensioner is giving up (sometimes referred to as the pensioner's effective interest rate for the lump sum payment).[6] Moreover, a company may present confusing offer terms thereby making it difficult to understand the product. For example, the GAO Report notes that one company provided a quote including 63 different offers with varying terms and monthly payment amounts to one fictitious pensioner.[7] In addition, pensioners may not understand that they may be required to obtain a life insurance policy and that the payments for the policy are subtracted from the lump sum payment.

The GAO Report highlights other investor-protection concerns involving this product. Pension purchasing companies may attempt to circumvent federal and state laws by asserting that the product is neither a security nor a loan.[8] Companies may assert that the products are not securities so as to avoid the registration and disclosure requirements of federal and state securities laws. At the same time, companies may avoid calling the products loans so as to avoid making required truth-in-lending disclosures and to avoid complying with usury laws setting a legal limit on the interest rates and finance charges that may be imposed for some types of loans.[9] While the companies may assert that a product is neither a security nor a loan, the companies do not offer any alternative legal status for the product thereby leaving pensioners and investors without a clear legal recourse.

Furthermore, certain pension purchasing companies have changed their names or moved the location of their business operations in response to governmental investigations and litigation. Companies may also operate under more than one name.[10] These activities result in associated persons, pensioners and investors having limited publicly available information when evaluating transactions with the companies.

In addition to the GAO Report, FINRA and the SEC have previously issued alerts warning pensioners and investors of the risks associated with these products.[11] For further discussion of investor protection issues, individuals are urged to consider these alerts prior to entering into transactions related to pension income stream products.

Status of Pension Income Stream Products

As noted above, pension purchasing companies may attempt to circumvent federal and state laws by asserting that a pension income stream product is not a security. However, FINRA reminds firms that they have an obligation to independently assess whether a product is a security, particularly when determining how to treat an associated person's participation in the sale of such a product away from the firm, discussed further below in the next section. This is critical regarding a product such as a pension income stream product, which is marketed and sold to the general public and exhibits many characteristics of a security under recent case law.

Investors in pension income stream products enter into a contract that entitles them to a fixed return during the term of the contract in exchange for an up-front investment of money. The Securities Act of 1933 defines a "security" to include an investment contract.[12] In its most recent decision on investment contracts, the U.S. Supreme Court held in *SEC v. Edwards*,[13] among other things, that an investment scheme involving distinct contracts with a contractual entitlement to a fixed rate of return can be an investment contract, and thus a security, under the federal securities laws.[14] In addition, in an administrative proceeding, the SEC held that a product similar to pension income stream products was a security.[15] In that case, an online lending platform connected individuals who wished to borrow money with individuals or institutions that wished to purchase loans extended to borrowers. The online lending platform also performed certain pre- and post-sale functions.[16] The SEC concluded that the notes offered by the online lending platform were securities. Finally, a number of states have determined that pension income stream products are securities under relevant state laws.[17]

In the end, whether a particular pension income stream product is a security is dependent on the facts and circumstances specific to that product. However, a firm that treats a pension income stream product as a non-security product risks violating FINRA rules that impose specific obligations on securities activities if the pension income stream product is deemed a security.

FINRA Reminds Firms of Their Obligations Regarding Pension Income Stream Products

FINRA is aware that, in assessing an associated person's pension income stream activities away from the firm, some firms previously have not treated the products as securities for purposes of the applicability of FINRA Rule 3280 (Private Securities Transactions of an Associated Person) and have treated them instead as outside business activities under FINRA Rule 3270 (Outside Business Activities of Registered Persons). A firm is required to evaluate a proposed activity to determine whether it is properly characterized as an outside business activity under Rule 3270 or whether it should be treated as a private securities transaction under Rule 3280.

FINRA Rule 3270 requires a registered person to provide written notice to his or her firm prior to participating in an outside business activity subject to the rule. The firm must consider whether the proposed outside business activity will interfere with or otherwise compromise the registered person's responsibilities to the firm or its customers or be viewed by customers or the public as part of the firm's business. The firm must then consider imposing specific conditions or limitations on the outside business activity, including, where circumstances warrant, prohibiting the activity. The rule, however, does not require that a firm supervise the outside business activity.

