COMMONWEALTH *financial network*®

June 29, 2017

By Electronic Mail (pubcom@finra.org)

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 17-20: Retrospective Rule Review
Outside Business Activities and Private Securities Transactions

Dear Ms. Mitchell:

Commonwealth Financial Network® ("Commonwealth") welcomes and appreciates the opportunity to comment on the Financial Industry Regulatory Authority's ("FINRA") Request for Comment on the Effectiveness and Efficiency of Its Rules on Outside Business Activities and Private Securities Transactions pursuant to Regulatory Notice 17-20 (the "Notice"). Commonwealth is an independent broker/dealer and an SEC-registered investment adviser with home office locations in Waltham, Massachusetts, and San Diego, California, and more than 1,700 producing registered representatives ("RRs") who are independent contractors conducting business in all 50 states.

For reasons discussed more fully below, Commonwealth asserts that FINRA Rule 3270 is no longer necessary and should be retired. Further, Commonwealth urges FINRA to make substantial changes to, and provide updated guidance with respect to, the application and scope of Rule 3280.

FINRA RULE 3270, OUTSIDE BUSINESS ACTIVITIES OF REGISTERED PERSONS

Redundant to Existing Form U-4 and Form ADV Part 2B Disclosure Requirements

The Uniform Application for Securities Industry Registration or Transfer ("Form U4") requires all persons who are registered or seeking registration with a member firm to disclose the other business activities in which they are engaged. The criteria for reporting pursuant to Rule 3270 and Form U4 are substantially and materially similar. As such, the reporting obligation applicable to registered persons under Rule 3270 is unnecessarily redundant to the existing reporting obligation for individuals who are registered or seeking registration with a member firm.

Item *13. Other Business* of Form U4 requires individuals to answer "Yes" or "No" to the following question:

> "Are you currently engaged in any other business either as a proprietor, partner, officer, director, employee, trustee, agent or otherwise? (Please exclude non investment-related activity that is exclusively charitable, civic, religious or fraternal and is recognized as tax exempt.)"

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If the individual answers "Yes", the individual is required to provide the following details of the activity:

> " the name of the other business, whether the business is investment-related, the address of the other business, the nature of the other business, your position, title, or relationship with the other business, the start date of your relationship, the approximate number of hours/month you devote to the other business, the number of hours you devote to the other business during securities trading hours, and briefly describe your duties relating to the other business."

Registered persons must not only disclose their other business activities on their first Form U4 filing, but they must also promptly update their Form U4 whenever changes occur to the answers previously reported by the individual. Specifically, Item *15A. Individual/Applicant's Acknowledgement and Consent* of Form U4 requires the individual to acknowledge and consent to the following:

> 9. I understand and certify that the representations in this form apply to all employers with whom I seek registration as indicated in Section 1 (GENERAL INFORMATION) or Section 6 (REGISTRATION REQUESTS WITH AFFILIATED FIRMS) of this form. I agree to update this form by causing an amendment to be filed on a timely basis whenever changes occur to answers previously reported. Further, I represent that, to the extent any information previously submitted is not amended, the information provided in this form is currently accurate and complete.

In addition to the disclosure requirements of FINRA Rule 3270 and Form U4, Investment Advisers Act Rule 204-3 requires registered investment advisers to disclose the other business activities of their supervised persons on a Part 2B Brochure Supplement of Form ADV. Investment Adviser Representatives must disclose specific details regarding any other investment-related business activity in which they engage, as well as other business activities that involve a substantial amount of time or pay. The Securities and Exchange Commission allows advisers to make a presumption that other business activities representing less than 10 percent of the person's time or income are not "substantial."

At Commonwealth, nearly 96% of the firm's producing registered representatives are also investment adviser representatives of our corporate RIA. As such, Commonwealth's advisors must disclose their other business activities on their Commonwealth Part 2B Brochure Supplement in accordance with the requirements of SEC Rule 204-3. The other business activities disclosure required by Rule 204-3 is in addition to the disclosure obligations required by Form U4 and pursuant to FINRA Rule 3270.

The existing regulatory framework, therefore, requires substantially all Commonwealth advisors to disclose their outside business activities to Commonwealth under three separate rules. The outside business activity disclosure requirement of Rule 3270 is redundant to existing Form U4 and Rule 204-3 disclosure requirements, is administratively burdensome, fundamentally unnecessary, and provides no meaningful investor protection.

