

An aerial photograph of a city skyline, likely New York City, showing a dense cluster of skyscrapers and a river in the background. A semi-transparent green rectangular overlay is positioned in the upper middle section of the image, containing white text. The text is arranged in four lines, centered horizontally.

Distinguishing Between Outside Business Activities & Private Securities Transactions





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INTRODUCTION

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Defining and monitoring outside business activities (OBA) and private securities transactions (PST) is a big challenge for brokerages. As a result, FINRA has placed major emphasis on these disclosure types, exemplifying the frequency of these issue for firms and associated persons throughout the industry. In fact, FINRA has sanctioned over 1,663 firms and individuals for committing outside business activities and private securities transactions violations.

Even with regulators' express concern regarding these conflicts of interest, many firms and individuals continue to get penalized for these types of activities. *But, why?* In this white paper, we will help identify, and distinguish, the differences between outside business activities and private securities transactions while providing examples of deficiencies recorded by FINRA; as well as, tips on how your firm can remain compliant with its disclosure obligations.



FINRA will focus on these areas and determine whether customers have been harmed due to failures to follow the provisions of Rule 3270 (or Rule 3280 where applicable)”

- FINRA Examination Priorities Letter



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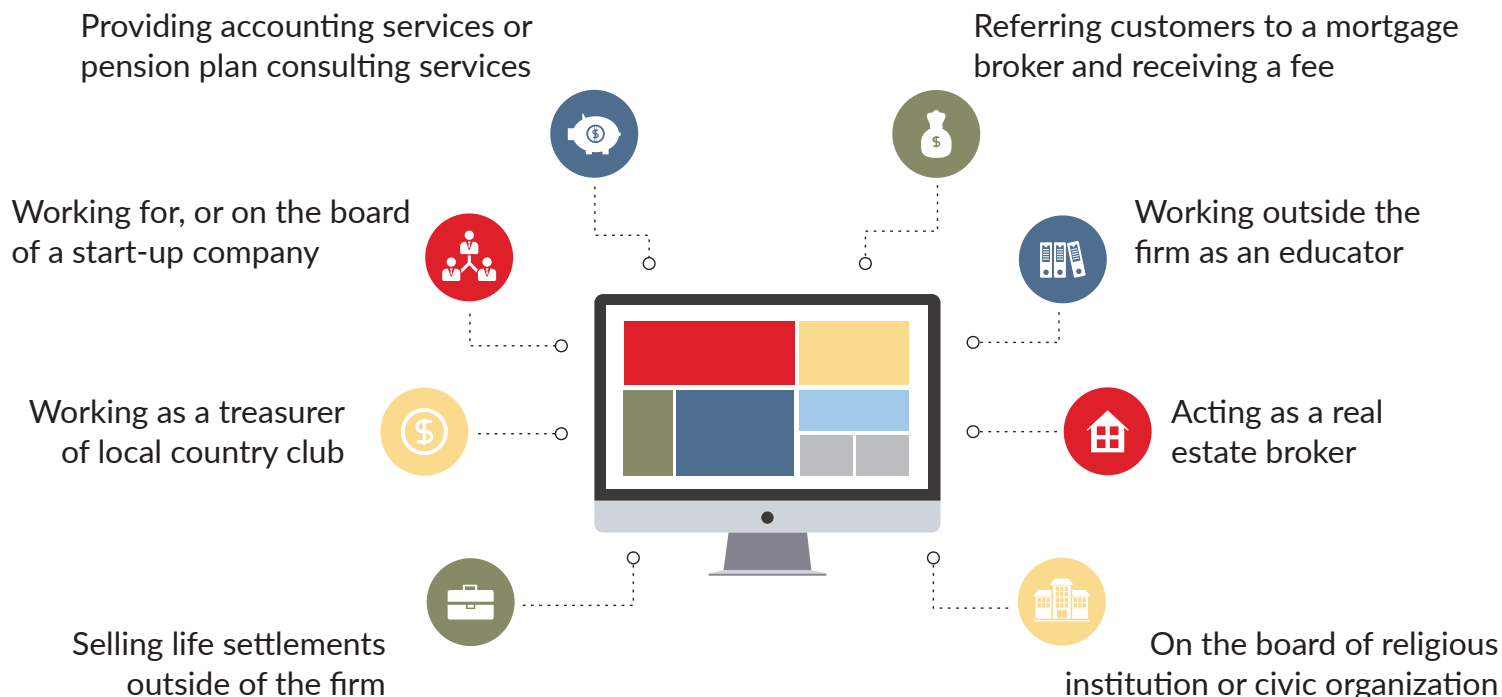
**OUTSIDE BUSINESS
ACTIVITIES**

OUTSIDE BUSINESS ACTIVITIES

FINRA Rule 3270 states 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. Passive investments and activities subject to the requirements of Rule 3280 shall be exempted from this requirement.”

