National Society of Compliance Professionals
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Philadelphia, Pennsylvania

Outside Business Activity

by:

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Chicago, Illinois

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OUTSIDE BUSINESS ACTIVITY

I. Introduction

In May 2008, FINRA issued Notice to Members ("NTM") 08-24 which proposed important changes to the current regulatory obligations relating to notice and supervision of outside business activities and private securities transactions. The new Outside Business Activity Rule 3110(b)(3) proposed by NTM 08-24 provides firms with both an incentive to review and (where necessary) to update their supervisory procedures for outside business activities.

This article focuses on outside business activities, particularly selling away issues. In it, we discuss the language and interpretations of FINRA Rules 3030, 3040 and 3050, describe the effect of the proposed amendments, and set out considerations for registered representatives dually registered as investment advisors (Section II, III, and IV). We provide an overview of how and when mandatory arbitration applies to selling away cases and set out the legal theories which may impose civil or regulatory liability against a firm for outside business activity (Section V and VI). Finally, we set forth some suggested procedures that firms could consider adopting as part of a reasonable system for supervision of outside activity (Section VII).[1]

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[1] We encourage firms reviewing their supervisory procedures also to review Chapter 5 "Supervision of Registered Representative's Outside Business Activities," *Broker-Dealer Regulation*, Practicing Law Institute, Corporate and Securities Law Library, which gives additional details, citations, history and in-sights that are very valuable to any supervisory program in this area.

II. FINRA's Current Outside Business Activity Rules

A. FINRA Rule 3030

Until proposed Rule 3110(b)(3) is adopted, FINRA Rules 3030, 3040 and 3050[2] govern outside business activity and selling away. Rules 3030, 3040, and 3050 dovetail in their application and apply separately to outside business activities depending upon whether the activities involve securities.

NASD current Rule 3030, entitled "Outside Business Activities of an Associated Person," reads as follows:

> No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member (emphasis added).

Importantly, this Rule applies not only to business activity involving securities, but to any business activity. However, it applies to registered associated persons.

B. FINRA Rule 3040

Rule 3040, "Private Securities Transactions of an Associated Person," is more complex and is too lengthy to be quoted in its entirety, but is attached as Exhibit 1 to this article. Rule 3040 compliments Rule 3030 and provides that no person associated with a member shall participate in any manner in a private securities transaction as defined, except in accordance with the Rule. Subsection (b) of the Rule 3040 states:

> Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of

[2] These rules have been interpreted by NASD NTM 94-44 (undated), NASD NTM 96-33 (May 1996), NASD NTM 01-79 (December 2001), and NTM 03-79 (December 2003).

> related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

Rule 3040 is more limited than Rule 3030 in that it only applies to securities transactions (as opposed to any business activity). However, it is broader than 3030 in that it applies to all associated persons, not just registered associated persons. Although an "associated person" under Rule 3040 includes unregistered individuals, it does not extend to every employee of the firm. Specifically, it does not include persons performing solely ministerial or clerical activities.

Subsection (c) of Rule 3040 deals with private securities transactions for compensation – what is traditionally thought of as "selling away." "Private securities transactions" is very broadly defined in subsection (e)(1) as follows:

> (1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in Rule 2790), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities shall be excluded (emphasis added).

"Selling compensation" is very broadly defined in subsection (e)(2). "Selling compensation" as defined includes any compensation direct or indirect in connection with or as a result of a purchase or sale of a security no matter what the source. It includes things such as commissions, finder fees, securities, options, profit participations, dissolution proceeds, tax benefits, expense reimbursement and a host of other things.

A member who has received the notice of a private securities transaction pursuant to subsection (b) of the Rule is required to advise the associated person in writing whether the member approves the proposed participation or disapproves of the participation. If the member approves the participation, the transaction is to be treated as any other transaction for the member and recorded on the member's books and records with all of the attendant supervision requirements

of the person's participation in the transaction as if the transaction were executed on behalf of the member. If the member disapproves the participation, the associated person may not participate in the transaction in any manner, directly or indirectly.

Rule 3040(d) provides a different set of rules for transactions that do not involve compensation. In transactions for which the associated person will not receive any "selling compensation" as defined, the member who has received notice shall provide the associated person with a written acknowledgement of the notice and may, at the discretion of the member, require the person to conform to certain specified conditions in connection with the participation in the transaction. It does not say that the member may disapprove the transaction, although most members require approval of transactions without selling compensation. The rule does not require the member to record the non-compensation transactions on its books or supervise them. As a practical matter, however, most members prohibit such a securities transaction without selling compensation and treat the transaction the same way as a transaction for compensation.

