FINRA REQUESTS COMMENT ON RULES GOVERNING OUTSIDE BUSINESS ACTIVITIES AND PRIVATE SECURITIES TRANSACTIONS

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INTRODUCTION

The Financial Industry Regulatory Authority ("FINRA") recently issued a notice requesting comments on the effectiveness and efficiency of its Rules 3270 (Outside Business Activities of Registered Persons) and 3280 (Private Securities Transactions of an Associated Person) (collectively, the "Rules").[1] This retrospective review of the Rules is further evidence of FINRA's belief that it is appropriate to review its significant rulemaking actions after an appropriate period to confirm that FINRA regulations are meeting the intended investor-protection goals.

The comment period for the review expires on June 29, 2017.

BACKGROUND

FINRA Rule 3270 prohibits registered persons from engaging in, or being compensated for, business activities outside the scope of the relationship with their member firm unless they have provided prior written notice to their employing broker-dealer. FINRA Rule 3280 prohibits associated persons from "trading away" from their firm and engaging in securities transactions for any economic benefit absent notifying the firm and obtaining affirmative consent from the firm. Rule 3280 further requires the firm to record the securities transaction on its books and records and supervise the transaction as if it were the firm's own. Both Rules aim to protect investors from potentially problematic activities that are unknown to the firm and that could be seen as being part of the firm's business and subject to its supervision. The Rules also help to protect firms by creating a regulatory framework through which firms may assess the proposed activities to determine whether or not such activities present conflicts that warrant the firm placing limits or conditions on the activities.

REQUEST FOR COMMENT

As part of the review of the Rules, FINRA is seeking input from member firms with respect to the following questions:

1. Have the Rules effectively addressed the problem(s) they were intended to mitigate? To what extent have the original purposes of and need for the Rules been affected by subsequent changes to the

markets, the delivery of financial services, the applicable regulatory framework, or other considerations? Are there alternative ways to achieve the goals of the Rules that should be considered?

2. What have been experiences with implementation of the Rules, including any ambiguities in the Rules or challenges to comply with them?
3. What have been the economic impacts, including costs and benefits, arising from the Rules? Have the economic impacts been in line with expectations described in the rulemaking? To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models?
4. Can FINRA make the Rules, interpretations, or attendant administrative processes more efficient and effective?

These Rules are particularly ripe for review and clarification, as many firms struggle with the language of the Rules and there has not been much historical guidance from FINRA.[2] In our experience, member firms have particularly struggled with interpreting Rule 3280. This is especially true in the context of bank securities activities. Since Rule 3280 was adopted under the old National Association of Securities Dealers ("NASD") Rules of Fair Practice, Congress adopted the Gramm-Leach-Bliley Act of 1999 and repealed Glass-Steagall. The Gramm-Leach-Bliley Act, among other things, eliminated the bank exclusion from broker-dealer regulation in existence since 1934. In its place, banks were granted exceptions from broker-dealer regulation tailored to their specific customary bank securities activities. Because the rule could indirectly reach into exempt bank securities activities when dual bank-broker/dealer employees perform permissible bank securities activities, the banking industry at that time asked for clarification of the application of Rule 3280 (then NASD Conduct Rule 3040). Namely, the banking industry argued that the rule should not apply to so-called dual bank-broker/dealer representatives in cases where dual representatives performed bank securities activities outside of the U.S. Securities and Exchange Commission's ("SEC") jurisdiction, but within bank regulatory oversight. FINRA did not formally respond to requests for clarification; nor did it clarify its application in the bank context later when incorporating the rule as FINRA Rule 3280. Absent clarification or relief, FINRA seems to assert jurisdiction indirectly over bank securities activities in the case of dual bank-broker/dealer representatives, even where those activities are outside of the SEC's jurisdiction granted under the Securities Exchange Act of 1934. This leads to the anomalous result of FINRA purportedly asserting greater authority over bank securities activities than that which is granted to the SEC, which would seem to be an impermissible application of the rule given that FINRA's authority is derivative of the SEC's authority over banks.

Although it does not raise potentially impermissible jurisdictional issues for investment advisers such as in the bank context, Rule 3280 does raise similar operational issues when it is applied to dual representatives of an investment adviser and broker-dealer. FINRA has previously addressed the application of the rule in several regulatory notices in the mid 1990's. Generally, the rule will apply if the dual representative renders advice and executes securities transactions based on that advice, as opposed to rendering advice and routing execution elsewhere. It seems a review of FINRA's previous interpretative positions in both the bank and investment adviser contexts may be in order.

There are other operational issues with the rule. For example, in the event that a firm approves an associated person's participation in a securities transaction away from the firm, subject to Rule 3280, Rule 3280 states that

the transaction must be "recorded on the books and records" of the member firm and that the member is required to "supervise the person's activities in the transaction as if the transaction were executed on behalf of the member." Many firms are unclear as to whether this means that the transaction compensation to the associated person must flow through the firm, or whether payment may be paid directly to the associated person.[3] Also, it is not clear what "supervise" means in this context. For instance, if the private securities transaction is a private placement offering and the associated person refers an investor to another firm acting as placement agent, would the associated person's firm also need to be authorized to engage in private placement activity or would it be sufficient that the associated person's supervisor is licensed as a Series 24 principal for the firm to properly supervise the activity? Member firms may wish to identify these points as requiring clarification as part of providing comments on the Rules. It is also unclear whether the firm must conduct its own due diligence of the private placement.

NEXT STEPS

At the conclusion of the review, FINRA will consider appropriate next steps, which may include: (i) modifications to the Rules; (ii) updated or new guidance on the Rules; (iii) administrative changes or technology improvements; or (iv) additional research or information gathering. FINRA has shown a willingness to revise its rules based on feedback received from member firms in connection with its retrospective reviews, including most recently with respect to the communication rules.[4] Accordingly, member firms should consider providing FINRA with their thoughts and comments on the Rules.

If you have any questions regarding the Rules please contact any of the authors listed below, or one of the K&L Gates attorneys with whom you work.

NOTES:

[1] FINRA Regulatory Notice 17–20 (May 15, 2017) is accessible at: http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-20.pdf.

[2] With respect to Rules 3280 and 3270, FINRA has not offered significant guidance on the application of the Rules since 2001, when the NASD published Notice to Members ("NtM") 01-79 reminding members of their supervisory responsibilities regarding private securities transactions involving promissory notes and outside business activities (NASD Notice to Members 01-79, December 10, 2001). Previously, the NASD had published NtM 96-33 (NASD Notice to Members 96-33, May 1, 1996) and NtM 94-44 (NASD Special Notice to Members 94-44, May 15, 1994) addressing the investment advisory activities of registered representatives. With respect to Rule 3270, FINRA also provided some interpretive guidance in Regulatory Notice 10-49 (October 15, 2010), issued as part of the rule conversion process.

[3] We note that NtM 96-33 suggests that documenting the payment in the firm's records may be sufficient.

[4] FINRA Regulatory Notice 17-06 (February 10, 2017).

