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May 27, 2025

Via electronic submission to pubcom@finra.org.

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1700 K Street, NW
Washington, DC 20006

Re: Regulatory Notice 25-05: Outside Activities

Dear Ms. Mitchell:

On behalf of The Alternative & Direct Investment Securities Association ("ADISA"),[1] we are submitting this comment letter regarding Regulatory Notice 25-05: Outside Activities (the **"Notice")** which requests comments on FINRA's proposal to adopt a new rule to govern the outside activities of member firms' associated persons. ADISA appreciates the opportunity to provide comments on behalf of its members, which include both members firms as well as registered investment advisers. ADISA has drawn upon its understanding of these firms and their differing business models, services and product offerings in putting together this comment letter, which we hope will enhance the credibility of the points made herein.

As set forth below, ADISA is focused on the Notice's request for input on the obligations of member firms to supervise and keep records for so-called "Outside IA" activities of its registered persons who are associated with unaffiliated investment advisers ("**IAs**"). At bottom, ADISA does not believe that significant benefits can and will be achieved by requiring that such activities be supervised by member firms, particularly in light of the burdens that such an obligation places on member firms. Requiring a member firm to involve itself with the advisory activities of persons who are employed by or otherwise working with an unaffiliated investment advisory firm is not likely to lead to informed supervision despite the significant costs that will otherwise be associated with meeting that obligation. From a simple cost-benefit standpoint, we believe that imposing high costs in return for a relatively modest (at best) benefit is not good regulatory policy and that the current supervisory and recordkeeping requirements should be removed.

[1] ADISA is the nation's largest trade association for the non-traded alternative investment space (i.e., retail vs. institutional). Through its 5,000 financial industry members (over 1,000 firms), ADISA reaches over 220,000 finance professionals, with sponsor members raising in excess of $200 billion annually, serving more than 1 million investors. ADISA is a non-profit organization (501(c)(6)), registered to lobby, and also has a related 501(c)(3) charitable non-profit (ADISA Foundation) assisting with scholarships and educational efforts.

Background:

In the Notice, FINRA seeks comment on a proposed new rule "to streamline and reduce unnecessary burdens involved with existing requirements applicable to the outside activities of member firms' associated persons, including registered persons (the "**Proposal"**)." The Proposal, which resulted from of FINRA's review of FINRA's rules governing outside business activities ("**OBA**s") and private securities transactions ("**PSTs**"),[2] would replace two rules – Rules 3270 and 3280 – with one rule. In FINRA's view, the Proposal is intended to enhance efficiency without compromising protections for investors and members relating to outside activities.

Current Rules and Interpretations:

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, by another person for any business activity outside the scope of the relationship with his or her member unless he or she has provided prior written notice to the member. Once notified pursuant to Rule 3270, the member must consider whether the proposed OBA will: (1) interfere with or otherwise compromise the registered person's responsibilities to the member or 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. Based on the member's review of such factors, the member must evaluate the advisability of imposing specific conditions or limitations on a registered person's OBA, including where circumstances warrant, prohibiting the activity.

Rule 3280 provides that, prior to participating in any PST, an associated person must provide written notice to the member with which he or she is associated, describing in detail the proposed transaction and the person's proposed role, and indicating whether the associated person has received or may receive selling compensation in connection with the transaction. If the PST does not involve selling compensation, the member must provide prompt written acknowledgement of the notice and may, at its discretion, require the person to adhere to specified conditions in connection with the person's participation in the transaction. If the PST involves selling compensation, the member must inform the associated person in writing whether it approves or disapproves the person's participation in the transaction. If the member approves participation in the PST for selling compensation, the member must supervise the associated person's participation as if the transaction were executed on behalf of the member.

Through a series of *Notices to Members* issued in the 1990s, FINRA applied these PST obligations to outside IA activities. These *Notices* stated that an associated person's outside IA activities constitute "participation in" PSTs if the person did more than simply recommend the securities transaction. In addition, the *Notices* provide that an associated person's receipt of asset-based or performance-based fees when participating in a PST at an outside IA constitutes "selling compensation," meaning that the member would have supervisory and recordkeeping obligations if it approved the activity.

Proposed Changes (2018)

FINRA by means of *RN 18-08* (February 2018) proposed changes to the current rules and interpretations (the "**2018 Proposal**"). Among other things, the 2018 Proposal would have eliminated members' supervisory and recordkeeping obligations for Outside IA activities. FINRA did not move forward with the 2018 Proposal.

[2] FINRA Rule 3270 (Outside Business Activities of Registered Persons) and FINRA Rule 3280 (Private Securities Transactions of an Associated Person), respectively.