Outside business activities of an associated person of a broker-dealer that involve securities purchases and sales not on the books and records of his or her employer broker-dealer may require the associated person to register as a separate broker-dealer under Section 15 of the Securities Exchange Act[3] ("Exchange Act") and applicable Commission staff interpretations and under certain state laws.

C. FINRA Rule 3050

Rule 3050, entitled "Transactions For or By Associated Persons," in a sense, also deals with outside business activities. Rule 3050 is attached as Exhibit 2. An associated person who opens an account or places an order for a securities transaction at another financial institution, including a broker-dealer, a notice-registered broker-dealer, an investment advisor, bank or other financial

[3] 15 U.S.C. §78(o).

institution that is not a FINRA member, is required to notify the employer member in writing, prior to execution of any transactions, of the intent to open the account or place an order. In such a case, the employer member may request in writing assurances that the other financial institution will provide the employer member with duplicate copies of confirmation statements or any other necessary information concerning the account or the order.

When an associated person opens an account or attempts to execute a securities transaction with another FINRA member, either for the person's account or for another account for which the associated person has discretion, the executing member has specific obligations including notifying the employer member.[4] The employer member may prohibit the associated person from executing personal transactions through another member or financial entity. Upon written request from the employer member, the executing member must provide the employing broker-dealer duplicate copies of confirmations, account statements and other information regarding the account. The executing broker-dealer must also notify the associated person of the executing member's intention to provide the notice and information to the employer member. Under Rule 3050, both members appear to have the obligation to supervise the securities activities of the associated person at the executing firm. This means that the employer member must receive confirmations and account statements and monitor the execution of transactions just as if the transactions were executed through the employer member. This involves primarily having adequate review for manipulation and insider trading, but it also involves supervision in other areas, if unusual transactions come to the attention of the firm. For example, if the associated person is effecting transactions far beyond his means, such conduct may indicate a possible Ponzi scheme or outside business activities not approved by the member.

[4] *See* NTM 97-25 (May 1997).

D. NTM 01-79 – NASD Reminds Members of Their Selling Away Responsibilities

In December 2001, the NASD issued NTM 01-79 (December 2001) to remind associated persons and firms of their responsibilities relating to Rules 3030 and 3040. The NASD stated that in the time period leading up to NTM 01-79, it had noticed an increase in selling away activity and had brought significant enforcement actions relating to outside business activity. NTM 01-79 warned associated persons of their responsibilities to report such activity to their member firms, reminded member firms of their supervisory responsibilities, and suggested actions firms could take to review and improve on their supervisory procedures and to educate associated persons. Notwithstanding NTM 01-79, selling away claims appear to have continued to increase, many of them in connection with note schemes, prime bank schemes, phony hedge funds and various types of property sold with management contracts which are later found to be investment securities for purposes of the state and federal securities laws. NTM 01-79 emphasized and explained to members the many pitfalls that associated persons encounter when they engage in outside business activity and warned against relying upon a lawyer's opinion that an investment is not a security.

III. FINRA's Proposed Rule 3110(b)(3)

In NTM 08-24 (May 2008), FINRA proposed to delete Rule 3040, simplify it and somewhat change it, and move it into Rule 3110(b)(3) subtitled "Supervision of Outside Securities Activities." The new provision would read as follows:

> (3) Supervision of Outside Securities Activities
>
> (A) Unless a member provides prior written approval, no associated person may conduct any investment banking or securities business outside the scope of the member's business. If the member gives such written approval, such activity is within the scope of the member's business and shall be supervised in accordance with this Rule, subject to the exceptions set forth in subparagraph (B).

(B) Dual Employees

(i) The supervision required by subparagraph (A) shall not be required with respect to the bank-related securities activities of dual employees when such activities are included within any of the statutory or regulatory exemptions from registration as a broker or dealer, provided that the member receives written notice of, and approves, such activities.

(ii) A member shall not approve the activities of dual employees pursuant to subparagraph (i) unless the member has written assurance that the bank or a supervised bank affiliate will:

a. have a comprehensive view of the dual employee's securities activities;

b. employ policies and procedures reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws; and

c. give prompt notice to the member of any dual employee's violation of such policies and procedures.

(iii) A member may rely upon the written representation of any enumerated entity in subparagraph (ii) that it is employing the policies and procedures required in subparagraph b. provided the member supplies access and information, in compliance with SEC Regulation S-P, as is necessary for the execution of such policies and procedures. Upon receiving notice of a dual employee's violation of the policies and procedures required in subparagraph b., the member shall assure itself that the policies and procedures of the enumerated entity in subparagraph (ii) are reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws or have been amended to achieve such compliance. In the event a member cannot reach such assurance, the member must revoke its approval of the dual employee's bank-related securities activities.

(iv) For purposes of this subparagraph (B), the term "dual employee" means a natural person who has prior written approval from the member to perform as both an associated person of a member and a bank employee.

