sigma FINANCIAL CORPORATION Member FINRA/SIPC

parkland SECURITIES, LLC Member FINRA/SIPC

May 12, 2025

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

Re: Comments on Regulatory Notice 25-05 and Proposed FINRA Rule 3290

Dear Ms. Mitchell:

Sigma Financial Corporation and Parkland Securities, LLC (collectively, the "Companies" or "we") are registered broker-dealers and FINRA member firms located in Ann Arbor, Michigan.[1] The Companies value FINRA's longstanding self-regulatory compact with member firms,[2] and we appreciate the opportunity to comment on proposed FINRA Rule 3290 as it pertains to the supervision of investment advisory activities.

Overall, the Companies were very supportive of the approach proposed in Regulatory Notice 18-08, which would have eliminated the requirement for members to supervise outside investment advisory activities.[3] Conversely, the Companies are not supportive of the recent about-face in Regulatory Notice 25-05, which would leave in place the general

[1] The Companies' CRD numbers are 14303 and 115368, respectively.

[2] This compact was articulated by one of FINRA's former CEOs. *See* Richard G. Ketchum, Chief Regulatory Officer, NYSE, Keynote Speech at the Practising Law Institute, Nov. 11, 2004 ("if we do not accept the fact that the burden of self-regulation is collaborative with equal responsibility to the industry and those in this hall who advise them, as it is with the SROs, then we have already failed").

The Companies believe FINRA fills an essential role in supervising member firms and protecting investors. To that end, the Companies do not support recent efforts to eliminate FINRA, such as H.R. 2689 introduced by Representative McClain on April 7, 2025, and referred to the House Committee on Financial Services.

[3] "[T]he 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." FINRA Regulatory Notice 18-08, p. 8 (Feb. 26, 2018).

supervision requirements of FINRA Rule 3280, Notice to Members 94-44, and Notice to Members 96-33.[4]

The stated purpose of the Proposal is to "streamline and reduce unnecessary burdens regarding existing requirements addressing the outside activities of member firms' associated persons[.]"[5] Respectfully, the Companies believe that proposed FINRA Rule 3290 will have the opposite effect because the Proposal fails to address or resolve—and leaves in place—significant legal and regulatory ambiguities that have existed for decades. These issues are discussed below in the Companies' responses submitted in connection with the request for comments in Regulatory Notice 25-05.

<u>1. Request for Comment</u>: The Proposal does not alter members' obligations for outside IA activities. What are the challenges members face regarding supervising and recordkeeping outside IA activities for selling compensation?

Members face at least three significant challenges with respect to supervising and recordkeeping outside investment advisory activities, all of which arise from the legal and regulatory ambiguity surrounding key aspects of members' obligations. To borrow a phrase from a relevant law review article, the Proposal has not done anything to clear up the "regulatory muddy waters"[6] that have only become cloudier with time. The following challenges are significant "pain points" for member firms, all of which the Proposal leaves unaddressed in contradiction to the industry's self-regulatory compact.

- <u>*Challenge #1: Privacy Laws*</u>

Members face a significant challenge with respect to privacy laws, including Regulation S-P and the patchwork of privacy laws enacted by states. For example, Regulatory Notice 18-08 observed that the existing framework has led to significant privacy concerns:

> Under Rule 3280 and related guidance, members must supervise and record on the members' books and records the transactions resulting from most outside IA

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4 "The Proposal does not alter members' obligations for outside IA activities." FINRA Regulatory Notice 25-05, p. 15 (Mar. 14, 2025).

NASD Notice to Members 91-32 is also relevant. However, it is mentioned less frequently than NASD Notice to Members 94-44 and NASD Notice to Members 96-33 (e.g., it is not mentioned in the Proposal).

5 FINRA Regulatory Notice 25-05, p. 1.

6 Susan R. Finneran, *Investment Advisory Regulatory Muddy Waters: Registration and Control Issues Are Confused with Issues of Disclosure and Anti-Fraud*, 19 CAMPBELL L. REV. 349, 356 (Spring 1997) (critiquing Notice to Members 94-44 on the basis that "[t]urning the NASD and its member broker-dealers into an investment advisory SRO to supplement SEC oversight (no matter how well-intended) is legislatively questionable").

> activities of their associated persons. 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.[7]

However, unlike with other prior FINRA rules,[8] the Proposal does nothing to alleviate, clarify, or otherwise address these privacy concerns—it merely repeats them in vague terms.

In terms of members obtaining necessary client data from the outside investment adviser, FINRA's original position was that if the client "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 [i.e., outside investment advisory] activity."[9] Such guidance is problematic for at least two reasons.

