FINANCIAL SERVICES INSTITUTE
VOICE OF INDEPENDENT FINANCIAL SERVICES FIRMS AND INDEPENDENT FINANCIAL ADVISORS

VIA ELECTRONIC MAIL

April 27, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-08 | FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities and Private Securities Transactions (Notice)

Dear Ms. Mitchell:

On February 26, 2018, the Financial Industry Regulatory Authority, Inc. (FINRA) published its request for public comment on a new proposed rule (Proposed Rule) governing advisors' outside business activities (OBAs) and private securities transactions (PSTs).[1] The Proposed Rule, in general, would alleviate firms' responsibilities to supervise advisors' third party and affiliated advisory activities, as well as advisors' outside insurance and banking activities. The stated purpose of the Proposed Rule is to reduce unnecessary regulatory burdens while strengthening investor protection in areas with greater risk.

The Financial Services Institute (FSI) appreciates the opportunity to comment on this important FINRA Proposal. The Proposed Rule stemmed from FINRA's retrospective rule review.[2] Retrospective rule review is an important part of the regulatory process and FSI commends FINRA for seeking industry feedback and encourages FINRA to continue to engage with stakeholders through the retrospective rule process. The Proposed Rule is an important foundation for revising FINRA rules regarding OBAs and PSTs and to commence an essential dialogue on ways to enhance and clarify the rules.

Nonetheless, FSI members do not believe there is a "one-size-fits-all" approach to supervising advisors' outside investment-related activities. Conversely, whether investor protection necessitates supervision of these activities, will depend on a number of factors, including the advisor's history, the firm's business operations, whether the advisor has more than one investment-related OBA, and the results of the firm's risk assessment. Thus, FSI believes that firms are in the best position, based on their risk assessment and internal intelligence, to determine whether investment-related OBAs should be supervised. Moreover, if they should be supervised, firms are in the best position to determine the nature of the supervision that should be afforded to the proposed activity. Towards that end, and as discussed more fully below, FSI respectfully proposes modifications to the Proposed Rule that would require firms to act on the results of their risk assessment. FSI believes its proposed modifications strengthen investor protection by

[1] *See, generally*, FINRA Regulatory Notice 18-08 (Feb. 26, 2018).
[2] *Id.* at p. 2.

requiring firms to supervise investment-related OBAs that may present a risk to the investing public, while providing firms with the flexibility to customize, or forego entirely, their supervision of low-risk activities.

Additionally, FSI asks that FINRA consider adopting FSI's modifications to the Proposed Rule in whole, or in part. To the extent that FSI's modifications are not adopted, FSI believes the rule should be clarified in several respects. Initially, in response to FINRA Regulatory Notice 17-20, FSI suggested that FINRA require advisors to inform firms of any material changes in the advisor's OBA[3]. FSI fully supports this concept, but believes the rule should contain guidance regarding what would constitute a material change triggering an advisor's disclosure obligations under the Proposed Rule. It is imperative that the Proposed Rule be as clear as possible because advisors, and not firm's compliance personnel, would need to interpret the rule to determine the nature and extent of their disclosure obligations. Lack of clarity in the Proposed Rule, therefore, may have the unintended consequences of depriving advisors of proper notice of their obligations. We expand on these points in more detail below.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.[4] These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).[5]

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate $48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly $6.8

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[3] See Letter dated June 29, 2017 from David T. Bellaire, Esq. Executive Vice President General Counsel – FSI to Ms. Jennifer Piorko Mitchell- FINRA, available at http://www.finra.org/sites/default/files/notice_comment_file_ref/17 (June 29th Letter) at p. 4.

[4] Cerulli Associates, Advisor Headcount 2016, on file with author.