Supervisory Liability

As FINRA describes in the Notice, Rule 3270 requires registered persons to disclose business activities that are outside the scope of the relationship the registered person has with the member firm. FINRA expresses its concern that a registered person's outside business activities could potentially involve "problematic or risky activities that are unknown to the firm but could be perceived by the investing public as either part of the firm's business or having the firm's imprimatur." FINRA also explains in the Notice that the rule is designed to "protect" the firm:

> "The rules seek to protect the firm from the concomitant reputational and litigation risks. In keeping with these purposes, the rules provide a regulatory framework for firms to be informed of such activities, implement a system to assess them, determine whether to limit or place conditions on the employee's participation in them and, in the case of private securities transactions for compensation, record and supervise the transactions."

As discussed above, the disclosure obligations of Rule 3270 are redundant to existing disclosure requirements on Form U4 and SEC Rule 204-3. Firms already have the opportunity to review significant details about a registered person's outside business activities during the onboarding process and as individuals update their Form U4 and Part 2B Brochure Supplement in compliance with existing requirements. As such, firms already have the ability to limit or impose conditions or restrictions on the registered person's involvement in other business activities should they choose to do so.

When FINRA originally requested comment on Rule 3270, the proposed rule included a requirement that members supervise the outside business activities of their registered persons. During the Rule's comment period, there was consistent industry feedback that including a supervisory requirement for business activities outside the scope of the relationship the registered person had with the member firm exceeded FINRA's authority. Firms were rightly concerned that including such a requirement would unjustly result in supervisory liability for the firm related to activities that had no relationship with the firm. FINRA subsequently modified the rule and withdrew the supervisory component originally proposed.

However, upon modifying the proposed rule FINRA included Supplementary Material .01 Obligations of Member Receiving Notice, which reads as follows:

> **.01 Obligations of Member Receiving Notice.** Upon receipt of a written notice under Rule 3270, a member shall consider whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the member and/or the member's customers or (2) be 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. Based on the member's review of such factors, the member must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including where circumstances warrant, prohibiting the activity. A member also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of Rule 3280. A member must keep a record of its compliance with these obligations with respect to each

written notice received and must preserve this record for the period of time and accessibility specified in SEA Rule 17a-4(e)(1).

Contrary to FINRA's stated intent that the rule seeks to protect member firms, the specific obligations of members required by Supplementary Material .01 actually serves to *increase* the reputational and litigation risks for firms. Although Rule 3270 does not technically contain any specific approval or supervisory requirements, Supplementary Material .01 effectively creates these requirements.

The disclosure and firm review requirements of Rule 3270 have been used as the basis for legal arguments that firms have an obligation to review and supervise their registered person's outside business activities. Plaintiffs have alleged wrongdoing by registered persons who disclosed that they were involved in activities outside the scope of the relationship the registered person had with the member, and they have sought to hold firms accountable for the registered person's outside business activities.

In one such case, a Commonwealth registered person disclosed his involvement as a member of an LLC that owned real property. Among the written representations made by the representative to Commonwealth on the Disclosure of Outside Business Activity form were that he had no signing authority over the organization's banking or investment accounts, and that no Commonwealth customers were involved in the outside business activity. At the time the disclosure was made the firm reviewed the LLC membership agreement and confirmed that no Commonwealth customers were listed as members of the LLC. The representative was subject to several branch office examinations over multiple years by Commonwealth exam staff, and the representative submitted multiple annual questionnaires over several years, consistently confirming that no changes had occurred with respect to the disclosed activity.

Subsequent to Commonwealth's original review of the LLC agreement, and notwithstanding the representative's repeated representations to Commonwealth about the current nature and scope of the activity, a Commonwealth customer of the representative later became an active member of and contributed funds to the LLC. Several years later the customer wished to withdraw as an active member of the LLC and requested the funds be returned. The customer ultimately filed a complaint against the representative and Commonwealth when those funds were not returned. The arbitration panel, citing the disclosure and review requirements of Rule 3270, concluded that Commonwealth had an ongoing duty to supervise the representative's involvement in the LLC. The panel argued that it was not reasonable that Commonwealth did not request and review copies of the LLC membership agreement *on an ongoing basis*, and that it was not reasonable that Commonwealth did not request and review the LLC's financial records *on an ongoing basis* following the original outside business disclosure. In the panel's view, had Commonwealth done so it would have found that the customer had subsequently become involved as an active member in the LLC. While there is no language in Rule 3270 that suggests Commonwealth had either an initial or ongoing duty to supervise the outside business activity, much less take the unusual steps described above, the panel interpreted the rule differently and Commonwealth had little choice but to settle with the customer.

