PUBLIC INVESTORS ADVOCATE BAR ASSOCIATION

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Via Email Only: *pubcom@finra.org*

Ms. Jennifer Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, N.W.
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 25-05 – Proposed New Rule Governing Outside Business Activities and Private Securities Transactions

Dear Ms. Mitchell:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitration and litigation. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by the Financial Industry Regulatory Authority (hereinafter "FINRA") related to investor protection.

FINRA Regulatory Notice 25-05 seeks comments concerning reforms to FINRA Rules 3270 and 3280. While FINRA has proposed retaining most aspects of the supervisory requirements in these rules, there are several exceptions and modifications which PIABA believes increases risk for the investing public. FINRA proposes to exempt member firms from supervising:

- Investment related activities at member affiliates including IAs, banks, and insurance companies;
- Non-investment related work and outside business activities; and
- Personal investments in non-securities;

PIABA's position is that FINRA's proposed rule changes would result in member firms implementing supervisory procedures that would be deemed unreasonable under the Exchange Act, subject members to substantial reputational and litigation risk, and increase investor harm and exploitation by representatives who would exploit the rules. Further, PIABA believes that the proposed rule change would not result in meaningful differences in supervisory practices while potentially increasing confusion. Consequently, PIABA strongly disfavors the implementation of this rule.

FINRA's supervisory rules concerning outside business activities ("OBAs") and private securities transactions (a/k/a "selling away") have serious consequences for investors and members alike. Despite the existing rules, selling away remains a top concern. Each year FINRA brokers engage in dozens of fraudulent schemes costing investors their irreplaceable life savings.[1] For over 30 years the NASD and now FINRA have emphasized that private securities transactions "presents serious, regulatory concerns." Notice To Members ("NTM") 85-84. The SEC has stated that:

> [FINRA] Conduct Rule 3040 [prohibiting "selling away"] is designed not only to protect investors from unsupervised sales, but also to protect securities firms from liability and loss resulting from such sales. Such misconduct deprives investors of a firm's oversight, due diligence, and supervision, protections investors have a right to expect.

In re Siegel, 2008 SEC LEXIS 2459 at *36 (Oct. 2, 2008), *aff'd Siegel v. SEC,* 592 F.3d 147, 156 (D.C. Cir. 2010) (citation omitted).

Selling away is the practice of a registered representative who has a license to legally sell securities to engage in the unlicensed sale of securities. Those who do so act as brokers within the meaning of Section 3(a)(4) of the Exchange Act [15 U.S.C. §78c(4)] and are not registered with the SEC in accordance with Section 15(b) of the Exchange Act [15 U.S.C. § 78o(b)]. Firms that fail to supervise their registered representatives to reasonably detect and prevent such activities run the risk of being sanctioned by the SEC because firms are responsible for preventing their registered representatives from violating the securities laws.

Exchange Act Section 15(b)(4)(E) provides that the SEC can sanction or revoke the registration of any member firm "if it finds… that such broker or dealer… has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, ***or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes*****,** ***rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision."*** 15 U.S.C. § 78o(b)(4)(E) (emphasis added).

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[1] For the past 15 years the sales of unregistered securities by unlicensed salesman have been noted as one of the top violations that The North American Securities Administrators Association ("NASAA") reports each year. *See* NASAA 2024 Enforcement Report (available at: https://www.nasaa.org/wp-content/uploads/2024/10/FINAL_2024-Enforcement-Report.pdf) ("The top three violations charged were the offer or sale of securities/investment advice by unlicensed parties (394 actions), the offer or sale of unregistered securities (386 actions)..."); 'Selling away' again a concern for regulators, InvestmentNews, (Oct. 14, 2011) (available at: https://www.investmentnews.com/broker-dealers/selling-away-again-a-concern-for-regulators/39244#:~:text=Stockbrokers%20who%20sell%20products%20that,concern%20for%20state%20securities%20regulators) (NASAA reported that in 2011 there were 54 enforcement actions involving selling away.)

