The Commonwealth of Massachusetts
Secretary of the Commonwealth
State House, Boston, Massachusetts 02133

William Francis Galvin
Secretary of the Commonwealth

April 26, 2018

Via email to pubcom@finra.org.

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006

Re: <u>Comments in Opposition to Proposed Rule 3290. Outside Business Activities</u>

Dear Ms. Piorko Mitchell:

I am writing in my capacity as the chief securities regulator for Massachusetts to strongly oppose FINRA's proposed Rule 3290 (the "Proposed Rule"), as explained in Regulatory Notice 18-08 (the "Notice"), regarding members' supervision of their agents' outside business activities. As described in the Notice, the Proposed Rule would replace FINRA Rule 3270 (Outside Business Activities of Registered Persons) and FINRA Rule 3280 (Private Securities Transactions of an Associated Person) with a set of weaker standards.

Investor protection, including oversight of those who provide financial services to investors, is a responsibility that is shared by both regulators and industry participants. FINRA's member firms have insight into the day-to-day activities of their agents, so they are in the best position to detect potential misconduct and harm to investors before they occur. FINRA claims that the Proposed Rule will strengthen investor protections, but it is not at all clear how investors will be protected by the removal of supervisory oversight. The absence of proper oversight of outside business activities will increase the risk of fraud and abuse. The Proposed Rule would weaken protections for investors by shifting necessary supervisory obligations away from brokerage firms, who are best situated to spot problems relating to outside business activities.

The Notice separates various outside business activities into five broad categories, and lists them in descending order of the level of scrutiny and supervision required under the Proposed Rule.[1] This letter will address each in turn.

[1] *See* FINRA Regulatory Notice 18-08, at 3.

1. **Even at its most stringent, the Proposed Rule is inadequate with respect to the sale of private placements because the required risk assessment is too narrow.**

My office agrees that the sale of private placements by agents of FINRA member firms should be subject to requirements of prior notice and approval, a meaningful assessment of the risks of the outside activity, and reasonable supervision. But even at its most stringent, with respect to the sale of private placements, the Proposed Rule fails to adequately protect investors. The risk assessment required under the Proposed Rule for the sale of private placements and the conduct of third-party investment advisory business is overly narrow because it focuses on the risk the activity may pose to the member firm, rather than the risk to investors. This focus is fundamentally misplaced. The Proposed Rule and any risk assessment should give investor protection the highest priority.

The widespread harm resulting from the sale of private placements in Medical Capital Holdings, Inc. and Provident Royalties, LLC provides conclusive proof of the need to fully vet the risk to investors from private placements. In 2010, my office filed an enforcement action against a FINRA member firm for willful, fraudulent, and unethical conduct in connection with its sale of approximately $697 million of Medical Capital Holdings promissory notes, as well as the member's failure to supervise such sales by its agents. Medical Capital's 2008 default on its debts and the resulting receivership caused massive investor losses and left millions of dollars of investors' life savings frozen and illiquid. Also, the SEC and FINRA were both involved in actions against various parties in connection with the approximately $485 million dollar ponzi scheme by Provident. These cases demonstrate that the Proposed Rule's focus on the risk *to the member firm* is insufficient to protect investors.

2. **FINRA member firms should be required to supervise their agents' activities with unaffiliated investment advisers.**

While current outside business activity rules impose burdens on member firms, FINRA should not move away from these fundamental supervisory requirements. Strong supervision is at the heart of a firm's obligation to observe high standards of commercial honor and just and equitable principles of trade. The current supervisory burden on member firms is fully justified, particularly in light of financial conflicts of interest permitted under the Proposed Rule. The Proposed Rule would allow a member firm to condition its approval of its agents' third-party investment advisory activity on whether the third-party investment adviser maintains custody of its clients' assets with the member. However, the Proposed Rule imposes no supervisory obligation on the member firm beyond ensuring compliance with that condition, even though the member firm receives trading revenue and other fees from the underlying activity. It is also not clear how this arrangement is any different from the sale of private placements, which the member is required to supervise as a part of the member's own business.

Although third-party investment advisory activity is subject to the Proposed Rule because it is "investment-related," it is not clear whether the Proposed Rule imposes any obligation on member firms with respect to outside activities at third-party banks and insurance companies. These latter activities are also "investment-related," as that term is defined in the Proposed Rule, and should be subject to the same level of scrutiny as activity at third-party investment advisers.

