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Associated Persons' Disclosure Obligations to Their Firm

The following sections serve as a checklist of items that must be disclosed, updated, or at least acknowledged on an annual basis. Certain sections are highlighted when the specific obligation is mentioned. As a "best practices" measure, firms should document that they solicited these disclosures, updates, and acknowledgments from their associated persons on an annual basis.

❖ Conflicts of Interest

A conflict of interest is best defined as a difference between your own interests and your duties as a representative to uphold the wishes or needs of your clients and the ethical business dealings with your employing firm. Conflicts of interest are not necessarily violations of securities rules in and of themselves, but failing to disclose potential conflicts is a violation.

As an associated person of a broker/dealer, you have a duty to your firm and to your clients to disclose any conflicts of interest that could interfere with your objective advice or recommendations to your clients, or to your duties to your firm.

❖ Form U-4

Associated persons are obligated to notify their employing broker/dealer if there are any changes to the information contained in their U-4s so the firm can update them in the Central Registration Depository (CRD). The information that must be maintained as current in the U-4 includes:

- Name and current address
- Regulatory actions
- Customer complaints and settlements
- Criminal charges and convictions, including arrests and DUIs
- Judgments, liens, and bankruptcies

The firm must file amendments within 30 days of when a significant event occurs, such as a change of address, a criminal charge, or a bankruptcy. If a reportable event includes a statutory disqualification, the event must be disclosed within 10 days.

❖ Firm Element Continuing Education

Each broker/dealer must establish and deliver a Firm Element Continuing Education program (commonly known as Firm Element CE) on an annual basis. The firm is required to determine its specific educational needs based on a documented "Needs Analysis." Not only does the curriculum have to be based on the firm's specific training needs, but the courses selected must be specific to the job functions of each rep or set of reps, called "covered persons." Each covered person must complete their Firm Element assignments by the set deadline, or the firm will administer consequences accordingly. Depending on the consequences prescribed in the firm's procedures, representatives may receive fines from their firm, be



suspended from activities requiring registration, and/or have commissions suspended until the Firm CE requirement is completed.

❖ **Annual Compliance Meeting**

Each year, every FINRA member firm is required to conduct an annual compliance meeting of relevant topics to keep associated persons aware of the rules that govern our industry.

All registered representatives, as well as registered principals and all associated persons, must demonstrate attendance at an annual compliance meeting.

The annual compliance meeting can be in the form of an interview, live meeting, or compliant online presentation. Under FINRA rules, the meeting must be interactive and give the participant an opportunity to ask questions if clarification of the rules is needed.

❖ **FINRA Rule 3270 — Outside Business Activities of Registered Persons**

Effective December 15, 2010, FINRA's consolidated Rule 3270 implemented a new set of definitions and requirements for the applicability, notification, and supervision of a registered person's activities outside the scope of employment with a FINRA member firm.

Regulatory rules are the baseline that firms use to develop their own policies and procedures. Broker/dealers may decide to go above and beyond the rules when writing procedures for their registered persons to follow. As you review the following outline of Rule 3270, keep in mind that your own firm's procedures may be stricter than the bare minimum standards set by the new rule.

Timing and Applicability

FINRA Rule 3270 requires *prior written notice* of any professional activities considered to be outside the scope of a registered person's employment with a member firm. This rule applies to all employees registered with a FINRA securities license; however, firms may wish to extend this notification requirement to all associated persons as well.

The following is a list of activities that falls under the *prior written notification* requirement of Rule 3270:

- Any employment away from the member firm, including work as an:
 - Independent contractor
 - Sole proprietor
 - Officer
 - Director
 - Partner
- Any activity for which the registered person is compensated
- Any activity where there is a reasonable expectation of compensation, such as consulting for a start-up company, where the compensation is not immediately forthcoming



The *prior written notification* requirement under Rule 3270 does not apply to passive investments or private securities transactions. However, these activities must still be reported as prescribed by your firm's procedures to comply with NASD Rule 3050 regarding personal trading accounts, and NASD Rule 3040 regarding private securities transactions.

❖ Private Securities Transactions

Private securities transactions are any involvement in a securities transaction by a registered representative, regardless of the potential for compensation. FINRA rules require the registered rep to provide notice in writing and receive *written* permission before participating in the transaction. If the registered rep will receive compensation for the activity, the transaction must be recorded in the broker/dealer's books and records.

Keep in mind that a private securities transaction is different from a personal trading account you might have at another brokerage firm.

