



NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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April 27, 2018

By *electronic mail* to pubcom@finra.org.

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 18-08 – Outside Business Activities & Private Securities Transactions

Dear Ms. Piorko Mitchell:

On behalf of the North American Securities Administrators Association, Inc. (“NASAA”),¹ I hereby submit the following observations and recommendations in response to FINRA Regulatory Notice 18-08 (the “Proposal”) regarding oversight of outside business activities and private securities transactions.² The Proposal, if implemented, would undermine investor protection. As outlined below, the Proposal’s potential streamlining of broker-dealer supervisory responsibilities, in its attempt to lower costs for FINRA members, misses the mark and cuts into the current supervisory approach far too deeply.

Our concerns, discussed in more detail below, fall into four major areas. First, the Proposal’s definition of “investment-related” activity is too narrow, as it would allow firms to eliminate critical day-to-day oversight over several activities that are excluded from the proposed definition. Limiting firm supervision to outside business activities that only fall into the narrowly proposed definition of “investment-related” would hamper *firms’* ability to identify risks posed by unmitigated conflicts of interest, questionable compensation arrangements, potential liability for broker fraud, and unregistered product sales and unlicensed individual activity. Second, FINRA

¹ NASAA is the association of the 67 state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA serves as a forum for these regulators to work with each other to protect investors at the grassroots level and promote fair and open capital markets.

² See FINRA Regulatory Notice 18-08, *Outside Business Activities – FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities and Private Securities Transactions* (Feb. 26, 2018), available at <http://www.finra.org/industry/notices/18-08>.

members should continue to be required to supervise and maintain records related to registered representatives' associations with unaffiliated investment advisers. The proposed change removing this supervisory oversight would undermine the ability of both state and federal regulators to oversee in an efficient manner the activities of dually-registered representatives. Furthermore, it would impede state and federal regulators from countering the efforts of bad actors engaging in regulatory arbitrage. Third, FINRA should continue to require its members to supervise the private securities transactions of their associated persons – registered or otherwise. Such supervision provides an important tool to scrutinize the private placement market and other activities of associated persons. Fourth, the Proposal would tend to confuse and harm investors by encouraging opportunistic hat-switching, obfuscating applicable duties of care and exposing investors to an increased risk of fraud and abusive practices.

Effective compliance and supervision are the cornerstones of our capital markets' regulatory structure. State and federal law, and a body of rules and regulations, have been built on this foundation with the common goal of combating and preventing fraudulent conduct in the securities industry. Regulation and supervision are related concepts, but they are distinct. FINRA rules rightly require its member firms to maintain written supervisory procedures and implement supervisory control systems to help ensure that firms and their associated persons remain compliant with applicable laws and rules. FINRA member firms have important direct supervisory responsibilities, with securities regulators (FINRA, the Securities and Exchange Commission and NASAA members) providing additional periodic examinations and reviews. Regulators provide oversight, but it is firms, not regulators, that have the best access to the day-to-day activities of their associated persons.

Nevertheless, fraud and other forms of misconduct arising from outside business activities and private securities transactions by associated persons of broker-dealers are perennial problems for regulators, investors and the securities industry.³ NASAA believes the Proposal, if implemented, would undermine investor protection. The Proposal's potential streamlining of broker-dealer supervisory responsibilities to only those registered representatives considered most likely to raise investor protection concerns takes the wrong approach by prioritizing cost savings for FINRA member firms over investor protection. Therefore, we urge FINRA to withdraw the Proposal or at a minimum substantially revise it to incorporate the changes proposed below.

1. The Proposed Definition of "Investment-Related" is Too Narrow.

The Proposal would require registered persons to notify their firms of all outside business activities while absolving the firms of any responsibility for supervising unaffiliated activities that

³ See Letter from Mike Rothman, NASAA, to Jennifer Piorko Mitchell, FINRA, Re: Regulatory Notice 17-20 – Retrospective Rule Review, Outside Business Activities and Private Securities Transactions (Jun. 29, 2017), available at <http://www.finra.org/industry/notices/17-20>; FINRA Statistics, available at <https://www.finra.org/newsroom/statistics>.

