

BROKER-DEALER RESPONSIBILITIES FOR SUPERVISING THE OUTSIDE INVESTMENT ADVISORY SERVICES OF DUALY REGISTERED BROKERS

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ABSTRACT

How broker-dealers supervise the disclosed outside business activities of their dually registered brokers has become a prominent area of discussion in the securities industry. Broker-dealers routinely fail to adhere to regulatory requirements concerning these activities. On February 16, 2018, FINRA issued Notice to Members 18-08, which proposed to eliminate various broker-dealer supervisory obligations. This article argues that Notice to Members 18-08 is a step in the wrong direction and that more supervision is required to maintain investor protection.

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I. INTRODUCTION

New York's Wall Street is considered the top financial center in the world.¹ In 2019, fifty-three percent of families in the United States were invested in the stock market.² Regulation of the stock market is paramount to Wall Street's success.³ One area of regulation that is becoming more prominent in the securities space is how broker⁴-dealers⁵ supervise the disclosed outside investment advisory services of their employees.⁶ Many broker-dealers fail to comprehend how to properly supervise the disclosed outside business practices of its broker employees.⁷

Part I of this article addresses the applicable Financial Industry Regulatory Authority (FINRA) rules that apply to disclosed outside business activities. Next, Part II identifies the responsibilities of broker-dealers in supervising their registered advisors' outside business activities. Part III of this article analyzes recent case law to further clarify the supervisory requirements of broker-dealers. Finally, this article recommends that more regulations are necessary to ensure broker-dealers satisfy their responsibilities for supervising their advisors' outside business activities.

II. RULES GOVERNING SUPERVISING OUTSIDE BUSINESS ACTIVITY

The Securities and Exchange Act of 1934 provides that the Securities and Exchange Commission (SEC) can sanction or revoke the registration of any member firm if it finds that a broker-dealer failed reasonably to supervise a broker who violates the securities laws and was subject to supervision.⁸ Said differently, a broker-dealer reasonably supervises a broker if it establishes procedures that can

¹ Matthew Johnston, *The Top 3 Financial Centers in the World*, INVESTOPEDIA (Sept. 26, 2011), <https://www.investopedia.com/articles/investing/030116/top-three-financial-centres-world.asp>.

² *What percentage of Americans own stock?*, USAFACTS (Mar. 2, 2021), <https://usafacts.org/articles/what-percentage-of-americans-own-stock/>.

³ Andrew Beattie, *The SEC: A Brief History of Regulation*, INVESTOPEDIA (Feb. 3, 2022), <https://www.investopedia.com/articles/07/secbeginning.asp>.

⁴ 15 U.S.C.S. § 78c(a)(4)(A) (LEXIS through Pub. L. 117-80) ("broker" means any person engaged in the business of effecting transactions in securities for the accounts of others).

⁵ 15 U.S.C.S. § 78c(a)(5)(A) (LEXIS through Pub. L. 117-80) ("dealer" means any person engaged in the business of buying and selling securities . . . for such person's own account, either individually or in fiduciary capacity, but not as a part of a regular business).

⁶ *Finra reviewing rules on outside business activities and private securities transactions*, INVESTMENTNEWS, (May 15, 2017), <https://www.investmentnews.com/finra-reviewing-rules-on-outside-business-activities-and-private-securities-transactions-71340>.

⁷ *See Does Your Broker-Dealer Have an Adequate Supervisory System in Place?*, SIA PARTNERS, (Oct. 30, 2020), <https://www.sia-partners.com/en/news-and-publications/from-our-experts/does-your-broker-dealer-have-adequate-supervisory-system> (illustrating that broker-dealers continue to be reprimanded for failing to adequately supervise the outside business activities of its employees).