The Exchange Act was written with the understanding that those who commit securities fraud might abuse their securities registration and association with licensed firms to perpetrate fraud. The Exchange Act requires broker-dealers to supervise all of a representative's investment activities, no matter how the activity is executed, providing a prophylactic approach to supervision designed to prevent violations of the securities laws. Registration by a representative under the Investment Advisor Act or any other securities act in no way lessens a broker-dealers responsibility to reasonably supervise the activity of the representative to prevent violations of the securities laws. [2] In sum, The Exchange Act has no provision allowing for the delegation of supervision to another securities statute.

FINRA and the SEC have both reinforced members' need to comply with the requirements of the Exchange Act. *See* Staff Legal Bulletin No. 17: Remote Office Supervision, SEC Rel. No. SLB-3A(CF), 2004 WL 5698359 (Mar. 19, 2004) ("Sections 15(b)(4)(E)1 and 15(b)(6)(A) 2 of the Securities Exchange Act of 1934 (Exchange Act) authorize the Commission to impose sanctions on a firm or any person that fails to reasonably supervise a person subject to their supervision that commits a violation of the federal securities laws."). In a joint notice FINRA and the SEC stated:

> The responsibility of broker-dealers to supervise their associated persons is a critical component of the federal regulatory scheme. Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act authorize the Commission to impose sanctions on a firm or any person that fails to reasonably supervise someone that is subject to the supervision of such firm or person who violates the federal securities laws. In order to defend such a charge, a broker-dealer could show that it has established procedures that would reasonably be expected to prevent and detect a violation by such other person, and has a system for applying such procedures that has been effectively implemented. Such a system must be designed in such a way that it could reasonably be expected to prevent and detect, insofar as practicable, securities law violations.

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[2] FINRA also incorrectly states in its Proposal that the "current rules and the Proposal impose a regulatory burden for members that is not matched by equivalent requirements in the IA industry." Pg. 10. This is not true as the duty is exactly the same on the IA side. IA's have the same duty to reasonably supervise their representatives to prevent them from violating the Exchange Act and other securities statutes. *See* 15 U.S. Code § 80b-3(e)(6) SEC may sanction any IA that "has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933 [15 U.S.C. 77a et seq.], the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.], subchapter I of this chapter, this subchapter, the Commodity Exchange Act [7 U.S.C. 1 et seq.], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision."

National Examination Risk Alert: By the Office of Compliance Inspections and Examinations in cooperation with the Financial Industry Regulatory Authority, Vol. 1, Iss. 2, pg. 4 (Nov. 30, 2011). Both Staff Legal Bulletin No. 17 and National Examination Risk Alert focused on the need to supervise OBAs and selling away activity to prevent violations of the Exchange Act.

I. Associated Person's Non-BD Activity On Behalf of a Member Or its Affiliate

FINRA's proposal excludes from a Member's supervisory responsibility an associated person's non-BD activity conducted on behalf of a member or its affiliate. FINRA provides examples as being IA activity at a dually registered firm and insurance or banking activity conducted at an affiliate. FINRA states that the justification for the exclusion for activity conducted at an affiliate recognizes members' ability to implement meaningful controls across business lines.

PIABA's position is that FINRA firms must supervise the activities of their registered representatives' investment related activities no matter where such activities occur in order to comply with the Exchange Act's requirements. The Exchange Act provides no exemption for reasonable supervision based on the fact that the investment activity takes place through an affiliate of a broker-dealer. As such, FINRA's proposal would leave firms potentially vulnerable to failure to supervise claims by the SEC and other regulators.

Further, FINRA's statements are inconsistent. On the one hand, FINRA claims that members implement meaningful controls across business lines. On the other hand, FINRA claims that activity performed on behalf of a dually registered firm is not considered activity performed away from the member as if there is no corporate distinction between a broker-dealer and an investment advisor if they are affiliates. Any activity performed away from a FINRA member cannot be the member's activity and must be supervised as if it was conduct through the member.

