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

Re: FINRA Regulatory Notice 18-08 – Proposed New Rule Governing Outside Business Activities and Private Securities Transactions

Dear Ms. Mitchell:
I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in securities arbitration proceedings. 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 18-08 seeks comments concerning reforms to FINRA Rules 3270 and 3280. FINRA has proposed eliminating supervision requirements, including record keeping, for all registered representatives' outside business activities, with two exceptions. First, if a member imposes conditions or limitations on participation in an investment-related activity, the member would be required to reasonably supervise compliance with those limitations, but the member would not have to actually supervise the underlying activities. Second, an approved private securities transaction would have to be supervised only where the person would otherwise need to register as a broker or dealer under the Exchange Act if not for the member's registration.

FINRA proposes to exempt member firms from supervising:

- Investment related activities at third-party investment advisor firms ("IA");
- Investment related activities at member affiliates including IAs, banks, and insurance companies;
- Non-investment related work and outside business activities; and,
- Personal investments.

PIABA strongly disfavors the proposed modifications to FINRA Rules 3270 and 3280.

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 risks; and, increase investor exposure to harm through those who would exploit the rules. FINRA's supervisory rules that deal with selling away and private securities transactions have serious consequences for investors and members alike. Despite the existing rules, each year FINRA members and their representatives engage in dozens of fraudulent schemes that cost investors millions of dollars.[1] For over 30 years, the NASD and now FINRA have emphasized that private securities transactions present "serious, regulatory concerns." *See* 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).

FINRA's current efforts to limit supervisory requirements for registered representatives' outside IA activities is a significant deviation from the NASD's and FINRA's former stated positions on the subject. Previously, NASD stated that its National Business Conduct Committee found 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." [2] Accordingly, FINRA Rules 3270 and 3280 and NTMs 91-32, 94-44, and 96-33 are designed to assist members in reasonably achieving compliance with their supervisory obligations under the Exchange Act. Repealing existing guidance and rules will endanger member firms and remove guidance that is an essential foundation for firms to use in understanding their supervisory obligations under federal law.

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).

The Exchange Act was written with the understanding that those who commit securities fraud might use various entity affiliations, whether registered or not, to perpetrate their frauds. The Exchange Act requires broker-dealers to supervise 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

[1] http://www.investmentnews.com/article/20111002/REG/310029969/selling-away-again-a-concern-for-regulators (The North American Securities Administrators Association reported that in 2011 there were 54 enforcement actions involving selling away.)

[2] NASD NTM 91–32.

the Investment Advisor Act or any other securities act in no way lessens a broker-dealer's responsibility to reasonably supervise the activity of the representative, in order to prevent violations of securities laws.

FINRA's proposed rule does not address how it reasonably complies with the Exchange Act's explicit supervisory requirements. In addition, FINRA's proposed rule contains confusing and inconsistent supervisory loopholes that create an avenue for wrongdoing. Ultimately, FINRA's proposed rule leaves member firms defenseless to a charge of failure to supervise under the Exchange Act and unable to claim available statutory defenses.[3]

FINRA's proposed rule states that it "would not impose a general supervisory obligation over the IA activities…" Regulatory Notice 18-08, pg. 8. It is unlikely that a rule limiting supervision of an activity that could lead to a violation of the securities laws could be deemed reasonable under the Exchange Act. Consequently, a member firm citing FINRA's guidance under the proposed rule when charged by the SEC with failing to supervise would be unable to show that following FINRA's guidance would lead to reasonable supervision of its registered representatives.