[5] The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.[6]

Discussion

FSI appreciates the opportunity to comment on FINRA's Proposed Rule. FSI, respectfully, proposes alternative rule language and asks that FINRA consider this proposed language in whole or, in part. To the extent, however, FINRA's Proposed Rule is adopted, FSI suggests that FINRA modify the Proposed Rule to clarify, among other aspects, what constitutes a material change to an advisor's OBA. Further, FSI members have requested additional clarification on the definition of "investment-related." While FSI understands that FINRA may not be able to provide an exhaustive list of examples, FINRA should consider publishing Frequently Asked Questions (FAQs) regarding this issue on, or close to, the effective date of the Proposed Rule.

I. FSI Comments and Suggestions

A. Background and Introduction

On May 17, 2017, FINRA published Regulatory Notice 17-20, requesting public comment on its rules governing OBAs and PSTs.[7] That request was part of FINRA's retrospective rule review process and was designed to assess the effectiveness and efficiency of the OBA and PST rules.[8] FSI responded to this request by letter dated June 29, 2017, suggesting:

- Updated guidance on Registered Investment Advisers as OBAs; and
- That FINRA consider imposing an ongoing duty requiring advisors to inform broker-dealers of material changes to their OBAs.[9]

Critically, FSI requested updated guidance on supervising advisors' outside advisory business, not that those supervision requirements be alleviated altogether.[10] The responses FINRA received during the retrospective rule review led to this proposal.[11]

OBAs and PSTs are governed primarily by FINRA Rules 3270 and 3280, respectively. The Proposed Rule purports to streamline the revised requirements into a single rule. The Proposed Rule requires advisors to provide prior written notice to their firms of any business activities performed "outside the scope of the relationship with the [advisor's] member firm".[12] As previously recommended by FSI,[13] unlike its predecessor rules, the Proposed Rule would require advisors to update that notice to reflect any material changes in those activities.[14]

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[6] Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).
[7] See FINRA Regulatory Notice 17-20 (FINRA Requests Comment on the Effectiveness and Efficiency of Its Rules on Outside Business Activities and Private Securities Transactions) (May 2017).
[8] *Id.*
[9] See June 29th Letter at pgs. 3 &4.
[10] *Id.*
[11] See Notice at p. 1.
[12] See Proposed FINRA Rule 3290(a).
[13] See June 29th Letter at p. 3.
[14] See Proposed FINRA Rule 3290(a).

With respect to investment-related OBAs, the Proposed Rule defines the term 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)."[15] The Proposed Rule requires advisors to provide prior written notice to, as well as obtain prior approval from, firms prior to participating in any investment-related activities that are not expressly excluded from the Proposed Rule.[16] Once a firm receives notice of an advisor's investment-related activity, the firm must perform a risk assessment, including assessing whether the public would view the proposed OBA as activities of the firm and whether the activity constitutes broker-dealer activity under the Securities Exchange Act of 1934 (Exchange Act).[17] Also, firms must keep records demonstrating their compliance with this, and all other aspects of Proposed Rule 3290, for three years after the advisor's employment, or association, with the firm has ended.[18]

The Proposed Rule also requires firms who restrict advisors from participating in investment-related activities to supervise for compliance with those restrictions.[19] Further, firms who permit advisors to participate in OBAs that require the advisors to be associated with a broker-dealer (e.g., selling private placements away from the firm), would need to supervise that activity as if it was their own. [20] If the advisor is associated with more than one broker-dealer, the broker-dealers may allocate the supervisory responsibilities related to that activity so long as the allocation is in writing.[21]

Certain investment-related activities, such as the following, are excluded:

- Transactions on behalf of immediate family members, so long as they are not performed for transaction-related compensation,
- A broker-dealer's non-broker-dealer activities,
- An advisor's personal investments, but these activities may be subject to FINRA Rule 3210; and
- Non-broker dealer activities (e.g., insurance, investment advisory, or banking) conducted on behalf of the firm's affiliate, unless that activity would, in itself, require registration as a broker or dealer.[22]

For the above activities, the Notice seems to intimate that prior written notice would not be required and firms would not be required to conduct assessments.[23] Nonetheless, as outlined below, this requires clarification.