(v) For purposes of this subparagraph (B), the term "supervised bank affiliate" means a bank affiliate that is subject to consolidated supervision by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Director of the Office of Thrift Supervision.

The proposed rule makes two principal changes. First, under the proposed rule, all securities and investment banking transactions outside the scope of the member's business are treated the same way and must be inside the firm's business. The proposed rule eliminates the distinction between private securities transactions for which compensation is and is not received. Similarly, the proposed rule eliminates the exemption for personal transactions in investment companies and variable annuity securities.

Because the proposed rule places all outside business activities involving the investment banking or securities business under the member's business, the rule requires the firm to record the transactions on their books and records and to supervise them as any other transaction. Notably, neither the New York Stock Exchange nor the NASD have, in the past, required a broker-dealer to apply the financial responsibility rules of FINRA and the Securities and Exchange Commission ("SEC") to transactions recorded on the books and records of a different broker-dealer under Rule 3040. However, an argument could be made that this requirement applies under the proposed rule. Hopefully, FINRA will, in a footnote or in the adopting release, clarify this point when the rule becomes effective. Under the proposed rule, a member continues to have the option to prohibit an associated person from engaging in any outside business activity.

The second major change is with respect to "dual employees." Subsection (b) of the new rule, entitled "Dual Employees" attempts to clarify an area of some confusion with respect to bank-related securities activities of dual employees when their activities are within the statutory or regulatory exemptions for banks or its affiliates from registration as a broker-dealer. Subsection (b)(2) sets forth a number of conditions on the approval of activities of "Dual Employees." A member need not supervise the exempt bank's security activities of the associated person if the member meets certain requirements as follows:

1. A member must receive written notice of any such activities and approve the activities.

2. A member must receive written assurance that the bank or supervised affiliate of the bank will have a comprehensive view of the Dual Employee's securities activities, employ procedures reasonably designed to achieve compliance with the anti-fraud provision of the federal securities laws and give prompt notice to the member of any Dual Employee's violation of such policies and procedures.

A member may rely on a representation of a bank or its supervised affiliates with respect to (b)(2). But, if a member receives notice of a violation of the policies and procedures of a bank or its affiliates by the Dual Employee, the member shall assure itself that the bank or its affiliate's policies and procedures are reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws or have been subsequently amended to achieve such compliance. In the event the member cannot obtain such assurance, the member must revoke its approval of the Dual Employee's relationship. The Dual Employee provision puts a new burden on broker-dealers to monitor the activities of Dual Employees that work in exempt securities activities of a bank or its affiliate as defined, such as trust services, custodial services and other securities activities of banks that are exempt from broker-dealer registration under the Exchange Act.

The proposed rule does not deal with other conflicts arising from dual registration requirements. As noted below, it does not deal with conflicts between a registered representative who is also an individual registered IA or affiliated with an investment advisor that is not affiliated with the associated person's broker-dealer employer. It does not deal with potential conflicts of a broker-dealer registered under §15b-11 of the Exchange Act that engages in futures activities as an FCM but is a notice-registered broker-dealer (to be able to transact certain types of single stock futures and/or narrow securities index futures). Likewise, it does not address the potential conflict where a registered representative is registered in the United States for a United States-registered broker-dealer, but is also registered offshore with the broker-dealer or with an offshore entity

affiliate of the broker-dealer, such as an entity operating in the United Kingdom regulated and registered with the Financial Service Authority ("FSA"). Hopefully, these issues will be raised in comment letters and FINRA will provide appropriate guidance.

IV. Considerations for Registered Representatives with Dual Registration as an Investment Advisor

NASD NTM 96-33 (May 1996), attached hereto as Exhibit 3, and NASD NTM 94-44 are particularly important when an associated person registered representative ("RR") is also a registered investment adviser or associated with an investment adviser ("IA"). In these Notices, the NASD gives particular attention to the supervision of securities transactions conducted by an RR/IA. In NTM 94-44, the NASD warned that Rule 3040 conduct is triggered whenever a RR/IA participates in the execution of a security transaction to the extent that his or her actions go beyond a mere recommendation. Implementing any sort of recommendation by phone calls or placing orders would be included within the definition of execution of a private securities transaction, triggering the recordkeeping and supervision requirements of FINRA for the transaction by the RR's member firm even though the transaction is not executed through the RR's member firm.

The interplay between Rule 3040 and the investment adviser's Codes of Ethics[5] that are required for investment advisors presents another interesting issue for a dual registrant. The ethics code of investment advisor may be more encompassing or less encompassing than the supervision required by Rule 3040. The supervision of an affiliated investment advisor where there is a dually registered representative should be carefully coordinated so that nothing is overlooked under the Investment Advisors Act requirements as well as the requirements for a broker-dealer and its applicable rules. There also may be the same type of differences between the broker-dealer's system of supervision and the ethics code of a state-registered broker-dealer.