To identify a private securities transaction, one must first understand how broadly the term "securities" can be defined. For this we look to "The Modified Howey Rule," which arose from a Supreme Court case interpreting sales of interests in a Florida orange grove as a "security." The ruling states that a security is: *"...an investment in a common venture premised on a reasonable expectation of profit to be derived from the entrepreneurial or managerial efforts of others."*

Depending on how something is sold, this definition can encompass more than you might imagine.

Private securities transactions are defined as: Any securities transactions outside your regular scope of employment, effected away from your firm that does not run through your personal trading account or is not reported to your firm. Examples of common private securities transactions include:

- Unregistered securities (new offerings)
- Selling promissory notes
- Private limited partnerships
- Privately-held companies not registered
- Pyramid schemes
- Multilevel marketing ventures
- Real estate deals

Note: The private securities definition does not include passive investments.

To seek approval for a private securities transaction, the representative must provide the employing firm with the following in writing:

- Detailed information about the proposed transaction
- The representative's role in the transaction
- Whether the representative has or will receive any compensation in connection with the transaction



Once the firm receives written notice, it must provide prompt, written acknowledgement stating whether the firm approves or disapproves of the person's participation. The firm may require the representative to follow certain conditions, or may not allow the representative to participate at all. If the transaction is approved, the firm must supervise it, and any compensation the representative receives must run through the firm's books and records. If the representative participates in the transaction without the firm's approval, it is considered *selling away* — a prohibited activity.

❖ Personal Brokerage Accounts

Personal trading accounts are brokerage accounts held either at the employing firm's broker/dealer, or at a broker/dealer other than the employing firm, called the "executing firm." Firms can differ greatly in their procedures to comply with notification requirements for these accounts. NASD Rule 3050 governs the activity in this area and requires that:

FINRA registered and associated persons must notify:

- Their employing firm of their intentions to open or maintain a personal brokerage account at another firm (the executing firm)
- The executing firm of their association with the employing firm, and if duplicate copies of confirmations and statements are required by the employing firm

The executing member firm is required to:

- Notify the employing firm that its representative intends to open or maintain an account
- Transmit duplicate confirmations and/or statements upon written request by the employing firm
- Notify the representative of the its compliance with the employing firm's request for duplicate confirmations and/or statements

These requirements do not extend to mutual funds, unit investment trusts, or variable annuity accounts because the representative does not have discretion over the trading activities in these accounts.

❖ Gifts

A broker/dealer or registered representative cannot *receive* more than \$100-worth of gifts from a client or "business partner" in one year. Nor can a broker/dealer or registered representative *give* more than \$100-worth of gifts to a client or "business partner" in one year.

This rule restricts the potential for conflicts of interest. Gifts and gratuities received by a registered person or firm must be documented in a gifts and gratuities list. The purpose of the prohibition is to prevent undue influence in the sales of securities or treatment of customers.

The \$100 limit applies to all member firms, registered representatives, and associated persons.

Example

If Manny, a sales RR from Firm X, were to give you a gift worth \$80 and then Eli — also with Firm X — offers you a gift worth \$60 during the same calendar year, you may not accept Eli's gift because it would put you



over the allowable limit. If Manny and Eli were employed by two different member firms, both gifts would be acceptable. However, because the same corporate entity, or “business partner,” employs both reps, only one gift can be accepted and must be reported to your compliance/legal department.

Exceptions are granted in the case of gifts associated with birthdays and holidays, relatives, and personal friends, as well as for low-value items, such as pens or coffee cups. These items are referred to as *de minimus* or promotional items — often with the company logo — and fall outside of the intent of FINRA rules. It is not required to record gifting these items.

Some firms go beyond what FINRA requires. Check your firm requirements to understand if you must report when you refuse a gift that would take you over the limit as well.

❖ Entertainment

Another exception to the \$100 gift rule is for business entertainment expenses. FINRA defines “business entertainment” as entertainment in the form of:

- Social, hospitality, charitable, sporting, or entertainment events, meals, or leisure activities, as long as they are not lavish or excessive

The regulators freely admit that terms like “lavish” and “excessive” are subjective and open to interpretation. However, they apply the “reasonable person” standard (i.e., would a reasonable person deem the entertainment lavish or excessive?).

