

IBDC

Issues In Supervising Registered Representatives Who are Also RIA's



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FINRA'S 2016 PRIORITIES LETTER

- Areas of Focus:
- Evaluation of firm procedures related to outside business activities (OBAs)
- FINRA Rule 3270 or,
- FINRA Rule 3280, where applicable,
 - Requires firms to determine whether OBAs should be treated as a private securities transaction.
- Notice to Members 91-32 and 94-44, FINRA (then the NASD)
 - Placing orders for an advisory client is a “private securities transaction” if done for compensation, which it almost always is.
- Regulatory Notice 12-25,
 - OBAs do not require the same level of supervision as private securities transaction, but FINRA warned of the obligation of firms to monitor situations involving the overlap of securities and non-securities transactions
 - i.e., recommendation to obtain second mortgage on her house in order to purchase securities.
- With respect to OBAs, the agency notes that one of its most common exam findings is firms’ failure to adequately assess their registered representatives’ written notifications of OBAs.

FINRA RULE 3270

No registered person may be an employee, independent contractor, sole proprietor, officer, director or partner of another person, or be compensated, or have the reasonable expectation of compensation, from any other person as a result of any business activity outside the scope of the relationship with his or her member firm, ***unless*** he or she has provided ***prior written notice*** to the member, in such form as specified by the member.

Passive investments and activities subject to the requirements of ***Rule 3280*** shall be exempted from this requirement.

FINRA Rule 3280

- **Applicability - *private securities transaction***
 - 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, provided however that transactions subject to the notification requirements of NASD Rule 3050, transactions among immediate family members (as defined in FINRA Rule 5130), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded

Guidance – What Constitutes a PST?

- Notice 16-12
 - Pension income stream products
 - Some firms have not been treating these as securities for purposes of Rule 3280
 - Instead treat them as falling under 3270
- FINRA's suggestions:
 - Adopt special procedures and training re: pension income stream products in particular
 - Prohibit the sale of these types of products entirely
 - Keep a list of certain products that reps are permitted to sell

FINRA Rule 3280 Cont'd

- **Written Notice** describing *in detail*
 - the proposed *transaction*
 - the person's proposed *role* therein
 - whether he has received or may receive *selling compensation* in connection with the transaction
 - in the case of a *series of related transactions* in which no selling compensation has been or will be received, an associated person may provide a single written notice

FINRA Rule 3280 Cont'd

- **Transactions for Compensation**

- A member which has received notice pursuant to paragraph (b) shall advise the associated person in writing stating whether the member:
 - approves the person's participation in the proposed transaction; or disapproves the person's participation in the proposed transaction
- If the member approves a person's participation in a transaction:
 - The transaction shall be recorded on the books and records of the member **AND**
 - The member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member
- If the member disapproves a person's participation pursuant to paragraph (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly

Compensation Issues

- "Selling compensation" shall mean 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.

FINRA Rule 3280 Cont'd

- **Transactions Not for Compensation**
- In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to paragraph (b) shall provide the associated person prompt written acknowledgment of said notice and ***may, at its discretion,*** require the person to adhere to specified conditions in connection with his participation in the transaction.

Supervision, Inspection, & Auditing

- With respect to OBAs, the agency notes that one of its most common exam findings is firms' failure to adequately assess their registered representatives' written notifications of OBAs

Elements For Proper Supervisory System

Elements we will Examine when defending claims against you for Supervisory Practices:

- (a) What are the systems in place;
- (b) Explanations for why the systems in place are reasonable
 - “Can always Do More” but can you explain why you didn’t?
- (c) Are the “Independent office” or RIA’s falling through the cracks?
- (d) Product Approval

Elements For Proper Supervisory System

- Computer Systems:
 - Are they designed to catch the errors
 - If not can a system be set up to catch the errors?
 - Is there an explanation for why such a system cannot be set up?
 - Are the products authorized inputted into system
 - How are you setting up systems to catch non approved investments:
 - When you deny a rep's request for product approval – are those being put into system as well?
 - Did the RIA trade outside parameters

Identify Documentation for Supervision

- Supervisory Procedures/Compliance Manuals
- Registered Rep Agreements
- Registered Rep File
- Audits/Inspections (specific offices/testing of procedures)
- Recommendations From Procedure Testing
- Computer Monitoring Systems
- Other Business Activities Reports
- Your Books – compensation related to registered rep
- Communications from Rep – did they ask for approval of investment(s) in question
- Customer Files/Documentation on Claimants
- Performance Reports – Could the Investment Have been Discovered

Branch Office Inspections

FINRA Has Identified Elements of “Good” Branch Office Inspections (Reg. Notice 11-54):

- (a) tailored to business conducted in branch and assess risks specific to that business
- (b) Frequency and Intensity of Exams are Based on Assessed Risk as opposed to an arbitrary cycle
- (c) Minimum Frequency – 1 time per year
- (d) Engage in Significant percentage of Unannounced Exams selected by combination of risk base analysis and random selection
- (e) Inspections by sufficiently senior branch office examiners who understand business and have gravitas to challenge assumptions
- (f) Procedures avoid conflict of interest

Branch Office Inspections

FINRA Identification of Elements for “Deficient” Branch Office Inspections (Reg. Notice 11-54)

- (a) Utilization of Generic Examination Procedures
- (b) Use of Novice or Unseasoned Branch Office Managers who do not have significant experience or understanding of the business.
- (c) Performance of the inspection in a “check the box” fashion without critically questioning the integrity of the underlying control environments and their effect on risk exposure
- (d) Devote minimum time and resources to reviewing the effectiveness of the Branch Office Exam program
- (e) FAILURE TO FOLLOW FIRM’S OWN POLICIES AND PROCEDURES
- (f) Failure to have adequate policies and procedures – esp. when firms use independent contractor model and allow personnel to also conduct business away from the firm.
- (g) Lack of heightened supervision of individuals with disciplinary histories or who were previously associated with firms with disciplinary history

Branch Office Inspections

FINRA believes that a well designed Branch Office Inspection System is useful in overall risk management program in that it allows firms opportunity to validate its surveillance results and to gather on site intelligence.

Document, Document, Document –

Do inspections audits result in written reports with specific recommendations for areas of improvement goals and timeline for reaching them?

Audits (announced/unannounced)

FINRA likes the unannounced visits – so use them when you can

Go in Prepared –

- (a) Risk Assessment;
- (b) Information gathered at the branch office inspections
- (c) On Site Inspections of Each (At least annually)
 - Office locations
 - OSJ's
 - Offices that Supervise Non Branch Locations
- (d) On Site Inspections of all Non Supervising Branch Offices – (At least every 3 years but consider more)
 - Factors to consider for more frequent:
 - (a) Nature and Complexity of Branch's securities business
 - (b) Volume of Business conducted
 - (c) Number of associated persons assigned to each branch
 - (d) Frequency – is there documentation for the cycle selected and the factors considered to determine the frequency of the supervisory inspections?

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