[5] 17 CFR 275.204A-1.

The NASD specified in NTM 94-44 that the RR is required to provide written notice to the member with which he or she is associated of any proposed employment or outside business activity involving securities from which he or she will or may receive compensation from others. If a member has approved a RR/IA's participation in private securities transactions for execution of transactions of the IA for which the RR will receive compensation, the member must develop and maintain a recordkeeping system that among other things captures the "outside" transactions executed by the RR in its books and records sufficiently to exercise supervision over that activity. Recording the transactions is not enough. The member must have a recordkeeping system and procedures that, for example, enable the member to collect sufficient information to supervise the individual transactions of the RR/IA. NTM 96-33 specifies the following books and records as possible requirements:

- dated notifications from the RR/IA detailing the services to be performed by the RR/IA and the identity of each RR/IA customer serviced at another firm in a private securities transaction;
- dated responses from the NASD member to the RR/IA acknowledging and approving or disapproving the RR/IA's intended activities;
- a list of RRs who also are IAs;
- a list of RR/IAs approved to engage in private securities transactions;
- a list of RR/IA customers, including those that are customers of both the member firm and the RR/IA, with a cross reference to the RR/IA;
- copies of customer account opening cards to determine, among other things, suitability;
- copies of discretionary account agreements;
- duplicate confirmation statements;
- duplicate customer account statements;
- a correspondence file for RR/IA customers;
- investment advisory agreements between the RR/IA and each advisory client;
- advertising materials and sales literature used by the RR/IA to promote investment advisory services wherein the RR/IA holds himself or herself out as a broker/dealer, complemented by a process that shows whether proper filings have been made at

the NASD and whether the RR/IA is using any electronic means, such as the Internet, to advertise services or correspond with customers;

- exception reports, where feasible, based on various occurrences or patterns of specified activity, such as frequency of trading, high compensation arrangements, large numbers of trade corrections, and cancelled trades; and
- supervisory procedures fully responsive to Article III, Section 27 requirements and designed to address Section 40 compliance. The procedures may include such items as the identity of persons responsible for Section 40 compliance, the recordkeeping system to be used and followed, and memoranda or compliance manuals that notify RR/IAs of the member's procedural requirements for Section 40 compliance.

The Questions and Answers of NTM 96-33 provide a wealth of additional detail that should be reviewed in any case by a FINRA member involving RR/IAs and the supervisory procedures should be adjusted accordingly. In the answers to Frequently Asked Questions which is part of NTM 96-33, the NASD clarified that a RR/IA does not need to give prior notice of each transaction for which investment advisory services will be provided. Rather, the RR/IA must receive approval to conduct investment advisory activities for a fee on behalf of his advisory clients. The rule specifies what must be included in the notice and members have the right to approve or disapprove. If it is approved, "the employer member must thereafter record subsequent transactions on its books and records and supervise activity in the affected accounts as if it were his own."

Under the proposed Rule 3110(b)(3), all securities business or investment banking business is included within the area of supervision and there is no provision for non-compensated transactions. This seems to indicate that any transactions by a RR affiliated with an independent IA would have to be supervised and carried on the books and records of the member employer of the RR.

V. FINRA Mandatory Arbitration Requirements

A. The FINRA Rules

FINRA Rule 12101 requires that the Code of Arbitration Procedure ("Code") apply "to any dispute between the customer and a member or associated person of a member that is submitted to arbitration under Rules 12200 or 12201."[6] Rule 12200 reads as follows:

> Parties must arbitrate a dispute under the Code if:
>
> - Arbitration under the Code is either:
>
> (1) Required by a written agreement, or
>
> (2) Requested by the Customer;
>
> - The dispute is between a customer and a member or associated person of a member; and
>
> - The dispute arises in connection with the business activities of the member or the associated person, except disputes involving the insurance business activities of a member that is also an insurance company (emphasis added).

Given the mandatory language of Rule 12200, it is essential for members and associated persons to understand the scope of its application, and the breadth of the terms "customer" and "business activities." FINRA Rule 12100's only limitation on the term "customer" is that "a customer shall not include a broker or dealer."[7] The term "business activity" is not specifically defined in the FINRA code. Notably, however, Rule 12200 does not limit arbitration to cases involving conduct at the member firm where the associated person is employed. The sheer breadth of potential claims and claimants which can be included in these extremely broad terms would

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[6] The requirement of Rule 12101 applies to individual claims by customers. Rule 12204 prohibits arbitration of class action claims unless under specific provisions a party has opted out or the class is not certified and under certain other conditions. Further, shareholder derivative actions will not be arbitrated under 12205.