Further, FINRA requires member firms to have policies and procedures in place to:

- Define the types of business entertainment that are appropriate and those that are inappropriate
- Promote the kind of conduct that serves the best interests of their customers
- Effectively supervise compliance with FINRA rules
- Maintain records of the types and costs of business entertainment
- Ensure that the persons designated to supervise business entertainment costs are adequately qualified
- Provide appropriate education and training for all applicable personnel

❖ Non-Cash Compensation

Educational meetings (also called due diligence meetings) are the most common form of non-cash compensation. Typically, firms selling mutual funds or variable annuities invite *registered representatives* of other firms who sell their products to these meetings. The inviting firms are permitted to pay for the food consumed at the meetings, as well as room and board for reps to attend. As this is a form of non-cash compensation, *registered or associated persons must request permission of their member firms to attend.*

For the educational or training meeting to comply with the non-cash compensation rules, *all* of the following six conditions must be met:

- Prior approval must be obtained by the member firm.
- The meeting itself must last for a substantial part of the business day.



- Many firms require an approved agenda showing the meeting lasts at least six hours each day for which expenses are paid.
- Participation in a training or educational meeting must not be based on reaching a sales target or other incentive, but can be based on "anticipation" of future sales goals.
- Although there is no requirement to hold the meeting at the inviting firm's main headquarters, the location must be appropriate for the meeting's purpose, such as a site where the firm has an established Office of Supervisory Jurisdiction.
- Any guests accompanying the associated or registered person cannot be reimbursed for their room and board costs by the inviting member firm.
- Reimbursement for associated costs are limited to expenses such as lodging, meals, and transportation only (e.g., no greens fees).
- Reimbursement for associated costs is subject to record-keeping requirements.

These restrictions do not apply when a broker/dealer is paying the expenses for its own employees to attend an annual compliance meeting or a product education meeting.

❖ **MSRB Political Contributions**

In an effort to protect the investing public, the MSRB imposes a business restriction on broker/dealers if campaign contributions are made in excess of certain limits. MSRB Rule G-37 prohibits a broker/dealer from engaging in underwriting municipal securities business with an issuer for two years if the broker/dealer has made the following types of campaign contributions:

- A contribution to an issuer official by the broker/dealer or a Political Action Committee (PAC) controlled by the broker/dealer, or a PAC controlled by any of its Municipal Finance Professionals (MFPs) or a non-MFP executive officer
- A contribution in excess of \$250 per election cycle by any MFP or non-MFP executive officer to an issuer official for whom the MFP is entitled to vote
- A contribution of any amount by any MFP to an issuer official for whom the MFP or non-MFP executive officer is not entitled to vote

To help ensure the integrity of the political contribution regulations, there are certain reporting requirements for broker/dealers who engage in the underwriting process of municipal bonds.

Contributions are to be reported, using MSRB Form G-37, by the end of the month after the end of each calendar quarter (i.e., reports must be filed by January 31, April 30, July 31, and October 31). This form must be filed electronically through the MSRB Gateway, or submitted by certified or registered mail, or some other equally prompt means that provides a record of sending (e.g., overnight courier).

A firm's municipal securities principal should explain the requirements of Rule G-37 to all registered representatives. This ensures that all political contributions made by registered representatives are monitored and appropriate.

(The previous section is covered in the FIRE Solutions Firm Element CE course, *MSRB: Underwriting and Political Contributions*.)



❖ IA Political Contributions

Those familiar with the MSRB Rule G-37 are aware that it imposes a two-year “business ban” (for underwriting services) on non-allowable contributions made by a municipal finance professional. Rather than imposing a business ban, the Investment Advisers Act Rule imposes a compensation ban, referred to as a “time-out.” Essentially, an IA who makes a contribution that triggers the time-out can still perform advisory duties, but cannot receive compensation during the time-out. The two-year period begins on the date of the contribution.

There are allowances within SEC Rule 206(4)-5 for small contributions. Allowable contributions are as follows:

- \$350 per election cycle, per candidate, for candidates in which the contributor is qualified to vote (primary and general elections are counted separately)
- \$150 per election cycle, per candidate, to any candidate
- Small contributions made in error (maximum \$350) and promptly returned, called the *return contribution exception*

Any contributions over these limits trigger the two-year time-out on investment advisory compensation received from the government entity.

To help ensure the integrity of the political contribution regulations, certain reporting requirements are expected of IAs and IA broker/dealers.

All contributions made by covered persons must be reported to their employing IA and kept in the firm's books and records.

The books and records must record:

- A list of the firm's covered persons, their titles, and business and residence addresses
- A list of the firm's governmental clients (direct clients and indirect clients through a covered investment pool)
- All direct and indirect contributions made by the IA or its covered persons to political officials or PACs
- The name and business address of any regulated firm or person soliciting a government entity on the IA's behalf

(The previous section is covered in the FIRE Solutions Firm Element CE entitled, *IA Pay-to-Play Rules*.)

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