⁸ 15 U.S.C.S. § 78o(E)(i)-(ii) (LEXIS through Pub. L. No. 117-80).

be reasonably expected to prevent and detect securities violations and that the broker-dealer reasonably discharges the duties and obligations incumbent upon it “without reasonable cause to believe that such procedures and systems were not being complied with.”⁹ Such procedures include establishing a supervisory system that satisfies the minimum requirements set forth by FINRA.¹⁰ To name a few, these requirements include, but are not limited to, designating principals responsible for supervision, creating offices of supervisory jurisdiction, assigning supervisors for registered representatives, and determining the qualifications of supervisory personnel.¹¹ FINRA states that these rules enhance investor protection and market integrity as they play a crucial role in the prevention of sales abuses.¹²

FINRA is a not-for-profit organization that is authorized by Congress to protect America’s investors through ensuring that U.S. broker-dealers operate fairly and honestly.¹³ As part of effectuating its purpose, FINRA requires that a broker or dealer supervise employees with respect to business activities outside the scope of their relationship with their firm.¹⁴ If a broker receives compensation or expects to be compensated by the sale of securities as a result of any business activity outside the scope of the relationship with his or her member firm, the broker must disclose that activity and the broker-dealer must supervise such activity.¹⁵ In other words, broker-dealers must supervise the outside business activities of their brokers when they receive or expect to receive compensation through the sale of securities.¹⁶

Broker-dealers must also, in certain circumstances, supervise the private securities transactions of their employees.¹⁷ Per FINRA Rule 3280, “no person associated with a member shall participate in any manner in a private securities

⁹ *Id.*

¹⁰ *Regulatory Notice 14-10*, FINRA, <https://www.finra.org/rules-guidance/notices/14-10> (Mar. 2014).

¹¹ *Id.*

¹² *Regulatory Notice 18-15*, FINRA, <https://www.finra.org/rules-guidance/notices/18-15> (Apr. 30, 2018).

¹³ *About FINRA*, FINRA, <https://www.finra.org/about> (last visited Feb. 16, 2022).

¹⁴ *See generally 3270. Outside Business Activities of Registered Persons*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3270> (Sept. 21, 2015).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *See generally 3280. Private Securities Transactions of an Associated Person*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3280> (Apr. 3, 2017).

transaction¹⁸ except in accordance with the requirements of this Rule.”¹⁹ Prior to participating in any private securities transaction, Rule 3280 requires an associated person to provide written notice to their associated member describing the proposed transaction, their role therein, and stating whether they have or may receive selling compensation²⁰ in connection with the transaction.²¹ However, as defined in FINRA Rule 5130, “transactions among immediate family members²², for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.”²³ FINRA Rule 5130 essentially provides an exception to Rule 3280 for transactions among immediate family members.²⁴ In other words, except for “transactions among immediate family members” as defined under FINRA Rule 5130, an associated person cannot participate in a private securities transaction without providing their respective member written notice.²⁵

After a member receives notice from an associated person, they must decide whether to approve or disapprove the person’s participation in the proposed transaction.²⁶ In cases of transactions where an associated person “has received or may receive selling compensation, a member which has received notice...shall

¹⁸ 3280. *Private Securities Transactions of an Associated Person*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3280> (Apr. 3, 2017) (“‘Private securities transaction’ shall mean 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 Rule 3210, 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.”).

¹⁹ *Id.*

²⁰ 3280. *Private Securities Transactions of an Associated Person*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3280> (Apr. 3, 2017) (“‘Selling compensation’ means 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.”).

²¹ *Id.*

²² 5130. *Restrictions on the Purchase and Sale of Initial Equity Public Offerings*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/5130> (Jan. 1, 2020) (“‘Immediate family member’ means a person’s parents, mother-in-law or father-in-law, spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children, and any other individual to whom the person provides material support.”).

²³ *Id.*

²⁴ See 3280. *Private Securities Transactions of an Associated Person*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3280> (Apr. 3, 2017) (stating that “transactions among immediate family members” as defined under FINRA Rule 5130 are excluded from Rule 3280).