[7] This mirrors FINRA Rule 0120(g) which states "the term 'customer' shall not include a broker or dealer."

seem to indicate that most situations involving a registered representative and another party, who is not a broker or dealer, could arguably be brought to arbitration. Fortunately, various court interpretations of the FINRA Rules provide some guidance as to their scope and limitations.

B. Court Interpretations[8]

1. "Customer." Several federal cases have recently set out the parameters of who is, and is not, a "customer." In so doing, circuit and district courts have recognized that the term "customer" must not be defined so broadly as to upset the reasonable expectations of FINRA members.[9] Generally, courts are less likely to find a party to be a "customer" of the member firm where that party has no written agreement with the member firm and does not invest with a member firm, but rather with a third party, non-employee, who invests with the member firm.[10] In such cases, the relationship is usually considered too tenuous to render the investor a "customer" of the member firm.[11]

Courts are far more likely to recognize that a party is a "customer," for purposes of arbitration, if that party is an investor who invests directly with a member firm. However, courts

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[8] The discussion of the case law and all of the interpretations is beyond the scope of this article. The court of appeals and district court cases herein are provided as an illustration of the wide scope given to the definition of "customer," and "business activities" of the member or associated person.

[9] *Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc.*, 264 F.3d 770, 772 (8th Cir. 2001) (holding that when the relationship between the parties is more tenuous, courts should determine if there is some form of business relationship that includes some brokerage or investment relationship between the parties); *Oppenheimer & Co. v. Neidhardt,* 56 F.3d 352, 357 (2d Cir. 1995); *Wheat, First Sec., Inc. v. Green,* 993 F.2d 814, 820 (11th Cir. 1993) (recognizing that courts are guided by the notion that the term "customer" should not be too narrowly construed, nor should the definition upset the reasonable expectations of FINRA members).

[10] *Herbert J. Sims & Co., Inc. v. Roven*, 548 F. Supp. 2d 759 (N.D. CA 2008); *see also Brookstreet Securities Corp. v. Bristol Air, Inc.,* 2002 U.S. Dist. LEXIS 16784, at *23 (N.D.CA 2002)(ruling that a customer relationship was not established when investors interacted only with their investment advisor, who maintained an account with the member firm, but was not an employee, agent or registered representative of the firm – even if the investment advisor would be a "customer" of the member firm).

[11] *Id.*; s*ee also Bensadoun v. Jobe-Riat,* 316 F.3d 171 (2nd Cir. 2003) (finding that, where investors pool funds and relinquish all investment authority to a third party who deals with a member firm, that third-party, not the investors, will normally be considered the "customer").

have held that a direct customer relationship between the member firm and the purported customer is not necessary, so long as there is "some nexus between the investor and the member or associated person."[12] For example, if a broker is complicit in misleading an investor into thinking that the investor is a "customer," then the investor will likely be considered a "customer" for purposes of the FINRA Code.[13] Further, if the associated person of the member firm induces, or shepherds, the investment, then the investor is likely a "customer" of that firm.[14] Thus, in a typical "selling away" case, to the extent an investment is made through an associated person of the member firm, the investor may very well be considered a "customer" of the member, for purposes of compelling arbitration.

2. "Business Activities." Courts which have addressed the term "business activities" of the member or the associated person have regarded it quite broadly.[15] Courts which have addressed the issue in the selling away context have usually considered the investment through an associated person as constituting an "activity" which falls within the scope of the rule.[16]

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[12] *Malak v. Bear Stearns & Co.,* Inc., 2004 U.S. Dist. LEXIS 1422 at *13 (S.D.N.Y. 2004).

[13] *Bensadoun v. Jobe-Riat,* 316 F.3d at 178.

[14] *John Hancock Life Insurance v. Wilson,* 254 F.3d 48, 59 (2d Cir. 2001); *see also O.N. Equity Sales Company v. Thiers,* 2008 U.S. Dist. LEXIS 3765 (D. AZ 2008) (finding an investor a "customer" of a member firm for purposes of compelling arbitration where she alleged she was induced to invest in a ponzi scheme by an associated person at the time the associated person worked for the member). The court in *O.N. Equity Sales Company* did recognize, however, that courts may require that the "customer" status be determined at the time of the events providing the basis for the alleged cause of action. 2008 U.S. Dist. LEXIS 3765 at 11, fn. 5 (citing *Wheat, First Securities, Inc. v. Green,* 993 F.2d 814 (11th Cir. 1993).

[15] *See Miller v. Flume,* 139 F.3d 1130 (7th Cir. 1998) (focusing on the "in connection" language of the rule to hold that the rule's scope should be "quite broad"); *First Montauk Securities Corp. v. Four Mile Ranch Development Company, Inc.,* 65 F. Supp. 2d 1371 (S.D. FL 1999) (same); *see also O.N. Equity Sales Company v. Thiers,* 2008 U.S. Dist. LEXIS 3765 at *11 (D. AZ 2008) (finding that a ponzi scheme by an associated person constituted a business "activity" to subject the claim to arbitration).

