

July 30, 2010

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

**Re: File No. SR-FINRA-2009-042 – Response to Comments**

Dear Ms. Murphy:

This letter responds to comments submitted to the Securities and Exchange Commission (“SEC” or “Commission”) regarding the above-referenced rule filing,<sup>1</sup> a proposed rule change to adopt new FINRA Rule 3270 (Outside Business Activities of Registered Persons). The Commission received six comment letters in response to the proposal.<sup>2</sup>

The proposed rule change would require registered persons to give notice to member firms prior to engaging in an outside business activity. Specifically, proposed FINRA Rule 3270 would prohibit any registered person from being an employee, independent contractor, sole proprietor, officer, director or partner of another person, or being compensated, or having the reasonable expectation of compensation, from another 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. The proposed rule’s Supplementary Material sets forth the obligations of a member upon receipt of a written notice of a proposed outside business activity.

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<sup>1</sup> See Securities Exchange Act Release No. 60199 (June 30, 2009), 74 FR 32668 (July 8, 2009) (Notice of Filing of Proposed Rule Change Relating to Outside Business Activities of Registered Persons; File No. SR-FINRA-2009-042).

<sup>2</sup> Letter from James Livingston, National Planning Holdings, Inc., dated July 28, 2009 (“NPH”); Letter from Dale E. Brown, CAE, Financial Services Institute, dated July 29, 2009 (“FSI”); Letter from Joan Hinchman, National Society of Compliance Professionals, Inc., dated July 29, 2009 (“NSCP”); Letter from Gary A. Sanders, National Association of Insurance and Financial Advisors, dated July 29, 2009 (“NAIFA”); Letter from Clifford E. Kirsch and Susan S. Krawczyk, Sutherland Asbill & Brennan LLP, on behalf of the Committee of Annuity Insurers, dated July 29, 2009 (“Sutherland”); and Letter from Stephanie L. Brown, LPL Financial Corporation, dated August 6, 2009 (“LPL”).

Generally, proposed FINRA Rule 3270, like its predecessor NASD Rule 3030, requires members to be cognizant of the non-securities activities engaged in by their registered persons away from the firm, to implement a system to assess the risk that these outside business activities may cause potential harm to investors and to manage these risks by taking appropriate actions as prescribed by the proposed rule. The proposed rule does not aim to regulate the day-to-day outside business activities of registered persons nor does it impose a comprehensive supervisory requirement on such activities.

The comments received by the Commission on proposed FINRA Rule 3270 and FINRA's responses to the comments are discussed in detail below.

### **General Requirement**

#### ***➤ Prior Member Consent to Outside Business Activities of Registered Persons***

Certain commenters suggest that FINRA amend proposed FINRA Rule 3270 to require a member's consent before a registered person may engage in any outside business activity. One commenter<sup>3</sup> notes that in practice most registered persons are required to get written acknowledgement from their firm prior to engaging in outside business activities, and believes that requiring member consent ensures that the registered person does not engage in an outside business activity before the member completes its due diligence as required under the proposed Supplementary Material in proposed FINRA Rule 3270. According to two commenters,<sup>4</sup> allowing a registered person to engage in outside business activities upon notice of the proposed activity without a requirement that the firm consent to such activity places the firm in a position of risk during the interim period since the firm may not have had ample time to review the matter. Certain commenters believe the proposed rule should require an affirmative written response from the member<sup>5</sup> or a written response noting any objections or concerns to the proposed activity.<sup>6</sup> One commenter supports the proposal not to incorporate a member consent requirement but notes that the requirements of proposed Supplementary Material .01 are the functional equivalent of requiring prior consent from the member.<sup>7</sup>

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<sup>3</sup> NPH

<sup>4</sup> FSI, LPL

<sup>5</sup> FSI, LPL

<sup>6</sup> NAIFA

<sup>7</sup> NAIFA

FINRA does not plan to amend the proposal to incorporate a prior member consent requirement for a registered person's outside business activities as such a requirement is not necessary for all types of firms. FINRA notes that the proposal does not preclude any member from including a prior member consent requirement as part of its procedures to manage the outside business activities of its registered persons. If a member is concerned about interim risk exposure, the member should implement a system of procedures that would allow the firm to complete its review of proposed outside business activities and make a determination on how to proceed in a reasonable time period, or prohibit a registered person from engaging in outside business activities until the member has completed its review.

