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FINRA Proposes Rule to Streamline Broker/Dealers' Oversight of Outside Business Activities

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On February 26, 2018, FINRA issued Regulatory Notice 18-08 announcing its proposed rule 3290 addressing outside business activities of registered persons. The proposed rule is an attempt to streamline broker/dealers' oversight of outside business activities, including relieving them of supervisory and record-keeping responsibilities for unaffiliated registered investment advisers. The proposed rule replaces Rule 3270 (Outside Business Activity) and 3280 (Private Securities Transactions of an Associated Person). According to FINRA, the proposed rule is intended to "reduce unnecessary burdens while strengthening investor protection relating to outside activities."

Noteworthy changes under the proposed rule include the requirement that registered persons provide their broker/dealers with prior written notice of a broad range of activities, while imposing on broker/dealers a responsibility to perform a reasonable risk assessment of a narrower set of activities that are investment-related. According to FINRA, this will allow broker/dealers to focus on outside activities that are most likely to raise investor protection concerns.

The proposed rule also requires registered persons to provide their firms with prior written notice for all investment-related or other business activities outside of the scope of the relationship with the broker/dealer. The written notice should include a description of the proposed activity and the registered person's proposed roll therein. With respect to investment-related activity only, a registered person must receive prior written approval from the broker/dealer before participating in the activity.

The concept of "business activity" is defined in the proposed rule as (1) acting as an employee, independent contractor, sole proprietor, officer, director, or partner of another person; or (2) receiving compensation or having the reasonable expectation of compensation from any other person as a result of the activity.

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

The proposed rule applies only to the outside activities of registered persons. It does not apply to the activities of non-registered associated persons. However, the proposed rule does not preclude FINRA broker/dealer members from instituting policies and procedures relating to the outside activities of the associated persons more broadly.

Broker/Dealers' Responsibilities Upon Receiving Notice
If an activity is not investment-related, the broker/dealer has no obligation under the proposed rule. If the activity is investment-related, then the broker/dealer is required to perform a reasonable risk assessment of the activity in question.

Assessment
The broker/dealer is required to evaluate whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the broker/dealer's customers or; (2) be viewed by customers of the public as part of the broker/dealer's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. The rule's focus is on the registered person's participation in the activity, and, according to FINRA, ordinarily would not require the broker/dealer to perform an analysis of the underlying outside business activity. Then, based on the foregoing, the broker/dealer is required to determine whether to approve the registered person's participation, to approve it subject to conditions or limitations, or to disapprove it. The broker/dealer is required to advise the registered person, in writing, of its determination. Broker/dealers are no longer required to conduct a risk assessment of a non-investment related activity, such as a registered person driving for Uber or Lyft or holding seasonal retail employment, regardless of whether the registered person received compensation.

Supervision
The proposed rule imposes a supervisory obligation in two situations. First, if a broker/dealer imposes conditions or limitations on a registered person's participation in an investment-related activity, the broker/dealer must reasonably supervise the registered person's compliance with those conditions or limitations. The proposed rule does not require broker/dealers to supervise the underlying activities. Second, to the extent that a broker-dealer approves a registered person's participation in a proposed investment-related activity and such activity would require (if not for the person's association with a broker/dealer) registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity would be deemed to be the broker/dealer's business. In other words, if the person can only legally engage in the outside business activity because the person is associated with a broker/dealer, the broker/dealer approving that activity must treat it on its own. Accordingly, all applicable securities laws and regulations, and FINRA Rules, including supervision and record keeping, would apply to the broker/dealer with respect to that activity.

Record Keeping
The proposed rule requires broker/dealers to maintain and preserve records demonstrating compliance with the obligation of the Rule for at least three years after the registered person's employment or association with the broker/dealer has terminated.

continued.

Proposed Exclusions from the Rule

The proposed Rule has several exclusions that, according to FINRA, would reduce unnecessary burdens without lessening investor protection. First, registered persons' personal investments (e.g. buying away) are excluded. Second, the proposed rule excludes activities conducted on behalf of a broker/dealer's affiliate, unless those activities require registration as a broker/dealer if not for the person's association with a member. In addition, any non-broker/dealer activity conducted on behalf of the broker/dealer (e.g. any investment advisory activities for a dually-registered broker/dealer or investment adviser) would not be subject to the rule. Finally, the proposed rule does not apply to transactions on behalf of registered persons or immediate family members for which the registered person receives no transaction-related compensation.

Application to Registered Person's Investment Advisory Activity

The proposed rule changes the current approach with respect to investment advisory activities and registered persons. Under the proposed rule, any investment advisory activity conducted on behalf of a dually-registered BD/IA or for an investment adviser affiliate of a FINRA member firm would be excluded from the rule. Any investment advisory activity conducted for a third-party, non-affiliated investment adviser would constitute an "investment related" activity under the rule. As such, the rule requires that the registered person provide prior written notice of such activity, and the member is required to conduct the up-front risk assessment described above and, based on its assessment, to a) approve the registered person's participation; b) to approve it subject to conditions or limitations; or, c) to disapprove it. However, the proposed rule does not impose a general supervisory obligation over the investment advisory activities and does not require the broker/dealer to record on its books and records transactions resulting from such activities. These investment advisory activities would continue to be subject to regulatory oversight by the SEC and states under a different regulatory scheme.

Primary Concerns in Comment Letters Relate to RIA Oversight

In a comment letter dated April 27, 2018, the Financial Services Institute (FSI) opined that FINRA should allow a broker/dealer to maintain supervision of an outside RIA if it is determined that it would be in the best interests of investor protection. In the comment letter, FSI Executive Vice President and General Counsel David Bellaire wrote, "FSI believes that firms are in the best position, based on their risk assessment and internal intelligence, to determine whether investment related [outside business activities] should be supervised. If they would be supervised, firms are in the best position to determine the nature of the supervision that should be afforded to the proposed activity."

Several broker/dealers have written comment letters endorsing FSI's approach or generally taking the position that broker/dealers are in the best position to make a risk-based decision on whether and how to supervise the outside investment advisory activity of their representatives. Other broker/dealers have taken the position that FINRA's rule proposal should be delayed pending the finalization of the SEC's recent Regulation Best Interest proposal which proposes a new standard of conduct as well as certain disclosures which apply to broker/dealers and registered representatives, investment advisers and their associated persons. The SEC Regulation Best Interest is likely to go through several iterations following the comment period which ends in mid-July 2018.

FINRA received numerous comment letters from broker/dealers and trade organizations, among others. There is the potential for FINRA to revise its proposal in light of the comments received. The SEC must give final approval to FINRA's proposed rule before it can go into effect.

Comments suggestions or inquiries are welcome and should be directed to: mary.pat.fischer@aon.com

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