In contrast, if a pension income stream product is a security and an associated person sells the product outside the regular scope of his or her employment with the firm, FINRA Rule 3280 requires that the firm treat the sale as a private securities transaction. The associated person must notify the firm in writing before participating in a private securities transaction. If the associated person will receive selling compensation, which is defined broadly, for his or her participation in the transaction, the firm must provide written approval or disapproval of the participation. If the firm approves the transaction, it must record the transaction on its books and records and supervise the associated person's participation in the transaction, including for compliance with suitability standards for recommended securities, as if the transaction were executed on behalf of the firm.[18]

There are significant consequences if a firm incorrectly treats a pension income stream product as not being a security. For instance, the firm may incorrectly treat it as an outside business activity under FINRA Rule 3270, rather than a private securities transaction under FINRA Rule 3280, and thereby fail to supervise sales of the product as required by FINRA rules.[19] The firm may also violate FINRA's qualification and registration requirements if associated persons engaged in the marketing and sale of pension income stream products are not appropriately qualified and registered (*e.g.*, registered as a General Securities Representative) to engage in such activities.

Supervisory Measures

Due to potential investor protection issues and regulatory violations that may arise in the marketing and sale of pension income stream products, firms that permit their associated persons to participate in the sale of pension income stream products are well advised to adopt special procedures and training of associated persons with respect to the products.

In developing any special procedures or training, it is important for associated persons to understand the features of these types of products and the extent to which a particular product meets the needs of a customer. Because these products are complex and offer terms vary, an associated person's general familiarity with these types of products may not adequately qualify him or her to understand the specific terms and features of a particular product. FINRA also notes that firms may elect to prohibit the sale of all pension income stream products or maintain a list of those that they find acceptable for their associated persons to market or sell.

In addition, firms should ensure that their procedures comply with applicable state securities laws regarding pension income stream products. As emphasized above, a number of state securities regulators have found that pension income stream products are securities under state securities laws.

As in all other areas, FINRA expects each associated person to comply with the procedures adopted by his or her firm regarding pension income stream products.

Endnotes

1. These types of products may be referred to by one of several names, such as pension loans, pension advances, pension sales, pension income programs, mirrored pensions or annuity utilization contracts. Moreover, the pensioner may have a pension or defined benefit plan related to employment with a private company, the federal government or a state government. Retired members of the military and government employees are the most common pensioners approached for these types of products. For brevity, these types of products are referred to herein as "pension income stream products."

2. *See, e.g.*, GAO, Report to the Committee on Health, Education, Labor, and Pensions, U.S. Senate, *Pension Advance Transactions: Questionable Business Practices Identified*, at 6-7 (June 2014) (GAO Report).

3. *See, e.g., id.* at 9.

4. *See, e.g., id.*

5. *Id.* at 22.

6. *See, e.g.,* John F. Wasik, *Reading the Fine Print on Pension Advance Agreements,* The New York Times (December 12, 2014) (noting that the profiled pensioner's cost for the product was the equivalent of an annual rate of 30.7 percent).

7. *See, e.g.*, GAO Report at 30.

8. *See, e.g., id.* at 28-32.

9. FINRA notes that in August 2015, the Consumer Financial Protection Bureau (CFPB) and the Superintendent of Financial Services for the State of New York filed a complaint in a California federal district court asserting that a

pension income stream product was a loan and, therefore, was subject to the CFPB's jurisdiction. In February 2016, the parties stipulated and agreed to a preliminary injunction order without a finding by the federal district court of fact or law on the status of the pension income stream product. *See CFPB v. Pension Funding, LLC,* Compl. Filed Aug. 20, 2015, Case No. 8:15-cv-1329 (C.D. Cal.).

10. *See, e.g.*, GAO Report at 15.

11. *See* FINRA and SEC, *Investor Alert: Pension or Settlement Income Streams – What You Need to Know Before Buying or Selling Them* (May 2013). *See also* CFPB, *Consumer Advisory: Protect Your Retirement Pension* (March 2015); Federal Trade Commission, *Consumer Information: Pension Advances: Not So Fast* (June 2014).

12. *See* Section 2(a)(1) of the Securities Act of 1933. *See also SEC v. W.J. Howey Co.,* 328 U.S. 293, 301 (1946).

13. 540 U.S. 389 (2004).

14. *Id.* at 397. *See also Dougherty v. VFG, LLC*, 118 F. Supp. 3d 699 (E.D. Pa. 2015) (treating, without discussion, fixed-income pension stream products sold through a registered representative as securities).

15. *See In re Prosper Marketplace, Inc.*, Securities Act Release No. 8984 (November 24, 2008).

16. *See also SEC v. Mut. Benefits Corp.*, 408 F.3d 737, 743-44 (11th Cir. 2005) (stating that both pre- and post-purchase managerial activities should be taken into consideration in determining whether the *Howey* test is satisfied).