First, it is outdated in terms of how members supervise outside investment advisory activity, which is typically by means of data feeds and automated surveillance,[10] neither of which practically allow for excluding clients on an individual basis. Moreover, the SEC has suggested in a similar context that automated surveillance tools, rather than manual processes, is the most plausible means of supervising a significant level of trading activity,[11] which will almost certainly be the case for a member supervising the trading activity of a dually-registered representative through an outside investment adviser.

Second, this guidance suggests that client consent is needed (since the consent can be withheld) in order for information-sharing to occur between the outside investment adviser and the supervising member firm. However, it may no longer be the case that client

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7 FINRA Regulatory Notice 18-08, p. 8 (emphasis added).

8 *See, e.g.*, Frequently Asked Questions Regarding FINRA Rules Relating to Financial Exploitation of Senior Investors, Q.5.1 ("[A] member's disclosures to a trusted contact consistent with Rules 2165 and 4512 would be permissible under Regulation S-P"), *available at* https://www.finra.org/rules-guidance/guidance/faqs/frequently-asked-questions-regarding-finra-rules-relating-financial-exploitation-seniors.

9 NASD Notice to Members 96-33, p. 240 (May 1996) (Question #6). Section 40 eventually became FINRA Rule 3280: "While NTMs 91-32, 94-44, and 96-33 refer to NASD art. III, § 40 and NTM 01-79 refers to NASD Rule 3040, both of these rules are predecessors to FINRA Rule 3280. NASD art. III, § 40 was renamed to NASD Rule 3040, and NASD Rule 3040 was wholly adopted, without substantive change, as FINRA Rule 3280." *Milliner v. Mut. Secs., Inc.*, 207 F. Supp. 3d 1060, 1067 n.7 (N.D. Cal. 2016).

10 *See, e.g.*, *In re Cetera Advisor Networks LLC*, FINRA AWC No. 2015046716901, p. 5 (Dec. 15, 2020) ("[Respondent] responded that it expected to establish an electronic connection to obtain electronic reporting information (i.e., a data feed) by the end of September 2015 to capture, monitor, and supervise ORIA transactions.").

11 *See Investment Adviser Code of Ethics*, Advisers Act Release No. 2256, 69 Fed. Reg. 41696, 41700 (July 9, 2004) ("[W]e question seriously whether a larger investment advisory firm will be able adequately to review [access persons' personal securities] reports manually or on paper.").

consent is necessary, although this remains unclear. Notice to Members 96-33 was issued prior to the promulgation of Regulation S-P in response to the Gramm-Leach-Bliley Act of 1999. Among other exceptions, Rule 15 of Regulation S-P permits the sharing of nonpublic personal information in order to comply with federal, state, or local laws, rules, and other applicable legal requirements.[12]

Importantly, the federal courts have concluded that the requirements of Notice to Members 94-44 and Notice to Members 96-33 fall squarely under FINRA Rule 3280:

> [Notice to Members 94-44 and Notice to Members 96-33] are clear that, for purposes of applying FINRA Rule 3280, selling compensation includes asset-based fees. Therefore, if a broker-dealer approves the outside advisory investment activities of its registered individuals who receive asset-based fees, the broker-dealer must properly supervise the activities as its own. . . . Because the NTMs are an SRO's interpretation and clarification of its own rules, the Court must grant the NTMs deference in applying SRO rules. Naturally, here, the Court must give substantial weight to the NTMs interpreting FINRA Rule 3280[.][13]

Because FINRA rules have the force of federal law,[14] this could suggest that client consent is unnecessary and that sharing of nonpublic personal information between an outside investment adviser and supervising member firm is automatically permitted under Rule 15(a)(7)(i) of Regulation S-P in order to comply with FINRA Rule 3280. However, it does not appear that FINRA, the SEC, or the courts have made this clear or resolved this open legal question for members.

The current compliance landscape is clear: Data feeds and automation are the norm for members supervising account and trading activity at an outside investment adviser. However, the Proposal's failure to address the acknowledged "privacy challenges" leaves members caught in a potentially no-win situation.

On the one hand, if a member takes the position that client consent is *not* required for information-sharing, it has entered into legally untested waters that are the focus of all regulators in this age of constant cybersecurity threats. On the other hand, if client consent

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12 17 C.F.R. § 248.15(a)(7)(i). There is also the question of state privacy laws, which are <u>not</u> preempted by Regulation S-P and may involve a stricter opt-in regime. *See, e.g.*, *In re Raymond James & Associates, Inc.*, FINRA AWC No. 2013035599201, p. 3 (Mar. 8, 2016) ("Certain States require affirmative consent, i.e., the customer must opt-in to sharing the customer's nonpublic personal information with the nonaffiliated third parties before the information may be shared.").