Critical to many of FSI's member's businesses, activities at third-party investment advisers are not excluded from the rule. Thus, advisors are required to provide notice of these activities and,

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[15] See Proposed FINRA Rule 3290, Supp. Material .02(c).
[16] See Proposed FINRA Rule 3290(a); see, also Proposed FINRA Rule 3290(a) Supp. Material .01.
[17] See Proposed FINRA Rule 3290 (b)(1).
[18] See FINRA Proposed Rule 3290 (b)(5).
[19] See FINRA Proposed Rule 3290 (b)(3).
[20] See FINRA Proposed Rule 3290 (b)(4).
[21] See Notice at p. 6.
[22] See Proposed FINRA Rule 3290, Supp. Material .01.
[23] See Notice at p. 7.

since they are investment-related, firms are required to conduct assessments.[24] However, firms will not be required to supervise these activities or to keep records related to them.

B. The Proposed Rule Raises Investor Protection Concerns

Many FSI members have reported that they will continue to supervise their advisors' investment-related OBAs (particularly, outside investment advisory activities), despite the proposed rule changes. Those FSI members believe doing so is in the best interest of the clients they serve. In particular, FSI members note that many of their advisors provide holistic financial planning services to Main Street investors. In these cases, investment advisory clients may also be clients for broker dealer and/or insurance or advisory services. For instance, it is not uncommon for an investment advisory client to receive a financial plan that is implemented, in part, through the purchase of securities *vis a vis* a broker-dealer. Thus, like the services they provide, FSI member firms have an interest in taking the same holistic view towards investor protection in respect of these clients. FSI's members believe that, in the client's view, these services are interconnected. Consequently, those FSI members believe that there are certain circumstances in which investor protection considerations mandate that the various businesses work in conjunction with each other to supervise the activities.

C. The Proposed Rule Presents Interpretative Challenges that Require Clarification

In addition to the concerns outlined above, the Proposed Rule presents certain interpretive concerns. First, advisors would require notice regarding what constitutes a material change in their outside business activities. The phrase "material change" may be subject to multiple interpretations and, thus, advisors may not know what to report. Also, the ambiguity of the phrase makes it vulnerable to inconsistent interpretation and application by both the industry and FINRA. There are other instances in FINRA's rules where material changes have invoked a reporting obligation and FINRA has propounded definitions that provide members with reasonable notice regarding when these obligations are triggered. [25] This should be the case with respect to the Proposed Rule, as well.

Second, what constitutes broker-dealer activity under the Exchange Act has been the subject of endless interpretive debate and countless no-action letters. Thus, it may be difficult for the industry to always reach a consensus on this issue. Further, FINRA staff often (and understandably) defers to the US Securities and Exchange Commission on these issues and, therefore, industry participants may find it difficult to obtain FINRA guidance on ambiguous activities.

Further, clarification is needed regarding whether the excluded activities are subject to the notification requirement in the Proposed Rule. Proposed Rule 3290, provides, in pertinent part, that:

> No registered person may participate in ***any*** manner in an investment-related or other business activity outside the scope of the relationship with the person's member firm unless the person provides prior written notice to and, with respect to ***any*** investment-related activity, receives prior written approval from, the member.

(emphasis added).

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[24] *Id.* at p. 2.

[25] *See, e.g.,* NASD Rule 1017 (a)(5), referring to NASD Rule 1011(k) regarding what constitutes a material change in a firm's business operations such that the firm would be required to file a continuing membership application.

Use of the word "any" makes this seem to be an absolute obligation. However, both the Notice and the Rule seem to insinuate that the excluded activities are not subject to the notice or approval provisions above. Thus, if this proposal is adopted, this aspect of the proposed rule requires clarification. FSI suggests that this portion of the rule be modified as follows:

> With the exception of the exclusions set forth in Supplementary Material .01 of this rule, [n]o registered person may participate in ***any*** manner in an investment-related or other business activity outside the scope of the relationship with the person's member firm unless the person provides prior written notice to and, with respect to ***any*** investment-related activity, receives prior written approval from, the member.