3. **FINRA member firms should be required to assess the risks of ostensibly "non-investment-related" activities.**

The Proposed Rule requires neither supervision nor a risk assessment for activities deemed "non-investment-related." Although the Notice uses innocuous examples, such as "car service" and "seasonal retail," to illustrate this category of outside business activities, investors have suffered grievous economic harm as a result of activities that would be deemed "non-investment-related" under the Proposed Rule.

The Woodbridge ponzi scheme, in which the primary business was ostensibly commercial lending, was pitched as a non-security investment opportunity that was low-risk and conservative. Yet, this supposedly "non-investment-related" activity has cost retail investors millions in losses.[2] Woodbridge was marketed as a loan product, not a security, and does not appear to fit within any of the other categories of activities included within the definition of "investment-related." Under the Proposed Rule, Woodbridge would conceivably have been deemed "non-investment-related" and would not have been subjected to even the minimal scrutiny of a risk assessment. The Proposed Rule would also require no supervision or scrutiny of other activities and products which are ripe for fraud and abuse, and many of which are lightly regulated, if at all. These include alternative investments such as initial coin offerings and cryptocurrencies, viaticals, reverse mortgages, structured finance, as well as payday lending activity. It is perverse to say that the Proposed Rule strengthens investor protection when the Rule would explicitly exempt some of the most untested and harmful "investment opportunities" from any significant scrutiny or oversight.

4. **Outside business activities at FINRA member firms' affiliates should not be exempted from risk assessment or supervision.**

Outside activities conducted at affiliated banks, insurance companies, and investment advisers are generally excluded from the Proposed Rule. The exclusion appears based on "members' ability to implement meaningful controls across business lines" and the idea "that such activities are subject to other regulatory regimes and oversight." However, day-to-day supervision is distinct from regulatory oversight. FINRA member firms with affiliated banking and insurance entities are incentivized to consolidate customer assets among the affiliated entities by cross-selling. In recent years, my office has seen multiple instances of violations resulting from a failure to ensure effective supervision of cross-selling between FINRA member firms and affiliated banks and insurance companies.

In 2016, my office filed an enforcement action against a major wirehouse for violations stemming from the firm's agents' sale of securities-based lending products sponsored by the firm's private banking affiliate. These products were aggressively sold to brokerage customers without disclosure of the selling incentives. The issues my office identified within this wirehouse, as well as the recent scandals at Wells Fargo, demonstrate that it is not enough for FINRA member firms to simply pass the buck when it comes to supervision of their own agents'

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[2] *See* SEC Charges Operators of $1.2 Billion Ponzi Scheme Targeting Main Street Investors, https://www.sec.gov/news/press-release/2017-235.

outside business activities, particularly where the outside activities directly affect the member firm's customers.

5. **<u>"Buying away" presents risks to investors and markets, and must remain subject to supervision</u>.**

Finally, the Proposed Rule requires no scrutiny or oversight whatsoever of associated persons' personal investments held away from the member ("buying away"). This portion of the Proposed Rule displaces the obligations currently in place under FINRA Rule 3280, which requires prior notice to the member firm and imposes supervision and recordkeeping obligations on the member firm. FINRA Rule 3210 (Accounts at Other Broker-Dealers and Financial Institutions) is not an adequate backstop, as it does not require the outside financial institution to provide information about the activity in any account subject to the rule unless that information is requested in writing by the member firm. History has shown that if there are regulatory loopholes, they will be used to the fullest extent possible. If FINRA member firms are no longer required by rule to supervise personal securities transactions by their associated persons, it is not clear that these activities will be supervised at all. This is unacceptable, as "buying away" poses significant risks to both investors and markets. The exclusion of "buying away" activities from the Proposed Rule is an invitation to engage in front-running, self-dealing, and other conflicts of interest that are likely to result in harm to investors. Insight into the private securities transactions of their associated persons is critical to FINRA member firms' ability to identify and stop such abuses and potential market manipulation.

Investor protection is a shared responsibility between regulators and the industry. I strongly urge FINRA to reconsider the degree to which the Proposed Rule should absolve FINRA's member firms of the necessary supervisory obligations imposed under current rules. Please contact me or Bryan Lantagne, Director of the Massachusetts Securities Division, at (617) 727-3548, if you have questions or we can assist in any way.

Sincerely,

William Francis Galvin

William F. Galvin
Secretary of the Commonwealth
Commonwealth of Massachusetts