are not “investment-related.”⁴ The proposed definition of “investment-related” is too narrow, however, and neglects to specify several types of activities that should be expressly included. Failure to include these activities in the proposed definition will almost certainly inhibit critical day-to-day oversight that allows FINRA member firms to identify risks posed by unmitigated conflicts of interest, questionable compensation arrangements, as well as potential liability for broker fraud and unregistered activity. Accordingly, we recommend the following revisions to the proposed definition of “investment-related” in Supplementary Material .02:

(c) “Investment-related” means pertaining to securities, commodities, banking, insurance, ~~or~~ real estate, collectibles or cryptocurrencies (including, but not limited to, acting as or being associated with a securities or commodities broker or dealer ~~broker-dealer~~, issuer, investment company, private fund, investment adviser, futures sponsor, bank, ~~or~~ savings association, money transmitter, investment partnership or cooperative, cryptocurrency exchange, or cryptocurrency sponsor, and whether or not such entity is properly registered or licensed with appropriate regulatory authorities).⁵

The proposed revisions above would make explicit: (i) that participation in these other types of activities – such as money transmission, cryptocurrency ventures, and investment partnerships or cooperatives – require scrutiny by FINRA member firms as “investment-related” activities, particularly as those services are offered by the firm’s representatives to the firm’s clients; and (ii) that it is immaterial, for purposes of the Proposal, whether the entity engaging in such activity is meeting all of its registration or licensing obligations.

2. FINRA Members Should Be Required to Supervise and Maintain Records Related to Registered Representatives’ Associations with Unaffiliated Investment Advisers.

Under the Proposal, a much lower standard of supervisory responsibility would be imposed on broker-dealers regarding their registered persons’ employment or association with unaffiliated investment advisers.⁶ The Proposal would require FINRA firms to supervise compliance with any conditions or limitations the firm imposed on such relationships but relieve them of any other

⁴ The Proposal states: “the proposed rule would require registered persons to provide prior written notice of a broad range of outside activities, [however] the focus of a member’s responsibilities is on investment-related activities. If an activity is not investment related, the member has no obligation under the rule.” Regulatory Notice 18-08, p.5.

⁵ While beyond the scope of this Proposal, NASAA is open to discussing expanding the definition of “investment-related” as it is used in the Form U4.

⁶ In this regard, the Proposal states: “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.” Regulatory Notice 18-08, p.6.

supervisory responsibility of the dually-registered representative/investment adviser representative. Weakening the current standard of supervisory responsibility is inherently dangerous because it eliminates day-to-day oversight while undermining the ability of state and federal regulators to efficiently oversee dually-registered representatives and to counter the efforts of bad actors who would otherwise engage in regulatory arbitrage.

FINRA member firms are currently held responsible for oversight of outside investment-related activities for good reason: they have insights into the day-to-day activities of their associated persons and are well positioned to detect potential misconduct that may occur through an unaffiliated investment adviser. The compliance function at FINRA member firms thus provides an important safeguard for investor protection in these circumstances. Eliminating FINRA firms' responsibilities in this area would place investors at risk by eliminating day-to-day oversight in favor of routine, but intermittent state and federal securities regulators oversight to identify or prevent misconduct. The NASD Board of Governors noted these types of concerns when it first proposed an Outside Business Activities rule in 1988:

The NASD Board of Governors has noted that in recent disciplinary cases, prior notice to a member firm of an associated person's outside business activities could have prevented the firm's entanglement in legal difficulties and harm to the investing public. The Board concluded that it is imperative that member firms receive prior notification of all outside business activities of their associated persons so that the member's objections, if any, to such activities may be raised at a meaningful time and so that *appropriate supervision* may be exercised as necessary under applicable law (emphasis added).⁷

FINRA firms also should be required to maintain books and records related to these independent advisory and other business relationships. This serves a useful investor protection purpose. When FINRA, the SEC and state securities regulators conduct examinations, they routinely request trade data and other types of information feeds. The availability of such records related to third-party relationships through FINRA member broker-dealers is extremely useful, even if it may be duplicative of information the adviser or other entity is required to maintain. If this recordkeeping requirement were lifted, it would be more difficult for regulators to obtain or validate such data in broker-dealer or investment adviser examinations, investigations and enforcement actions.

