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VOICE OF INDEPENDENT
FINANCIAL SERVICES
FIRMS AND INDEPENDENT
FINANCIAL ADVISORS

Supervision Workshop



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Agenda

- Laying the groundwork
- Regulatory concerns
 - Recent enforcement actions
- Regulatory framework
 - FINRA's OBA/PST Rules
 - Requirements regarding payment of compensation
 - Expense sharing arrangements
 - Form BD/BR



Laying the Groundwork

- The various types of DBAs
- Why are they popular?
 - Tax savings
 - Succession and estate planning
- Terminology—DBA v. LLC



Regulatory Concerns

- Loss of control by BD over its representatives
- Holding out/customer confusion
- DBAs are growing in size and in number
- An extension of the concerns we have with the independent BD model generally



Regulatory Concerns

- Angel Oak Capital Partners LLC
 - February 2017 SEC enforcement action for BD registration violations
 - Respondents:
 - Angel Oak Capital Partners, LLC (unregistered entity)
 - Peraza Capital & Investment LLC (BD)
 - Prabhu (Angel Oak owner/co-founder of AOCP)
 - Wells (supervisor for Peraza’s “Angel Oak” branch)
 - Registration violation by AOCP
 - “Cause” violations by Peraza, Prabhu (owner) and Wells (supervisor)
 - Disgorgement by AOCP of \$3+ million commissions plus \$75K penalty; fines for Prabhu and Wells
 - Still open for Peraza



Regulatory Concerns

- Angel Oak Capital Partners LLC (cont.)
 - AOCP formed in 2008 for securities business
 - AOCP was “GP” of RIA firm and owned other unregistered entities
 - Owner defendant (Prabhu) was co-founder, CIO for RIA firm and for a time registered with Peraza
 - At outset, AOCP had “independent contractor” agreement with Peraza, later replaced by one with Wells, the Angel Oak OSJ branch manager
 - Angel Oak branch engaged in fixed income trades
 - AOCP trader employees were registered with Peraza
 - In 2014 an AOCP affiliate registered as a BD



Regulatory Concerns

- Angel Oak Capital Partners LLC (cont.)
 - What went wrong?
 - Angel Oak marketing activities
 - Independent contractor agreement
 - Hiring of registered personnel for Angel Oak branch
 - Commission flows
 - Control of Angel Oak branch by unregistered persons



Regulatory Concerns

- Summit Equities, Inc., Mass. Securities Division Consent Order (Dec 26, 2018)
 - BD fined \$100,000 for mishandling of clients' personal information
 - Firm policy prohibited independent contractors and employees from disclosing customer personal identifiable information (PII) to third parties without customer's consent.
 - Firm allowed reps to enter clients' into third-party CRM system.
 - When reps left the firm, the firm had no access or control over PII, while those reps had the access and could share it.
 - The firm couldn't erase clients' information from reps' devices using the third-party CRM.



Regulatory Concerns

- Summit Equities, Inc., Mass. Securities Division Consent Order (Dec 26, 2018) (cont.)
 - Key Takeaways
 - Firms must follow their own procedures.
 - Case received a lot of publicity because it dealt with PII
 - Firms need to consider
 - Use of CRM
 - Their policies about reps leaving/joining their firm
 - Privacy notice disclosure



Regulatory Framework

- FINRA's OBA Rule

- Current FINRA Rule 3270 (OBAs)

- Requires RRs to notify their BDs of proposed outside business activities (OBAs)
 - BD must consider whether the proposed activity will: (1) interfere with or compromise the RR's responsibilities to the BD and/or customers or (2) be viewed by customers or the public as part of the BD's business.



Regulatory Framework

- FINRA's OBA Rule

- Current FINRA Rule 3270 (OBAs)

- BD must evaluate the advisability of imposing specific conditions or limitations on a RR's OBAs, including prohibiting the activity.
 - BD must evaluate whether the activity is properly characterized as an OBA or whether it should be treated as a PST.
 - BD must keep and preserve records of its compliance with these obligations with respect to each written notice received.



Regulatory Framework

- FINRA's PST Rule

- Current FINRA Rule 3280 (PSTs)

- Requires APs (Aps) to notify their BDs of proposed private securities transactions (PSTs).
 - Prior to PST: AP must provide written notice to the BD describing the proposed PST and the AP's proposed role, and whether he has received or may receive selling compensation in connection with the PST



Regulatory Framework

- FINRA's PST Rule

- Current FINRA Rule 3280 (PSTs)

- If selling compensation may be received: BD must provide a notice to either: (a) approve the PST; or (b) disapprove the PST.
 - If approved: The PST must be recorded on the books of the BD. The BD must supervise the AP's PST as if the transaction were executed on behalf of the BD.
 - If disapproved: AP must not participate in the PST.



Regulatory Framework

- FINRA's Proposed OBA Rule
 - Proposed FINRA Rule 3290
 - FINRA is proposing a single streamlined rule to address OBAs/PSTs
 - BD must receive prior written notice of a broad range of OBAs
 - BD must perform a “reasonable risk assessment” of OBAs that are investment related, allowing BD to focus on OBAs most likely to raise investor protection concerns



Regulatory Framework

- FINRA's Proposed OBA Rule
 - Proposed FINRA Rule 3290
 - Generally excludes registered person's personal investments and work performed on behalf of a BD's affiliates.
 - No supervisory and recordkeeping obligations for most other OBAs, including IA activities at an unaffiliated third-party IA.
 - BD responsible for approved OBAs that could not take place but for the registered person's association with the BD.



Requirements Regarding Payment of Compensation

- The Exchange Act requires that a person selling securities be registered with the SEC as a BD unless he is an AP
- FINRA Rule 2040 prohibits BDs and APs from, directly or indirectly, paying any compensation, fees, concessions, discounts, commissions or other allowances to: (1) any person that is not registered as a BD but is required to be registered; or (2) any appropriately registered AP unless the payment complies with all applicable laws.