[VIEW RULE >>](#)

EXAMPLES OF OUTSIDE BUSINESS ACTIVITIES





COMMON DEFICIENCIES

FINRA's rule is designed to deter firms and registered representatives from engaging in activity that could expose them to potential risk. Seems fair, right? Well, it's proven to be more difficult than expected. In fact, one of the most common discrepancies FINRA has found is that many registered representatives have simply been failing to disclose their outside business activities to their firms.

Conversely, FINRA has found that many firms do not, or do not adequately, assess registered representatives' written notifications of proposed outside business activities. Another major issue FINRA has observed is that firms have had issues with determining whether disclosed information should be treated as an outside business activity or a private security transaction - *more on this to come.*



DISCLOSING AN OBA

When a registered representative is interested in participating in a voluntary or compensated activity outside of the daily functions of their member firm, the representative must first provide a written notice to the firm before engaging in the activity. Necessary information includes, but is not exhaustive to: the activity's start date and end date (if applicable), the name of the entity where the activity is taking place, the position title, a description of the representatives duties and the number of hours per week that would be dedicated to the activity.

From there, the firm must evaluate the information and consider the following: will the proposed activity interfere with, or compromise, the representative's responsibilities, be viewed as part of the firm's business by customers or members of the public, and other considerations. Firms are also responsible for keeping record of all outside business activities and for submitting the outside business activity information to the registered representative's Form U4.

WHAT YOUR FIRM NEEDS TO KNOW



- ✓ Will the individual be compensated for the activity?
- ✓ Will the proposed activity be viewed as part of the firm's business by customers or members of the public?
- ✓ How much time each week will be dedicated to the OBA?
- ✓ Will the non-fingerprinted OBA employees have access to firm records?
- ✓ What email address is the rep using for correspondence of the OBA?

SANCTIONS & FINES

If a firm or representative commits an outside business activity violation, FINRA will consider several factors when determining a course of action. The following will be considered: whether the outside activity involved customers of the firm; whether the activity resulted directly or indirectly in injuries to other parties, including the investing public, and, if so, the nature and extent of the injury; the duration of the activity; the number of customers and the dollar volume of sales; whether the respondent's marketing and sale of the product or service could have created the impression that the member firm had approved the product or service; whether the respondent misled his or her member firm about the existence of the activity or otherwise concealed the activity of the firm and the overall importance of the role played by the respondent in the outside activity.



Failing to comply with FINRA's rules can result in consequences including: receiving fines ranging from \$2,500 up to \$73,000; getting suspended from anywhere between ten days up to a couple of years; or, getting barred from the industry all together.

FINRA TARGETS OBAS

FINRA's first Examination Findings Report highlighted widespread issues among firms and associated persons in meeting their obligations under Rules 3270 and 3280. Specifically, FINRA identified three key areas of concern:

Notice – FINRA observed several situations where a new hire or current registered person failed to notify their prospective or current firm in writing of an existing outside business activity or private securities transaction.

In some cases, individuals did not understand what constitutes the difference, or did not satisfy important provisions of the rules. In other cases, individuals failed to provide the information with sufficient detail for a firm to make an adequate determination on how to proceed.

Notice Reviews – A lack of oversight was noted in many firms' review processes. Some firms either had no written supervisory procedures for handling such notices or had procedures that were inadequate.

And even when some firms did have well-designed procedures, they executed them poorly. Most commonly, these firms failed to retain supporting documentation or executed their reviews with sufficient depth.

Post-Approval – In some cases, firms did not fully understand the representatives' private securities transaction activity and, as a result, failed to supervise it effectively.

Additionally, firms sometimes had difficulty recording the transactions because private securities transactions can take many forms and the uniqueness of their structures may not fit easily into firm electronic systems that are designed with fields tailored to a firm's existing business.





CASE STUDIES

Rep Fined for Timely Disclosure

A representative from Greenwich, CT was fined \$10,000 and suspended from association with any FINRA member firm in any capacity for four months for failing to disclose his outside business activity as a baseball umpire, in which he profited only \$2,800 in wages.

The findings stated that he engaged in an outside business activity, without appropriate written notice to his member firm. It's in situations like this that the representative's failure to disclose may have had more to do with a lack of knowledge than premeditated intent to conceal.

As a firm, it's important to educate your representatives on what qualifies as an outside business activity and what those requirements entail.