13 *Milliner*, 207 F. Supp. 3d at 1068, 1070.

14 FINRA Regulatory Notice 16-25, p. 3 (July 2016) ("FINRA's rules are approved by the Securities and Exchange Commission (SEC), binding on FINRA member firms and associated persons, and have the force of federal law.").

is required, and a client refuses to provide consent or revokes consent,[15] the supervising member is stuck in the awkward and difficult position of trying to exclude that client from an automated data feed while also instructing the associated person of an outside entity (i.e., the investment adviser) that it must turn that client away because it is "precluded from participating" in the advisory services.[16] Such a "my way or the highway" approach is certain to sour any business relationship.

Ultimately, FINRA has yet to make clear—despite two Proposals on the issue—exactly how these and other "privacy challenges" should be resolved or how members can ensure that their business practices are consistent with regulatory expectations. This presents ongoing challenges for members that continue to await clarification or resolution from regulators.

- *Challenge #2: Control Person Status and Liability*

Members face a significant challenge with respect to control person status and liability. Courts analyzing FINRA Rule 3280 (and its predecessors), Notice to Members 94-44, and Notice to Members 96-33 have applied different tests for determining when a member that is supervising investment advisory activities qualifies as a "control person" with respect to those activities and the investment adviser.

In one federal case, *Milliner v. Mutual Securities, Inc.*, the court concluded that a member did not qualify as a control person in the context of the Exchange Act, seemingly as a matter of law, because violations of FINRA rules do not give rise to a private cause of action and therefore "a violation of FINRA rules, by itself, cannot satisfy the first element of control person liability."[17] In *Milliner*, the court also applied a narrow test for control person liability, requiring the plaintiff to prove that the defendant "**exercised actual power or control** over the primary violator."[18]

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15 It is certainly possible that clients could consent to information-sharing in their agreement with the investment adviser. However, such consent also could be revoked by the client, which would present serious logistical and business challenges when the primary way of supervising outside investment advisory activities is through the utilization of automated surveillance tools.

16 NASD Notice to Members 96-33, p. 240 (Question #6).

17 *Milliner*, 207 F. Supp. 3d at 1073 (evaluating control person liability under Exchange Act § 20(a)). Had the court applied the Advisers Act instead, the outcome might have been quite different, as "the U.S. Supreme Court has ruled that there is an *implied private cause of action* for the violation of the federal statute [i.e., the Advisers Act] that regulates SEC-registered investment advisers." DAVID E. ROBBINS, 1 SECURITIES ARBITRATION PROCEDURE MANUAL § 5-31 (2024).

18 *Milliner*, 207 F. Supp. 3d at 1072 (citing *Howard v. Everex Sys., Inc.*, 228 F.3d 1057 (9th Cir. 2000), and distinguishing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990)) (emphasis added).

However, in a similar state case, *Garrison v. SagePoint Financial, Inc.*, the court reversed summary judgment in favor of the defendant broker-dealer on the question of control person status, thereby suggesting that such status is a question of fact under the Washington State Securities Act.[19] More importantly, in *Garrison* the court applied a broader test for control person liability, requiring the plaintiff to prove that the defendant "**possessed the power to control** the specific transaction or activity upon which the primary violation is predicated, but he **need not prove that this later power was exercised**."[20]

In other words, state securities laws follow a different test for control person liability than the Exchange Act. Whereas the actual *exercise* of power or control is necessary for liability under the Exchange Act, the mere *possession* of power or control, even without its exercise, is sufficient for liability under state securities laws, meaning states utilize a far more expansive test than the federal securities laws. This disparity invites forum shopping and makes it impossible to anticipate the outcome of any litigation, as control person status can be a question of law or fact and is subject to different tests depending on the venue.

The consequences of control person status are also far reaching. Certainly, a member could be held liable for failing to supervise the outside investment advisory activities,[21] which raises special challenges given that the member's required standard of supervision is lower than what would be alleged by a plaintiff's attorney, as discussed below.

In addition, the investment adviser itself could be deemed deficient with respect to its own regulatory disclosure obligations. For example, control persons must be disclosed in Item 10 and Schedule D of Form ADV Part 1A. As a result, an investment adviser which fails to realize that the supervising member is a control person[22] will likewise fail to update its Form ADV accordingly, thereby risking a regulatory deficiency for inadequate disclosure.