Early SEC and FINRA Guidance

- *Letter from Douglas Scarff, Director, Division of Market Regulation, SEC to Gordon S. Macklin, President, NASD (June 18, 1982)*
 - Independent contractor salespersons who act as independent principals, in selling or inducing the purchase or sale of securities must be registered with the SEC as BDs.
 - An independent contractor salesperson, whose activities are subject to control by a BD, whether by contract or otherwise, must be registered with a SRO as an AP of the BD.



Early SEC and FINRA Guidance

- *Letter from Douglas Scarff, Director, Division of Market Regulation, SEC to Gordon S. Macklin, President, NASD (June 18, 1982) (cont.)*
 - A simple denial of “control” of an independent contractor by a BD would not remove its responsibility for supervising that person.
 - To the extent that a BD forms a relationship with an independent contractor, that firm would be responsible for either: (i) ensuring that the independent contractor was registered as a BD or (ii) assuming the supervisory responsibilities attendant to a relationship with an AP.
 - The SEC believes that if a salesperson was not registered and a BD permitted him to hold out to the public that he was acting on behalf of the BD, such salesperson would be deemed to be an AP of the BD.



Requirements Regarding Payment of Compensation

- Early SEC and FINRA Guidance
 - NASD Notice to Members 86-65, *Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel* (Sept. 12, 1986)
 - Irrespective of an individual's location or compensation arrangements, all APs are considered to be employees of the firm with which they are registered for purposes of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the BD.
 - The fact that an AP conducts business at a separate location or is compensated as an independent contractor does not alter the obligations of the individual and the firm to comply fully with all applicable regulations.



Requirements Regarding Payment of Compensation

- SEC No- Action Letters
 - *Wolf Juall Investments, LLC, Vanasco, Wayne & Genelly, Birchtree Financial Services, Inc., SEC v. FTC Capital Markets, Inc., and SEC v. UBS AG*
 - The receipt of transaction-related compensation is a key factor in determining whether a person or entity is acting as a BD
 - Absent an exemption, an entity that receives commission or other transaction-related compensation in connection with securities-based activities that fall within the definition of "broker" or "dealer" generally is required to register as BD



Requirements Regarding Payment of Compensation

- SEC No- Action Letters
 - *SEC v. Kramer & Maiden Lane Partners, LLC v. Perseus Realty Partners, G.P. II, LLC*
 - “The [SEC’s] proposed single-factor ‘transaction-based compensation’ test for broker activity (i.e., a person ‘engaged in the business of effecting transactions in securities for the accounts of others’) is an inaccurate statement of the law . . .”
 - “[A]n array of factors determine the presence of broker activity. In the absence of a statutory definition enunciating otherwise, the test for broker activity must remain cogent, multi-faceted, and controlled by the Exchange Act.”



Requirements Regarding Payment of Compensation

- SEC No-Action Letters - Specific Circumstances
 - Relief Granted
 - *National Pension Administrators, Inc.*
 - BD agents will assign their commissions which are due from Detroit (BD) over to National (insurance agency). All commissions paid from Detroit to National will be redistributed by National only for the benefit of those agents of National who are also RRs of Detroit. No portion of assigned commissions will ever inure to the benefit of National, either directly or indirectly.



Requirements Regarding Payment of Compensation

- SEC No-Action Letters Specific Circumstances
 - Relief Granted
 - *Moran & Associates, Inc.*
 - Moran (BD) proposes to have commissions that are generated by the RRs deposited in a BD commission account established for Moran at its clearing firm, Pershing & Company ("Pershing"). At the end of each month, Moran would instruct Moran Management (IA) to pay the RRs of Moran a predetermined percentage of gross commissions generated. Moran Management would pay the RRs on behalf of Moran, but using its own funds. Moran Management would not have any rights to the funds held in account by Pershing. In turn, Moran Management would bill Moran each month for RRs' expenses paid along with rent, phones, postage and other operating expense.



Requirements Regarding Payment of Compensation

- SEC No-Action Letters granting relief
 - *Time Insurance Co.*
 - Time (insurance company affiliate) and AMEV (BD) propose that commissions payable by AMEV to AMEV's independent contractors be paid first to Time for disbursement to AMEV's independent contractors in one check that combines all compensation payable by Time and AMEV to AMEV's independent contractors. Time would not retain any portion of the commissions payable to AMEV's independent contractors, nor would any portion of the commissions inure to Time's benefit. Time would not exercise any discretion over the AMEV commissions or disbursement thereof.



Requirements Regarding Payment of Compensation

- SEC No-Action Letters denying relief
 - *Lombard Securities Corporation*
 - *American Capital Equities, Inc.*
 - The APs of P&W (IA), who were also representatives of ACE (BD), requested that ACE enter into an arrangement whereby checks representing all commissions earned by APs in their capacity as RRs of ACE be made payable to P&W. The NASD informed the SEC that P&W retains a significant portion of the commission payable to representatives to cover overhead expenses of P&W.
 - *Mutual Benefit Financial Services Company*
 - FSC (BD) would pay and direct all commissions owing to RRs and supervisory representatives to the Advisory Group (unregistered corporation) which in turn would distribute commissions to the RRs and supervisors after allocations and deductions are made for operating expenses and withholding taxes. Advisory Group would receive commissions solely for purposes of covering designated expenses and would not share, directly or indirectly, in any commissions.



Expense Sharing

- What expenses are properly the expenses of the BD?
- Why does it matter?
- FINRA Regulatory Notice 03-63
- Form BD/ Form BR
 - Item 11 of Form BD
 - Section 4.D. of Form BR



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