

## Outside Business Activities

### FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities and Private Securities Transactions

Comment Period Expires: April 27, 2018

#### Summary

FINRA seeks comment on a proposed new rule to address the outside business activities of registered persons. The proposal is the result of FINRA's recent retrospective review of FINRA's rules governing outside business activities and private securities transactions, FINRA Rule 3270 (Outside Business Activities of Registered Persons) and FINRA Rule 3280 (Private Securities Transactions of an Associated Person), respectively. The proposed rule would replace FINRA Rules 3270 and 3280 and is intended to reduce unnecessary burdens while strengthening investor protections relating to outside activities.

The proposed rule text is available in *Attachment A*.

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
- ▶ Meredith Cordisco, Associate General Counsel, OGC, at (202) 728-8018.

#### Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 27, 2018.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:  
Jennifer Piorko Mitchell  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

February 26, 2018

#### Notice Type

- ▶ Request for Comment

#### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Senior Management
- ▶ Systems

#### Key Topics

- ▶ Outside Business Activities
- ▶ Private Securities Transactions
- ▶ Recordkeeping
- ▶ Supervision

#### Referenced Rules & Notices

- ▶ FINRA Rule 2010
- ▶ FINRA Rule 3210
- ▶ FINRA Rule 3270
- ▶ FINRA Rule 3280
- ▶ FINRA Rule 5130
- ▶ Notice to Members 85-21
- ▶ Notice to Members 94-44
- ▶ Notice to Members 96-33
- ▶ Regulatory Notice 17-20

To help FINRA process comments more efficiently, persons should use only one method to comment.

**Important Notes:** All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.<sup>1</sup>

Before becoming effective, the proposed rule change must be filed with the Securities and Exchange Commission (SEC or Commission) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA or Exchange Act).<sup>2</sup>

## Background & Discussion

In May 2017, FINRA launched a retrospective review of its outside business activities and private securities transactions rules to assess their effectiveness and efficiency.<sup>3</sup> These rules serve important goals – they seek to protect the investing public when a member’s registered or associated persons engage in potentially problematic activities that are unknown to the member but could be perceived by the investing public as part of the member’s business. An ancillary benefit is that the rules protect the member from resulting reputational and litigation risks.

The retrospective rule review confirmed the continuing importance of rules relating to outside activities, but also indicated that the current rules, as well as related guidance,<sup>4</sup> could benefit from changes to better align the investor protection goals with the current regulatory landscape and business practices.<sup>5</sup> In particular, FINRA received significant feedback on members’ obligations with respect to the investment advisory (IA) activities of their registered persons, which is addressed in detail below.

Consistent with a number of recommendations by stakeholders<sup>6</sup> during the retrospective review, FINRA is proposing a single streamlined rule to address the outside business activities of registered persons.<sup>7</sup> The proposed rule would clarify the obligations in this area and reduce unnecessary burdens while strengthening protections relating to activities that may pose a greater risk to the investing public. The proposed rule would require registered persons to provide their members with prior written notice of a broad range of outside activities, while imposing on members a responsibility to perform a reasonable risk assessment of a narrower set of activities that are investment related, allowing members to focus on outside activities that are most likely to raise investor protection concerns. The proposed rule also would generally exclude from the rule a registered person’s personal investments (sometimes referred to as “buying away”) and work performed on behalf of a member’s affiliates. Moreover, the proposed rule would not impose supervisory and recordkeeping obligations for most other outside activities, including IA activities at an unaffiliated third-party IA. At the same time, the proposal would hold a member responsible for approved activities that could not take place but for the registered person’s association with a member.

The following illustration summarizes core concepts of the proposed rule, which are discussed in greater detail in this *Notice*.



## Registered Persons' Obligation to Provide Notice of Outside Activities

A majority of stakeholders that provided feedback during the retrospective review believed that the scope of activities subject to the outside business activities rule, Rule 3270, should be narrowed.<sup>8</sup> On the other hand, a significant minority of stakeholders favored the rule's current notice requirement to ensure that registered persons report a broad range of outside activities to their employing firms. Moreover, a number of stakeholders believed that notice of private securities transactions under Rule 3280 should not be narrowed.<sup>9</sup> The proposed rule takes a balanced approach that would ensure that members are apprised of their registered persons' outside activities, while tailoring members' responsibilities to those activities that are most likely to raise investor protection concerns.