FINRA Finds Firm's Supervision Inadequate

In a separate case, a firm from Kirkwood, MO was censured and fined \$20,000 for inadequately supervising its representatives' outside business activities.

The findings stated that the firm's written supervisory procedures (WSPs) required the firm to document the review and approval or non-approval of outside business activity forms.

Yet, no registered principal at the firm had reviewed or approved the registered representative's disclosures. As a result, the firm consented to the sanctions from FINRA.



TECHNOLOGY THAT MAKES THE DIFFERENCE

Not surprisingly, many firms today are relying on outsourced technology to help review their outside business activities and private securities transactions. At Quest CE, we offer a comprehensive compliance management system that makes the process of managing these activities easy and intuitive. Our multi-tiered approval system gives you the ability to build your own hierarchy and conditions to handle disclosure requests that need to be approved at different levels across the company.

At each stage, the assigned approver can login to the system to review, accept or reject pending disclosures, as well as request more information. You can also choose to have certain disclosures skip levels and go directly to the final approver. Each transaction is additionally time-stamped to dictate accountability and establish compliance with record retention requirements.

[LEARN MORE >>](#)



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**PRIVATE SECURITIES
TRANSACTIONS**

PRIVATE SECURITIES TRANSACTIONS

FINRA Rule 3280 states that “Prior to participating in any private securities transaction, an associated person (both registered and non-registered representatives) shall provide written notice describing in detail the proposed transaction and the person’s proposed role there in and stating whether he or she has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.”

[VIEW RULE >>](#)



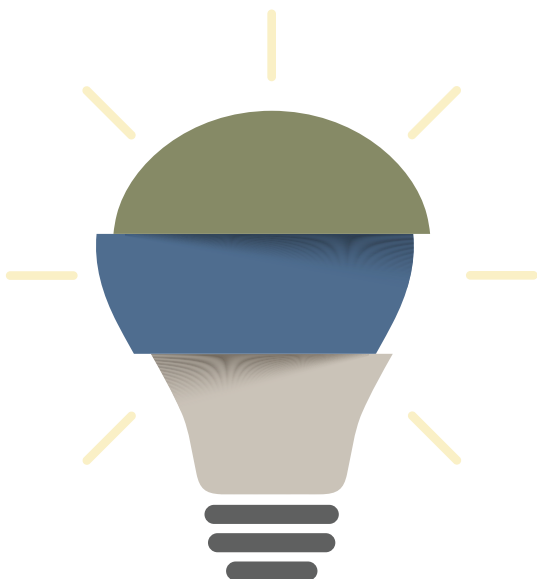
OBA VS. PST

Although these disclosure types are similar, mistaking a private securities transaction for an outside business activity can lead to FINRA taking disciplinary action against the firm or associate person. Similarly, outside business activities and private securities transactions are regulatory and examination priorities, as they can both result in conflicts of interest that firms must understand and mitigate.

So what's the difference between the two? An outside business activity can be any activity taking place outside the member firm whereas a private security transaction, also referred to as "selling away," is more specifically an outside activity where an associated person has involvement in a securities transaction taking place outside the normal course of business of the member firm.

This could be any type of investment, including publicly traded stocks, bonds or funds to non-public investments offered by private parties. FINRA has observed over the past few years that firms and individuals have been falsely disclosing private securities transactions as outside business activities, which has been a growing concern for FINRA and has led to hundreds of disciplinary actions.

DISTINGUISHING BETWEEN THE TWO



Do you find, or assist others in finding, investors for any type of offering as part of your outside activity?



Will you ever be involved in buying or selling interests in any type of offering as part of your outside activity?



Do you receive direct or indirect compensation for involvement in any of the above activities?





MEMBER FIRM OBLIGATIONS

Similar to an outside business activity, once the associated person submits written notice to the member firm about a private securities transaction, the firm must review the notice and decide whether to approve or reject it. To assist in the decision making process, a firm should reference its written supervisory procedures.

Once the firm has come to a decision, it must provide written approval or disapproval of the proposed transactions. If a member firm does approve a private securities transaction for compensation, then they must retain the necessary documents to demonstrate their compliance with the supervisory obligations.

The member firm must also keep proper record of the securities transactions on their books and records. If a firm denies a private securities transaction request, then the associated person cannot participate in the transaction in any manner and the firm should monitor for compliance.




SANCTIONING FOR PST

When FINRA takes action against a firm or an associated person for private securities transaction offenses, there are several factors that help determine the sanctions for the violation. FINRA will start off by assessing the extent of the violation, such as the dollar amount of the sales, the number of customers who were involved or affected, and the length of time that the private securities transaction took place.