➤ ***“Compensation” and “Reasonable Expectation of Compensation”***

One commenter believes that the “reasonable expectation of compensation” standard in proposed FINRA Rule 3270 is too vague, particularly if this initial determination is made by the registered person,<sup>8</sup> and fears that FINRA will question the initial determinations made by registered persons and/or their supervisors. This commenter requests guidance on facts and circumstances that would be relevant in making this initial determination. Also, the commenter recommends that FINRA clarify that the initial determination should be made by the member, based on information provided by the registered person, and that it would not be triggered absent a concrete understanding or agreement between the registered person and its outside business that compensation will or will likely be paid over time. Another commenter requests that FINRA define the term “compensation.”<sup>9</sup>

FINRA believes that the standards in the proposed rule are appropriate and workable. FINRA expects that members will demand sufficient information to enable them to make the necessary determinations. Moreover, FINRA does not believe that the reasonableness of a determination will be judged in hindsight, but rather based on the information requested and obtained at the time of the registered person's prior written notice. Also, FINRA does not intend to amend the proposal to adopt a definition for the term “compensation” in the proposed rule. FINRA notes that neither NASD Rule 3030 nor NYSE Rule 346, upon which the proposed rule change is based, includes a definition of the term “compensation,” and FINRA believes that incorporating a definition of this term in the proposed rule may frustrate the intent and application of the rule as it may encourage registered persons to structure outside business arrangements to purposefully evade the requirements of the proposed rule.

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<sup>8</sup> Sutherland

<sup>9</sup> FSI

Also, a commenter suggests changing language in the general requirement of proposed FINRA Rule 3270.<sup>10</sup> The proposed rule provides that “[n]o 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.” The commenter requests that the phrase “as a result of any business activity” be replaced with “in conjunction with an established business enterprise.” The commenter advocates a revised approach noting that an individual is an employee, officer or director in a business entity or not, so it does not make sense to connect these relationships to the phrase “as a result of any business activity.”

First, the language that the commenter finds confusing (i.e., the reference to “as a result of any business activity”) is from NASD Rule 3030 and has not been changed under the proposal. Second, this language does not modify the terms “employee, officer or director...” The phrase “as a result of any business activity” modifies the compensation language directly preceding it. Accordingly, the proposed rule prohibits a registered person from either acting in one of the enumerated roles or from being compensated by, or having 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 notice to the member. FINRA does not intend to amend the proposal to incorporate the suggested language.

➤ *Reporting Material Changes to Outside Business Activities*

A few commenters request that the proposed rule impose an ongoing obligation on registered persons to provide prior written notice to a member should an outside business activity undergo a material change.<sup>11</sup> Two commenters note that without such a requirement, a member has no way to make knowledgeable decisions regarding these activities subjecting the firm to regulatory risk and harm.<sup>12</sup> One commenter requests clarification on a member’s liability in the event an outside business activity changes over time.<sup>13</sup>

FINRA believes that the requirement for a registered person to amend or supplement the nature of the prior written notice is implicit in the proposed rule change. A registered person’s prior written notice is valid only to the extent that it

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<sup>10</sup> FSI

<sup>11</sup> FSI, LPL, NPH

<sup>12</sup> FSI, LPL

<sup>13</sup> NSCP

continues to accurately describe the outside business activity. Thus, it is incumbent on the registered person to provide prior written notice before altering the nature of any outside business activity previously disclosed in writing to the firm.

Moreover, a member's supervisory system should demand that each registered person notify the member in the event of a material change to his or her outside business activities.