²⁵ *Id.*

²⁶ *Id.*

advise the associated person in writing whether the member” approves or disapproves the person’s participation in the proposed transaction.²⁷ If the member approves a securities transaction, the transaction must “be recorded on the books and records of the member and the member must supervise the person’s participation in the transaction as if the transaction were executed on behalf of the member.”²⁸ Therefore, if a member approves a transaction or series of transactions, it must supervise the transaction as if it is on the members’ books and records. This means that if a broker-dealer approves the sale of securities through an outside investment advisory firm, the broker-dealer must supervise the securities transactions at the investment advisory firm. However, if the member disapproves a transaction or series of transactions, the broker must “not participate in the transaction in any manner, directly or indirectly.”²⁹ Meaning the associated person can take no part nor play any role in the proposed transaction, regardless of the size of the transaction. In cases where “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...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.”³⁰ In sum, after receiving appropriate notice from an associated person, approving that person’s participation in the transaction means they must supervise the transaction as if it was on completed on their behalf, while disapproving that person’s participation means that person can play no role in the transaction.³¹

FINRA Rule 3280 applies “to all investment advisory activities conducted by registered representatives other than their activities on behalf of the member that result in the purchase or sale of securities by the associated person’s advisory clients.”³² Concluding otherwise would allow registered persons to participate in securities transactions outside the scope of supervision of both their employer and a self-regulatory organization which could be potentially detrimental to investors.³³ In other words, if FINRA Rule 3280 did not apply to all investment advisory activities, registered persons could essentially evade the very supervision that is designed to protect investors.³⁴

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Notice to Members 91-32*, FINRA, <https://www.finra.org/rules-guidance/notices/91-32> (July 1, 1991).

³³ *Id.*

³⁴ *See Notice to Members 91-32*, FINRA, <https://www.finra.org/rules-guidance/notices/91-32> (July 1, 1991) (stating that FINRA Rule 3280 applies to all investment activities to prevent registered persons from evading supervision).

In sum, broker-dealers are required to reasonably supervise their dually registered brokers.³⁵ A broker-dealer reasonably supervises a broker if it establishes procedures reasonably expected to detect and prevent securities violations and reasonably discharges their duties and obligations without reasonable cause to believe that their procedures and systems were not being complied with.³⁶ This required supervision of broker-dealers also extends to the outside business activities and, under certain circumstances, to the private securities transactions of their registered persons.³⁷ With respect to private securities transactions, registered persons must provide their respective member written notice describing the proposed transaction, their role therein, and whether they have received compensation or expect to be compensated in connection with the transaction.³⁸ If the member approves participation in said transaction, they must supervise that person's participation in the transaction as if it were completed on its behalf.³⁹ However, if the member disapproves participation in said transaction, that registered person cannot participate in the transaction in any manner.⁴⁰

III. BROKER-DEALER'S OBLIGATION TO ESTABLISH A SUPERVISORY SYSTEM

With the numerous supervisory requirements imposed on broker-dealers with respect to their dually registered brokers, FINRA provided a methodology which helps broker-dealers comply with all of them.⁴¹ To comply with the Exchange Act's supervision requirements, FINRA implemented Rule 3110.⁴² Per this rule, "each member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."⁴³ FINRA Rule 3110 allows broker-dealers to ensure their associated persons are complying with securities laws by setting a high standard of what

³⁵ 15 U.S.C.S. §78o(E)(i)-(ii) (LEXIS through Pub. L. No. 117-80).

³⁶ *Id.*

³⁷ 3280. *Private Securities Transactions of an Associated Person*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3280> (Apr. 3, 2017).

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *See generally* 3110. *Supervision*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3110> (Jan. 1, 2022) (requiring broker-dealers to establish a system which is specifically tailored to achieve compliance with securities laws).

⁴² *Id.* (identifying the system that is required to ensure broker-dealers comply with applicable securities laws).