Finally, FINRA does not even identify any regulatory burden that it is alleviating through its proposed rule change. As noted, the "vast majority of member affiliates are under common control; thus, these affiliates may share compliance resources and systems." Proposal, pg. 10. Those compliance resources would include common compliance officers, supervisors, unified books and records, email systems, examination cycles, clearing firms, etc. Accordingly, the Proposal not only fails to protect member firms against failure to supervise claims, but is a solution in search of a problem that does not exist.

II. Non-Investment Related Work and Outside Business Activities

FINRA's Proposal's limits the scope of OBAs to those that are investment related and excludes the need to report non-investment related OBAs. FINRA claims that non-investment related activities are common and varied and that removing reporting requirements for such activities would relieve both registered persons and members from costs associated reporting and review of these activities. FINRA concludes that "there is likely little risk that noninvestment-related activities could be perceived by the investing public as part of the member's business." Pg. 9.

PIABA's position is that FINRA firms must supervise the OBAs of their registered representatives' in order to detect and prevent violations of the securities laws in compliance with the Exchange Act's requirements.

The SEC has stated that all OBAs should be assessed for potential risks.

> a firm should be alert to and investigate "red flags" indicating possible undisclosed outside business activities and assess all outside business activities by a representative, whether or not related to the securities business. The Commission has recognized that there is a risk that representatives will use outside business activities to carry out or conceal securities law violations.

Staff Legal Bulletin No. 17.

In the National Examination Risk Alert, FINRA and the SEC stated that OBAs should be inspected during branch examinations to confirm "that the scope of outside business activities of registered branch office personnel conform to those activities authorized by the firm[,] is an important component of the branch office inspection, and addresses a risk that may be more difficult to monitor." pg. 3.

PIABA members' experience has been that registered representatives use a variety of OBA businesses to solicit investors for financing. Such schemes include all manner of businesses including real estate, restaurants, health care related facilities, equipment, or medications, leasing or equipment companies, film companies, software related companies, and other private equity ventures. Arguably none of the foregoing types of businesses that result in common selling away activity and investor harm would be classified as investment-related activity under the Proposed FINRA Rule 3290(f)(2).

In addition, FINRA's Proposal appears to place the registered representative in charge of determining what an "investment-related activity outside the scope of such person's relationship with the member that is not in connection with a securities transaction" is. An outside investment-related activity that is not a securities transaction has not been previously defined by any regulator or securities statute. Due to the confusing nature of the Proposal's application most firms are likely to continue to document all OBAs and require their registered representatives to bring all OBAs to the firm's attention for review. It is likely firms would continue to make determinations as to whether or not the disclosed OBA would have to be reported on the representatives Form U4 or be internally classified and monitored as an outside non-investment related activity.

Proposed Rule 3290(a) also requires firms to monitor for a "material change to the outside activity" that would render the activity either an outside investment-related activity that is not a securities transaction or an outside investment-related activity that is a securities transaction (a/k/a private securities transaction). Firms would have to have documentation of even non-investment related activity in order to keep track of disclosed activity that may be subject to the rule's material change provision.

FINRA's proposed changes to disclosures of OBAs does little to either protect investors or provide firms and registered representatives with clarity while failing to provide any meaningful supervisory relief. Moreover, FINRA does not identify any significant regulatory burden on registered representatives and firms to disclose activities such as refereeing sports games or being an Uber driver.

III. PIABA's Comments on Dually Registered Representatives with Unaffiliated RIAs

As PIABA noted with respect to FINRA Regulatory Notice 18-08 a rule change with respect to dually registered unaffiliated IAs would result in member firms implementing supervisory procedures that would be deemed unreasonable under the Exchange Act, subject members to substantial reputational and litigation risk, and increase investor harm and exploitation by representatives who would exploit the rules. PIABA continues to strongly disfavor the implementation of rules that expose members and public to harm and regulatory sanctions.