New Proposed Approach (2025)

The Proposal addresses activities that are outside the regular scope of an individual's employment with a member, but narrows the focus to "investment-related activities" to reduce unnecessary burdens.[3] "Investment-related activities" are defined in the Proposal as those "pertaining to financial assets, including securities, crypto assets, commodities, derivatives (such as futures and swaps), currency, banking, real estate or insurance." The term therefore "includes, but is not limited to, acting as or being associated with a broker-dealer; issuer; insurance agent or company; investment company; investment adviser; futures commission merchant; commodity trading advisor; commodity pool operator; municipal advisor; futures sponsor; bank; savings association; or credit union."

Under this approach, the decision by a member firm's registered person to associate him- or herself with an investment advisory firm would mandate that the member firm assess whether the outside activity "will interfere with or otherwise compromise the registered person's responsibilities to the member or the member's customers" and will be "viewed by the member's 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." In addition, a member firm that has a registered person that has applied for and received permission to "participate in an investment-related activity outside the scope of such person's relationship with the member "would be required to keep a record of its compliance with the obligations under this Rule…," including records of the member firm's evaluation of the "advisability of imposing specific conditions or limitations on [the] registered person's outside activity," including "where circumstances warrant" prohibiting the activity.

The Proposal relaxes (technically, removes) a member firm's obligation to supervise and keep records for these investment-related activities where the activities are performed at an advisory firm that is affiliated with the member: "This Rule shall not apply to an associated person's (including a registered person's): (1) non-broker-dealer activity on behalf of a member or its affiliate (e.g., investment advisory activity conducted for a dually registered broker-dealer/investment adviser or investment advisory, insurance or banking activity conducted at an affiliate of the member)." In other words, the full panoply of oversight and recordkeeping duties under the proposed new Rule would not apply only where the outside IA activity is performed for an affiliated firm (or a dual registrant). They apply in full, therefore, where the firms in questions are not affiliated. In simplest terms, then, having one registered person of a member firm join or work with an advisory firm that is otherwise unrelated to the member firm would bring to the member firm an obligation to supervise that person's "investment-related activity" at such unaffiliated firm.

Request for Comment.

While the Proposal leaves an obligation on members firms to supervise non broker-dealer activities of its registered persons at unaffiliated IA firms, FINRA stated that it is "interested in updating the prior feedback it received" and "learning of current experiences and views with respect to Outside IA activity." In the Notice, FINRA requested comment *inter alia* on the following:

- What are the alternative approaches, other than the Proposal, that FINRA should consider?

- What are the challenges members face regarding supervising and recordkeeping outside IA activities for selling compensation? Would the removal of the requirement for FINRA member oversight of outside IA activities by their associated persons impact investor protection considering that IAs are regulated by either the [Securities and Exchange Commission, or "**SEC**"] or the states?

[3] The Proposal intentionally focuses on outside investment-related activities "that may pose a greater risk to the investing public and members."

What are the benefits of BD supervision and recordkeeping of outside IA activities for selling compensation?

We address each of FINRA's requests below.

1. Alternative Approaches.

ADISA believes that, for the reasons stated below, where a registered person of a broker-dealer is working for or is otherwise associated with an unaffiliated investment adviser, the best approach is to impose no duty on the broker-dealer to supervise the activities of the registered person that are not brokerage-related in nature.[4]

Apart from this fully "hands off" approach, however, ADISA submits that FINRA could adopt an approach whereby the member firm' supervision of its registered person is limited to those activities or tasks that bear directly on the person's interactions with the IA's clients. To our thinking, this would mean focusing solely on activities of the person that constitute a recommendation to a client or clients that is clearly and demonstrably attributable to the person acting in their advisory capacity. While the line in question is not as clear and defined a line as that drawn by SEC in Regulation Best Interest and while we recognize that an IA's duty under the federal securities laws "is principles-based and applies to the entire relationship between the adviser and its client,"[5] the SEC has made it clear that the duties placed on IAs are "imposed under the Advisers Act in recognition of the nature of the relationship between an adviser and its client—a relationship of trust and confidence."[6]

We believe that this client-centric language supports an approach that would locate the duty to supervise in the relationship between the registered person acting for the adviser and the adviser's client with regard to recommended or proposed course(s) of actions, and not across the entire spectrum of activities that comprise an IA's business. This focus on the client-directed activities of a registered person employed by or associated with an IA also ensures that there would be no supervision required where the registered person is not in a client-facing role at the IA. While it is somewhat likely that the person will have client-facing duties, there is no assurance that the registered person will in fact be in any kind of client-facing role at the advisory firm. There in fact may be little about the registered person's role at an unaffiliated IA firm that can be (much less should be) overseen by a member firm. The advisory business is different than the brokerage business, and the skill and knowledge needed to supervise registered persons may be very different than those needed to supervise the advisory activities of a person working for an unaffiliated advisory firm.