**Supplementary Material .01 (Obligations of Member Receiving Notice)**

All of the comment letters received by the Commission address proposed Supplementary Material .01. Certain commenters oppose the proposed Supplementary Material, in whole or in part, and request that it be removed from the proposal.<sup>14</sup>

Generally, the commenters believe that the proposal exceeds FINRA's jurisdiction by imposing on members a supervisory obligation for the outside business activities of its registered persons.<sup>15</sup> The commenters note that members do not have the resources to supervise the wide variety of outside business activities in which their registered persons engage. One commenter further provides that this limited knowledge or expertise impedes the determination of whether an outside business activity raises investor protection concerns.<sup>16</sup> Certain other commenters believe that the proposed Supplementary Material will distract members from core supervisory functions<sup>17</sup> by requiring supervision of activities beyond their purview or practical control, and advise the SEC and FINRA not to spread the attention of member firms too thinly.<sup>18</sup> One commenter expresses concern that requiring firms to "implement procedures or restrictions" is wholly inconsistent with the activity being an *outside* business activity, effectively resulting in a supervision requirement, particularly when combined with the "investor protection concerns" standard.<sup>19</sup> This commenter also believes requiring supervision of outside business activities could subject members to additional licensing and registration requirements under other regulatory schemes applicable to the outside business activity.<sup>20</sup>

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<sup>14</sup> FSI, LPL, NAIFA, Sutherland

<sup>15</sup> FSI, LPL, NAIFA, NPH, NSCP, Sutherland

<sup>16</sup> NPH

<sup>17</sup> FSI, NAIFA

<sup>18</sup> NAIFA

<sup>19</sup> Sutherland

<sup>20</sup> Sutherland

Certain commenters suggest that FINRA clarify the due diligence required in making a determination whether a proposed outside business activity raises “investor protection concerns”<sup>21</sup> and, further, how FINRA defines the terms “investor,” “protect investors” and “investor protection concerns” for purposes of the proposed rule.<sup>22</sup> One commenter notes that the term “investor protection concerns” could be subject to interpretation and applied differently across member firms.<sup>23</sup> Another commenter states that almost any activity could raise investor protection concerns and suggests that, unless this term is defined as it relates to non-securities activities, FINRA should remove it from the proposal.<sup>24</sup> One commenter believes the proposed Supplementary Material is overly broad because many outside business activities have nothing to do with traditional investors or investor protection issues and requests clarification on the application of an investor protection concerns standard to outside business activities.<sup>25</sup>

In response to the comments received by the Commission, FINRA is amending proposed Supplementary Material .01. FINRA will expect members to assess the impact of the outside activity on the member’s business and the member’s customers, as well as the extent to which customers or the public would perceive the outside activity to be part of the member’s business. Specifically, the revised proposal would provide that, upon receipt of a written notice under proposed FINRA 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. Additionally, based on the member’s review of such factors, the member would be required 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.

The proposed requirement that a member determine whether an activity properly is characterized as an outside business activity or as an outside securities activity subject to the requirements of NASD Rule 3040, and the proposed recordkeeping requirement, would remain in Supplementary Material .01 as originally proposed.

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<sup>21</sup> LPL, NPH, NSCP

<sup>22</sup> FSI, NSCP, Sutherland

<sup>23</sup> LPL

<sup>24</sup> NSCP

<sup>25</sup> Sutherland

While FINRA recognizes that a member does not have the same supervisory responsibilities over a registered person's outside *non-securities* activities as it does for his or her outside *securities* activities, a member nevertheless has an important regulatory responsibility to evaluate the potential impact of the outside business activities of its registered persons, and this provision emphasizes that responsibility. FINRA does not believe that a member can neglect to consider the impact of a registered person's outside business activities on the firm and/or its customers, or the extent to which such activity may be perceived as part of the member's business owing to the fact that the person is registered with the member.

In addition, FINRA believes that the commenters' concerns regarding an implied supervision requirement for a registered person's outside business activities are overstated and introduce a requirement into the proposed rule that does not exist. Proposed Rule 3270, including Supplementary Material .01, aims to strike a reasonable balance that will allow a member to permit registered persons to engage in outside business activities while addressing the impact of the registered person's outside activities on the firm and investors. As noted above, this requirement is particularly important as investors may not perceive the distinctions between a registered person's business at the member and his or her outside business activities, and may mistakenly believe that all of a registered person's financial activities are endorsed and reviewed by the firm.