- *<u>Challenge #3: Unclear Standard of Supervision</u>*

Members face a significant challenge with respect to the proper standard for supervising outside investment advisory activity. As noted above, Notice to Members 96-33

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19 *Garrison v. SagePoint Fin., Inc.*, 345 P.3d 792 (Wash. Ct. App. 2015), *review denied*, 352 P.3d 188 (Wash. 2015) (evaluating negligent supervision and control person liability under the Washington State Securities Act).

20 *Id*. at 810 (citing *Hines v. Data Line Sys., Inc.*, 787 P.2d 8 (Wash. 1990), and further mentioning *Hollinger* in support) (emphasis added).

21 ROBBINS, 1 SECURITIES ARBITRATION PROCEDURE MANUAL § 5-4 (describing a "failure to supervise" case as one "with a good chance of success" for the plaintiff/claimant). Furthermore, "negligent supervision" was one of the claims brought by the plaintiffs in *Garrison* under the Washington State Securities Act and included an argument based on control person status.

22 The Form ADV glossary (Appendix C) defines "control" as "[t]he power, directly or indirectly, to direct the management or policies of a *person*, whether through ownership of securities, by contract, or otherwise." The glossary is available at https://www.sec.gov/files/rules/final/2011/ia-3221-appc.pdf.

calls for ensuring transactional "suitability." With the promulgation of Regulation Best Interest ("Reg BI"), which is a "fiduciary-like" standard,[23] we expect that "suitability" has been replaced by the Care Obligation for retail customers.[24] However, the Proposal does not clarify this issue or even reference Reg BI.

Regardless of the appropriate standard (i.e., suitability or Care Obligation), it will necessarily be *below* the higher fiduciary standard to which outside investment advisers are held under the Advisers Act.[25] This is problematic for at least two reasons.

First, this higher fiduciary standard is very likely to bleed over to the supervising member, despite the fact that Reg BI is not a fiduciary standard and does not allow for a private right of action.[26] For example, an outside party (e.g., a plaintiff's attorney) could naturally expect that a member firm which is required to supervise outside investment advisory activities will ordinarily do so based on the regular standard applicable to those activities, which is the Advisers Act's fiduciary standard. This is even more the case if the member firm is a control person of the investment adviser which, as explained above, is not implausible. However, broker-dealers are not held to the same fiduciary standard as investment advisers, and in fact their supervision can be much less extensive under Reg BI.[27] In the case of litigation, this will leave members in the challenging position of extricating themselves from being held to a broad fiduciary standard which many do not understand is inapplicable to broker-dealers.[28]

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[23] "It is a fiduciary-like standard, elements of which were drawn from the Advisers Act and recent ERISA rulemaking, but the proposal is grounded in concepts and limitations in the Exchange Act." ROBERT E. PLAZE, STANDARDS OF CONDUCT FOR INVESTMENT ADVISERS AND BROKER-DEALERS, p. 4 (Nov. 2018), *available at* https://prfirmpwwwcdn0001.azureedge.net/azstgacctpwwwct0001/uploads/96a378347abb262b879f48399034e8f3.pdf.

[24] 17 C.F.R. § 240.15*l*-1(a)(2)(ii).

[25] In 1963, the U.S. Supreme Court concluded that the Advisers Act reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 191 (1963) (citation omitted).

[26] "Furthermore, we do not believe Regulation Best Interest creates any new private right of action or right of rescission, nor do we intend such a result." *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Release No. 86031, 84 Fed. Reg. 33318, 33327 (July 12, 2019).

[27] For example, whereas account monitoring is expected for investment advisers, the SEC clarified that Reg BI "does not impose a duty to monitor a retail customer's account," and it further warned that in "agreeing to provide any account monitoring services, broker-dealers need to consider whether the monitoring services fit within the broker-dealer exclusion from the Advisers Act." *Id*. at 33340 & n.210.

[28] As the Public Investors Arbitration Bar Association (PIABA) has noted, "The simple truth is that more than three out of four investors don't understand that the current laws and rules impose different duties on brokers and investment advisors, according to a 2010 survey conducted for the Consumer Federation of America (CFA), AARP, the Investment Adviser Association, the Financial Planning Association, the CFP Board, the North American Securities Administrators Association (NASAA), and the National Association of Personal

Second, there is no clear benefit to requiring members to supervise outside investment advisory activities according to a fiduciary-like standard when the investment adviser itself is required to supervise these same activities according to a higher fiduciary standard. In other words, supervising activities at a lower standard, when those same activities are already supervised according to a higher standard, is needlessly duplicative and unlikely to yield additional benefits, as further explained below.