2. Benefits and Burdens Associated with Supervising Outside IA Activities

In its request for comment, FINRA ask three separate but interrelated questions: In brief, they are: (i) what are the challenges members face regarding supervising and recordkeeping outside IA activities for selling compensation? (ii) would the removal of the requirement for FINRA member oversight of outside IA activities by their associated persons impact investor protection considering that IAs are regulated by either the SEC or the states? and (iii) what are the benefits of BD supervision and recordkeeping of outside IA activities for selling compensation?

(a) Absence of Proven Benefit.

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[4] According to the Proposal, roughly 11 percent of members have one or more registered persons associated with an unaffiliated registered IA.

[5] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (July 12, 2019).

[6] Ibid.

We start with real questions about the efficacy of member supervision of the non-brokerage activities of a registered person of a member firm that are performed for or with an unaffiliated IA. There are real challenges in asking a member firm to supervise the IA (or non-brokerage) activities of a registered person in their role with an unaffiliated IA. Those challenges make it clear, in ADISA's view, that the benefits associated with such supervision are not significant even if potentially attractive, such that their "removal" would not greatly impact investor protection:

- It is not necessarily true that the business of an IA is well understood by a member firm or that the set up and operation of the IA firm will naturally lend itself to supervision by the member firm. IA firms can and typically do operate under very different fee and advice parameters than member firms typically do; they provide advice or recommendations differently, charge differently for their services and typically have large differences in the scope of services provided. While both types of organizations deal with financial instruments in the form of securities, the nature of their interactions with clients is often very different and the goal of each type of firm's relationship with its clients different greatly as well.

- As ADISA has repeatedly said in testimony and comment letters dealing with regulatory issues involving member firms and IA firms, the models are so different that it is worthwhile to ensure that each survives in a robust form so that investors and savers have real options when it comes to how advice and guidance involving securities is obtained and compensated for. Those differences, moreover, include different types of products and services, as well as the pricing and delivery model for each. There is no reason to think that member firm compliance and oversight personnel will have the industry or product knowledge necessary to properly supervise the non-brokerage activities of a registered person taken at an unaffiliated IA firm.

When it comes to what would be lost by ending the requirement, therefore, there is a genuine question as to whether there is any meaningful supervisory benefit achieved under the current approach. Asking the supervisory element of one type of regulated entity – a FINRA member firm – to oversee the conduct of a person who works at another entirely different type of entity – an IA – raises a host of important issues that act as hurdles or bars to effective supervision. The assets that the latter type of firm provides advice and guidance regarding, the way that such advice and guidance is communicated and implemented and the fees charged for such are very different. There is no reason to believe that the familiarity of member firms with the recommendation and purchase of securities by their clients gives them any particular insight into the way in which those activities are conducted in an IA, thereby diminishing any potential benefit associated with the "second set of eyes."

(b) Significant Costs and Inefficiencies

In ADISA's view, there are numerous negatives or "cons" that weigh against maintaining the supervisory and recordkeeping requirements. These go to the question of good regulatory policy, which seeks to avoid where possible redundancy, customer confusion, undue cost and insufficient native expertise. Requiring that a firm that is managing and overseeing a firm with one distinct business model to supervise activities carried out at another firm with a different model (and different products and services, in all likelihood), does not make it likely that the oversight element will contribute meaningfully to the supervisory goal.

- Many member firms faced with the current obligations request all manner of records from the unaffiliated IAs where their registered persons work or are associated with, in many cases generating voluminous amounts of data that are difficult to distill and which may contain confidential, private or proprietary information. Despite these infirmities, requesting

member firms often attempt to utilize this data to supervise their registered persons' non-brokerage activities, thereby heightening privacy and confidentiality concerns.

- Many member firms feel compelled to insert themselves into the business operations of the unaffiliated IA to better understand their registered persons' activities, thus creating cost, redundancy, confusion and delay. There is not necessarily any knowledge or other experience at the member firm with the products used or the models employed, or the pricing charged by the IA firm, thus increasing the likelihood that the supervisory element will either be uninformed or expensive and delaying (or both).

Thus, whether one focuses on the absence of expertise on the member firm's part to supervise the IA's business, or the host of issues associated with having one entity effectively supervise another, unaffiliated one – e.g., cost, redundancy, confusion and privacy concerns – the negatives appear to far outweigh the benefits of the obligations. That is not the hallmark of an effective supervisory requirement.

One final point on the question of the benefits and challenges associated with maintaining the current supervisory requirement for unaffiliated IAs. As discussed in more detail below, many of the comments submitted in response to the 2018 Proposal that were in favor of maintaining the current supervisory standards were based on the notion that IA regulatory oversight was insufficient and that IA resources dedicated to compliance were not adequate. These claims should be heavily discounted, as they were made prior to the SEC's implementation of Regulation BI and, more importantly, the agency's issuance of guidance regarding the "Standard of Conduct for Investment Advisers" under the Investment Advisers Act. These developments, and in particular the SEC's prominent statement on (and enforcement of) how the duties imposed on IA need to be effectuated, have enhanced and will continue to enhance the level and quality of IA compliance. In the final analysis, quality IA oversight and compliance can and will do more than secondary oversight accomplished by member firms in relation to certain of their associated persons.