17. *See, e.g.*, *In re Sobell Corp.* , Emergency Cease and Desist Order, Order No. ENF-16-CDO-1741, Texas State Securities Board (February 1, 2016); *In re VFG, LLC f/k/a Voyager Financial Group*, Cease and Desist Order and Notice of Intent to Impose Sanctions, Case No. 13-10-0013, State of New Mexico, Regulation and Licensing Department, Securities Division (December 10, 2013); and *In re VFG, LLC f/k/a Voyager Financial Group, LLC*, Cease and Desist Order, Case No. S-12-0015, Arkansas Securities Commissioner (April 22, 2013). The definition of a "security" under federal and state securities laws may differ.

18. *See Notice to Members 96-33* (May 1996) (discussing the rule on private securities transactions and stating that "the records created and recordkeeping system used, together with relevant supervisory procedures, must enable the firm to properly supervise the [registered representatives who also are investment advisers (RR/IAs)] by aiding the firm's understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA's authority, *and the suitability of the transaction*") (emphasis added); *Notice to Members 85-84* (December 1985) ("First, the rationale/purpose behind the rule, as set forth when adopted in 1985, was to address concerns because "securities may be sold to public investors without the benefit of supervision or oversight by a firm and, perhaps, without adequate attention to such regulatory protections as due-diligence investigations *and suitability determinations*.") (emphasis added).

19. Although the focus of this *Notice* is on activities away from an employing firm regarding pension income stream products, firms must consider their obligations under all applicable FINRA rules, including their supervisory obligations under FINRA Rule 3110 (Supervision), if the product is sold as part of the firm's business.

INFORMATIONAL

Selling Away And Outside Business Activities

NASD Reminds Members Of Their Responsibilities Regarding Private Securities Transactions Involving Notes And Other Securities And Outside Business Activities

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Executive Representatives
- Insurance
- Legal & Compliance
- Operations
- Registered Representatives
- Senior Management

KEY TOPICS

- Outside Business Activities
- Private Securities Transactions
- Promissory Notes
- NASD Rule 3030
- NASD Rule 3040
- Supervision

Executive Summary

NASD Regulation, Inc. (NASD Regulation) has brought a number of formal disciplinary actions against registered representatives for selling securities without prior notice to and approval from the representative's employer member firm and for engaging in outside business activities without prior notice to the employer member firm. A registered person who sells a security away from his or her firm without first obtaining written approval from the firm violates NASD Rule 3040, and a registered person who engages in an outside business activity without prior notice to his or her firm, including the sale of non-securities products, violates NASD Rule 3030.

Recently, NASD Regulation has seen an increase in selling away involving independent insurance agents registered solely as Series 6 Investment Company and Variable Contracts Products representatives. These Series 6 representatives are increasingly being targeted by issuers, promoters, and marketing agents to sell short-term promissory notes to their customers. Although in many instances these notes are securities, promoters of these products are marketing them to registered persons as non-securities products that do not have to be sold through a broker/dealer by a registered person. In a significant number of cases, associated persons have sold these notes to their customers away from their firms and without firm approval as required by Rule 3040.

Associated persons are required, either under Rule 3030 or Rule 3040, to report, in writing, any and all types of business that they plan to conduct away from their firms, whether or not it involves a security. Rule 3040 requires associated persons to obtain written approval from their firms before they sell any security, including securities in the form of promissory notes, and Rule 3030 requires prompt written notice to a member of any outside business activity for which an associated person receives compensation, including the sale of a promissory note that is not a security. Since there has been some confusion among associated persons as to whether particular financial instruments are securities, this *Notice* advises associated persons to provide written notice to their firms **before** they engage in the sale of any financial instrument.

This *Notice* also reminds members that they should: (1) review their supervisory procedures to make sure that they are reasonably designed to achieve compliance with NASD Rules 3030 and 3040 regarding outside business activities and private securities transactions; and (2) appropriately educate their associated persons regarding the requirements of Rules 3030 and 3040.

Questions/Further Information

Questions concerning this *Notice* may be directed to Shirley H. Weiss, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8844.