⁴³ *Id.*

constitutes an adequate supervisory system through identifying numerous features that it must include.⁴⁴

FINRA Rule 3110 provides a member's supervisory system must, at the very least, satisfy certain criteria. First, members must establish and maintain written procedures as required by this rule.⁴⁵ Second, members must designate, where applicable, appropriate registered principal or principals with authority to carry out supervisory responsibilities of members for each type of business which it engages.⁴⁶ Third, members must register and designate a branch office or an officer of supervisory jurisdiction ("OSJ") for each location, including its main office.⁴⁷ Fourth, members must designate one or more registered principals in each OSJ and one or more registered representatives in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.⁴⁸ Fifth, members must assign each registered person to a registered representative or principal who will be responsible for supervising their activities.⁴⁹ Sixth, members must use reasonable efforts to determine that all supervisory personnel are qualified, either by experience or training, to carry out their responsibilities.⁵⁰ Seventh, members must ensure that they meet with each registered representative and principal, either in an interview or meeting, to discuss compliance matters relevant to the activities of the representatives and principals.⁵¹ In sum, the supervisory system must include written procedures, designated principals with the authority to carry out supervisory responsibilities, and assignments for each registered to a designated principal to meet to discuss compliance matters.⁵²

It is a firm's responsibility to "review their supervisory procedures to make sure that they are reasonably designed to achieve compliance with [FINRA] Rules [3270] and [3280] regarding outside business activities and private securities transactions."⁵³ To be effective, supervision "must be designed to monitor securities related activities and detect and prevent regulatory compliance problems of such associated persons working at unregistered offices."⁵⁴ In addition, "relevant supervisory procedures, must enable the member to properly supervise the

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Notice to Members 96-33*, FINRA, <https://www.finra.org/rules-guidance/notices/96-33> (May 1996).

⁵⁴ *Notice to Members 98-38*, FINRA, <https://www.finra.org/rules-guidance/notices/98-38> (May 1998).

representative by...evaluating the ‘suitability of the transactions.’”⁵⁵ In other words, firms must review their supervisory procedures to ensure they are designed to monitor, detect, and prevent regulatory compliance problems and enable the member to supervise their representatives by evaluating the suitability of the transactions.⁵⁶ To evaluate the suitability of transactions, firms may utilize many of the following books and records: (1) dated notifications from representatives detailing their services to be performed and the identity of each of their customers serviced at another firm in a private securities transactions, (2) the dated responses from the member to the representative acknowledging or disapproving their intended activities, (3) a list of a representatives customers, (4) copies of customers account opening cards, (5) copies of discretionary account agreements, (6) duplicate confirmation statements, (7) duplicate customer account statements, (8) a correspondence file for representatives customers, (9) investment advisory agreements between representatives and clients, (10) advertising materials and sales literature used by representatives to promote investment advisory services, and (11) exception reports based on various occurrences or patterns of specified activity, such as frequency of trading, high compensation arrangements, large number of trade corrections, and cancelled trades.⁵⁷ No single document or combination of the referenced documents is required to comply with securities laws.⁵⁸ Rather, each member has the ability to determine which combination of records is necessary to develop an adequate supervisory system.⁵⁹ This provides members with tremendous flexibility to develop and implement recordkeeping and supervisory systems that can meet their individual needs.⁶⁰

In addition, there are certain circumstances where firms are required to record transactions on their books and records as if they were their own.⁶¹ Under Article III, Section 27 of the Rules of Fair Practice, a member who approves a transaction where the registered person has received or may receive selling compensation must record the transaction in its own books and records, as well as supervise the registered person’s participation in the transaction as if it was the member’s own.⁶² After a representative provides the member with a subsequent written notice that details changes and requests member’s further approval to conduct advisory activities on behalf of the customer, “the employer must record subsequent transactions on its books and records and supervise activity in the

⁵⁵ *Notice to Members 96-33*, *supra* note 53.

⁵⁶ *Notice to Members 98-38*, *supra* note 54; *Notice to Members 96-33*, *supra* note 53.

⁵⁷ *Notice to Members 96-33*, *supra* note 53.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ See *Notice to Members 94-44*, FINRA, [finra.org/rules-guidance/notices/94-44](https://www.finra.org/rules-guidance/notices/94-44) (last visited Feb. 10, 2022) (identifying the circumstances where firms must record transactions on their books and records as if they were their own).