- *Challenge #4: Increased Litigation Exposure through FINRA's Arbitration Forum*

Finally, members face a significant challenge with respect to litigation involving the clients of outside investment advisers. Consider a dual-registered representative who is approved by his broker-dealer to own and operate an outside registered investment adviser. Under FINRA Rule 3280, the member firm is required to supervise the representative's trading activities conducted through this outside investment adviser, even with respect to clients who are *solely* clients of the investment adviser ("Outside Clients") and have no direct relationship whatsoever with the member firm (e.g., no accounts, no transactions, no receipt of brokerage services, etc.). Due to the expansive language of FINRA's rules, such Outside Clients have in the past sought to compel both the dual-registered representative and the member firm to FINRA arbitration against their will, even though all Outside Client account activity takes place through an investment adviser that is not a FINRA member.

FINRA Rule 12200 states that parties *must* arbitrate a dispute under the Code of Arbitration Procedure for Customer Disputes (the "Code") if (1) requested by the customer, (2) the "dispute is between a customer and a member or associated person of a member," and (3) the "dispute arises in connection with the business activities of the member or the associated person."[29] Therefore, an Outside Client bringing a "failure to supervise" claim against the member firm under FINRA Rule 3280 on the basis of control person liability, or against the dual-registered representative operating the outside investment adviser, could potentially satisfy the requirements for compelling arbitration under FINRA Rule 12200.

This outcome is due to the possibility that Outside Clients will qualify as customers for purposes of the Code, despite their lack of direct relationship with the member. Specifically, a "customer" is defined expansively in FINRA Rule 12100(k) as follows: "A

Financial Advisors." PIABA, REPORT: DEBUNKING THE TOP 5 BROKERAGE INDUSTRY MYTHS ABOUT FIDUCIARY DUTY (June 25, 2015), *available at* https://piaba.org/report-debunking-top-5-brokerage-industry-myths-about-fiduciary-duty-june-25-2015/.

There are certainly specific and narrow contexts in which broker-dealers are held to a fiduciary standard (e.g., best execution). However, the point is that broker-dealers are not held to a general fiduciary standard in the same way that investment advisers are, a fact which is clearly indicated by Section 913(g) of the Dodd-Frank Act: "Section 913(g) expressly authorizes the Commission to adopt rules that would hold broker-dealers to the same standard of conduct as investment advisers." *Regulation Best Interest*, 84 Fed. Reg. at 33330.

[29] FINRA Rule 12200 contains an exception for "disputes involving the insurance business activities of a member that is also an insurance company." There is no similar exception for investment advisers.

customer shall not include a broker or dealer."[30] As the federal courts have explained, to qualify as a customer under this definition one need not transact directly with the FINRA member itself. Instead, it is sufficient to "merely transact with one of the FINRA member's many non-clerical, non-ministerial employees—finance professionals, investment advisers, and anyone else in the member's substantive employ . . . . Rule 12200 entitle[s] a customer to arbitrate against a FINRA member simply because he purchased [a] good or service from [that member's] associated person acting on behalf of his or her own independent company[.]"[31]

It is not mere speculation that Outside Clients of an outside investment adviser which is owned and operated by a dual-registered representative can be found to qualify as customers for purposes of FINRA Rule 12200. In fact, this was the exact result in a recent case, *Purshe Kaplan Sterling Invs., Inc. v. Thomsen*, decided in 2024 by a federal district court:

> Jeff and Carol Thomsen recently initiated FINRA Dispute Resolution Services . . . alleging claims . . . against [member firm] Purshe Kaplan Sterling Investments ("PKS"). . . . The Thomsens have no direct relationship with PKS. . . . The Thomsens' only relationship with PKS is through their relationship with Adam Nugent ("Mr. Nugent"), a former representative of PKS. . . . Mr. Nugent never opened a PKS account on behalf of any of his clients. Mr. Nugent never sold securities or otherwise transacted any business with or through PKS during his time as PKS's registered representative. It is undisputed that Mr. Nugent's only reason for registering with PKS was to become eligible to collect trail commissions on his past sales.
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> As a result of Mr. Nugent's registration as PKS's representative, PKS was required to "exercise appropriate supervision" over Mr. Nugent's activities "in order to prevent violations of the securities laws." . . . To comply with this obligation, PKS began recording copies of all of Mr. Nugent's emails, including those regarding his activities as the Thomsens' investment advisor. . . . At all relevant times, Mr. Nugent operated his own registered advisory firm, Foresight Wealth Management, LLC . . . .

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30 The same definition is used in FINRA Rule 0160(b)(4) and FINRA Rule 13100(k).