Private Securities Transactions Involving Promissory Notes Have Significantly Increased

There has been a significant increase in private securities transactions involving the sale of promissory notes. In 2000, NASD Regulation brought more than 100 formal disciplinary actions involving violations of NASD Rule

3040, including cases against 39 individual representatives who sold more than $12 million in notes to more than 300 investors. In 2000, the Securities and Exchange Commission (SEC), acting in conjunction with state securities regulators, also brought a series of disciplinary actions against hundreds of individuals and entities that had raised more than $300 million from the sale of fraudulent promissory notes to thousands of investors.[1]

Types Of Notes Being Marketed To The Public Through Associated Persons

Various types of schemes are being marketed to the public through associated persons, including promissory notes, payphone and ATM schemes, prime bank schemes, and Ponzi schemes.[2] Promoters also are actively marketing associated persons to sell "viatical settlements" away from their firms.[3] Members and associated persons should be aware that, depending on its structure, a viatical product may or may not be a security.[4]

Members and associated persons should be on the lookout for the various types of fraudulent statements that are used to market these notes to associated persons. Associated persons may be falsely told that the notes are low risk, with "guaranteed," high returns, or that they are collateralized. Associated persons also are being told that the notes are not securities, and therefore, persons selling them are not required either to be registered or to report the sales to their firms. Associated persons often are urged to invest themselves and, in some instances, are being offered large commissions for selling to their customers. Associated persons can avoid the regulatory pitfalls associated with selling notes away from their firms by first obtaining written approval from their firms, as required by Rule 3040, before they sell any note.

How Can An Associated Person Determine Whether A Note Is A Security

There appears to be some uncertainty among associated persons as to whether notes being sold to the public are securities, especially when issuers and marketing agents may insist that they are not. Except for some commercial loans,[5] most notes are securities. A promissory note is most likely a security if the seller is selling notes to the general public to raise money for the general use of a business enterprise and the buyer is lending money as an investment and is interested primarily in the profit that the note is expected to generate.[6]

Thus, it is likely that promissory notes that are marketed and sold to the general public are securities, and a registered person may not sell these notes without prior notice to and the express written permission of his or her firm. Further, it is not sufficient to have a Series 6 registration to sell promissory notes. An individual who sells promissory notes to public customers must be registered as a Series 7 registered representative.

Associated persons at times solely rely on information provided to them by issuers, issuers' counsel, or promoters, and they fail to confirm the facts. NASD Regulation strongly urges registered persons not to make the assessment of whether a particular note is a security, but to give their firms the opportunity to determine whether sale of the note is merely an outside business activity or the sale of a security that requires written notice to the firm and firm permission. Associated persons are reminded that even if the product they wish to sell is a non-securities product, they may not accept compensation away from their firms unless and until they have provided prompt written notice to their firms.

Associated Persons' Reporting Responsibilities

Associated persons are required, either under Rule 3040 or Rule 3030, to report ***any*** kind of business activity engaged in away from their firms. Rule 3040 prohibits an associated person from selling any security "away" from the member firm unless the firm has authorized the associated person to make the sale. Rule 3040 applies to all sales of securities, including promissory notes that are securities. Rule 3040 ensures that, if a firm approves an associated person's participation in a securities transaction,[7] the firm assumes certain critical regulatory responsibilities that go with offering and selling securities to customers. In addition to requiring that the transactions be recorded on the firm's books and records, the firm must exercise appropriate supervision over the associated person in order to prevent violations of the securities laws. As recently stated by the SEC, Rule 3040 "protects investors from the hazards of unmonitored sales and protects the firm from loss and litigation."[8]

Rule 3040 requires registered persons to provide notice of the proposed transaction, in writing, to his or her firm, before the sale is made. The notice must describe the proposed transaction(s) in detail and the associated person's proposed role and must also state whether the individual has received or may receive selling compensation (including any type of referral fee). Oral notice to the firm is not sufficient to meet the requirements of Rule 3040. If the associated person expects to receive compensation, the firm must advise the registered person, in writing, whether it approves or disapproves the person's participation in the proposed transaction. If the firm disapproves the person's participation, he or she may not participate in the transaction in any manner, directly or indirectly. If the member approves the person's participation in the proposed transaction, the firm must record the transaction on its books and records and supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.

If the note in question is not a security, the registered person is required under Rule 3030 to provide prompt written notice to his/her member firm that he or she has accepted compensation outside the scope of his relationship with the firm. Because of the differences in the requirements of Rule 3030 and Rule 3040, it is important for registered persons to establish with their firms whether a particular note is a security and to follow the appropriate NASD rule requirements.

Associated persons are reminded that it is not sufficient to verify the non-securities status of a note solely by relying on the advice of the issuer or issuer's counsel. An associated person who attempts to conduct his or her own investigation of the issuer does so at his or her own regulatory risk, because an associated person's conclusions may be erroneous and because failure to report the proposed sales to the associated person's firm deprives the firm of the opportunity to challenge the issuer's analysis and conclusion. NASD Regulation strongly urges all associated persons to notify their firms in advance of any sales, so that the legal status of the note may be determined, and the proper notice given to the firm prior to any sales.