This case provides a clear illustration of how Rule 3270 failed its mandate to protect both Commonwealth and the customer. In fact, the rule was the root cause of inappropriate litigation against Commonwealth relating to activity for which there was no Commonwealth relationship and was misinterpreted by the arbitration panel to Commonwealth's detriment. There are no doubt many examples that firms likely have involving overreach by customers and regulators related to the requirements and implications of Rule 3270.

Harmonization of Outside Business Disclosure Requirements

The outside business activity disclosure requirements of Rule 3270, Form U4 and SEC Rule 204-3 each have their own nuance differences, although the criteria for disclosure pursuant to Rule 3270 and Form U4 are substantially similar. FINRA staff have frequently commented that where it is appropriate to harmonize FINRA rules with the rules of other regulators such as the SEC, they will seek to do so. If FINRA insists on maintaining Rule 3270 it should consider revising the criteria for disclosure under the rule to be consistent with the disclosure criteria applicable to investment advisers. Further, to the extent that a registered person of a member firm is also a supervised person of an investment adviser and is subject to the disclosure requirements of Rule 204-3, such registered persons should be exempt from the redundant Rule 3270 disclosure requirements.

Taking this approach would provide much-needed harmonization between the outside business activity disclosure requirements applicable to broker-dealers and investment advisers. Harmonizing Rule 3270 with Rule 204-3 would also help to eliminate the reporting obligation confusion that exists among registered persons and the resultant discrepancies that exist between Rule 3270 and Part 2B Brochure Supplement disclosures. Further, this approach would provide an opportunity for member firms to streamline their processes for obtaining the requisite disclosures, providing time and monetary cost savings to member firms and their advisors.

FINRA RULE 3280 PRIVATE SECURITIES TRANSACTIONS OF AN ASSOCIATED PERSON

Definitions of "Participation" and "Selling Compensation"

FINRA defines a private securities transaction in Rule 3280(e)(1) as follows:

> "*any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission.*"

Paragraph (c)(2) of Rule 3280 requires any member that approves an associated person's *participation* in a private securities transaction *for selling compensation* to record the transaction on the member's books and records and to "*supervise the person's participation in the transaction as if the transaction were executed on behalf of the member*."

In footnote 7 of Notice to Members 01-79, the NASD "reminded" associated persons that:

> "'*participation' in a private securities transaction includes not only making the sale, but referring customers, introducing customers to the issuer, arranging and/or participating in meetings between customers and the issuer, or receiving a referral or finder's fee from the issuer*."

Over the years, I have encountered countless associated persons who did not understand the scope of the term "participation" as defined by FINRA in NtM 01-79. The vast majority of these cases arise from confusion related to the concept of "introducing customers to the issuer" or "arranging and/or participating in meetings between customers and the issuer." Many advisors' wealthiest clients routinely reach out to their trusted advisors on an unsolicited basis to ask for their opinions or guidance about private securities transactions that the client is considering.

For example, it is not uncommon for some of an advisor's best clients to express interest in participating in a particular type of transaction that is not offered by the advisor's broker-dealer. While the advisor knows that the broker-dealer does not offer a particular product type, they often have knowledge of reputable issuers that do offer such products to public investors. As a result, the advisor decides to introduce or refer their client to the issuer so that the client may pursue the type of transaction in which the client wishes to engage. Likewise, it is not uncommon for some of an advisor's best clients to bring a potential investment idea to their trusted advisor with a request that the advisor join the client in a meeting with the issuer to help the client ask relevant questions and understand the risks and potential benefits of the investment.

These transactions are not introduced, solicited or recommended by the advisor to the client in any respect. Naturally, the advisor feels compelled to help their best clients with these important decisions, and they are most often in the best position to do so. Based on the current definition of the term "participation", if the advisor does nothing more than refer or introduce a client to an issuer, or agrees to accompany the client in a meeting between the customer and the issuer pursuant to the client's specific request, the advisor would be deemed to have "participated" in the transaction. Rule 3280 should be modified to narrow the term "participation" in a manner that permits advisors to provide unsolicited assistance to their clients relating to private securities transactions when they are asked to do so and do not otherwise receive any direct selling compensation from the transaction.

