Dual Registration and FINRA Supervision

By Dan LeGaye

Daniel E. LeGaye has been involved actively in Corporate, Securities and Business Law since 1980. His primary career focus has been on the financial and securities industry where he has worked closely with institutions, broker/dealers, investment advisers and insurance agencies to ensure compliance with the myriad of applicable securities laws, rules and regulations. Mr. LeGaye has successfully represented individuals and businesses, and has guided them in a wide variety of commercial transactions, corporate structuring and regulatory compliance issues.

Overview

Supervision of registered persons has always been a challenge for senior management and the compliance staff of member firms of the Financial Industry Regulatory Authority (FINRA). However, as the financial services industry has evolved, the supervision of registered persons that are dually registered or affiliated, either with another broker-dealer, an investment adviser or other financial services firm has become increasingly complex. While FINRA speaks regularly about how there is no "one size fits all" approach to compliance, it is clear that supervisory issues related to dual registration have made a standard approach to supervision of these activities an exception.

In an effort to "compartmentalize" the issue for our purposes here, this article will focus on dual affiliations with registered investment advisers. However, note that the concepts related to the supervision of outside investment advisory activities have also been utilized by FINRA to address the sale of variable annuities, promissory notes and the supervision of life settlements.[1] Thus, the same analysis and process should be applied to the approval of any outside business or securities activities.

Due to the many variations in advisory platforms and services that have evolved in recent years, dual registration supervision has become complex. While the supervision obligation of a firm is clear to FINRA, there is little clarity as to whether the supervision standards actually implemented will be acceptable. FINRA will judge in hind-sight and with the clarity of perfect vision if there is a failure in supervision. Thus, prior to approving an outside securities activity which results in a dual registration situation, compliance professionals have a matrix of issues and facts to review and analyze. This analysis includes factors such as whether the activity is with an affiliated or unaffiliated entity, whether it is with an entity owned or managed by the registered person, the level of advisory services which will be provided to the advisory clients, including activities

that may result in custody issues. If the advisory services include recommending and executing securities transactions (for example, affiliation with an investment adviser where the registered person gives discretionary and or non-discretionary portfolio advice), the supervisory obligations are significantly greater than where the dual registrant is engaged in solicitor activity. That is based upon solicitor activity being deemed an outside business activity, while portfolio management is an outside securities activity.

Regulatory Obligations of Dually Registered Persons

Registered persons of FINRA member firms are required, either under NASD Rule 3030 (Rule 3030) or NASD Rule 3040 (Rule 3040) to report any kind of business activity engaged in away from the member firm that they are associated with as a registered person. At this time, Rule 3030 requires that a registered person give prompt written notice to be employed, or accept compensation from any business activity, other than a passive investment, outside the scope of his or her relationship with a member firm.[2] Notwithstanding the current status of Rule 3030, FINRA is proposing to adopt Rule 3030 as FINRA Rule 3270 (Outside Business Activities of Registered Persons) in the consolidated FINRA rulebook. [3] Proposed FINRA Rule 3270 would prohibit any registered person from engaging in an outside business activity, or being compensated, or having the reasonable expectation of compensation, as a result of any such outside business activity, unless such registered person provided prior written notice to the member firm. While the proposed rule change expands the obligations imposed under Rule 3030, those issues, while significant, are outside the scope of this discussion.

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However, it is fair to say that the proposed rule will potentially move outside business activities to the same notice and supervisory obligation as outside securities activities. Daniel M. Gallagher, Jr., Co-Acting Director, Division of Trading and Markets, U.S. Securities and Exchange Commission, confirmed that in a speech given to the Practicing Law Institute in New York on October 28, 2009, where he stated that "FINRA is proposing to transfer NASD Rule 3030 into the consolidated FINRA rulebook with changes that would require a member to make a determination whether an outside business activity raises investor protection concerns. If so, under the proposed rule change, the firm would be required to implement procedures or restrictions on the activity to protect investors, or prohibit the activity". In other words, even if full-blown supervision was not required, the firm would not be able to turn a blind eye to the activities of its representatives.

Rule 3040 on the other hand, does require registered persons to provide written notice of proposed outside securities transactions or activities before such activities are engaged in. The notice must describe the proposed activity and or transaction in detail, the registered person's proposed role, and must also state whether the individual has received or may receive compensation for those activities.[4] Additionally, if the registered person expects to receive compensation for such activities, the firm must advise the registered person, in writing, whether it approves or disapproves the person's participation in the proposed transaction.