31 *Oppenheimer & Co., Inc. v. Mitchell*, No. 24-2379, 2025 U.S. App. LEXIS 9784, at *15–16 (9th Cir. Apr. 24, 2025) (internal quotation marks omitted). *See also Multi-Financial Secs., Corp. v. King*, 386 F.3d 1364, 1369 (11th Cir. 2004) ("the term 'customer' refers to either a member's or an associated person's customer, affording customers of an associated person a right to compel arbitration against a member"); *John Hancock Life Ins. Co. v. Wilson*, 254 F.3d 48, 59 (2d Cir. 2001) ("No federal appellate court has prohibited the customer of an associated person, asserting a claim arising out of the associated person's business, from compelling a member to arbitrate under Rule [12200]"); *Purshe Kaplan Sterling Invs., Inc. v. Thomsen*, No. 2:24-cv-00002-JNP, 2024 U.S. Dist. LEXIS 55305, at *11 (D. Utah Mar. 26, 2024) ("nothing in the FINRA Rules requires (or even suggests) that a 'customer' must have a direct relationship with a FINRA member"); *WMA Secs., Inc. v. Ruppert*, 80 F. Supp. 2d 786, 789 (S.D. Ohio 1999) ("By conducting business with Plaintiff's registered representatives, Defendants conducted business with Plaintiff and became its customers."); 1 THOMAS H. OEHMKE, COMMERCIAL ARBITRATION § 28:14 (2003) ("A dispute that arises from a securities brokerage firm's lack of supervision over its brokers arises in connection with its business (for purposes of NASD rules compelling arbitration of disputes).").

> [T]he court concludes and finds that 1) the Thomsens are "customers" under FINRA Rule 12200; 2) the dispute is between a customer and a FINRA member or its associated person; and 3) the dispute arises in connection with the business activities of the member or the associated person. . . . PKS asserts that the primary factor that precludes arbitration of the Thomsens' claims is that the Thomsens lacked any direct relationship with PKS. The court finds that PKS is mistaken, its position being contrary to the plain language of FINRA Rule 12200 . . . . Mr. Nugent's alleged misrepresentation does not alter the fact that the Thomsens' allegations of negligent representation and other claims arose in connection with Mr. Nugent's business activities as the Thomsens' investment advisor or PKS's business activities, which include supervising the firm's associated persons.[32]

Such an outcome is problematic for at least two reasons. First, it exposes the member firm to unknown risk from outside litigation. For example, in the case quoted above, PKS was sued by the Thomsens no doubt because of PKS's "deep pockets," as Mr. Nugent and the investment adviser he owned and operated were fined by the SEC for their activities related to the offering of a private fund that primarily invested in two cannabis-related holding companies.[33] Importantly, PKS was not negligent and repeatedly informed Mr. Nugent that he was not permitted to engage in such activity:

> Mr. Nugent emailed PKS's compliance team to request to discuss "a REG D we are looking to do through our RIA." . . . PKS's Compliance Officer responded to Mr. Nugent, informing him that he was "not permitted to do a Reg D private placement . . . unless it is sold through and would be custodied at your normal RIA Custodian[,]" which was TD Ameritrade. "Otherwise[,]" the email continued, "this would constitute selling away from PKS and would not be permitted." Following this email exchange, PKS's compliance team contacted Mr. Nugent on three separate occasions to request additional information about any potential Reg D private placement and other facts relevant to PKS's compliance obligations. Mr. Nugent failed to provide the requested information.[34]

Here, PKS did exactly what it was supposed to do and warned Mr. Nugent that his proposed activities were not permitted. Nevertheless, PKS was still able to be sued by Mr. Nugent's defrauded investors (i.e., the Thomsens), which suggests that a member faces the real possibility of being compelled to FINRA arbitration for virtually *anything* that might occur or go wrong involving the outside investment adviser, no matter how attenuated and regardless of the reasonable steps taken by the member to prevent the harm in question.

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32 *Purshe Kaplan Sterling Invs.,* 2024 U.S. Dist. LEXIS 55305, at *1–5, 9–11, 29.

33 *In re Foresight Wealth Management, LLC*, Admin. Proc. File No. 3-21312, Advisers Act Release No. 6250 (Feb. 27, 2023).

34 *Purshe Kaplan Sterling Invs.,* 2024 U.S. Dist. LEXIS 55305, at *4–5 (internal citations omitted).

Second, such an outcome is problematic because there are times when a member would prefer *not* to be compelled to arbitration under FINRA Rule 12200. For example, plaintiffs' attorneys routinely favor FINRA arbitration for older or stale claims that would otherwise be dismissed by a court on statute of limitations grounds, as the six-year eligibility requirement of FINRA Rule 12206(a) is not regularly enforced and has been subject to inconsistent rulings.[35] In addition, FINRA arbitrators are not required to follow legal precedent[36] or rules of evidence,[37] as FINRA's forum is equitable in nature.[38] In terms of legal strategy, plaintiffs' attorneys happily utilize these features to their clients' advantage.