For example, a member that failed to supervise a registered representative that committed a violation of the Investment Advisers Act of 1940, through a third-party IA, would likely be unable to demonstrate reasonable supervision under FINRA's proposed rule. The SEC has sanctioned brokerage firms in the past for these types of failures. In the matter of *In re Commonwealth Equity Services, LLP,* Bleidt, a registered representative, misappropriated over $31 million from more than 100 victims. SEC Rel. No. 56362, 2007 WL 3071391 (Sept. 6, 2007). Bleidt misappropriated client funds to fund his own radio station and to run other ventures. He was dually registered with Commonwealth and was the owner of an IA firm, which was "an independent investment adviser registered under the Advisers Act and not affiliated with or controlled by Commonwealth." *Id.* at *2. The SEC was clear in describing the applicable supervisory requirement: "[u]nder Section 15(b)(4)(E) of the Exchange Act, broker-dealers are responsible for reasonably supervising, with a view to preventing violations of the federal securities laws, persons subject to their supervision." *Id.* at *3. The SEC continued, finding that Commonwealth had "failed to establish reasonable policies and procedures for responding to red flags related to Bleidt's outside business activities." *Id.* There are other similar examples of firms being sanctioned for failing to supervise third-party IA activities.[4]

FINRA's only stated justification for the proposed rule is that "IA activities would continue to be subject to regulatory oversight by the SEC and states under a different regulatory scheme." Regulatory Notice 18-08, pg. 8. However, FINRA's reasoning does not address the Section 15(b)(4)(E) of the Exchange Act, which imposes obligations on broker-dealers to supervise their representatives with a view of preventing violations of the securities laws. There

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[3] "[N]o person shall be deemed to have failed reasonably to supervise any other person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with." 15 U.S.C.A. § 78o(b)(4)(E).

[4] *In re Signator Investors, Inc., et al,* SEC Rel. No. 75690 (Aug. 13, 2015) (finding that Signator failed to reasonably supervise both brokerage and advisory client activity of its representative leading to 125 clients being defrauded of $13.5 million); *FINRA v. MidAmerica Financial Services, Inc.,* AWC No. 2012034475001 (FINRA, Jun. 2, 2014) (failing to supervise two brokers' IA activities); *FINRA v. VFG Securities, Inc.,* 2014038997601 (Jan. 26, 2017) (same); *NFP Advisor Services, LLC,* AWC No. 2011025618702 (Jul. 16, 2015) (same).

are no exemptions to the supervisory obligations contained in the Exchange Act. As such, FINRA's reliance on other statutory schemes as support for its proposed rule is misplaced.

In addition, FINRA's proposed rule creates loophole issues that make it difficult, if not impossible to implement the rule. As proposed, "a member also must consider any 'red flags' indicating problematic activities" associated with its registered representatives' activities. Regulatory Notice 18-08, fn. 15. If a registered representative ran his promissory note Ponzi scheme through an outside business that was not an investment advisory firm, his broker/dealer would be required to supervise the activity (and presumably prevent the Ponzi scheme from succeeding). If the same person registered himself as an IA, and ran his scheme through that IA operation, his broker/dealer would not be under the same obligation to monitor the conduct. When called to task, the member firm would surely claim it conducted FINRA's nebulous and meaningless "risk assessment,"[5] but was otherwise not required to supervise the activity. Registered representatives seeking to engage in violations of the securities laws will be incentivized to establish advisory practices in order to shield their activities from the supervision of their member firms.

To further illustrate the unworkable nature of the proposal, we will change the above fact pattern so that some Ponzi scheme victims never sign opening account forms with the IA and no accounts are established at the IA firm. The member firm would be unable to show that the Ponzi scheme, with respect to at least certain victims, was conducted through the IA. Accordingly, the registered representative would be engaging in promissory note sales outside the context of the IA firm, and that activity would accordingly have to be registered under the Exchange Act and subject to the supervision of the registered representative's broker-dealer.

FINRA should not propose a private securities transaction rule whereby a Ponzi schemer's ability or inability to complete paperwork has the effect of altering a member's supervisory responsibilities. A member's supervisory responsibilities stem from the Exchange Act - not from the ability of the firm's representatives to claim supervisory loopholes.

Beyond Ponzi schemes, FINRA's proposed rule would contradict multiple Notice to Members (hereinafter "NTMs") regarding topics 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 held at a member firm to invest entirely in private placements through the registered representative's IA would be a recommendation or investment strategy that the registered representative's member would have to supervise under NTM 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, FINRA's rule proposal does not provide guidance on the supervision of a registered representatives liquidation and transfer of assets to institutions under the registered representative's control or how to comply with NTM 12-

[5] FINRA's stated "risk assessment" test is meaningless as a supervisory device because it merely requires a brokerage firm to approve an activity based upon unverified assertions of its registered representative and without any due diligence or subsequent supervision of the activity. Regulatory Notice 18-08, pg. 5 (the risk assessment would "ordinarily would not require the member to perform an analysis of the underlying outside business activity."); *Id.* pg. 6 (no supervision required if no conditions are placed on the activity).