Registration by a representative under the Investment Advisor Act or any other securities act in no way lessens a broker-dealers responsibility to reasonably supervise the activity of the representative to prevent violations of the securities laws under Sections 15(b)(4)(E) and 15(b)(6)(A) of the Exchange Act. Neither the current Proposal nor NTM 18-08 addressed how such rule proposals would change member's supervisory responsibilities under Exchange Act's explicit supervisory requirements.

The current FINRA Rules 3270 and 3280 and NTMs 91-32, 94-44, and 96-33[3] are designed to reasonably achieve compliance with a member's supervisory obligations under the Exchange Act. Repealing existing guidance and rules will endanger member firms and remove guidance essential for firms to understand their supervisory obligations under Federal law. No FINRA study or notice has provided evidence or justification that outside businesses or activities engaged in by dually registered representatives no longer pose a risk that such activities would not be used to conceal securities laws violations. Failing to supervise disclosed investment activities or those discovered by "red flags" would subject member firms to charges of failing to supervise and increase the likelihood of investor harm.

It has been the experience of PIABA members that registered representatives establish solo or small IA firms and use OBAs in order to avoid member supervision to the harm of investors. Below are just some examples of investors losing hundreds of millions in investment frauds perpetrated by registered representatives through third-party IAs established by the registered representative:

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[3] NASD NTM 91–32 (the NASD states that Rule 3040 "should apply to all investment advisory activities" and "to conclude otherwise would permit registered persons to participate in securities transactions outside the scope of the oversight and supervision of the employer member and of a self-regulatory organization to the potential detriment of customers."

Registered Representative	Securities Violation Details
Patrick Churchville (CRD#: 2245842)	FINRA panel found that Churchville's member firm failed to supervise Churchville's private equity fraud conducted through his IA. The award was later confirmed in court. Churchville's fraud caused $27 million in losses to more than 220 victims and was subject to an SEC action and criminal charges.
Adam Nugent (CRD#: 4549399)	SEC found that advisor Adam E. Nugent defrauded clients to invest in Agronomic Capital, LP. In addition, to Agronomic, Mr. Nugent also engaged in other PSTs including the Auto Loan Fund LLC, Union Commercial Service Group, Candera Capital LLC, Mountain Bike, and in one instance a personal loan to finance Mr. Nugent's business endeavors. Mr. Nugent was dually registered as an IA through Foresight Wealth Management ("FWM") while also being registered as a broker. Investors brought a claim against the broker-dealer alleging over $13 million in investor losses.
In re Purshe Kaplan Sterling Investments, Inc., Docket No. E-2021-0014 (Mass. Jan. 4, 2024	From September 2016 through 2024 the State of Massachusetts found that PKS failed to have in place written policies and procedures to review the investment advisory transactions of its dually registered advisors ("DRAs") in 2017 and 2018 for transactions that occurred in accounts managed solely by unaffiliated registered investment advisers. The unaffiliated RIA engaged in leveraged ETF transactions that were not supervised and PKS never flagged any of the transactions for review.
Brendan Shaw (CRD#: 4721215)	PKS paid a $1.6 million settlement with 50 clients for failing to supervise Brendan Shaw. Mr. Shaw defrauded the Claimants by trading their accounts through his RIA firm, Thomsen Financial Advisors LLC ("TFA"). Mr. Shaw and his business partner engaged in reckless options trading that caused his clients tremendous losses.
Dean Mustaphalli (CRD#: 2792038)	Some victims have alleged that Mustaphalli's member firm failed to supervise a hedge fund operated through his IA. Mustaphalli's fraud caused $10 million in losses to 58 victims and was subject of an action by the New York Attorney General's office.
Cory Burnell (CRD#: 3260340)	Some victims have alleged that Burnell's member firm failed to supervise extraordinarily risky leveraged ETF trades conducted through Burnell's IA. Burnell's fraud caused about 30 investors more than $2 million.
Tamara Steele (CRD#: 3227494)	Some victims have alleged that Steele's member firm failed to supervise private placement sales conducted through Steele's IA. Steele's sales caused approximately 100 investors more than $7.5 million in losses
Vetea Ribet (CRD#: 4823379)	Mr. Ribet was an IA through Westside Investment Management's ("WIM"). Mr. Ribet recommended that an investor engage in a speculative options investment strategy involving a bear call spread that caused over $2 million in losses. Correspondence showed that Mr. Ribet represented the speculative strategy to as conservative.