Regulatory Obligations of the Firm

Where a member firm has approved a registered person's participation in outside securities activities, its requirement for ongoing compliance activities has just begun. FINRA has repeatedly stated that the member firm must develop and maintain a recordkeeping system that, among other things, captures the transactions executed away from the

Advisory Record and Supervision Matrix

Recordkeeping	Advisory Activity	Activity	Activity Supervision	Transaction Suitability
External	Unaffiliated – Portfolio Management [1]	Outside Securities	Oversight of Off Site Activities	Oversight Of External Data
Internal[2]	Affiliated – Portfolio Management	Outside Securities	Existing Oversight Structure[3]	Existing Oversight Structure[3]
External	Unaffiliated – Third Party Money Manager Program	Outside Securities	Oversight of Off Site Activities	Oversight Of External Data
Internal[2]	Affiliated – Party Money Manager Program	Outside Securities	Existing Oversight Structure[3]	Existing Oversight Structure[3]
External	Unaffiliated Financial Planning w/ implementation	Outside Securities	Oversight of Off Site Activities	Oversight Of External Data
Internal[2]	Affiliated Financial Planning w/ implementation	Outside Securities	Existing Oversight Structure[3]	Existing Oversight Structure[3]
External	Unaffiliated Financial Planning w/ implementation	Outside Securities	Oversight of Off Site Activities	Oversight Of External Data
Internal[2]	Affiliated Financial Planning w/ implementation	Outside Securities	Oversight of Off Site Activities	Existing Oversight Structure[3]
External	Unaffiliated Financial Planning w/o implementation	Outside Business	Oversight of Off Site Activities	N/A
Internal[2]	Affiliated Financial Planning w/o implementation	Outside Business	Oversight of Off Site Activities	N/A
External	Unaffiliated Solicitor	Outside Business	Grey Area[4]	N/A
Internal [2]	Affiliated Solicitor	Outside Business	Existing Oversight Structure[3]	N/A

[1] Portfolio management would include managing securities (debt, equities, mutual funds, etc) on a discretionary or non-discretionary basis.
[2] Assumes utilization of the member's Clearing Firm. Utilization of third party custodian would change access to records to external sources.
[3] Assumes that the affiliated advisory entity has supervisory procedures and privacy policy allows sharing of information between firms.
[4] While an outside business activity, it is arguable that in the event of a violation of securities laws, the broker-dealer had an obligation to supervise. As a result, some firms require a third party review of advisors to confirm they comply with relevant securities laws, even where the advisory activities appear to be an outside business activity.

firm by the registered person in its books and records, and supervise that activity.[5]

The supervisory obligation is really comprised of four separate parts. First the firm must maintain adequate records documenting the approval of outside business activity and or transactions. Then the firm must: (i) maintain adequate records documenting the approval of the outside securities transactions; (ii) integrate the utilization of those records into its policies and procedures so as to maximize supervision of the advisory activities of the dual registrant; and (iii) determine the suitability of the transactions recommended by the registered person to advisory clients. As reflected on the Advisory Record and Supervisory Matrix above, while some advisory activities do not rise to the level of an outside securities activity, those unaffiliated advisory activities that do, result in the need to access external records, which means that oversight of the advisory activities is more difficult, including confirmation of transactions for suitability.

Record Keeping Requirements

To the extent the advisory activity is subject to Rule 3040, the firm may be required to maintain records that it obtains from third parties who may or may not be affiliated with the dual registrant. Access to these records is critical, especially where the records required are documented in the firm's written supervisory procedures. The recordkeeping system developed, together with relevant supervisory procedures, must enable the firm to supervise the dual registrant by aiding the firm's understanding of the nature of the service provided by a registered representative/investment advisor (RR/IA), and the suitability of the transactions.

Depending on the advisory services that the registered person actually provides to advisory clients, other documentation is helpful; although any system utilized must capture in the firm's books and records, all of the transactions executed by the dual registrant away from the firm.

Supervisory Requirements – Registered Persons Activities

NASD Rule 3010 governs the obligation to supervise, and it generally requires that a member's supervisory system be reasonably designed to achieve compliance with applicable laws and regulations. FINRA has stated that the standard recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations. However, they believe the standard does require that the system be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business described above. Because reasonableness is determined in light of the particular facts and circumstances surrounding a situation, and in hindsight, it is difficult for anyone to articulate with any specificity, a standard that would be applicable in all circumstances. Notwithstanding that, the firm remains responsible for supervision, and, pursuant to Rule 3010, that includes the supervision of the activities of *each registered representative*, *registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations*, and with applicable NASD Rules.[6] Final responsibility for proper supervision rests with the member firm, and that includes supervision of outside securities activities.

Supervisory Requirements – Suitability of Transactions

NASD Rule 2310 states that in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.[7] In general, it is asserted that a member's suitability obligation applies to securities that the member "recommends" to a customer. Historically, the FINRA suitability rule has been deemed to have been violated when a broker-dealer "recommends" a security to a customer that might be suitable for some investors, but is unsuitable for that particular customer.[8] With respect to outside securities activities, FINRA believes that the suitability rule applies, and as such, the firm has an obligation to confirm the suitability of "recommendations" made to advisory clients by the dual registrant.

Ramifications of Non-Compliance

The ramifications of non-compliance to the registered person who is a dual registrant are significant, and the cases against members are relatively easy to make by simply following the paper trail … it either evidences written approval or it does not. There were twenty seven (27) enforcement actions against registered representatives between August 2009 and February 2010. Of the six (6) actions brought concerning outside securities activities, five (5) persons were barred, and one (1) person received a $25,000 fine and a fifteen (15) month suspension. Of the twenty one (21) actions brought concerning outside business activities, seven (7) persons were barred, and fourteen (14) persons received fines in the aggregate of $119,000 (ranging from $2,500 to $25,000), and suspensions ranging from twenty (20) days to two (2) years.[9]

Interestingly, the ramifications are significant to firms, but they don't generally come from FINRA or the SEC enforcement actions. Generally, while sanctions against firms do occur for failure to supervise registered persons for Rule 3030 or Rule 3040 violations, they are not as frequent as sanctions against registered persons. This is due to the fact that most registered persons' violation of the rule is, by definition, done outside the firm, and because the cost to prosecute a failure to supervise case by the regulators is substantial. Short of an obviously egregious case, regulators have tended to focus on other cases. Notwithstanding that, the plaintiffs' bar has clearly focused on failure to supervise Rule 3030 and Rule 3040 activities, and actively promote litigation with respect to those activities. Thus the real, on-going ramification for a firm is the cost of reputation, and the cost of litigation combined with opportunity cost. The opportunity cost is directly related to the lack of focus on the "business" that often occurs from the reallocation of resources to defending litigation based upon the lack of supervision claim. Collectively, this can be as significant as regulatory sanctions.

With the above thoughts in mind, we are brought to a point where you have to ask yourself, "what

can I do in the real world to mitigate the regulatory and litigation exposure for my firm"? What is practical, what is logical, and what can be reasonably implemented so as to reasonably protect the public, your firm, and you as a compliance professional? While, unfortunately, no bright line rules exist, which if followed would alleviate all exposure; there are a number of steps that can be taken to mitigate exposure for firms. The following represent action items which will provide support to the supervisory processes used by a firm in the supervision of its dually registered persons.

Action Items for Supervision of Dually Registered Advisory Persons

Education regarding Rule 3030 and Rule 3040 ramifications and process

Knowing that most regulatory actions are brought against registered persons who fail to advise you of their activities is valuable. This alerts you to the fact that your first course of action should be to protect your firm and mitigate its exposure by fully educating your registered persons on their obligations with respect to NASD Rule 3030 and 3040. To address that issue, it is recommended that the registered persons affiliated with the firm be regularly advised of:

- the differentiation between outside business activities and outside securities activities;
- the ramifications of engaging in a Rule 3030 or Rule 3040 activity without written approval; and
- your firm's process to have such potential activities reviewed and approved by the firm, prior to their engaging in the same.

Additionally, the education should be regular and periodic, not just when registered representatives are first hired. Notwithstanding that, being apprised of the firm's policies and procedures regarding outside business activities and outside securities activities is important at the time of hiring, and it should be documented by requiring new hires to sign an attestation indicating understanding of the policies and procedures, and to advise the firm whether they are currently engaged in either of the activities. Additionally, information regarding outside business and securities activities should be integrated into the Firm Element of Continuing Education, and also be addressed in the annual and or quarterly written attestation process to further document the process. While registered representatives should be required to update their initial attestations quarterly and or annually to address any changes in their activities, this is also an opportunity to continue the educational process.

Finally, and probably as important, is the ongoing education of the supervisory staff as to the specific regulatory issues that affect an advisory firm, so that they can better see the potential pitfalls for the broker-dealer. Without this ongoing professional growth, supervisors subject themselves to being buried in the regulatory box that is created by not seeing or knowing that which they are unaware of.

While the supervision obligation of a firm is clear to FINRA, there is little clarity as to whether the supervision standards actually implemented will be acceptable.

Process

Once approved, the firm has to approach the supervision of outside business activities and securities activities in a proactive manner. By understanding its obligations, and reviewing the processes that are utilized to assure, the firm is positioned to actually supervise those activities from a risk management perspective. But as stated previously, the process will also require an understanding of the services provided by the dual registrant, and the recordkeeping requirements of the firm.

Documentation necessary to address initial approval recordkeeping requirements

Based upon the analysis described above, you should be able to start putting the basic documentation process in place, which would include a combination of the following books and records:

- A written summary detailing the services to be performed by the dual registrant;
- A written request from the registered person to engage in the outside business and or securities activity, and

- A written response from the firm acknowledging and approving the registered persons intended advisory activities.

The approval set out above should include express conditions to such approval that address your future documentation requirements. At a minimum, the conditions should include a commitment from the dual registrant to provide copies and commitment from that person's supervisor to make certain that they receive copies of the following documents for your files, if appropriate:

- Customer account opening documents with other broker-dealers to determine, among other things, suitability;
- Discretionary account agreements;
- Correspondence generated by the registered person for advisory customers;
- Investment advisory agreements between the registered person and each advisory client; and
- Advertising materials and sales literature used by the dual registrant to promote investment advisory services.
- Additionally, you should confirm with any third party custodians and review your operational systems to confirm that you can generate:
- A list of all registered persons who are approved and also dually registered with a investment advisory firm;
- A list of each advisory customer serviced at another firm in a private securities transaction by the registered person; and or a list of advisory customers (customer listings should be updated as changes are made), including those that are customers of both the firm and investment advisory firm, cross referencing the registered person's accounts. Prior approval from the firm for each transaction should not be required, but prior approval for each new client should be required.

Analyze advisory services and relationship to Rule 3030 and 3040

During the approval process, it is critical to review the actual advisory services to be provided and determine the relationship such services have to the recordkeeping and supervision obligations of the firm. Once you have profiled those obligations, you are able to then make assumptions on the best way to proceed and handle the prospective activities of your potentially dually registered person. This would include at least a review of the following documentation, along with a comparison to the business description provided during the approval process:

- The proposed client advisory agreements that are anticipated to be utilized. This will allow for a determination as to whether the services that the dual registrant states will be provided conform with what is being presented to a prospective advisory client. It also allows you to make a determination of how active the registered representative will be in the transaction process (i.e. do they provide solicitor, recommend third party managers, or are they involved in providing actual advice as to the investment portfolio).
- The Form ADV Part II and Schedule F, and or Schedule H, if appropriate, to again, confirm advisory services, along with determining who is disclosed to be utilized for custodial services (i.e, confirm whether the services will be provided on or off your brokerage trading platform). It is also important to review the disclosures related to trading and compensation to make sure that any conflicts of interest between the firm, the dual registrant and the advisory client are disclosed.

Written Supervisory Procedures

It is also important to review and revise your written supervisory procedures to assure that they address the supervision and recordkeeping requirements, including the identity of persons responsible for Rule 3030 and Rule 3040 supervision and compliance, the recordkeeping system to be used and followed, and the documentation and or compliance manuals that notify dual registrants of the member's procedural requirements. This is critical in that ultimately you will need to be able to back test to confirm that the supervisory actions you took complied with what you committed to do in your procedures.

Other Recommendations

Based upon the advisory activities engaged in, the business model utilized (i.e. private label, franchise platform, etc), there are a number of other items that you should consider:

E-Mail. E-Mail monitoring should be included in the overall supervisory platform as it is already

required, and it is not only proactive, but transparent. Since NASD Rule 2210 requires firms to treat e-mail in the same manner as written correspondence, email review parameters should be expanded to include the targeting of outside activities, as well as determining if outside activities have not been reported.