[16] *See Washington Square Securities, Inc. v. Aune,* 385 F.3d 432 (4th Cir. 2004) (ruling in favor or arbitration in a selling away case, recognizing that many courts interpret the rule broadly to encompass many activities of a member or associated person); *John Hancock Life Insurance v. Wilson,* 254 F.3d 48, 59 (2d Cir. 2001) (holding that even where the investor had no account with the member, the sale of fraudulent promissory notes by an associated person constituted a sufficient "activity" of the associated person to compel arbitration).

Indeed, courts have nearly universally found that disputes arising from a firm's lack of supervision over its brokers arises "in connection with" business activities of the member, so as to compel arbitration.[17]

Based on the breadth of the terms used in the FINRA Rules and court decisions, outside business activities of the associated person may be subject to arbitration where the "customer" may in fact never have had a customer agreement or effected a transaction that was recorded on the books of the broker-dealer because the member did not know of it. Indeed, the activity of the associated person in dealing with any person investing in securities (whether or not at the member firm) generally will bring the associated person and the member within the scope of FINRA Rules for mandatory arbitration.

VI. Outside Business Activities Claims and Defenses

A. Civil Claims

Theories of civil liability against a registered representative for his or her outside business activity include (among other things) express and implied remedies under the federal and state securities laws, common law claims, breach of contract, and state statutory consumer fraud claims. The merit of such claims depends upon the specific facts of individual cases and a discussion of them is well beyond the scope of this article.

Theories of civil liability against the firm when a registered representative is engaged in outside business activity, however, are more limited. In many outside business activity cases, the member broker-dealer may not even know of the activity of the associated person. Notwithstanding, the member still may have potential liability under theories of vicarious liability.

[17] *See Mutli-Financial Securities, Corp. v. King,* 386 F.3d 1364, 1370 (11th Cir. 2004) (holding that a dispute that arises from a member's lack of supervision over its associated persons arises "in connection with its business"); *Vestax Secs. Corp. v. McWood,* 280 F.3d 1078, 1082, 1081 (6th Cir. 2002); *John Hancock Life Insurance v. Wilson,* 254 F.3d 48, 58-59 (2d Cir. 2001) (same); *MONY Secs. Corp. v. Bornstein,* 250 F. Supp. 2d 1352, 1357 (M.D. Fla. 2003) (same); *Hornor, Townsend & Kent, Inc. v. Hamilton,* 218 F. Supp. 2d 1369, 1384 (N.D. Ga. 2002) (same); *First Montauk Secs. Corp. v. Four Mile Ranch Dev. Co., Inc.,* 65 F. Supp. 2d 1371, 1379 (S.D. Fla. 1999) (same).

Those vicarious liability theories include respondeat superior, agency, and control person liability under federal and state law. These theories will each be discussed in turn below.

1. Respondeat Superior. Respondeat superior, which is Latin for "let the master answer," is a legal doctrine imposing liability on an employer for the acts of an employee performed within the course of the employee's employment. Although respondeat superior is a state common law doctrine, Courts have held that it also applies to statutory causes of action, including actions for securities fraud.

Where the registered representative is an independent contractor, the respondeat superior arguably is inapplicable because the doctrine generally applies only to employer-employee relationships. However, even where an employer-employee relationship does exist, respondeat superior should be inapplicable to selling away cases because the registered representative is engaged in a "private securities transaction" which by definition, is "a securities transaction outside the regular course or scope of an associated person's employment with a member firm." Rule 3040(e); Proposed Rule 3110(b)(3)(A) (applicable to "investment banking or securities business outside the scope of the member's business").

2. Agency (Actual and Apparent Authority). Because employees are agents of their employers within the scope of employment, agency is often confused with respondeat superior. However, agency is a doctrine distinct from respondeat superior, which can apply to both employees and non-employees. Generally, an agency relationship is created when a principal (the firm) grants either *actual* authority or *apparent* authority to an agent (the registered representative) to engage in the conduct which caused the harm.

Firms generally prohibit private securities transactions without prior written approval. In selling away cases, approval has rarely been granted and, accordingly, actual authority to engage in

selling away transactions rarely exists. Thus, most claimants in selling away cases rely upon apparent authority.