⁶² *Id.*

affected accounts as if it were its own.”⁶³ In sum, after a member approves a transaction where their registered person has received or may receive selling compensation or approves any request to conduct advisory activities on the member’s behalf, they must record the transaction on its own books and records, as well as supervise the approved activity as if it were the member’s own.⁶⁴

Broker-dealers’ supervisory obligations stem in large part from FINRA Rule 3110.⁶⁵ Under this rule, members must establish a supervisory system that is reasonably designed to achieve compliance with applicable securities laws, regulations, and FINRA rules.⁶⁶ However, establishing a supervisory system alone is not enough.⁶⁷ Members must periodically review their supervisory system and procedures.⁶⁸

IV. ANALYSIS OF HOW TO STRENGTHEN SUPERVISION

The rules governing outside business activities and private securities transactions serve important goals.⁶⁹ They seek to protect the investing public when a member’s associated persons engage in problematic or potentially problematic activities that are not known to the member but could be interpreted by the public as being part of the member’s business.⁷⁰ A secondary benefit is that the rules protect the member from reputational and litigation risks.⁷¹ However, the overarching purpose of these supervision rules is to protect investors from actors who seek to evade regulatory requirements and harm investors for their own personal gain.⁷²

In May 2017, FINRA launched a retrospective review of its outside business activities and private securities transactions rules to assess their effectiveness and efficiency.⁷³ Specifically, FINRA looked closely at members’ obligations with respect to the investment advisory activities of their registered

⁶³ *Notice to Members 96-33*, FINRA, <https://www.finra.org/rules-guidance/notices/96-33> (May 1996).

⁶⁴ *Notice to Members 94-44*, *supra* note 61.

⁶⁵ *See generally 3110. Supervision*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3110> (Jan. 1, 2022) (identifying the system that broker-dealers must establish).

⁶⁶ *Id.*

⁶⁷ *See Notice to Members 96-33*, FINRA, <https://www.finra.org/rules-guidance/notices/96-33> (May 1996) (explaining that establishing a system alone is not sufficient in that broker-dealers must also periodically review their system and procedures to ensure compliance with applicable laws, regulations, and FINRA rules).

⁶⁸ *Id.*

⁶⁹ *Regulatory Notice 18-08*, FINRA, <https://www.finra.org/rules-guidance/notices/18-08> (Apr. 27, 2018).

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Regulatory Notice 18-15*, *supra* note 12.

⁷³ *Regulatory Notice 18-08*, *supra* note 69.

persons.⁷⁴ Their review confirmed the continuing importance of rules relating to outside activities, but also indicated that current rules could benefit from changes to better align them with the goal of protecting investors.⁷⁵ During the review, a majority of broker-dealers that provided feedback believed that the scope of activities governed by FINRA Rule 3270 should be narrowed.⁷⁶ Conversely, a significant minority of investing public and their representatives favored the current scope of FINRA Rule 3270.⁷⁷ As a result, FINRA proposed a rule to reduce the supervisory obligations of broker-dealers to supervise the investment advisory services of brokers dually registered businesses.

FINRA proposed Rule 3290, which stated in relevant part “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.”⁷⁸ The proposed new rule had several effects. First, it would replace FINRA Rules 3270 and 3280.⁷⁹ Second, the rule would clarify a member’s obligations with respect to outside business activities and reduce its burdens, while allegedly strengthening protections relating to activities that may pose risks to investors.⁸⁰ Third, the proposed rule would require registered persons to provide their employers with prior written notice with respect to a broad range of outside activities that they engaged in.⁸¹ Fourth, the rule required members to perform risk assessments on a narrower set of investment related activities.⁸² Fifth, the rule excluded a registered person’s personal investments and work done on behalf of the member’s affiliates.⁸³ Sixth, the proposed rule would impose no supervisory or recording obligations for most other outside activities not specifically addressed within this rule.⁸⁴ This proposed rule would effectively relieve broker-dealers of their supervisory obligations, leaving registered persons the unfettered discretion to engage in outside business activities with the investing public.⁸⁵

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *See id.* (explaining that proposed rule 3290 would replace rules 3270 and 3280).