For a member firm to prefer disputes with Outside Clients—who are essentially strangers to the member firm—to be decided by a court that will follow legal precedent and honor statutes of limitations seems quite reasonable. However, this desirable outcome is entirely frustrated and foreclosed by the broad language of the Code, thereby leaving members in the difficult position of potentially being *compelled*, both against their wishes and at a strategic disadvantage, to litigate stale claims of Outside Clients on equitable grounds and without the benefit of legal precedent, rules of evidence, or robust discovery.[39]

2. Request for Comment: 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?

No, the removal of this requirement would *not* meaningfully impact investor protection. The Companies respectfully insist that a contrary conclusion is incorrect for at least two reasons.

- *Reason #1: NSMIA*. The Companies believe this prompt should be conjunctive in nature, not disjunctive, meaning "or" should read "and." Specifically, the National Securities Markets Improvement Act of 1996 ("NSMIA") left in place the ability of

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35 DAVID E. ROBBINS, 1 SECURITIES ARBITRATION PROCEDURE MANUAL § 5-10 (2024) (FINRA's "failure to make clear whether its eligibility rule is akin to a statue of repose or a statue of limitation has resulted in many motions and inconsistent rulings").

36 SEC Office of Investor Education and Advocacy, *Broker-Dealer/Customer Arbitration: Investor Bulletin* (June 14, 2022) ("Arbitrators are not required to follow state or federal rules of evidence and are not bound by legal precedent."), *available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/broker-dealercustomer-arbitration-investor-bulletin.

37 FINRA Rule 12604(a).

38 FINRA Dispute Resolution Services Arbitrator's Guide, p. 9 (Mar. 2025) ("Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.").

39 *See, e.g.*, FINRA Rule 12510 ("Depositions are strongly discouraged in arbitration.").

states securities regulators to investigate and bring enforcement actions against investment advisers with respect to fraud or deceit.[40] Consequently, investment advisers are already subject to *dual* oversight by both the SEC and state securities regulators. Concluding that this is not sufficient to protect investors, and that for-profit broker-dealers need to remain involved in the oversight process,[41] defies common sense. Not only does it impose a third layer of external oversight[42] on one set of advisory activities, but it also necessarily implies that two groups of independent and full-time government regulators are not up to the task on their own. Moreover, past concerns about the limitations of the SEC and state regulators are not shared by members of the current Commission.[43]

- *Reason #2: Duplicative Effort*. The policy rationale articulated in Notice to Members 96-33 is that of ensuring transactional suitability:

> 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. . . . [T]he 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**

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40 NSMIA § 303, codified at 15 U.S.C. § 80b-3a(b)(2) (Advisers Act § 203A).

41 One suspects that some member firms may be in favor of the status quo not due to investor protection concerns alone, but also due to the supervisory fees they collect from their financial professionals who operate outside investment advisers. *See, e.g.*, *In re Cetera Advisors Network*, at p. 3 ("The [Respondents] charged and collected fees from their [dually-registered representatives] for such supervision.").

42 As the law currently stands, there is actually a fourth layer of oversight with respect to qualified accounts under the definition of "investment advice fiduciary" promulgated by the Employee Benefits Security Administration under Section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974. *See Retirement Security Rule: Definition of an Investment Advice Fiduciary*, 89 Fed. Reg. 32122 (Apr. 25, 2024).

43 For example, the Proposal remarks that "one commenter asserted that 'the SEC has made clear that it is ill-equipped to routinely examine the many investment advisers it regulates. Similarly, due to limitations on many State regulatory resources and budgets, States also substantially lack sufficient resources to examine State-registered investment advisers with any reasonable regularity, if at all.'" FINRA Regulatory Notice 25-05, p. 13.

However, the views expressed by Commissioner Uyeda at a recent NASAA conference, during which he recommended shifting more investment adviser oversight to state securities regulators, suggests that the Commission is *confident* in states' ability to oversee investment advisers: "In my view, it is time to re-examine the mid-size adviser regulatory split and consider whether it should be adjusted. Doing so could help to ensure Congress's intent that the SEC focus on the larger, more complex investment advisers while the states concentrate their resources on the smaller firms." Mark T. Uyeda, Acting Chair, U.S. Securities and Exchange Commission, Remarks to the Annual Conference on Federal and State Securities Cooperation, April 8, 2025, *available at* https://www.sec.gov/newsroom/speeches-statements/uyeda-nasaa-040825.