Apparent authority generally exists when a firm – through the firm's own words and conduct – vests the registered representative with the appearance of actual authority to engage in the conduct and the claimant relies to his or her detriment upon that appearance of authority. Whether apparent agency exists can be a factually intensive question affected by such factors as:

- whether the firm's agreement with the customer spells out the limitations of the representative's actual authority;
- whether the representative, the documents, or other individuals involved in the selling away activity tell the Claimant that the investment is or is not sanctioned by the firm;
- whether the representative conducts the selling away activity under a business name other than the name of the firm;
- whether the representative conducts the selling away activity out of the firm's office (as opposed to a separate office or home);
- whether the representative furthers the selling away activity using the firm's name, logo, letterhead, email, or through some other means indicating firm involvement; and
- the extent of contact between the investor and people not affiliated with the firm, but involved in the selling away activity.

The above is not meant to be exhaustive of the factors that affect apparent authority, but they do illustrate a pattern. Each factor considered in a determination of whether apparent agency exits relates either to the steps the firm took to cloak the registered representative with the appearance that the representative was acting on behalf of the firm or to the reasonableness of the claimant's reliance upon the appearance of authority during the selling away activity.

3. Control Person Liability under the Exchange Act. Control person liability is another argument for imposing liability upon a firm for the conduct of a registered representative. Control person liability can arise under Section 20 of the Securities Exchange Act of 1934 (the "Exchange Act"), which provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.
>
> 15 U.S.C. § 78t.

Section 20 control person liability differs from common law doctrines of respondeat superior and agency in several important respects. For example, the common law doctrines generally can be used to impose liability for any cause of action, whether it arises from common law or statute. Thus, Courts have held that a registered representative's violation of the federal securities law or violation of common law can be imputed to the firm through respondeat superior. By comparison, Section 20 control person imputes liability only for breaches of the Exchange Act. Thus, if a registered representative breaches a common law duty (common law fraud for example), Section 20 does not impute the representative's common law liability to control persons of the representative.

The standard of conduct for imposing liability under Section 20 is also very different. Section 20 does impose liability based solely upon the control person's relationship with the primary violator. However, a control person can avoid liability under Section 20 if he acted in "good faith" and did not "directly or indirectly induce the act or acts" constituting the primary violation. Because the firm generally knows very little or nothing about the selling activity in a selling away case, the firm's direct or indirect inducement of the conduct is rarely an issue. Good faith, however, is the subject of a great deal of litigation.

Courts have generally held that a firm acts in "good faith" if it has and enforces a reasonable system of supervision over the conduct of its registered representatives. Courts have also held that, to impose liability upon the control person, the failure in supervision must amount to

scienter or recklessness – negligence generally is not enough. *Scienter* requires "an extreme departure from the standards of ordinary care" posing "a danger of misleading buyers that was either known to the control person or was so obvious that the control person must have been aware of it."

4. Control Person Liability under the 1933 Act. Control person liability can also arise under Section 15 of the Securities Act of 1933 (the "1933 Act"), which provides:

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12 [*15 USCS § 77k* or 77 l], shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.
>
> 15 USCS § 77o.

Just as Section 20 of the Exchange Act can only impute liability for violations of the Exchange Act, Section 15 of the 1933 Act (where applicable) can only impute liability to a control person for breaches of the 1933 Act. In the selling away context, the 1933 Act commonly becomes important when the associated person mistakenly believes that the investment is not a security, resulting in a claim for rescission under the 1933 Act. At least one court has held, in this context, that a firm is not liable under Section 15 where the firm had "no knowledge of or reasonable ground to believe" that: (i) the sale of an investment was taking place; (ii) that the investment was unregistered; and (iii) that the associated person was making use of the mails or facilities of interstate commerce in connection with the sale or offer.[18]

5. State Control Person Liability. Blue sky laws also incorporate provisions that impose control person liability, but some blue sky laws define "control person" much more

[18] *Swensen v. Engelstad,* 626 F.2d 421, Fed.Sec.L.Rep. (CCH) P97,639 (5th Cir. 1980).

narrowly than the Exchange Act. Some blue sky laws, for example, define "controlling person" as a "person offering or selling a security or a group of persons acting in concert in the offer or sale of a security, owning" sufficient shares of the security to control the company. Arguably, in a selling away case, because the firm did not offer, sell, or act in concert in the offer or sale, the firm should not be liable as a control person under these narrower blue sky law definitions. Of course, claimants may still argue that the firm is liable for the blue sky law violation of a registered representative under the doctrines of respondeat superior or agency discussed above.

6. Direct Liability. In addition to secondary liability theories like respondeat superior, agency, and control person, claimants' attorneys often seek to impose liability upon firms in selling away cases for their own direct conduct. A claimant may, for example, attempt to sue a firm for negligently hiring the registered representative who engaged in the selling away activities or attempt to claim that the firm's new account agreement contained an implied contractual term that the firm would safeguard any investment sold through the registered representative, whether or not known or made through the firm. Whether such theories have merit generally is dependent upon the facts presented by a specific case.