Members' Supervisory Obligations

Given the significant number of fraudulent promissory note schemes that have been uncovered, members should review their supervisory and compliance procedures to make sure that their reporting requirements are clear and complete and that each associated person receives appropriate education and training regarding the sale of notes. Problems may arise, for example, when insurance sales persons, who also are registered as Series 6 representatives, are not required by their firms to report certain outside business activities, such as the sales of other insurance products. To avoid confusion, members are urged to adopt procedures that would require registered persons to report any kind of income-producing activity.

NASD Regulation also suggests that firms review their supervisory and compliance programs to determine whether they are adequately educating their registered persons regarding the current proliferation of promissory note schemes and the importance of reporting all sales of notes under either Rule 3030 or Rule 3040. Firms should review their annual compliance checklists to make sure that their registered persons understand that all outside sales of notes, whether securities products or not, should be reported to their firms prior to any sales. Annual audits, compliance meetings, and continuing education programs also should include issues regarding the sale of notes. Firms also might consider conducting "preventive compliance conferences" that specifically address selling notes away from the firm.

Endnotes

1 *See* NASD Regulation Investor Alert, "Promissory Notes Can Be Less Than Promised," Jan. 11, 2001, which can be found on NASD Regulation Web Site (*www.nasdr.com*).

2 For a description of some of these schemes, see "Top 10 Investment Scams List Released by State Securities Regulators" which can be found on the North American Securities Administrators Association (NASAA) Web Site (*www.nasaa.org*).

3 Viatical settlements are interests in the death benefits of terminally ill patients. In a viatical settlement, investors acquire fractional interests in individual insurance policies. In general, the insured gets a percentage of the death benefit in cash, and the investors get a share of the death benefit when the insured dies.

4 *See SEC v. Life Partners, Inc.,* 87 F.3d 356 (D.C. Cir), *reh'g denied,* 102 F.3d 587 (D.C. Cir. 1996); *Timothy James Fergus, et al.,* C10990025 (NAC May 5, 2001).

5 For example, consumer financing notes, notes secured by mortgages on homes, and short-term business notes secured by the assets of the business or an assignment of accounts receivable generally are not securities.

6 *Reves v. Ernst & Young,* 494 U.S. 56, 64 (1990).

7 Associated persons are reminded that "participation" in a securities transaction includes not only making the sale, but referring customers, introducing customers to the issuer, arranging and/or participating in meetings between customers and the issuer, or receiving a referral or finder's fee from the issuer.

8 *Robin Bruce McNabb,* Exchange Act Rel. No. 43411 (Oct. 4, 2000).

NASD Notice to Members 96-33

NASD Clarifies Rules Governing RR/IAs

Suggested Routing

- [x] Senior Management
- [ ] Advertising
- [ ] Corporate Finance
- [ ] Government Securities
- [ ] Institutional
- [x] Internal Audit
- [x] Legal & Compliance
- [ ] Municipal
- [ ] Mutual Fund
- [ ] Operations
- [ ] Options
- [x] Registration
- [ ] Research
- [ ] Syndicate
- [ ] Systems
- [ ] Trading
- [x] Training

Executive Summary

On May 15, 1994, the NASD® issued *Special Notice to Members 94-44*, which clarified the applicability of Article III, Section 40 of the NASD Rules of Fair Practice to investment advisory activities of registered representatives (RRs) who also are investment advisers (RR/IAs). In particular, the Notice addressed the supervision of securities transactions conducted by RR/IAs away from the NASD members with which they are associated. Since the issuance of *Notice to Members 94-44*, the NASD has responded to questions concerning the types of records that may be used and recordkeeping systems that may be established by an NASD member to ensure that investment advisory transactions subject to Article III, Section 40 are properly recorded and the RR/IA adequately supervised. The NASD also has responded to other general compliance and interpretive questions relating to Article III, Section 40. To further facilitate member firm compliance with Article III, Section 40, this Notice discusses recordkeeping approaches and presents the answers to some of the most frequently asked questions regarding Section 40 since the release of *Notice to Members 94-44*.

Questions regarding this Notice may be directed to Daniel M. Sibears, Director, Regulation, at (202) 728-6911; or Mary Revell, Senior Attorney, Regulation, at (202) 728-8203.

