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Securities Alert

FINRA Requests Comment on Proposed New Outside Business Activities Rule

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FINRA is seeking comment on a proposed new rule, FINRA Rule 3290 (the “Proposed Rule”), which governs the outside business activities and private securities transactions of registered persons. The Proposed Rule would replace both current FINRA Rule 3270 (Outside Business Activities of Registered Persons) and current FINRA Rule 3280 (Private Securities Transactions of Associated Persons), and is intended to reduce unnecessary burdens and focus compliance resources on activities most likely to pose a risk to investors. The comment period expires on April 27, 2018. FINRA requests comment on all aspects of the proposal, and specifically requests comment on the issues listed in Appendix A.

Summary and Highlights

The proposed changes to the rules governing outside business activities and private securities transactions are based on FINRA’s retrospective review of these rules to assess their effectiveness. This retrospective review confirmed the continuing importance of these rules but also indicated that the rules could be better aligned with their goal of protecting the investing public when a member firm’s (“Firm’s”) registered or associated persons engage in potentially problematic activities that are unknown to the Firm but could be perceived by the investing public as part of the Firm’s business. In addition, the retrospective review confirmed that the rule could be better aligned with the current regulatory landscape and business practices. In this regard, notable changes of the Proposed Rule include:

- definitions of the terms “investment-related” and “business activity” and specific Firm obligations for each activity category; and
- exclusion of activities of registered persons on behalf of Firm affiliates from the scope of the Proposed Rule.

Scope of the Proposed Rule

The Proposed Rule would only apply to registered persons, unlike current FINRA Rule 3280 (governing private securities transactions), which currently applies to associated persons. Under the Proposed Rule, registered persons would be required to provide a Firm with written notice of their “investment-related” activities or other “business activities” outside the scope of their relationship with the Firm.

The term “investment-related” would have the same definition as used for Form U4 purposes, defined 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 advisor, futures sponsor, bank, or savings association).” Firms would be responsible for determining whether the proposed activity meets this definition. In this regard, the proposal notes that a Firm must have a process for reasonably determining which activities are investment-related.

The term “business activity” would be similar to the concept in current FINRA Rule 3270, with minor clarifying changes¹, and would include an activity where a registered person was either (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.

Exclusions from Proposed Rule

Certain activities would be excluded from the Proposed Rule. For these excluded activities, all requirements, including the requirement for a registered person to provide prior written notice to a Firm, would not apply. These excluded activities include:

- i. a registered person’s personal investments (which may be subject to other rules, such as FINRA Rule 3210);
- ii. activities conducted on behalf of a Firm affiliate (e.g., investment adviser, bank, insurance entity), unless the activity would require registration as a broker or dealer under the Exchange Act if not for the person’s association with a Firm²;
- iii. transactions in accounts that are subject to FINRA Rule 3210 or transactions on behalf of the registered person’s immediate family members for which the registered person receives no transaction-related compensation; and
- iv. investment advisory activities conducted on behalf of a dually registered broker-dealer/investment advisor or an affiliate investment advisor.³

Requirements of Proposed Rule

The following requirements apply to a proposed activity that meets the definition of “business activity,” “investment-related activity,” or investment advisory activity on behalf of a non-affiliate third-party, not otherwise excluded from the rule.

¹ Such minor changes consist of including within the definition of “business activity” either receiving or having the reasonable expectation to receive compensation from any other person as a result of any business activity outside the scope of the registered person’s relationship with the Firm, and excluding from the definition passive investments and activities subject to the requirements of current FINRA Rule 3280.

² When a registered person can only legally engage in such activity because the person is associated with a Firm, the Firm approving the activity must treat the activity as its own. See FINRA Regulatory Notice 18-08, Outside Business Activities, FINRA Requests Comment on Proposed New Rule Governing Outside Business Activities and Private Securities Transactions, *available at* www.finra.org, at 6.

³ A registered person may engage in investment advisory activities without providing the Firm with prior written notice as long as the Firm is either dually registered, or the activities are on behalf of an investment advisor affiliate. Affiliate is defined as “any entity that controls, is controlled by or is under common control with a [Firm].” A Firm would not be deemed to control an investment advisor merely because it is owned by a registered person of the Firm.

Business Activities

For business activities that are not investment-related, the Firm would only be required to maintain a record of the written notice of the proposed activity that the registered person provided to the Firm.