That said, FSI believes that all outside business activities should be disclosed to member firms, regardless of whether the firm would have an obligation to actually approve or supervise the activities. This helps the firm, independently, assess whether the outside activity properly falls into the excluded categories and whether it poses any risk to the investing public

D. FSI's Suggested Modified Rule Language to Strengthen Investor Protection by Adopting A Risk-Based Approach to Supervising Investment-Related OBAs

FSI suggests that FINRA adopt proposed rule 3290 with modifications (FSI Modified Rule 3290). FSI Modified Rule 3290 would provide, as follows:

> 1. No registered person may participate in any manner in an investment-related or other business activity outside the scope of the relationship with the person's member firm unless the person provides prior written notice to and, with respect to any investment-related activity, receives prior written approval from, the member. In the case of a material change to the activity, a registered person must provide the member with updated prior written notice and, with respect to any investment-related activity, receive updated prior approval. The notification shall be provided in such form as specified by the member, describing the proposed activity and the person's proposed role therein. If the member disapproves the proposed activity or places conditions or limitations on it, the registered person shall not participate in the activity or shall comply with such conditions or limitations.
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> 2. Members shall have no responsibility to supervise, or further assess, non-investment-related activities disclosed pursuant to this rule.
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> 3. Upon receipt of a written notice of any investment-related activities, or written notice of material changes in any investment-related activities, the member shall conduct a risk assessment, including whether the proposed activity will:
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> (i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or

(ii) be reasonably 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.

4. Upon completion of the risk assessment, the member must determine:

a. Whether to disapprove the registered person's participation in the investment-related activity; or
b. Whether to approve the registered person's participation in the investment-related activity; or
c. Whether to approve the registered person's participation in the investment-related activity, subject to conditions or limitations imposed by the member; and
d. Whether, based on the assessed risk, it is in the best interest of the investing public that the member supervises the registered person's participation in the investment-related activities.

5. In the event the member determines that, pursuant to section 4(d), it is in the best interest of the investing public to supervise the registered person's investment-related activities, the member shall employ risk-based principles to determine the policies and procedures necessary to reasonably detect and prevent violations of applicable securities laws.

6. Notwithstanding section 4 (above), a member is required to supervise registered persons' compliance with any conditions or limitations the member imposed on the registered person's participation in any activities disclosed pursuant to this rule.

7. A member must keep a record demonstrating its compliance with the obligations pursuant to this Rule and must preserve this record at least three years after the registered person's employment or association with the member has terminated.

*** Supplementary Material:

.01 For purposes of this Rule:

(a) "Affiliate" means any entity that controls, is controlled by or is under common control with a member, but a member would not be deemed to control an entity merely because it is owned by the member's registered person.

> (b) "Business activity" means: (i) acting as an employee, independent contractor, sole proprietor, officer, director or partner of another person; or (ii) receiving compensation, or having the reasonable expectation of compensation, from any other person as a result of the activity.
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> (c) "Investment-related" means 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).
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> (d) "Material change" means change in the nature of the outside business activity, such as the manner of compensation, nature of the related duties, time expended by the registered person on the activity, potential existence of conflicts, or any other similar material change.

FSI Modified Rule 3290 makes it clarifies that firms will not be obligated to supervise non-investment-related activities. It also provides a workable definition of "material change" such that advisors have notice regarding the kinds of changes that trigger their reporting obligations. It also requires firms to tailor supervision to the risk associated with the underlying activity, which is truly the hallmark of any effective compliance program and the cornerstone of investor protection.

Further, since it is FINRA's position that most investment-related activities need not be supervised, FINRA examinations should defer to a firm's determination regarding whether to supervise the activities and, more crucially, where applicable, to the firm's manner of implementing that supervision. Additionally, FSI encourages FINRA to consider working with industry stakeholders to develop a risk assessment template. While firms are welcome to go further than the template, this would ensure that firms are starting their risk assessment from the same point and starting with the same factors.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with FINRA on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 803-6061.

Respectfully submitted,

David T. Bellaire, Esq.
Executive Vice President & General Counsel