Background

As reviewed in *Notice to Members 94-44*, Article III, Section 40 requires that any person associated with an NASD member who participates in a private securities transaction must, before participating in the transaction, provide written notice to the member with which he or she is associated. The written notice must describe the transaction, the associated person's role, and disclose whether the associated person will or may receive selling compensation. Thereafter, the NASD member must advise the individual in writing whether it approves or disapproves the associated person's participation in a private securities transaction. If the member approves the transaction, the transaction must be recorded on the member's books and records, and the member must supervise the associated person's participation as if the transaction were executed on behalf of the member.

Most notably, *Notice to Members 94-44* clarifies the analysis that members must follow to determine whether the activity of an RR/IA falls within the parameters of Section 40. Fundamental to this analysis is whether the RR/IA participates in the execution of a securities transaction such that his or her actions go beyond a mere recommendation, thereby triggering the recordkeeping and supervision requirements of Section 40.

Where the RR/IA does not participate in the execution of securities transactions, *Notice to Members 94-44* reminds members and their RR/IAs that while Section 40 may not apply, the activity, nonetheless, may be subject to the notification provisions of Article III, Section 43. That section requires an RR to provide written notice to the NASD member with which he or she is associated of any proposed employment or outside business activity pursuant to which he or she will receive compensation from others. The form and content of an Article III, Section 43 notice is to be determined by the NASD member.

Article III, Section 40 Books And Records Relating To Investment Advisory Transactions

Where a member has approved an RR/IA's participation in private securities transactions for which he or she

will or may receive selling compensation, the member must develop and maintain a recordkeeping system that, among other things, captures the transactions executed by the RR/IA in its books and records and facilitates supervision over that activity. Recordkeeping systems that simply record all transactions will not result in adequate supervision under Article III, Section 27 of the Rules of Fair Practice. Rather, the records created and recordkeeping system used, together with relevant supervisory procedures, must enable the member to properly supervise the RR/IA by aiding the member's understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA's authority, and the suitability of the transactions.

Since the transactions subject to Section 40 by definition occur at and through another member or directly with a product sponsor, the NASD member licensing the RR/IA is not required to record the activity in the same manner it records transactions executed on behalf of its own firm (i.e., on its purchase and sales blotter). Rather, members may develop and use alternative approaches that meet their specific needs and business practices, such as special blotters, separate Section 40 recordation forms and files, and unit systems, for capturing the RR/IA activity that occurs through other firms. In this regard, Section 40 recordkeeping systems may involve many of the following books and records:

• dated notifications from the RR/IA detailing the services to be performed by the RR/IA and the identity of each RR/IA customer serviced at another firm in a private securities transaction;

• dated responses from the NASD member to the RR/IA acknowledging and approving or disapproving the RR/IA's intended activities;

• a list of RRs who also are IAs;

• a list of RR/IAs approved to engage in private securities transactions;

• a list of RR/IA customers, including those that are customers of both the member firm and the RR/IA, with a cross reference to the RR/IA;

• copies of customer account opening cards to determine, among other things, suitability;

• copies of discretionary account agreements;

• duplicate confirmation statements;

• duplicate customer account statements;

• a correspondence file for RR/IA customers;

• investment advisory agreements between the RR/IA and each advisory client;

• advertising materials and sales literature used by the RR/IA to promote investment advisory services wherein the RR/IA holds himself or herself out as a broker/dealer, complemented by a process that shows whether proper filings have been made at the NASD and whether the RR/IA is using any electronic means, such as the Internet, to advertise services or correspond with customers;

• exception reports, where feasible, based on various occurrences or patterns of specified activity, such as frequency of trading, high compensation arrangements, large numbers of trade corrections, and cancelled trades; and

• supervisory procedures fully responsive to Article III, Section 27 requirements and designed to address Section 40 compliance. The procedures may include such items as the identity of persons responsible for Section 40 compliance, the recordkeeping system to be used and followed, and memoranda or compliance manuals that notify RR/IAs of the member's procedural requirements for Section 40 compliance.

Neither the federal securities laws nor the NASD Rules of Fair Practice mandate the supervisory system or structure that a member must use. Rather, each member can develop and implement its own supervisory system that is reasonably designed to detect and prevent violations. In this regard, no single document or combination of the referenced documents is specifically required or necessarily adequate to comply with Section 40 requirements. Rather, each member that determines to permit its associated persons to transact securities business through another broker/dealer must decide which tailored combination of records is necessary to develop an adequate supervisory system that addresses the allowable activities of RR/IAs. For example, obtaining duplicate confirmation statements directly from the RR/IA alone would permit a member to fulfill recordation requirements for the trades represented by confirmations received, but would not necessarily permit a member to reasonably ensure that it is capturing all trades. However, an arrangement under which the member obtains duplicate confirmation statements directly from the firm (or firms) that executes transactions for the RR/IA should be sufficient to ensure that the member captures all trades.