In regard to FINRA's goal to "learn" from current experiences and views with respect to outside IA activities, it is hard to deny that the drawbacks presented by the current approach when it comes to unaffiliated IAs are substantive and substantial. The supervisory efforts of the member firm add costs and more, without any discernible improvement in oversight (in fact, if an IA were to rely on a member firm for supervisory contributions respecting its registered persons, the quality of supervision might be lessened due to differences in business models, services provided, and products offered. An extra pair of eyes can be useful – but given the differences outlined above, it is hard to believe that the member firm's supervisory efforts will prove more effective than those of IA own compliance resources.

Prior Comments

As stated in the Notice, commenters responding to the 2018 Proposal "had opposing views on whether FINRA members should be responsible for supervising and recordkeeping Outside IA activity, including activity performed at unaffiliated IAs." While noting that "many commenters strongly supported eliminating or substantially modifying the requirements for outside IA activities," FINRA also pointed out that "concerns were [] raised that doing so could pose risks to investors."

ADISA has reviewed the comments noted by FINRA in the Proposal. Even a relatively brief look makes clear that the "cons" of requiring supervision greatly outweigh the "pros," especially when the IA and the member firm are not affiliated. We have set out summaries of the comments below, but note that, in general, most of the "pro" comments go to potential or perceived process benefits (e.g., standardization of the process), while most of the "con" comments go to such core issues as cost, redundancy, knowledge and customer confusion associated with the practice, along with genuine concerns for the privacy of IA client data (There were even comments that suggested that the practice

under the current rules is a revenue producer for member firms, which even if true is not a basis for continuing the practice.).

In sum, inasmuch as FINRA's goal is to "update" prior feedback received, ADISA believes that the points made above show that the "cons" associated with the current approach – cost, duplication of effort, privacy and confusion concerns – are the same ones expressed by many commenters on the 2018 Proposal. They detracted from FINRA's regulatory policy then, and continue to do so now.

A. Comments in Favor of Maintaining FINRA Member Supervision and Recordkeeping for Outside IA Activities

Commenters in favor of maintaining BD oversight of IA activities performed by associated persons away from the FINRA member expressed the following points in support of continuing the practice:

- Standardizing the assessment that members must conduct, upon receiving notice of registered persons' outside activities or associated persons' outside securities transactions, would potentially benefit customers through better investor protection.

- The level of regulatory oversight of IA activities is not as rigorous as oversight of FINRA members' activities. These commenters claimed that the lack of meaningful oversight of IA activities could lead to IA client harm if FINRA members did not oversee some aspects of IA activities performed by associated persons at third-party IAs unaffiliated with a member.

- Many IA firms lack the resources and ability to properly supervise their own IA activities.

B. Comments in Favor of Eliminating FINRA Member Supervision and Recordkeeping for Outside IA Activities

As FINRA noted in the Notice, a majority of commenters favored FINRA's proposal to eliminate the requirement for FINRA member oversight of IA activities performed by associated persons away from FINRA members. Here are the areas and arguments cited by various commenters supporting the elimination of such an oversight requirement (citations omitted):

- Since IAs are regulated by the SEC, FINRA member oversight of outside IA activities is redundant and creates unnecessary compliance costs and burdens. Moreover, IA activities are regulated by the states.

- Member firms may be ill-equipped to supervise outside IA activities as they may not be familiar with the outside IA's services, advice and obligations. As one commenter stated. "IAs often engage in products and strategies that are not supported by the [BD]. Accordingly, to properly supervise such activities, [BDs] need to develop expertise in such products and strategies, which is simply not feasible for small firms, nor would it be a good use of their supervisory resources."

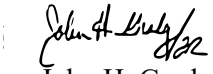
- There are privacy concerns over providing IA client information to a BD that is unaffiliated with the IA. There are risks associated with requiring the BD to handle private, personal information for unaffiliated IA clients."

- Requiring BDs to oversee outside IA activities could lead to customer confusion regarding which entity is responsible for the IA activities.

- BDs may have a business reason for preferring to oversee the outside IA activities of their associated persons. One commenter noted that "an [IA] will be forced to pay an average of 5 percent to 8 percent of its gross advisory fees to a [BD] for oversight…These costs are usually passed on to the client."

ADISA appreciates the opportunity to provide input on this important issue. We would be happy to discuss our concerns further and to continue to assist FINRA in creating appropriate protections for investors.

Sincerely,



John H. Grady
President

cc: Drafting Committee: Deborah S. Froling and Catherine Bowman, Co-Chairs ADISA Legislative & Regulatory Committee; John Grady.