by an RR/IA, the scope of the RR/IA's authority, and the suitability of the transactions.[44]

Continuing to impose this supervisory requirement on members no longer makes sense after 2003. For more than two decades, SEC-registered investment advisers have been required under Rule 206(4)-7 to designate a chief compliance officer ("CCO") responsible for administering the policies and procedures adopted by the investment adviser, which must be reasonably designed to prevent violation of the Advisers Act and SEC rules.[45]

Supervising the suitability of client transactions and the trading activity in client accounts is a critical component of every investment adviser's compliance program, as it is essential for ensuring that, among other things, the fiduciary duty of care is being satisfied. The investment adviser's CCO will necessarily be responsible for administering the policies and procedures related to this compliance program.

In other words, the concern raised by FINRA—"the suitability of [client] transactions" within the context of the scope of authority granted by the client—is already subject to the investment adviser's own supervision and oversight. Consequently, requiring an unaffiliated broker-dealer to significantly supervise[46] the same transactions, based on lower suitability (or Care Obligation) considerations, is entirely duplicative in nature as well as unnecessary because investment advisers are required to implement robust and comprehensive compliance programs aligned with fiduciary responsibilities.[47]

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[44] NASD Notice to Members 96-33, pp. 237–38 (emphasis added).

[45] 17 C.F.R. § 206(4)-7; *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2204, 68 Fed. Reg. 74714 (Dec. 24, 2003).

Most state securities regulations impose similar requirements. Form ADV Part 1B, Item 2A requires a state-registered investment adviser to indicate the person responsible for supervision and compliance of the investment adviser. Such a person is effectively acting in a capacity similar or equal to that of the CCO of an SEC-registered investment adviser.

[46] As a former Deputy Securities Commissioner of Texas once explained, the supervision must be "significant" in nature. *See* Ronak V. Patel and Courtney Bowling, *Securities Litigation and Enforcement: Broker-Dealer Supervision: Evolving Business Practices and Regulatory Enforcement*, 59 THE ADVOCATE 50, 54 (Summer 2012) ("In essence, if a broker-dealer's representative is involved in executing transactions for clients of a third-party investment adviser, the brokerage must significantly supervise the representative's investment advisory activities.").

[47] *See, e.g.*, SEC Office of Compliance Inspections and Examinations, *Risk Alert: OCIE Observations: Investment Adviser Compliance Programs* (Nov. 19, 2020); CLIFFORD E. KIRSCH, INVESTMENT ADVISER REGULATION: A STEP-BY-STEP GUIDE TO COMPLIANCE AND THE LAW, chap. 22 (3d ed. 2025).

<u>3. Request for Comment</u>: What are the benefits of BD supervision and recordkeeping of outside IA activities for selling compensation?

The Companies believe that there is little to no benefit derived from such supervision and recordkeeping. As FINRA previously noted, the current approach of member supervision required by Notice to Members 94-44 and Notice to Members 96-33 is deserving of modification, and there remains two levels of regulatory oversight with respect to investment advisory 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 . . . [a]ny 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. . . . [T]hese IA activities **would continue to be subject to regulatory oversight by the SEC and states under a different regulatory scheme**.[48]

Simply put, an investment adviser's own CCO and compliance staff, along with SEC staff and the staff of state securities regulators, are better resourced, equipped, and positioned to supervise such investment advisory activity. These three layers of oversight—two external and one internal—are entirely sufficient and appropriate for effective supervision. Adding a fourth layer of oversight from an unaffiliated broker-dealer with no enforcement authority and no genuine insight into the investment adviser's operations yields no meaningful additional benefits and adds little to the mix except duplicative effort.

<u>Conclusion</u>

FINRA may be unable to clear up these "regulatory muddy waters" on its own, while keeping existing Rule 3280 requirements in place as indicated in the Proposal,[49] due to the current state of securities laws and federal regulations. However, FINRA retains the power to clear these waters on its own simply by following its prior approach articulated in Regulatory Notice 18-08. Given the stated intent of the Proposal, and for the reasons explained herein, we invite FINRA to do so and eliminate the unnecessary obligation on members to supervise the activities of outside investment advisers.

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[48] FINRA Regulatory Notice 18-08, p. 8 (emphasis added).

[49] "The Proposal does not alter members' obligations for outside IA activities." FINRA Regulatory Notice 25-05, p. 15.

Ultimately, however, we respectfully remind FINRA of the importance of the self-regulatory compact and the responsibility that FINRA has to provide members with clear guidance. To that end, we implore FINRA not to leave the regulatory waters muddy by refusing to weigh in once more on these regulatory challenges.

Sincerely,

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