Investment-Related Activities

For investment-related activities, once the registered person provides written notice of the activity, the Firm would be required to perform a reasonable risk assessment regarding the investment-related activity. Specifically, the Firm would be required to evaluate whether the proposed activity will: (i) interfere with or otherwise compromise the registered person's responsibilities to the Firm's customers; or (ii) be viewed by customers or the public as part of the Firm's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. The risk assessment should consider the registered person's proposed role in the activity, whether the registered person intends to use separate or shared facilities or electronic presence, whether the registered person intends to solicit the Firm's customers, the general nature of the underlying activity, and any red flags indicating problematic activities that raise the risks associated with the registered person engaging in the activity.

The Firm would then be required to notify the registered person in writing whether the proposed activity is (i) approved; (ii) approved subject to conditions or limitations; or (iii) disapproved.

Supervision

The Proposed Rule would require the Firm to supervise the proposed activity under two scenarios: (i) if the Firm approves participation in the investment-related activity but imposes conditions on the approval; and (ii) if the approved investment-related activity requires registration as a broker or dealer.

If the Firm approves the investment-related activity subject to conditions and limitations, the Firm would be required to supervise compliance with the conditions and limitations. The Firm, however, would not be required to supervise the underlying investment-related activity.

If the approved activity is investment-related and such activity would require, if not for the person's association with a Firm, registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity would be deemed the Firm's business.⁴ As a result, the Firm would be required to treat the activity as its own, and comply with all laws and regulations regarding the activity, including supervision and recordkeeping. If the registered person is associated with more than one Firm, the Firms may develop a formal allocation whereby at least one Firm agrees in writing with specificity to comply with all applicable rules and regulations, including those regarding supervision and recordkeeping.

In addition, the Firm would be required to maintain records demonstrating compliance with the risk assessment and the written determination requirements.⁵

⁴ See, *supra*, note 2.

⁵ The Proposed Rule would require the Firm to maintain and preserve records for three years after the registered person's employment or association with the Firm has terminated. There is no general obligation to record transactions resulting from a registered person's outside activities on the Firm's books and records, except for activity described above that requires registration as a broker or dealer and must be treated as a Firm's own activity.

Investment Advisory Activities on Behalf of Non-Affiliate Third-Parties

In contrast to investment advisory activities on behalf of affiliates, which would be excluded from the scope of the Proposed Rule, investment advisory activities on behalf of non-affiliate third-parties are considered investment-related activities, and are subject to the same written notice, assessment, and written determination requirements described above. However, unlike current FINRA Rule 3280 and supporting guidance, there would be no general supervision requirement for these activities and the Firm would not be required to record on its books and records the transactions resulting from such activities.

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Appendix A: Specific Issues for Comment

1. What are the alternative approaches, other than the proposal, that FINRA should consider?
2. How would consolidation of the rules governing outside business activities and private securities transactions in this proposal simplify compliance? What impact would it have on the cost of compliance?
3. Unlike Rule 3280, the Proposed Rule would apply to registered persons, rather than to associated persons. Should the Proposed Rule be expanded to apply to all associated persons? If so, why?
4. Is the proposed scope of the notice requirement appropriately tailored to balance the interest of members to receive information regarding their registered persons' outside activities and any investor protection concerns?
 - a. Should the proposal be modified to require registered persons to provide notice with respect to a narrower set of activities? If so, should notice be required only with respect to investment-related or some other categorization of activities?
 - b. Would narrowing the scope of the proposal impose any additional risks to investors?
5. A member's obligation to conduct a risk assessment is only triggered under the proposal with respect to investment-related activities.
 - a. Does limiting the required risk assessment to activities that are "investment-related" properly balance the interest of allowing members to focus compliance efforts on activities that pose the greatest concerns and any potential harm to investors?
 - b. Is the definition of "investment-related," which is based on the definition used by the Form U4, appropriate given the regulatory objectives of the proposal, or should other activities be included in or excluded from the definition? If so, why?
 - a. The Proposed Rule's focus is on assessing the risks created by the registered person's engagement in the outside investment-related activity, rather than the underlying activity itself. Is this an appropriate focus? Should the risk assessment include a requirement for the member to perform due diligence of the underlying outside activity?
 - b. The member would be required in the risk assessment to evaluate whether the proposed activity will: (i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or (ii) 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. Are these appropriate criteria to evaluate conflicts of interests and other potential areas of harm to investors?
6. The proposal has several exclusions, including for registered persons' personal investments and activities conducted on behalf of an affiliate of a member, unless those activities would require registration as a broker or dealer if not for the person's association with a member. Are the proposed exclusions appropriate?
 - a. Should any other activities be excluded from the rule? If so, why?
 - b. Should the proposed exclusions, including the exclusion for activities on behalf of affiliates, be limited in any manner? For example, should the exclusion be limited to activities on behalf of affiliates that are subject to federal or state financial registration or licensing requirements, such as registered investment advisers, banks and insurance companies?
7. Unlike current Rule 3280 and related guidance, the Proposed Rule would not impose a general supervisory obligation over investment advisory activities and would not require the member to record on its books and records transactions resulting from such investment