Member firms have tremendous flexibility to develop and implement recordkeeping and supervisory systems that meet the unique nature and scope of their own operations, and the permitted activities and services provided by their dually registered persons. In all circumstances, however, recordkeeping and supervision

must be adequate to ensure that full and complete transaction information is captured, and be reasonably designed to detect and/or prevent misconduct that could violate the federal securities laws and NASD Rules.

Answers To Frequently Asked Questions Concerning The Application Of Article III, Section 40 To Investment Advisory Activities

Question #1: Does Article III, Section 40 require prior approval of each transaction executed by an RR/IA away from his or her NASD member firm if the compensation received by the RR/IA is not transaction based?

Answer: An RR/IA may be involved in numerous transactions on a daily basis for which he or she receives asset-based or performance-based fees. Requiring prior notice of each trade effected under these conditions may hinder investors from properly receiving the investment advisory services provided by RR/IAs. Accordingly, the Board of Governors, acting on the recommendation of a special Ad Hoc Committee, has interpreted Article III, Section 40 to require prior notice of the investment advisory services that will be provided by the RR/IA for an asset-based or a performance-based fee, rather than prior notice of each trade effected by an RR/IA for a particular customer. This interpretation is intended to vigorously apply the investor protection concepts of Article III, Section 40 to investment advisory activities in a practical manner.

A member must receive prior written notice from an RR/IA requesting approval to conduct investment advisory activities for an asset-based or performance-based fee on behalf of each of his or her advisory clients. This notice must include details such as:

• a declaration that the individual is involved in investment advisory activities;

• the identity of each customer to whom the notice would apply;

• the types of securities activities that may be executed away from the firm;

• a detailed description of the role of the RR/IA in the investment advisory activities and services to be conducted on behalf of each identified customer;

• information regarding the RR/IA's discretionary trading authority, if any;

• compensation arrangements;

• the identity of broker/dealers through which trades away will be executed; and

• customer financial information.

Only after written approval from the NASD member may the RR/IA engage in the disclosed activities. If there is a change in the RR/IA's proposed role or activities for any customer from what the member initially approved, the RR/IA must provide the member with a subsequent written notice that details the changes and requests the member's further approval to conduct advisory activities on behalf of the customer. The employer member must thereafter record subsequent transactions on its books and records and supervise activity in the affected accounts as if it were its own.

Members are reminded, however, that if the RR/IA receives transaction-based compensation, the member's prior approval of each trade is required.

Question #2: Does Article III, Section 40 apply to persons employed by or associated with registered investment advisory firms if such persons are not registered in an individual capacity with the Securities and Exchange Commission (SEC) or various states?

Answer: Yes. Article III, Section 40 of the Rules of Fair Practice applies to all of an associated person's private securities transactions, regardless of whether or not such associated persons are also registered with other regulatory authorities such as the SEC or the states. The reference to registered investment advisers in *Notice to Members 94-44* does not limit the applicability of Article III, Section 40 to only those persons individually registered as such with other regulatory entities. In addition, if the advisory service is not registered with any regulatory agency, a member should ensure that such registration is not required.

Question #3: Is it appropriate for a limited principal (i.e., a Series 26 Investment Company Principal) to supervise Article III, Section 40 transactions in products such as equity securities that are not covered by that registration category?

Answer: Limited principals may not supervise Article III, Section 40 transactions in products not covered by their registration category. Therefore, if a firm only has principals registered in a limited capacity, associated persons engaging in Article III, Section 40 transactions may do so only in products covered by the licenses of the firm's principals.

Question #4: Is it appropriate for a limited representative (i.e., a Series 6 Investment Company Representative) to execute Article III, Section 40 transactions in products such as equity securities that are not covered by that registration category?

Answer: A limited RR who is otherwise in compliance with applicable

federal and state registration requirements, such as the SEC's investment adviser registration requirements, may not execute transactions in securities not covered by his or her NASD registration. Registration with the NASD as a representative subjects an individual to all NASD rules, regulations, and requirements, including qualification requirements. Those rules preclude a limited representative from acting as a representative in any area not covered by his or her registration category. A limited representative who wishes to execute transactions in securities not covered by his or her registration category is required to pass an appropriate qualification exam.

Question #5: If an RR/IA is registered with more than one NASD member, must all members approve, supervise, and record the Article III, Section 40 transactions?