To that end, FINRA is proposing a single rule that would require registered persons to provide their firms with prior written notice for all investment-related or other business activities outside the scope of their relationship with the member. The proposed rule would require that a registered person include in the notice a description of the proposed activity and the registered person's proposed role therein, and that the registered person update the notice in the event of a material change to the activity.<sup>10</sup> With respect to investment-related activities only, a registered person would be required to receive prior written approval from the member before participating in the activity.

The rule would define "investment-related" as "pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association)." This definition is also used for purposes of the Uniform Application for Securities Industry Registration or Transfer (Form U4) and would better harmonize the Form U4 reporting requirements and the notice obligations under FINRA rules, an issue frequently raised during the retrospective review.<sup>11</sup> The concept of "business activity" would be similar to current Rule 3270, with minor clarifying changes, and would be defined in the rule as (1) acting as an employee, independent contractor, sole proprietor, officer, director or partner of another person; or (2) receiving compensation, or having the reasonable expectation of compensation, from any other person as a result of the activity.<sup>12</sup>

Similar to current Rule 3270, the proposed rule would apply only to the outside activities of registered persons. It would not apply to the activities of members' non-registered associated persons because the risk of potential conflicts is more prevalent with regard to registered persons.<sup>13</sup> However, the proposed rule would not preclude members from instituting policies and procedures relating to the outside activities of associated persons more broadly.

## Members' Responsibilities Upon Receiving Notice

Although the proposed rule would require registered persons to provide prior written notice of a broad range of outside activities, the focus of a member's responsibilities is on investment-related activities.<sup>14</sup> If an activity is not investment related, the member has no obligation under the rule. If the activity is investment related, then the member would be required to perform a reasonable risk assessment, as described below.

### Assessment

Upon receiving written notice of an outside *investment-related* activity, the proposed rule would require that a member perform an upfront reasonable assessment of the risks created by the engagement of the registered person in the proposed activity. Specifically, the member would be required to evaluate whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or (2) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. These considerations are similar to those required by current Rule 3270 and are aimed at assessing possible conflicts that could negatively impact the member's customers or the investing public. Although the risk assessment must be reasonable and will vary depending on the facts and circumstances, the rule's focus is on the registered person's participation in the activity and ordinarily would not require the member to perform an analysis of the underlying outside business activity.<sup>15</sup> In addition to this risk assessment, the member would be required to consider whether the person is relying on a member's registration as a broker or dealer to conduct the activity, in which case the activity would be deemed to be that of the member, if approved.<sup>16</sup>

Then, based on the foregoing, the member would determine whether to approve the registered person's participation, to approve it subject to conditions or limitations or to disapprove it. The member would be required to advise the registered person in writing of its determination.

By focusing the member's assessment on investment-related activities, the proposed rule would allow members to concentrate their compliance resources on those activities that may pose a greater chance of harm to investors. Members would no longer be required to conduct a risk assessment on a non-investment-related activity, such as a registered person driving for a car service or holding seasonal retail employment, regardless of whether the registered person receives compensation.<sup>17</sup>

## Supervision

The proposed rule would impose a supervisory obligation in two situations. First, if a member imposes conditions or limitations on a registered person's participation in an investment-related activity, the member would be required to reasonably supervise the registered person's compliance with those conditions or limitations. The proposed rule would not require members to supervise the underlying activities. For example, after conducting the required risk assessment of an investment-related activity, a member may approve a registered person to act as a registered investment adviser through an unaffiliated, third-party IA; however, the member also may condition that approval on the IA's custody of its clients' advisory assets with the member. In this example, the proposed rule would require the member to reasonably supervise the registered person's adherence to that condition, but the member would not be required by the rule to otherwise supervise the IA activity.<sup>18</sup>