In addition, FINRA and members that advocate for this rule change fail to provide a realistic vision of how such a rule could be realistically implemented. FINRA members would still be required to supervise emails, gather information about IA OBAs, and inspect branch locations for 'red flags' for violations of the securities laws. A firm with red flags of Ponzi scheme activities or other fraud would not be able to turn a blind eye and continue to employ that individual just because the broker-dealer believed the activity was only occurring at an IA.

Moreover, such schemes would most likely be conducted as an unregistered broker-dealer and not as an IA creating an enormous blind spot in members' ability to supervise violations not of the Investment Advisors Act but of the Exchange Act. If the IA sells a private venture to a client without having the asset custodied in an advisory account that charged an advisory fee the broker-dealer would not be able to show that the activity was IA activity as opposed to unregistered broker-dealer activity. If we change the above fact pattern so that Ponzi scheme victims never sign opening account forms with the IA and no accounts are established at the IA firm a member firm would also be unable to show that the scheme was conducted through the IA. FINRA should not propose a private securities transaction rule where a fraudster's unsupervised paperwork lapses have the effect of altering a member's supervisory responsibilities in the first instance. As repeated throughout this response a member's supervisory responsibilities stem from the Exchange Act which does not permit broker-dealers to claim supervisory loopholes based on dual registration.

The foregoing example is not a made up example but one that continues to occur in scenarios PIABA members encounter. For example, IA Adam Nugent ran several private equity funds. Mr. Nugent was dually registered as an IA through Foresight Wealth Management ("FWM") while also being registered as a broker. The broker-dealer argued in federal court that the private securities transactions occurred through FWM. However, these investments were never custodied in a FWM account nor was any evidence provided that FWM charged an advisory fee on these investments. A federal judge found that the "Agronomic investment was not made through the [investor's] accounts with Foresight." *Purshe Kaplan Sterling Invs., Inc. v. Thomsen,* No. 2:24-CV-00002-JNP, 2024 WL 1307268, at *9 (D. Utah Mar. 26, 2024). Accordingly, Mr. Nugent was engaged in unlicensed broker-dealer while being registered with a broker-dealer. In this example we can see how an IA can conceal violations of the Exchange Act within an IA firm. The only way to comply with the Exchange Act's requirements to protect member firms and the investing public is to supervise securities activities.

In addition, any such rule proposal would have to be harmonized with multiple NTMs as far reaching as suitability, record keeping, and branch audits. If the proposed rule were implemented FINRA would have to spend years clarifying whether or not dozens of previously issued NTMs were intended to be modified by the proposed rule or how firms would be expected to comply with prior guidance.

For example, a recommendation to a registered representative's client to sell all of their assets at a member firm to invest entirely in private placements at the registered representative's IA would be a recommendation or investment strategy that the registered representative's member would have to supervise under RN 12-25. *See* pg. 6. Under the proposed rule, registered representatives would be incentivized to move assets from brokerage accounts to their IA in order to make recommendations in products and services that their member firm would not approve. Yet, the movement of such assets would be a transaction that would still need to be supervised under prior guidance.

Other aspects of previous suitability guidance are also implicated. FINRA has stated that the suitability rule "requires a broker to seek to obtain and analyze a customer's other investments. The rule thus explicitly permits a suitability analysis to be performed within the context of a customer's other investments." RN 12-25, pg. 13. A FINRA member would have to have access to the IA's investments in order to ensure that member firms were acting in their client's best interests.