Notice to members 18-08 was a step in the wrong direction for several reasons.⁸⁶ First, stripping members of their supervisory requirements runs contrary to the goals of protecting both members and investors from potentially problematic outside business activities of a member's associated persons.⁸⁷ The rules governing outside business activities seek to protect the investing public from the potentially problematic activities that are unknown to the member.⁸⁸ In addition, these rules also protect members from reputational and litigation risks associated with their associated person's unknown outside activities.⁸⁹ FINRA and member firms play critical roles in protecting investors.⁹⁰ An effective supervisory system plays an essential role in, for example, preventing sales abuses, and as a result, strengthens investor protection.⁹¹ Therefore, relieving members of certain supervisory obligations weakens investor protection and thus runs contrary to the goals of FINRA in enforcing these rules pertaining to outside investor activities.⁹²

Second, relieving members of these well-established supervisory responsibilities creates a risk of members' associated person's engaging in outside activities that could negatively impact investors.⁹³ There are findings that suggest that when broker-dealers have geographically dispersed offices staffed by only a few people, many are not subject to onsite supervision.⁹⁴ The distance between offices and supervisory personnel can make it easier for associated persons to engage in and conceal violations of securities laws.⁹⁵ Strong supervisory systems

⁸⁶ See generally Andrew Stoltmann & Adam J. Gana, *REPORT: FINRA's Attempt to Gut Investor Protection; Proposed Reforms to FINRA Supervision Rules*, PIABA (Oct. 4, 2018), <https://piaba.org/piaba-newsroom/report-finras-attempt-gut-investor-protection-proposed-reforms-finra-supervision> (outlining the issues associated with FINRA's proposed new rule under NTM 18-08).

⁸⁷ See *In re Siegel*, No. 3-12659, 2008 SEC LEXIS 2459 at *36 (Oct. 6, 2008), *aff'd* *Siegel v. SEC*, 592 F.3d 147, 156 (D.C. Cir. 2010) (“[FINRA] Conduct Rule [3280] 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.”); see also *Notice to Members 91-32*, *supra* note 32 (addressing that FINRA’s new proposed rule [3290] would replace rule 3280).

⁸⁸ *Notice to Members 91-32*, *supra* note 32.

⁸⁹ *Id.*

⁹⁰ *Regulatory Notice 18-15*, *supra* note 12.

⁹¹ *Id.*

⁹² *Id.*

⁹³ See *What We Do*, FINRA, <https://www.finra.org/about/what-we-do> (last visited Dec. 5, 2021) (stating that FINRA’s mission is to “safeguard the investing public against fraud and bad practices”); see also *Regulatory Notice 18-15*, *supra* note 12

(explaining “an effective supervisory system plays an essential role in the prevention of sales abuses, and thus, enhances investor protection...”).

⁹⁴ Remote Office Supervision, Exchange Act Release No. SLB-3A (CF), 2004 WL 5698359, at *1 (Mar. 19, 2004).

⁹⁵ *Id.*

protect investors from questionable activities of their advisors.⁹⁶ Relieving members of supervisory responsibilities, especially those for monitoring outside business activities, subjects investors to risks associated with advisors engaging in such activities.⁹⁷ Furthermore, subjecting investors to such risks, again, runs contrary to the goals of securities laws in protecting investors.⁹⁸ In sum, notice to members 18-08 runs contrary to the goals of securities laws in that it weakens investor protection in that it creates a risk of members' associated persons engaging in outside activities that could be problematic to investors.⁹⁹

These rules governing supervision protect both investors and members.¹⁰⁰ FINRA, through notice to members 18-08, sought to enhance investor protection by effectively eliminating these very rules.¹⁰¹ While good intentioned, doing would run contrary to FINRA's core purpose of protecting the investing public.¹⁰² Additionally, abolishing these supervisory rules would create a risk of member's associated persons engaging in outside activities that could potentially harm investors.¹⁰³ Rather, more supervision is needed and members should be reminded of their current supervisory obligations under rules 3270 and 3280.¹⁰⁴

⁹⁶ *Regulatory Notice 18-15*, *supra* note 12.