Second, to the extent that a member approves a registered person's participation in a proposed investment-related activity and such activity would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity would be deemed to be the member's business. In other words, if the person can only legally engage in the outside business activity because the person is associated with a member, the member approving that activity must treat it as its own. Accordingly, all applicable securities laws and regulations and FINRA rules, including supervision and recordkeeping, would apply to the member with respect to that activity. This provision serves a critical investor protection interest and requires the member's supervision over the types of activities that the private securities transactions rule was originally adopted to address.<sup>19</sup> It would ensure that a registered person's outside broker-dealer activity – for example, selling private placements away from the member in a manner that would require broker-dealer registration – would be reported to the member and that such activity, if approved, would be under the supervision and control of a broker-dealer and subject to the same supervisory safeguards as any of the member's other broker-dealer business.

Under this second scenario, if the registered person is associated with more than one member, the proposed rule would allow members to develop a formal allocation arrangement whereby at least one member agrees in writing with specificity to comply with all applicable securities laws and regulations and FINRA rules regarding the proposed activity, including those covering supervision and recordkeeping.<sup>20</sup>

## Recordkeeping

The proposed rule would require a member to maintain and preserve records demonstrating compliance with the obligations of the rule for at least three years after the registered person's employment or association with the member has terminated.<sup>21</sup> Records required to demonstrate compliance with the rule would depend upon the facts and circumstances, but would include, for example, the registered person's written notice of the proposed activity, a record of the member's risk assessment, the member's written determination and whether any conditions or limitations are imposed. The proposed rule would not impose a general obligation to record transactions resulting from a registered person's outside activities on the member's books and records, except in the circumstance discussed above where a member approves an activity for which the registered person is relying on a member's broker-dealer registration.

## Proposed Exclusions from the Rule

The proposed rule has several exclusions that would reduce unnecessary burdens without lessening investor protection. First, the proposal would exclude from the rule's coverage registered persons' personal investments (*e.g.*, buying away), which commenters and stakeholders consistently noted do not raise the same investor protection concerns as selling away activities. Second, the proposed rule would exclude activities conducted on behalf of a member's affiliate, unless those activities would require registration as a broker or dealer if not for the person's association with a member. Therefore, a registered person generally would not be required to provide prior written notice, and a member would not be required to conduct the assessment required by the proposed rule, of any non-broker-dealer activity conducted for a member's affiliate, such as an affiliated IA, insurance entity or bank. In addition, any non-broker-dealer activity conducted on behalf of the member (*e.g.*, any IA activities for a dually registered broker-dealer/investment adviser (BD/IA)) would not be subject to the rule. These exclusions recognize members' ability to implement meaningful controls across business lines and are consistent with functional regulation – that such activities are subject to other regulatory regimes and oversight.<sup>22</sup> They also ensure that dually registered BD/IAs or members that share employees with affiliates are not faced with unnecessary additional burdens. The rule would define an "affiliate" as "any entity that controls, is controlled by or is under common control with a member," which is consistent with other FINRA rules.<sup>23</sup> For these purposes, a member would not be deemed to control an IA firm merely because it is owned by the member's registered person.

Finally, similar to the current private securities transactions rule, the proposed rule would not apply to transactions in accounts that are subject to FINRA Rule 3210 or to transactions on behalf of the registered person's immediate family members (as defined in FINRA Rule 5130) for which the registered person receives no transaction-related compensation.<sup>24</sup>

## Application to Registered Persons' Investment Advisory Activities

The proposed rule would change the current approach with respect to IA activities of registered persons. Under Rule 3280 and related guidance, members must supervise and record on the members' books and records the transactions resulting from most outside IA activities of their associated persons.<sup>25</sup> This approach has caused significant confusion and practical challenges, including, for example, privacy challenges with a member obtaining account information for customers of an unaffiliated IA through which a member's registered person may be acting in an IA capacity. Given these challenges, and in light of the fact that these activities are subject to another regulatory regime, some stakeholders argued that the current approach imposes unnecessary burdens without providing meaningful investor protections over the activities.

Based on FINRA's review of the rules, public comment and other stakeholder feedback, and the evolving environment in which members operate, modifications to the current approach appear appropriate. Under the proposed rule, as discussed above, any IA activity conducted on behalf of a dually registered BD/IA or for an IA affiliate of a member would be excluded from the rule. Any IA activity conducted for a third-party, non-affiliated IA would constitute an "investment-related" activity under the rule. As such, the rule would require that the registered person provide prior written notice of such activity, and the member would be required to conduct the upfront risk assessment described above and, based on its assessment, to approve the registered person's participation, to approve it subject to conditions or limitations or to disapprove it. However, the proposed rule would not impose a general supervisory obligation over the IA activities and would not require the member to record on its books and records transactions resulting from such IA activities. Although this proposed approach streamlines members' obligations over IA activities, these IA activities would continue to be subject to regulatory oversight by the SEC and states under a different regulatory scheme.<sup>26</sup>

## Economic Impact of the Proposal

### Regulatory Need

FINRA's recent review of the current rules on outside business activities and private securities transactions and industry and stakeholder input indicate that the current rules may benefit from substantive changes that clarify the obligations and tailor them to better achieve investor protection.

### Economic Baseline

The current rules governing member employees' business and securities activities outside the regular course or scope of their employment with their firms, Rules 3270 and 3280, and related guidance, serve as the economic baseline for the analysis. These rules impact a broad spectrum of members, irrespective of business model, client base and product type.



A survey on the rules sent to all FINRA members provided insights into the extent to which registered and associated persons are conducting, or proposing to engage in, activities subject to the rules.

Rule 3270 requires registered persons to provide prior written notice before engaging in an outside business activity. Approximately 80 percent of the members responding to the survey stated that they have received at least one written notice in the last five years pursuant to Rule 3270. Approximately 40 percent of the registered persons within those members provided written notices. Also, approximately 89 percent of the respondents stated that they had internal policies to limit or prohibit outside business activities, and 42 percent stated that they have limited or prohibited a registered person's participation in an outside business activity before, mostly due to potential conflicts of interest and potential confusion by the customer as to whether the activity falls within the firm's business.

Rule 3280 requires associated persons to provide prior written notice before participating in any manner in private securities transactions. In the survey, approximately 40 percent of the responding members stated that they have received at least one written notice in the last five years pursuant to Rule 3280. Approximately 19 percent of the associated persons within those members provided written notices. Also, approximately 89 percent of the respondents stated that they had internal policies to limit or prohibit private securities transactions for compensation to address the potential conflicts of interest between associated persons and the firm or its customers and to mitigate the litigation risk.

### **Economic Impacts**

The proposed rule would directly impact registered persons that seek to engage in outside investment-related or other business activities and the members that employ them, and may potentially provide benefits for customers through better investor protection.

Streamlining the rules into a single combined rule will benefit both members and registered persons by reducing the likelihood of regulatory confusion, as raised by stakeholders and identified in the survey, and should make it easier for both members and registered persons to determine the activities that are within the proposed rule's scope. Stakeholders noted that the potential overlap between the two rules may lead to inconsistent interpretation and application of the rules. Moreover, some outside business activities may evolve into private securities transactions, resulting in confusion over which rule applies. The simplified approach may encourage registered persons who have previously avoided these activities because of the perceived regulatory uncertainty to pursue outside activities.

The proposal's requirement that registered persons provide their firms with prior written notice for all investment-related or other business activities will benefit members by ensuring they receive notice of a broad range of registered persons' outside activities. At the same time, there could be marginal costs for registered persons who would be required

to report a broad range of activities. It may also increase compliance costs for members to the extent that members must determine which of the reported activities are subject to a risk assessment under the rule.

With respect to a narrower set of activities – investment-related activities – the rule requires the member to conduct a reasonable assessment of the risks created by the registered person’s engagement in the proposed activity and to approve or disapprove the registered person’s participation. Imposing these requirements on the narrower set of activities will reduce unnecessary burdens to members of having to conduct a risk assessment of non-investment-related activities that may pose little harm to the member or the investing public. Specifically, members may benefit from employing compliance resources on those outside activities that are more likely to raise investor protection concerns.

Unlike current Rule 3270, the proposed rule imposes a requirement, with respect to investment-related activities only, to determine whether to approve or disapprove the activity, and to provide the registered person with written notice of this determination. Although FINRA understands that many members already do so, members may incur compliance costs associated with the proposal in providing written responses to registered persons regarding approval or disapproval decisions. On the other hand, this requirement will provide clarity for registered persons, as they will have a clear understanding of the member’s determination. However, it may delay registered persons’ participation in the activity until the member’s written approval decision, if provided, which could result in additional costs to registered persons up to and including the possibility of lost business opportunities. At the same time, where the member disapproves of the investment-related activity, ex post costs of such prohibition would be relatively lower under the proposal as the registered person receives the information before engaging in the activity. In addition, requiring registered persons to receive an approval determination before engaging in an investment-related activity may also benefit the investing public as registered persons will not have the opportunity to engage in activities that the member ultimately disapproves.<sup>27</sup>

The current rules apply to different populations, with Rule 3270 applying to registered persons and Rule 3280 applying to associated persons. The proposed rule would eliminate this disparate treatment and apply uniformly to registered persons. In doing so, the proposal relieves associated persons from some obligations, which could potentially impact behaviors. Because non-registered associated persons would not be subject to the rule, they would have lower costs to engage in the covered activities under the proposal. This may create an incentive for associated persons to remain unregistered, to the extent that costs associated with the notification and, with respect to investment-related activities, assessment and approval requirements outweigh the benefits of being a registered person. The possible negative impact of this hypothetical may be tempered, however, by the fact that many activities require a person to be registered in one capacity or another before the person may engage in them.

Under current Rule 3280, if a member approves an associated person's participation in a private securities transaction for compensation, the member must record the transaction on the member's books and records and supervise the associated person's participation as if the transaction were executed on behalf of the member. The proposed rule, which imposes supervision only in the two limited situations described above, would eliminate those current requirements with respect to the majority of activities that fall within the current rule and, accordingly, should simplify the supervisory efforts and lower the direct compliance costs.

In addition, the proposed rule excludes non-broker-dealer activities conducted on behalf of a dually registered firm, such as IA or banking activities, and activities conducted for an affiliate of the member (unless those activities would require registration as a broker or dealer if not for the person's association with a member). These exclusions should potentially alleviate some of the burdens that are associated with reporting and assessing outside activities that may pose relatively little risk to the member and investing public.

FINRA also considered the potential impacts of the proposed amendments on investors. Limiting the risk assessment and approval requirements of the proposed rule to investment-related activities, as defined in the Form U4, mitigates the confusion and misalignment between the Form U4 and Rule 3270, and should enhance the investor protection purpose of the rule.

### Alternatives Considered

FINRA staff also considered a principles-based approach, as suggested by some stakeholders, which potentially would provide members with more flexibility in developing the systems and the protocols to assess and approve or disapprove outside business activities and private securities transactions. However, the approach presented here was deemed to better balance the costs and benefits of governing registered persons' outside business and private securities activities. It also takes into account the views of numerous other stakeholders that favored a rules-based approach with specific requirements.

### Request for Comment

FINRA requests comment on all aspects of the proposal. FINRA requests that commenters provide empirical data or other factual support for their comments wherever possible. FINRA specifically requests comment concerning the following issues:

1. What are the alternative approaches, other than the proposal, that FINRA should consider?
2. How would consolidation of the rules governing outside business activities and private securities transactions in this proposal simplify compliance? What impact would it have on the cost of compliance?

3. Unlike Rule 3280, the proposed rule would apply to registered persons, rather than to associated persons. Should the proposed rule be expanded to apply to all associated persons? If so, why?
4. Is the proposed scope of the notice requirement appropriately tailored to balance the interest of members to receive information regarding their registered persons' outside activities and any investor protection concerns?
  - a. Should the proposal be modified to require registered persons to provide notice with respect to a narrower set of activities? If so, should notice be required only with respect to investment-related or some other categorization of activities?
  - b. Would narrowing the scope of the proposal impose any additional risks to investors?
5. A member's obligation to conduct a risk assessment is only triggered under the proposal with respect to investment-related activities.
  - a. Does limiting the required risk assessment to activities that are "investment-related" properly balance the interest of allowing members to focus compliance efforts on activities that pose the greatest concerns and any potential harm to investors?
  - b. Is the definition of "investment-related," which is based on the definition used by the Form U4, appropriate given the regulatory objectives of the proposal, or should other activities be included in or excluded from the definition? If so, why?
  - c. The proposed rule's focus is on assessing the risks created by the registered person's engagement in the outside investment-related activity, rather than the underlying activity itself. Is this an appropriate focus? Should the risk assessment include a requirement for the member to perform due diligence of the underlying outside activity?
  - d. The member would be required in the risk assessment to evaluate whether the proposed activity will: (i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or (ii) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. Are these appropriate criteria to evaluate conflicts of interests and other potential areas of harm to investors?
6. The proposal has several exclusions, including for registered persons' personal investments and activities conducted on behalf of an affiliate of a member, unless those activities would require registration as a broker or dealer if not for the person's association with a member. Are the proposed exclusions appropriate?
  - a. Should any other activities be excluded from the rule? If so, why?



## Endnotes

1. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (Online Availability of Comments) (November 2003) for more information.
2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. *See Regulatory Notice 17-20* (May 2017).
4. *See, e.g., Notice to Members 94-44* (May 1994); *Notice to Members 96-33* (May 1996).
5. FINRA Rule 3270 is incorporated by reference into the Capital Acquisition Broker (CAB) Rules. *See* CAB Rule 327. Persons associated with a capital acquisition broker may not participate in any manner in a private securities transaction as defined in Rule 3280(e). *See* CAB Rule 328. FINRA will consider whether conforming changes to the CAB rules are appropriate as a result of any changes to FINRA Rules 3270 and 3280.
6. The term “stakeholder” is used to describe those entities, organizations and persons who may be impacted by or otherwise have an interest in FINRA Rules 3270 and 3280 and this proposed rule.
7. A number of stakeholders commented on the similar notice requirements of Rules 3270 and 3280 and noted confusion over the often overlapping concepts. A combined rule would eliminate this confusion and streamline the requirements.
8. Subject to specified exemptions, Rule 3270 prohibits a registered person from being an employee, independent contractor, sole proprietor, officer, director or partner of another person, or being compensated, or having the reasonable expectation of compensation, from another 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 a survey sent to all FINRA members as part of the retrospective review, approximately 60 percent of the respondents believed that there are outside business activities that should not be included within the scope of Rule 3270.
9. Rule 3280 provides that, prior to participating in any private securities transaction, an associated person must provide written notice to the member with which he or she is associated, describing the transaction and the associated person’s role, and disclosing whether the associated person has received or may receive selling compensation in connection with the transaction. The rule defines “private securities transaction” as any securities transaction outside the regular course or scope of an associated person’s employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, but excludes transactions subject to the notification requirements of FINRA Rule 3210 (Accounts At Other Broker-Dealers and Financial Institutions), transactions among immediate family members (as defined in FINRA Rule 5130 (Restrictions on the Purchase and Sale of Initial Equity Public Offerings)), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities.

10. For example, some stakeholders noted that an outside business activity that appears on its face to pose little risk to the investing public may evolve into a private securities transaction if the registered person seeks to sell interests in an outside business. Such a material change in the activity would require the registered person to provide updated written notice and, in this example, would trigger the member to conduct a risk assessment and, depending on the activity and whether the member approves the registered person's participation, may require the member's supervision.
11. See Form U4 Explanation of Terms, available at <https://www.finra.org/file/explanation-terms-crd-forms>.
12. FINRA notes that, irrespective of whether an outside activity is investment related, other rules may apply, depending on the facts and circumstances, to business-related conduct, including FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade).
13. FINRA Rule 3270 applies to registered persons, while FINRA Rule 3280 applies to associated persons. The proposed rule would harmonize this distinction, which was an issue raised by stakeholders during the retrospective review.
14. Because a member's obligations under the rule apply with respect to investment-related activities, a member necessarily must have a process for reasonably determining which activities are investment related.
15. As part of the risk assessment, FINRA would expect a member, for example, to consider the registered person's proposed role in the activity, whether the registered person intends to use separate or shared facilities or electronic presence, whether the registered person intends to solicit the member's customers and the general nature of the underlying activity. A member also must consider any "red flags" indicating problematic activities that raise the risks of the engagement of the registered person in the proposed activity. See, e.g., *Dep't of Enforcement v. Fox Fin. Mgmt. Corp.*, Complaint No. 2012030724101, 2017 FINRA Discip. LEXIS 3, at \*17-18 (FINRA NAC Jan. 6, 2017) (stating that the "supervisory duties imposed under NASD Rule 3010 include a responsibility to investigate and act upon 'red flags' that reveal irregularities or the potential for misconduct" and finding that the firm failed to investigate and act upon red flags indicating that an outside business activity in fact involved private securities transactions); *Dep't of Enforcement v. Merrimac Corp. Securities, Inc.*, Complaint No. 2009017195204, 2015 FINRA Discip. LEXIS 4, at \*9 (FINRA NAC Apr. 29, 2015) (affirming the imposition of sanctions for the firm's failure to adequately consider red flags of outside business activities and private securities transactions, for example, by neglecting "to investigate after it learned of allegations on a website that one of the outside businesses was a Ponzi scheme and was suffering serious financial difficulties").
16. As discussed more fully *infra*, in this circumstance, a firm would be responsible for complying with all applicable securities laws and FINRA rules, including supervision and recordkeeping.
17. The rule would not prohibit a member from deciding for its own business reasons to create additional obligations and procedures for its registered or associated persons regarding outside business activities.
18. In this example, the member would have other obligations related to its custodial role, but those are separate and apart from the proposed rule's treatment of *outside* business activities.

19. *See, e.g., Notice to Members 85-21* (March 1985) (requesting comment on private securities transactions rule, which was aimed at addressing transactions that had long been a regulatory concern, namely “transactions in which an associated person is selling securities to public investors on behalf of another party, *e.g.*, as part of a private offering of limited partnership interests, without the participation of the person’s employer firm”).
20. This provision is consistent with current guidance regarding the application of the private securities transactions rule to the activities of registered persons employed by more than one member. *See Notice to Members 96-33* (May 1996), Question 5 (allowing members to develop a detailed, formal allocation arrangement whereby at least one member agrees and is able to provide required supervision and recordkeeping under the private securities transactions rule with respect to outside investment advisory activities of a registered person employed with more than one member).
21. This retention period is consistent with the retention period in the current rule on outside business activities and with the retention period of other records relating to associated persons required to be made and preserved under the Exchange Act. *See* SEA Rule 17a-4(e)(1) (setting forth the retention period for specified records relating to associated persons).
22. For example, investment advisers registered with the SEC are overseen by the SEC and subject to the obligations of the Investment Advisers Act of 1940 (Advisers Act) and the regulations and rules promulgated thereunder. Other investment advisers are subject to state registration systems, many of which have requirements similar to the Advisers Act.
23. *See, e.g.,* FINRA Rule 5121(f)(1) (defining “affiliate” for purposes of the rule governing public offerings of securities when a participating firm has a conflict of interest); FINRA Rule 6710(ee) (defining “Non-member Affiliate” for purposes of the rules relating to the Trade Reporting and Compliance Engine (TRACE)).
24. The proposal would not alter the obligations under FINRA Rule 3210.
25. *See* Rule 3280(c)(2) (requiring a member that approves an associated person’s participation in a private securities transaction for compensation to record the transaction on the member’s books and records and supervise the associated person’s participation as if the transaction were executed on behalf of the member); *see also Notice to Members 94-44* (May 1994) (providing that an associated person is considered to be participating in the execution of the transaction, and, therefore, triggering the application of Rule 3280, if the person’s investment advisory activities exceed the mere recommendation of securities).
26. *See supra* note 22. To the extent that FINRA becomes aware of potentially problematic IA or other non-broker-dealer activities during the course of its oversight of broker-dealers, FINRA would take appropriate action within the scope of its authority, including, but not limited to, referring the matter to the SEC or states.
27. Under Rule 3270, a registered person must provide prior written notice to the firm of outside business activity, but there is no requirement in the rule that the member approve the activity before the registered person may engage in it.



## ATTACHMENT A

Below is the text of the proposed rule change. Proposed new language is underlined.

\* \* \* \* \*

### **3290. Outside Business Activities**

#### **(a) Obligations of a Registered Person**

No registered person may participate in any manner in an investment-related or other business activity outside the scope of the relationship with the person's member firm unless the person provides prior written notice to and, with respect to any investment-related activity, receives prior written approval from, the member. In the case of a material change to the activity, a registered person must provide the member with updated prior written notice and, with respect to any investment-related activity, receive updated prior approval. The notification shall be provided in such form as specified by the member, describing the proposed activity and the person's proposed role therein. If the member disapproves the proposed activity or places conditions or limitations on it, the registered person shall not participate in the activity or shall comply with such conditions or limitations.

#### **(b) Obligations of a Member Receiving Notice of an Investment-Related Activity**

(1) Upon receipt of a written notice of any investment-related activity, a member shall:

(A) perform a reasonable assessment of the risks created by the engagement of the registered person in the proposed activity, including an evaluation of whether the proposed activity will:

(i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or

(ii) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered;

(B) consider whether the activity would require the person's registration as a broker or dealer under the Exchange Act if not for the person's association with a member; and

(C) make a reasonable determination of whether to approve the registered person's participation in the proposed activity, to approve it subject to specific conditions or limitations, or to disapprove it.

(2) Upon completion of the member's assessment, a member shall advise the registered person in writing whether the member:

(A) approves the person's participation in the proposed activity and imposes any conditions or limitations on that participation; or

(B) disapproves the person's participation in the proposed activity.

(3) If the member imposes conditions or limitations on its approval of the person's participation in the proposed activity, the member shall reasonably supervise the registered person's compliance with such conditions or limitations.

(4) If the member approves the person's participation in the proposed activity and such activity would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity shall be deemed to be that of the member and the member shall be subject to all applicable securities laws and regulations and FINRA rules, including those requiring supervision and recordkeeping, with respect to that activity. If the person is associated with more than one member, the members may develop a detailed, formal allocation arrangement, which must be in writing, whereby at least one member agrees to be responsible for compliance with respect to all applicable securities laws and regulations and FINRA rules regarding the proposed activity, including those requiring supervision and recordkeeping.

(5) A member must keep a record demonstrating its compliance with the obligations pursuant to this Rule and must preserve this record at least three years after the registered person's employment or association with the member has terminated.

••• **Supplementary Material:** -----

.01 This Rule shall not apply to:

(a) a registered person's personal investments (including transactions in accounts that are subject to FINRA Rule 3210);

(b) transactions on behalf of the registered person's immediate family members (as defined in FINRA Rule 5130) for which the registered person receives no transaction-related compensation;

(c) activities conducted on behalf of a member's affiliate, unless those activities would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered; or

(d) a member's non-broker-dealer activities.

.02 For purposes of this Rule:

(a) "Affiliate" means any entity that controls, is controlled by or is under common control with a member.

(b) "Business activity" means: (i) acting as an employee, independent contractor, sole proprietor, officer, director or partner of another person; or (ii) receiving compensation, or having the reasonable expectation of compensation, from any other person as a result of the activity.

(c) "Investment-related" means pertaining to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association).