Likewise, member firms are obligated under Rule 17a-4 to record and supervise communications of their registered representatives related to firm business. *See* SEC Rel. No. 34-38245 (Jan. 31, 1997). Any potential rule would not clarify FINRA's past guidance on member firm's requirements to record correspondence and investigate "red flag" communications through OBAs, through affiliated firms or third-party IAs that share joint clients with members and other scenarios. It is unlikely that FINRA would be able to devise a correspondence supervisory protocol that would achieve compliance with Rule 17a-4 without requiring firms to monitor and record all investment-related emails.

Finally, any such proposed rule would clearly contradict prior SEC guidance and fails to clarify whether or not FINRA is proposing to limit the scope of branch audits and its joint guidance with the SEC under RN 11-54.

FINRA and member firms have provided weak justifications for providing guidance that is contrary to the Exchange Act's Section 15(b)(4)(E) supervisory requirements. Common arguments include that the SEC overseas RIAs, privacy concerns, and that RIAs are held to a fiduciary standard. None of these reasons provide much cause for concern.

The fact that the SEC overseas RIAs is irrelevant. The SEC also overseas broker-dealers, yet FINRA has yet to propose that firms should stop supervising their own representatives. Moreover, the SEC has repeatedly held that firm supervision is the first line of defense to prevent violations of the securities laws.[4]

Privacy concerns are routinely taken care of through disclosure of how investor information is shared and FINRA has never provided examples of firms' being sanctioned for supervising their representatives due to privacy law violations.

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[4] Richard Y. Roberts, SEC Commissioner, "The Role of Compliance Personnel" (Apr. 7, 1995) (available at: https://www.sec.gov/news/speech/speecharchive/1995/spch030.txt#:~:text=Section%2015(b)(4)(E)%20authorizes%20the%20Commission%20to%20impose,is%20subject%20to%20his%20supervision.%22%20It%20is) ("It should come as no surprise to you that the Commission views the role of inhouse compliance personnel as being critical to the maintenance of the integrity of our securities markets. You are the first line of defense against fraud and sales practice abuse…")

Finally, there are many situations where fiduciary duties are imposed on broker-dealers and a number of states apply a general fiduciary duty on broker-dealers. In addition, the SEC has stated that "Regulation Best Interest ("Reg BI") for broker-dealers and the fiduciary standard for investment advisers under the Investment Advisers Act (the "IA fiduciary standard") are drawn from key fiduciary principles that include an obligation to act in the retail investor's best interest and not to place their own interests ahead of the investor's interest."[5] "Both Reg BI and the IA fiduciary standard require your account recommendations to be in the retail investor's best interest and require you not to place your or your firm's interests ahead of the retail investor's interest." *Id.* Accordingly, the standard of care is more similar than dissimilar.

In addition, as FINRA itself has noted for RIAs affiliated with a broker-dealer, the "vast majority of member affiliates are under common control; thus, these affiliates may share compliance resources and systems." Proposal, pg. 10. It cannot be that the rules governing RIAs and broker-dealers are so vastly different that the same compliance and systems could be used by RIAs affiliated with broker-dealers and at the same time so different as to make it impossible to supervise effectively.

The current rules and guidance were issued in order to protect member firms from litigation risk and investors from unsupervised investment activity. Rule changes under consideration appear aimed at ensuring that members will be exposed to increased litigation and investors to increased potential harm.

In sum, PIABA is concerned that FINRA continues to entertain rule proposals that will lead to industry non-compliance with the supervisory requirements of the Exchange Act and provide unscrupulous advisors with a road map to commit securities laws violations to the danger of members and the investing public alike. PIABA thanks you for the opportunity to comment on this important topic.

Very truly yours,

Adam Gana, President Public Investors
Advocate Bar Association

[5] *Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest* (available at: https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest)