Points of Emphasis/Best Practice Summary

FINRA Rule 3270 governs the outside business activities of registered persons. It stipulates that "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." While this disclosure is not new and most firms and registered representatives are aware of the prior written notice requirement, some firms are either not aware of their responsibilities upon receipt of that written notice, or they have failed to complete their responsibilities following their receipt of the written notice from the registered representative.

Maintain records of the written notice and decision concerning outside business activities.

Supplementary Material .01 of Rule 3270 places requirements on the firm to evaluate the proposed outside business activity and make a determination as to whether limitations should be placed on the activity, whether the activity should be prohibited altogether, and whether the outside activity should be treated as a private securities transaction subject to the requirements of Rule 3040. In making their determination, firms should consider whether the proposed activity will interfere with their duties with the firm, or whether the activity will be viewed by customers or the public as part of the firm's business. The firm should then provide written notice to the registered representative of its determination to approve the activity, limit the representatives involvement with the activity, or prohibit the activity altogether.

This practice should be followed regardless of whether the representative is already engaged in the activity and disclosing the outside activity as part of the registration process, or if the representative is already registered with the firm. Firms are required to maintain records of its compliance with these requirements. Therefore, firms should maintain copies of the written notices received from the representative as well as the written notice of the firm's decision provided to the representative, in addition to any notes or memoranda that may have been created during the evaluation of the outside activity.

Regulatory Corner

The SEC has issued proposed rule, "Regulation S-ID: Identity Theft Red Flags," requiring entities that are subject to the SEC's jurisdiction to develop and implement a written identity theft prevention program that is designed to detect, prevent, and mitigate identity theft. The SEC is also proposing guidelines to assist these entities in the formulation and maintenance of a program that would satisfy the requirements of the proposed rules. The proposed rules and guidelines are substantially similar to the Fair and Accurate Credit Transactions Act of 2003, which was adopted in 2007. Among other financial institutions included in the scope of Regulation S-ID, an investment adviser that is registered or required to be registered under the Investment Advisers Act of 1940 will be subject to the proposed rules.

The definition of "financial institution" includes certain banks and credit unions and "any other person that, directly or indirectly, holds a transaction account (as defined in section 19(b) of the Federal Reserve Act) belonging to a consumer." Section 19(b) of the Federal Reserve Act defines a transaction account as "a deposit or account on which the depositor or account holder is permitted to make withdrawals by negotiable or transferable instrument, payment orders of withdrawal, telephone transfers, or other similar items for the purpose of making payments or transfers to third parties or others." The SEC recognizes that most registered investment advisers are unlikely to hold transaction accounts and thus would not qualify as financial institutions. The proposed definition nonetheless does not exclude investment advisers or any other entities regulated by the SEC because they may hold transaction accounts or otherwise meet the definition of "financial institution."

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The SEC acknowledges that some financial institutions may engage only in transactions with businesses where the risk of identity theft is minimal. In these instances, the financial institution may determine after a preliminary risk assessment that it does not need to develop and implement a program. Under the proposed rules, a financial institution or creditor that initially determines that it does not need to have a program would be required to periodically reassess whether it must develop and implement a program in light of changes in the accounts that it offers or maintains and the various other factors set forth in the proposed rule.

Word on the Street

FINRA has ramped up its regulatory and examination priorities for 2012, and also intends to employ a more risk-based approach of its examinations tailored to the individual firm. FINRA's first step in that process was to distribute a Risk Control Assessment to all member firms in the first quarter. The Assessment is in a survey format and asks questions relevant to a firms' business model. Firms are encouraged to complete the Risk Control Assessment as FINRA believes the result will yield a more risk-appropriate examination and better-informed examiners.

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Some of the areas FINRA will be focusing their exams this year include business conduct and sales practice concerns for retail customers, which will focus on, among other things, residential and commercial mortgage-backed securities, non-traded REITS, municipal securities, complex exchange traded products, variable annuities, structured products, securities offered through private placements, and life settlements. FINRA examiners will also be focusing on microcap fraud, reverse mergers, private securities transactions and outside business activities, integrity of supervision and internal controls, information technology and cyber security, outsourcing, fees, branch office inspections, social media and electronic communications, leverage and liquidity, margin-lending practices and custody of assets collateralizing margin loans, expense-sharing arrangements, information barriers, and OATS, among others.

Specific to information technology and cyber security, FINRA has indicated that they have received an increasing number of reports of incidents of customer funds stolen as a result of instructions emailed to firms from compromised customer email accounts. It is recommended that firms assess their policies and procedures on accepting instructions to transmit or withdraw funds via email to ensure they are adequate to protect customer assets from such risks.