Rule 3280(e)(2) defines "selling compensation" as follows:

> *"any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements."*

The concept of "indirect" compensation is intensely challenging for firms and has led to inadvertent and unintentional violations of the rule by associated persons. For example, some firms and FINRA staff have taken the position that "anything of value" received directly or indirectly would constitute

"selling compensation", without regard to any reasonable connection between the transaction and the compensation received. Additionally, some firms and FINRA staff consider the mere fact that a person is a customer of the firm to constitute de facto "selling compensation", even if the compensation received has no relationship to the 3280 transaction in question. FINRA should narrow the scope of the term "selling compensation" so that it is directly associated with the transaction giving rise to the receipt of compensation.

Finally, member firms should not be responsible for performing redundant supervision of the private securities transactions in which their associated persons participate that are conducted through other regulated entities. To the extent that an associated person participates in a private security transaction "for selling compensation" through a regulated entity other than their member firm, such as another broker-dealer, a registered investment adviser, bank or credit union, such transactions should be exempt from the books and records and supervisory obligations of Rule 3280.

For example, the NASD issued Notice to Members 94-44 and 96-33 more than 20 years ago when investment advisory business was still in its infancy. Since that time, the investment advisory business model has become a primary means of conducting business. Many registered representatives of broker-dealers operate "Hybrid" RIAs that are subject to direct State or SEC oversight in accordance with the National Securities Markets Improvement Act of 1996. Notice to Members 94-44 and 96-33 are outdated, widely misunderstood, and inconsistently applied across member firms. The wide disparity in interpretations of the requirements of NtMs 94-44 and 96-33 in today's marketplace has led to material, widespread differences in firm approaches to the underlying requirements, and FINRA has provided virtually no guidance since their release. FINRA should revise Rule 3280 so that it specifically exempts securities transactions executed through or on behalf of another regulated entity, and it should eliminate or substantially reduce the scope of the expectations described in NtMs 94-44 and 96-33.

ADDITONAL COMMENTS ON FINRA RULES 3270 AND 3280

Member Firm Written Approval or Acknowledgement

FINRA Rule 3270 requires a registered person to provide written notice to his or her member firm, in such form as specified by the member, prior to engaging in an outside business activity. Supplementary Material .01 outlines the specific obligations imposed upon members for review of the notices the firm receives from its registered persons. The rule also obligates firms to "evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including where circumstances warrant, prohibiting the activity." However, the Rule does not prohibit the registered person from engaging in the activity prior to the firm fulfilling its obligations required in Supplementary Material .01.

FINRA Rule 3280 requires a person associated with a member to provide written notice to the member prior to participating in a private securities transaction. Depending upon whether the

associated person has received or may receive selling compensation, the member firm must provide written approval or written acknowledgement of the associated person's participation in the transaction. Similar to Rule 3270, Rule 3280 does not prohibit the registered person from engaging in the activity prior to the firm fulfilling its obligations as described in Rule 3280.

In order to comply with their respective obligations under Rules 3270 and 3280, many member firm policies prohibit registered persons and associated persons from engaging in outside business activities or private securities transactions unless the person has received written approval or acknowledgement of the activity from the firm. While we strongly urge FINRA to retire Rule 3270, to the extent FINRA retains Rule 3270 or revises Rule 3280, we encourage FINRA to consider adding language that prohibits relevant persons from engaging in the activity until the person has received written approval or acknowledgement from their member firm. Doing so will help ensure that a member firm has adequate time to review the proposed activity and provide written notice of any conditions, limitations or prohibitions on the activity.

Non-Registered Persons

FINRA Rule 3270 applies only to "registered persons", while FINRA Rule 3280 applies to any "person associated with the member" whether or not in a registered capacity. FINRA should modify Rule 3280 to apply *only* to registered persons of the member. Persons who are not registered with the member, and who therefore do not engage in solicitation or sales activities through or on behalf of the member, should not be subject to Rule 3280 requirements.

Thank you for the opportunity to provide comment on FINRA's retrospective reviews of Rules 3270 and 3280. If you have any questions or would like to further discuss these issues, please do not hesitate to contact me.

Respectfully,
COMMONWEALTH FINANCIAL NETWORK

Paul J. Tolley
Senior Vice President
Chief Compliance Officer