25's suitability requirements. *See also* NTM 12-25, pg. 8 (Similarly NTM 12-25 states that "[s]uitability obligations apply…to a broker's recommendation…to liquidate securities to purchase an investment-related product that is not a security" but it is unclear whether the proposed rule would require members to supervise these transactions occurring in part at other financial institutions).

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). FINRA's proposed rule does not clarify FINRA's past guidance on member firms' requirements to record correspondence when "red flags" of misconduct are present through outside business activities, through affiliated firms, or third-party IAs that share joint clients with members. It is unlikely that FINRA would be able to devise a supervisory protocol that would achieve compliance with Rule 17a-4 without requiring firms to monitor and record all investment-related emails.

Finally, the proposed rule contradicts 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 NTM 11-54. FINRA's proposed rule states that "[i]f an activity is not investment related, the member has no [supervisory] obligation under the rule." Regulatory Notice 18-08, pg. 5. Yet the SEC has stated that "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."*** Staff Legal Bulletin No. 17: Remote Office Supervision, SEC Rel. No. SLB-3A(CF), 2004 WL 5698359 (Mar. 19, 2004) (emphasis added). "The Commission has recognized that there is a risk that representatives will use outside business activities to carry out or conceal securities law violation[s]." *Id.*

The SEC's position is completely in line with NASD's. The NASD stated long ago that off-site employees who engage in other non-securities businesses "have a greater opportunity than on-site personnel to engage in undetected selling away. Consequently, firms that employ such persons are responsible for monitoring their activities in a manner reasonably intended to detect violations." NTM 86-65. FINRA has also recommended that branch office inspections "identify the nature and extent of outside business activities of registered branch office personnel. Outside business activities conducted by registered persons may carry added risk because these activities may be perceived by customers as part of the member's business." NTM 11-54, pg. 2.

Regulatory Notice 18-08 has not provided evidence that outside businesses no longer pose a risk that registered representatives would use those businesses to conceal securities laws violations. Failing to supervise disclosed businesses or those discovered by "red flags" would subject member firms to charges of failing to supervise and increase the likelihood of investor harm.

PIABA members have seen, all too often, registered representatives establishing solo or small IA firms and using outside business activities in order to avoid member supervision, in order to engage in activities that 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 a registered representative:

Registered Representative	Securities Violation Details
Patrick Churchville (CRD#: 2245842)	Victims alleged that Churchville's member firm failed to supervise Churchville's private equity fraud conducted through his IA. Churchville's

	fraud caused $27 million in losses to more than 220 victims and was subject to an SEC action and criminal charges.
Dean Mustaphalli (CRD#: 2792038)	Victims 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)	Victims 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)	Victims 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.

Despite FINRA's stated intention to propose a single streamlined rule that addresses the outside business activities of registered persons, the proposal contained in Regulatory Notice 18-08 is unworkable. The proposal, if implemented, would clearly increase member firm's reputational and litigation risk as reduced levels of supervision would be unreasonable.

The current rules were issued in order to protect member firms from litigation risk and investors from unsupervised investment activity. FINRA's proposed rule only ensures that members will be exposed to increased litigation and increases the likelihood of investor harm. Moreover, FINRA's Regulatory Notice provides no justification for the rule proposal other than perceived confusion by members. Further, it creates an undue burden on other regulators, who would suffer increased supervisory obligations that are currently assumed by FINRA members.

In sum, PIABA is gravely concerned that FINRA's proposed rule will lead to industry non-compliance with the supervisory requirements of the Exchange Act and provide unscrupulous advisors with a clear road map to commit securities laws violations away from member supervision. PIABA thanks you for the opportunity to comment on this important topic.

Respectfully submitted,

Andrew Stoltmann
PIABA President