⁷ NASD Notice 88-5, *Request for Comments on Proposed NASD Rule of Fair Practice Regarding Outside Business Activities* (Feb. 14, 1988), available at http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=957.

3. *FINRA Rules Should Continue to Require Private Securities Transaction Reporting by All Associated Persons.*

The Proposal would remove the obligation that associated but unregistered persons at FINRA member firms disclose their private securities transactions.⁸ We appreciate that this proposed change might seem like a logical regulatory simplification: by definition, unregistered persons generally should not have disclosable activities under FINRA Rule 3280. However, the current, broader scope of Rule 3280 is appropriate and acts as a regulatory control against unregistered activity. While most unregistered associated persons undoubtedly report “None” to their compliance staffs when queried about their private securities transaction activities, it surely is not the case universally. Some associated persons might be involved in private securities transactions, either lawfully as investors or improperly as selling agents. FINRA rules thus should continue to require that all associated persons disclose (and all FINRA member firms inquire about) any level of involvement in private securities transactions. This supervision provides securities regulators an important window into this area and an opportunity to more closely scrutinize potentially inappropriate activity involving private placements.

4. *The Proposal Is Not in Step with The Needs of Investors.*

The investing public expects that broker-dealers, through the mere act of ‘hanging out a shingle’ and engaging in a brokerage business, will conduct themselves with high qualities of professionalism and fair dealing.⁹ Studies show investors are confused about the precise nature of the duties owed by investment professionals including broker-dealers.¹⁰ This confusion is particularly acute in the independent contractor broker-dealer model, in which registered representatives often provide a panoply of services ranging from insurance sales to tax advice. But oftentimes investors only see the name of the broker-dealer on the door. The SEC’s proposed Regulation Best Interest attempts to address this problem and impose additional obligations on broker-dealers designed to clarify their roles and duties to their clients.¹¹ The Proposal, however, would relieve broker-dealers of their current obligation to fully and proactively supervise their representatives’ activities. Removing this obligation potentially eliminates a source of information that a broker-dealer could use to determine whether a representative is acting in a client’s best

⁸ The Proposal states: “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.” Regulatory Notice 18-08, p.10.

⁹ See, e.g., Kahn v. SEC, 297 F.2d 112, 115 (2d Cir. 1961) (opinion of J. Clark, concurring).

¹⁰ See, e.g., SEC Staff Study on Investment Advisers and Broker-Dealers (Jan. 2011), p.2, available at <https://www.sec.gov/news/studies/2011/913studyfinal.pdf>; Letter from A. Heath Abshire, NASAA, to Elizabeth M. Murphy, SEC, Re: Framework for Rulemaking Under Section 913 of the Dodd-Frank Act, File No. 4-606 (Jul. 5, 2013), p. 11, available at <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Fiduciary-Duty-Letter-final-07052013.pdf>.

¹¹ See SEC Proposes to Enhance Protections and Preserve Choice for Retail Investors in their Relationships with Investment Professionals, SEC Press Release 2018-68 (Apr. 18, 2018), <https://www.sec.gov/news/press-release/2018-68>.

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interest. The Proposal thus is generally out of sync with the needs of investors and current trends in broker-dealer regulation. It is difficult to see the value of reducing oversight of financial service providers at a time when there is no demonstrable surplus of supervision or lack of need for existing investor protections.

NASAA appreciates the opportunity to submit its comments in connection with this matter and welcomes the opportunity for further discussion. If you have any questions about this letter, please contact any of: NASAA Broker-Dealer Section Chair Frank Borger-Gilligan (frank.borger-gilligan@tn.gov or 615-532-2375), NASAA Investment Adviser Section Chair Andrea Seidt (andrea.seidt@com.state.oh.us or 614-644-7435), NASAA CRD/IARD Steering Committee Chair Melanie Senter Lubin (mlubin@oag.state.md.us or 410-576-6365), or NASAA General Counsel A. Valerie Mirko (vm@nasaa.org or 202-737-0900).

Sincerely,

A handwritten signature in black ink, appearing to read "JP Borg", written in a cursive style.

Joseph P. Borg
NASAA President
Alabama Securities Commissioner