⁹⁷ *Id.*

⁹⁸ *See In re Siegel*, No. 3-12659, 2008 SEC LEXIS 2459 at *36 (Oct. 6, 2008), *aff'd* *Siegel v. SEC*, 592 F.3d 147, 156 (D.C. Cir. 2010) (“[FINRA] Conduct Rule [3280] 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”); *see also Regulatory Notice 18-08*, *supra* note 69 (addressing that FINRA’s new proposed rule [3290] would replace rule 3280).

⁹⁹ *See In re Siegel*, No. 3-12659, 2008 SEC LEXIS 2459 at *36 (Oct. 6, 2008), *aff'd* *Siegel v. SEC*, 592 F.3d 147, 156 (D.C. Cir. 2010) (“[FINRA] Conduct Rule [3280] 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”); *See also Regulatory Notice 18-15*, *supra* note 12 (explaining “an effective supervisory system plays an essential role in the prevention of sales abuses, and thus, enhances investor protection...”).

¹⁰⁰ *Regulatory Notice 18-08*, *supra* note 69.

¹⁰¹ *Id.*

¹⁰² *See In re Siegel*, No. 3-12659, 2008 SEC LEXIS 2459 at *36 (Oct. 6, 2008), *aff'd* *Siegel v. SEC*, 592 F.3d 147, 156 (D.C. Cir. 2010) (“[FINRA] Conduct Rule [3280] 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”); *see also Regulatory Notice 18-08*, *supra* note 69 (addressing that FINRA’s new proposed rule [3290] would replace rule 3280).

¹⁰³ *Regulatory Notice 18-08*, *supra* note 69.

¹⁰⁴ *Stoltmann & Gana*, *supra* note 86.

V. RECOMMENDATION AND CONCLUSION

Notice to Members 18-08 is a step in the wrong direction because relieving members of supervisory responsibilities has several negative consequences that undermine the objectives of securities laws.¹⁰⁵ As stated in this article, FINRA has imposed various rules on broker-dealers to supervise the outside business activities of their members. Specifically, members must establish, maintain, and review the system they have in place to supervise the activities of their associated persons.¹⁰⁶

First, relieving members of certain supervisory requirements, specifically narrowing the set of investment related activities that required risk assessments and not imposing supervisory requirements for activities that do not fall under the proposed rule, weakens the system that is intended to protect investors.¹⁰⁷ Second, relieving members of supervisory responsibilities opens the door for associated persons to engage in outside activities that could harm investors.¹⁰⁸ A weaker supervisory system, as well as fewer supervisory obligations imposed on the broker-dealers, can lead to violations of securities laws that fall through the cracks.

Instead, more supervision is required to accomplish the goals of protecting both investors and members from the potentially problematic outside business activities of their associated persons.¹⁰⁹ Rather, it would be most advantageous for FINRA to publish a notice to members specifically identifying, clarifying, and strengthening members supervisory requirements under rules 3270 and 3280.¹¹⁰ Specifically, FINRA should remind all broker-dealers of their obligations to supervise all outside business activity whether disclosed or undisclosed and detail for its members the specific ways in which the member firms can supervise the conduct of its employees to both detect and monitor outside investment advisory services.

¹⁰⁵ *Id.*

¹⁰⁶ *3110. Supervision*, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3110> (Jan. 1, 2022) (requiring broker-dealers to establish a system which is specifically tailored to achieve compliance with securities laws); *Notice to Members 96-33*, FINRA, <https://www.finra.org/rules-guidance/notices/96-33> (May 1996) (stating that broker-dealers must also periodically review their system and procedures to ensure compliance with applicable laws, regulations, and FINRA rules).

¹⁰⁷ *See In re Siegel*, 2008 SEC LEXIS 2459 at *36; *see also Regulatory Notice 18-08*, *supra* note 69 (addressing that FINRA's new proposed rule [3290] would replace rule 3280).

¹⁰⁸ *See Regulatory Notice 18-15*, *supra* note 12 (explaining "an effective supervisory system plays an essential role in the prevention of sales abuses, and thus, enhances investor protection...").

¹⁰⁹ Stoltmann & Gana, *supra* note 86.

¹¹⁰ *Id.*