Joint Supervision Agreements. I have seen more broker/dealers entering into joint supervision agreements whereby the parties clarify which entity is responsible for which type of activity (brokerage versus adviser) and jointly agreeing what documentation each firm will provide the other for their regulatory due diligence files. This has really been an evolution of the joint supervision agreements between banks and broker-dealers, and while you can't abdicate your responsibilities, you can make it clear who should be responsible for specific aspects of the supervisory process that are related solely to either the advisory business or the brokerage business. It is also helpful in that the parties agree and understand what documentation will be needed, and it mitigates the potential for supervisors of the different firms to posture as to what activities were their responsibility.

Annual Exams. A number of broker-dealers are now requiring dual registrants who provide advisory services to clients through an investment adviser that the dual registrant has an ownership interest or management position in, to provide the firm with third party reviews of the firm advisory activities to confirm that the advisory firm is complying with the Investment Advisers Act of 1940 ("Advisers Act") or related statutes. As a practical matter, even where the investment adviser is not affiliated with the Dual Registrant, the firm should request a copy of the annual review, even if prepared internally, as it provides a good window into the compliance culture. To the extent they haven't conducted one, or it appears that minimal effort was put into it, this could be viewed as a red flag as to potential future exposure created by the dual registrant's advisory activities.

Regulatory Inquiries. Clearly you should request a copy of any regulatory inquiries and or responses. While there is generally pushback on this, to the extent an advisory firm refuses to provide a copy of exam results, regulatory inquiries and the related responses; it does communicate that there may be an issue. Failure to address regulatory shortcomings will clearly undermine your firms' ability to defend itself if the advisory firm that a dual registrant is affiliated with has regulatory issues. Clients, and their counsel, tend to judge you by the firms you become affiliated with … either directly or indirectly.

Conclusion

There is no escaping the fact that the investment advisory and brokerage industries are each subject to substantial regulation. To make a complex situation worse, the statutes and rules with which the investment advisory firms must operate are not always intuitively consistent. Even with the proposed "harmonization" of regulation, it will be years before the two financial services platforms are fully and consistently integrated. In the meantime, this bifurcation has significant ramifications on the effective supervision of dually registered representatives, and creates both confusion and uncertainty for the compliance professionals tasked with that oversight.

As a result, there is an increase in the regulatory and professional expectations placed on compliance professionals in brokerage firms. Now they must not only keep up with the ever changing rules related to their primary business focus, but they are tasked with understanding the subtleties of the advisory industry, and must understand the impact it all might have on their firms. British writer, G. K. Chesterton best summarized the dilemma when he stated "It isn't that they can't see the solution. It is that they can't see the problem".

Where a member firm has approved a registered person's participation in outside securities activities, its requirement for ongoing compliance activities has just begun.

Compliance professionals must continue to manage their firms' growth by continually increasing their understanding of the evolving advisory industry, and continuing to learn about the impact it has on their supervisory processes. The end goal is to

assist registered representatives circumvent the regulatory "gotchas" stemming from outside business and securities activities; while protecting their firms from the regulatory and litigation exposure created by lack of supervision of related outside activities. By any standard, that is an honorable goal.

ENDNOTES

1 See NTM 01-79 NASD Reminds Members Of Their Responsibilities Regarding Private Securities Transactions Involving Notes And Other Securities And Outside Business Activities

2 See NASD Rule 3030. Outside Business Activities of an Associated Person for the full text of the rule.

3 See Securities and Exchange Commission (Release No. 34-60199; File No. SR-FINRA-2009-042); Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Proposed Rule Change Relating to Outside Business Activities of Registered Persons; June 30, 2009.

4 See NASD Rule 3040. Private Securities Transactions of an Associated Person

5 NTM 88-5 Request for Comments on Proposed NASD Rule of Fair Practice Regarding Outside; Business Activities; 94-44 Board Approves Clarification On Applicability Of Article III, Section 40 Of Rules Of Fair Practice To Investment Advisory Activities Of Registered Representatives; NTM 96-33 NASD Clarifies Rules Governing RR/IAs for more discussion on the supervisory obligations of member firms with respect to various activities.

6 3010. Supervision

7 NASD Rule 2310 Recommendations to Customers (Suitability)

8 NASD Notice to Members 01-23 –Online Suitability

9 See FINRA sanctions from August 2009 through February 2010.