Answer: All members with whom a person is registered are responsible for the registered representative's involvement in Section 40 transactions. Members may develop a detailed, formal allocation arrangement whereby at least one member agrees and is able to provide the supervision and recordkeeping required by Article III, Section 40. However, the other members would be required to take the reasonable steps necessary to ensure that Section 40's recordkeeping and supervisory requirements are being carried out since members cannot delegate, by contract or otherwise, their ultimate responsibility for compliance with regulatory requirements.

Question #6: What is a member's responsibility with regard to supervising Section 40 securities transactions where an advisory client of an RR/IA refuses to provide information to the member, citing the confidentiality of client information provisions of an investment advisory agreement?

Answer: Article III, Section 40, which was adopted in 1985, and its predecessor Interpretation of the Board of Governors have always stipulated that a member that allows an associated person to participate in a Section 40 transaction is responsible for supervising that transaction as if it were its own. If a member determines that in order to meet its supervisory obligations under Section 40, it must have certain information from the customer and if the customer refuses to provide the information, the member should deny the associated person's request who would then be precluded from participating in the Section 40 activity.

Question #7: Are there circumstances under which income received as salary payments may be deemed selling compensation as defined by Article III, Section 40?

Answer: As explained in *Notice to Members 94-44*, selling compensation is broadly defined to include any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security. If salary payments are direct or indirect compensation for an RR/IA's participation in the execution of securities transactions away from his or her member firm, the salary payments would be deemed "selling compensation," and the activities would be subject to Article III, Section 40.

Question #8: Where investment seminars are conducted by RR/IAs away from their employing NASD member and seminar participants are charged a fee for attendance, would any income derived from the seminar for this investment advisory activity be governed by Article III, Section 40 or Section 43 of the Rules of Fair Practice?

Answer: If an investment seminar itself does not result in the execution of securities transactions, Article III, Section 43 would govern the investment advisory activity. In determining whether Article III, Section 40 applies, the NASD has focused primarily upon the RR/IA's participation in the execution of securities transactions and whether the participation goes beyond a mere recommendation. If after an investment seminar, however, participants decide to engage in securities transactions with the participation of the RR/IA, that subsequent activity and any compensation received in connection therewith would be subject to Section 40.

Question #9: Must a member review performance reports produced by RR/IAs to properly discharge its supervisory responsibilities under Article III, Section 40?

Answer: It has come to the NASD's attention that some RR/IAs use information supplied by the broker/dealer through which they conduct private securities transactions or by the investment advisory service corporations with which they are associated to create performance reports for their advisory clients. These reports may be individualized performance reports that provide customized information for a specific client or standardized performance reports that provide general information to multiple clients. With regard to this practice, members and RR/IAs are cautioned that in creating or recreating performance reports, a risk is taken that calculations for securities transactions may be inaccurate, incomplete, or misleading, thus resulting in material misrepresentations being made or material facts being omitted. NASD member supervisory responsibilities should include a determination as to whether to permit associated persons to develop performance reports for securities transactions. If this activity is permitted, the member firm must review the performance reports.

Standardized reports sent to multiple clients are considered sales literature and must be reviewed by a registered principal at the member firm before distribution by the RR/IA to clients. If the RR/IA uses the same standardized format for different clients, principal approval before use is required only on the performance report prototype. This review must ensure that the reports are accurate, not misleading, or otherwise in violation of NASD or SEC Rules. In particular, members should review the standards set forth in Article III, Section 35 of the NASD Rules governing member communications with the public, as well as applicable SEC regulations.

Individualized performance reports are considered correspondence. As such, review by the member firm before RR/IA distribution to clients is not required. However, the firm must have appropriate procedures in place, as required by Article III, Section 27 of the NASD Rules of Fair Practice, for review and retention of individualized performance reports and other correspondence.

Question #10: Must NASD members that employ RR/IAs provide training to this segment of their associated persons under the Firm Element of the Continuing Education requirements?

Answer: The Firm Element of the Continuing Education requirements (see Schedule C of the NASD By-Laws) is designed to be flexible and to permit firms to develop tailored educational programs based on their business practices and needs. In this regard, each member that permits its associated persons to conduct securities transactions through another firm should assess the need to provide specific Firm Element training with regard to Section 40 requirements. Where the assessment establishes a need for educational initiatives for all or some portion of the covered persons conducting business away from the member, the firm's written training plan should include defined and scheduled Section 40 training for specified individuals.

Although this Notice and previously issued *Notices to Members 91-32* and *94-44* clarify the application of Article III, Section 40 to investment advisory activities, Section 40 has been in effect since November 12, 1985 (see *Notice to Members 85-84*). Accordingly, members and their RR/IAs are expected to be in compliance with Article III, Section 40.