FINRA will also look at whether the associated person attempted to create the impression that the member firm sanctioned the activity by using the firm's premises, facilities or name for the private securities transaction, or by selling a product similar to that of the member firm.

An associated person can be fined anywhere between \$5,000 and \$73,000 for failing to properly report private securities transactions to the member firm. The associated person can also be suspended for ten days up to a full year or even be barred from the industry.



A member firm can be sanctioned for a fine anywhere from \$2,500 to \$15,000 for not providing written notice of approval, disapproval or acknowledgment of an associated person's private securities transaction.

CASE STUDIES

CCO Fined for Outside Business Activity Misclassification

A chief compliance officer from Farmington Hills, Michigan was fined \$10,000 and suspended from association with any FINRA member in any principal capacity for one month due to the entry of findings that he approved a firm representative's participation in a private offering as an outside business activity, rather than a private securities transaction.

The CCO had approved the representative's request, despite the obvious indications that the representative's participation in the offering constituted outside securities activities for compensation. The action not only violated FINRA and NASD rules, but it also went against the firm's written supervisory procedures. As a result of the mistreatment of the representative outside activity, the transactions were not recorded in the firm's books and records and the firm did not supervise the activity.

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Firm Fined for Improper Record Retention

A FINRA-registered firm was fined \$10,000 for failing to comply with FINRA Rule 3270 after one of its registered representatives disclosed involvement in multiple outside business activities through various entities.

Although the representative did notify the firm about these activities, the firm failed to evaluate whether the activities involved the sale of securities. Additionally, the firm neglected to document or maintain records related to the disclosed outside business activities.

The firm did not begin documenting the activities until well after they had occurred, which ultimately led to regulatory action. FINRA held the firm accountable for its failure to appropriately evaluate and retain records of the representative's outside activities, resulting in formal sanctions.



MITIGATING DISCREPANCIES

In recognizing the common characteristics of these two disclosure types, our system was built to help determine whether an outside activity is considered an outside business activity or a private securities transaction. When an outside activity is submitted through our compliance management system, it will make its way through the approval hierarchy you put in place for your firm.

Once the activity makes it to the final approver, that person will be asked three important questions; these are questions that FINRA will likely ask during an on site audit. If an approver answers 'yes' to any of these questions, they will likely need to reconsider approving the activity, or re-categorize it as a private securities transaction.

QUESTIONS THAT POP-UP:

OBA Review Questionnaire

- 1.) Will the outside activity interfere with or otherwise compromise the registered person's responsibilities to the firm?
 - No
 - Yes (please explain):
- 2.) Will the outside activity be viewed by the public as part of the firm's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered?
 - No
 - Yes (please explain):
- 3.) How should this outside activity be characterized?
 - OBA under FINRA Rule 3270
 - Private Securities Transaction
 - Passive Investment: No Action Needed



CHANGING REGULATION – NOTICE 18-08

FINRA conducted a retrospective review of its outside business activities and private securities transactions rules to assess their effectiveness and efficiency. The review confirmed the importance of rules relating to outside activities, but also indicated that the current rules, as well as related guidance, could benefit from changes to better align with the current regulatory landscape and business practices.

As a result, FINRA released Regulatory Notice 18-08, which solicits comments on a proposed new rule to address the outside business activities of registered persons. The proposed rule would replace existing Rule 3270 and Rule 3280 with a single rule governing outside business activities.

The proposed rule would require registered persons to provide their members with prior written notice of a broad range of outside activities, while imposing on members a responsibility to perform a reasonable risk assessment of a narrower set of activities that are investment related, allowing members to focus on outside activities that are most likely to lead to potential risks.

The rule also imposes supervisory obligations on the member in two circumstances. First, if a member has imposed conditions on a registered person's investment-related activities, the member must reasonably supervise the registered person's compliance with those conditions. Second, if a registered person's approved participation in an investment-related activity would require registration as a broker-dealer but for the registered person's association with the member, the member must treat such investment-related activities as the member's own business.

[Regulatory Notice 18-08 >>](#)



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CONCLUSION

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FINRA's Regulatory Notice 18-08, 2018 Examination Priorities Letter and Exam Findings Report are all indications that outside business activities and private securities transactions will continue to be a topic of emphasis - now and in the future. This has been addressed through rulemaking, oversight and enforcement action. In recognizing that many firms have made progress over the years in improving these practices, much still needs to be done. With that in mind, your firm needs to prioritize its conflict management practices and procedures.

As a technology provider, we implore you to reach out with any questions regarding our training and disclosure tracking solutions to discuss how we can better assist your compliance efforts. To learn more about Quest CE's compliance management system, Renaissance, visit www.questce.com or contact a sales representative at 877.593.3366 or sales@questce.com.