advisory activities. Does the treatment of investment advisory activities under the Proposed Rule appropriately address investor protection concerns while recognizing that separate obligations exist under the IA regulatory regime?

8. Under paragraph (b)(4), if a member approves a person's participation in a proposed activity that would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act, the activity is deemed to be the member's business and the member must supervise accordingly.

- a. Is registration under the Exchange Act the appropriate trigger for this provision?
- b. Should paragraph (b)(4) be expanded to require a member to supervise a registered person's sale of securities through an entity that is not required to register under the Exchange Act?
- c. When the registered person is associated with more than one member, the Proposed Rule allows members to develop a formal allocation arrangement whereby at least one member has the regulatory responsibility, including the supervision and recordkeeping of the proposed outside business activity. Are there any competitive effects of such allocation arrangements? Does this flexibility potentially create a disadvantage for some firms regarding how the costs are allocated? Should FINRA consider any other approaches?

9. Are there any material economic impacts, including costs and benefits, to investors, issuers and firms that are associated specifically with the proposal? If so:

- a. What are these economic impacts and what are their primary sources?
- b. To what extent would these economic impacts differ by business attributes, such as size of firm or differences in business models?
- c. What would be the magnitude of these impacts, including costs and benefits?

10. Are there any expected economic impacts associated with the proposal not discussed in this Notice? What are they and what are the estimates of those impacts?

Appendix B: Text of Proposed Rule

3290. Outside Business Activities

(a) Obligations of a Registered Person

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.

(b) Obligations of a Member Receiving Notice of an Investment-Related Activity

- (1) Upon receipt of a written notice of any investment-related activity, a member shall:

(A) perform a reasonable assessment of the risks created by the engagement of the registered person in the proposed activity, including an evaluation of whether the proposed activity will:

(i) interfere with or otherwise compromise the registered person's responsibilities to the member's customers; or

(ii) 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;

(B) consider whether the activity would require the person's registration as a broker or dealer under the Exchange Act if not for the person's association with a member; and

(C) make a reasonable determination of whether to approve the registered person's participation in the proposed activity, to approve it subject to specific conditions or limitations, or to disapprove it.

(2) Upon completion of the member's assessment, a member shall advise the registered person in writing whether the member:

(A) approves the person's participation in the proposed activity and imposes any conditions or limitations on that participation; or

(B) disapproves the person's participation in the proposed activity.

(3) If the member imposes conditions or limitations on its approval of the person's participation in the proposed activity, the member shall reasonably supervise the registered person's compliance with such conditions or limitations.

(4) If the member approves the person's participation in the proposed activity and such activity would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered, the activity shall be deemed to be that of the member and the member shall be subject to all applicable securities laws and regulations and FINRA rules, including those requiring supervision and recordkeeping, with respect to that activity. If the person is associated with more than one member, the members may develop a detailed, formal allocation arrangement, which must be in writing, whereby at least one member agrees to be responsible for compliance with respect to all applicable securities laws and regulations and FINRA rules regarding the proposed activity, including those requiring supervision and recordkeeping.

(5) 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 This Rule shall not apply to:

(a) a registered person's personal investments (including transactions in accounts that are subject to FINRA Rule 3210);

(b) transactions on behalf of the registered person's immediate family members (as defined in FINRA Rule 5130) for which the registered person receives no transaction-related compensation;

(c) activities conducted on behalf of a member's affiliate, unless those activities would require, if not for the person's association with a member, registration as a broker or dealer under the Exchange Act and the person is not so registered; or

(d) a member's non-broker-dealer activities.

.02 For purposes of this Rule:

(a) "Affiliate" means any entity that controls, is controlled by or is under common control with a member.

(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.

(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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