➤ ***Books, Records and Reporting Requirements for Outside Business Activities***

One commenter seeks clarification regarding the level of documentation required to be maintained by a member in making its determination with respect to a registered person's outside business activities, specifically that legal opinions or other documentation are not required to support the member's characterization of the activity.<sup>26</sup>

Under the proposed rule change, a member would be required to maintain a record of its compliance with the proposed rule for each written notice received from a registered person and to preserve such records as specified in Exchange Act Rule 17a-4(e)(1). These records would include the assessment that a firm makes with respect to whether a proposed outside business activity interferes with or otherwise compromises a registered person's responsibilities to the member and/or the member's customers, or could be viewed by customers or the public as part of the member's business. Additionally, a member would be required to maintain records addressing specific conditions or limitations placed on a registered person's outside business activity, or prohibition of such activity. The nature of these records will vary based upon the scope of the proposed outside business activity. However, there is nothing in the proposed rule change that would require an opinion of counsel.

Another commenter requests guidance on whether the proposed rule imposes a reporting obligation if a member determines that a registered person's outside business activity should be prohibited and believes that the concern is systematic in nature, such as fraud, or whether it is sufficient to prohibit the activity.<sup>27</sup> The proposed rule does not expressly require that a member report a registered person for activities that it determines should be prohibited. However, certain events or violations are subject to reporting and disclosure requirements under the federal securities laws and regulations and other SRO rules.<sup>28</sup>

### **Implementation of the Proposed Rule**

#### **➤ *Pre-existing Outside Business Activities***

Certain commenters request guidance on the application of the proposed rule to pre-existing outside business activities in which registered persons are already actively engaged in such activity since prior notice would be impossible.<sup>29</sup> One commenter notes that it will be a substantial task to analyze established outside business activities and adopt policies and procedures for each of them.<sup>30</sup> A second commenter questions whether the member has an obligation to reach out to registered persons whose activities were not covered under NASD Rule 3030, but would be covered under the proposed rule.<sup>31</sup> And, another commenter believes that in circumstances where a registered person is already engaged in an outside business activity before becoming associated with a member (*i.e.*, transfers his or her registration from one member to another or enters the securities business for the first time), the proposed rule should require that the registered person give notice prior to the registered person's registration with the member.<sup>32</sup>

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<sup>27</sup> NPH

<sup>28</sup> See, *e.g.*, Forms BD, U4 and U5. See also, *e.g.*, NASD Rule 3070 and NYSE Rule 351. See Regulatory Notice 08-71 (FINRA Requests Comment on Proposed Consolidated FINRA Rule Governing Reporting Requirements) (November 2008); see also Regulatory Notice 08-70 (FINRA Provides Guidance Regarding Credit for Extraordinary Cooperation) (November 2008).

<sup>29</sup> FSI, NPH, Sutherland

<sup>30</sup> FSI

<sup>31</sup> NPH

<sup>32</sup> Sutherland

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FINRA believes that before a member employs a registered person, the member should review the outside activities of such person. If the member cannot acquire sufficient information on these activities prior to a registered person's employment (i.e., merger, acquisition or other transition of a group of individuals to the firm), the firm should obtain this information within a reasonable amount of time following employment.

With respect to registered persons who are currently actively involved in outside business activities that have not been reviewed under the requirements of the proposed rule, FINRA believes that firms must undertake a review of these activities on or before the effective date of the proposed rule change. FINRA will allow sufficient time for firms to review the outside business activities of their registered persons to satisfy the standards in proposed FINRA Rule 3270. FINRA does not see any justification to "grandfather" existing outside business activities of a registered person from the requirements of the proposed rule change.

If you have any questions, please contact me at (202) 728-8104 or at [gary.goldsholle@finra.org](mailto:gary.goldsholle@finra.org).

Very truly yours,

A handwritten signature in black ink, appearing to read "Gary Goldsholle", with a long horizontal line extending to the right.

Gary L. Goldsholle  
Vice President and Associate General Counsel  
Office of General Counsel