7. Practical Application. At hearing or trial, Claimants' attorneys focus on small details which, with Herculean effort, a firm could have investigated to uncover the selling away activity. Because selling away cases are litigated after the selling away activity has come into the focused view of 20-20 hindsight, the connection between slight information and the outside business activity can appear much more obvious than it would or could have been to the firm at the time the activity was occurring. As a result, in many cases jurors and arbitration panels unintentionally impose liability against firms using standards significantly lower than those discussed above.

The authors find that many times firms are sued for outside business activities of associated persons where the firm has absolutely no knowledge of the activity. Sometimes, the associated person just did not understand that the activity was an outside business activity involving securities and did not understand the importance of reporting it to the firm and sometimes the associated person's selling away is a deliberate attempt to defraud. In some cases, firms are sued by "investors" who thought they were dealing with the firm, but in other cases, the investor knew the firm was not involved and sometimes, the claimants have even aided the associated person in affirmatively concealing the activity.

As noted above, even FINRA has recognized that notwithstanding the very best supervisory and compliance policies, procedures and controls, firms will not detect all selling away activity. Even with the very best policies, procedures and controls, selling away claims can be very difficult to defend and liability is often wrongly imposed upon firms, particularly in arbitration, not because the claimant proved the elements of his or her case, but because the firm is the only deep pocket and the decision-maker feels a great deal of sympathy for the injured investor. This can occur even when the investor was never a customer of the broker-dealer.

B. Regulatory Liability

1. General. Unlike civil liability from private actions, there are additional theories in enforcement actions. Enforcement by the SEC, FINRA, or state regulatory agencies is not limited to the above vicarious liability theories, but also includes aiding and abetting and in the case of FINRA, failure to supervise.

2. SEC. Exchange Act §§15(b)(4)(E) and 15(b)(6) generally spell out the supervisory responsibility of broker-dealers and persons who may be supervisors. The Exchange Act indirectly mandates supervisory procedures by providing that the SEC may sanction a broker-dealer and its supervisory personnel, a broker-dealer or an associated person who has violated the

securities laws, or who "has failed reasonably to supervise, with a view to preventing violations of the provision of such statutes, rules and regulations, another person who commits such a violation if such person is subject to his supervision." Subsection (E) further provides that no person shall be deemed to have failed reasonably to supervise any other person if:

> (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such person, and
>
> (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and systems without reasonable cause to believe that such procedures and systems were not being complied with.[19]

3. FINRA. Although private litigants should not be entitled to pursue actions based directly upon them, FINRA itself can and does pursue regulatory actions based directly upon violations of its rules. In addition to pursuing violations of Rules 3030, 3040, and 3050, FINRA often pursues actions for violations of Conduct Rule 2110 (Standards of Commercial Honor and Principles of Trade) and Rule 2310 (Suitability) against registered representatives who engage in selling away. In these same cases, FINRA often pursues the firm, and in extreme cases, the individual charged with supervising the registered representative, for violations of Rule 3010 and 3012 (Supervision) and/or Rule 3070 (Reporting Requirements).

4. State Regulators. State securities departments or divisions generally have the independent authority to investigate and, where violations of state law have occurred, to issue temporary or permanent cease and desist orders, suspensions, or monetary sanctions against individuals, broker-dealers, investment advisors, or others. State regulators often impose sanctions even where FINRA or the SEC have already acted to punish the wrongdoer or the firm.

[19] Exchange Act, Section 15(b)(4)(E) ; 15 U.S.C. 78(o)(b)(4)(E).

VII. Supervision and Compliance

A. General

A firm's supervision and compliance procedures are supposed to "be reasonably designed to achieve compliance with the applicable securities laws and regulations and with applicable FINRA rules." *See* FINRA Rule 3010. FINRA has interpreted this standard as recognizing that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations and, accordingly, that the rule requires only that the system be a "product of sound thinking" and "within the bounds of common sense," taking into account the member firm's business. NTM 99-45.

In designing these systems, regulators want firms to utilize a risk-based approach which tailors the firm's supervisory system to the firm's business and to the products that are being sold. Consequently, there is no standard set of compliance procedures or supervisory procedures to control outside business activities. Rather, in designing a firm's system, each firm considers the risks of unreported outside business activity and the methods of supervision of reported activity based upon the firm's own business model. Thus, a firm with single associated person offices in widespread operations is expected to have very different supervisory procedures than a firm with large relatively good sized branch office or Office of Supervisory Jurisdiction ("OSJ") each with a number of supervisory personnel on site. Similarly, a firm whose associated persons are involved in the sale of other financial products, such as insurance, real estate, or even more exotic products that may look like an investment in personal or real property, but may turn out to be securities, will have very different supervisory procedures than firms whose associated persons devote their full time to sales of mutual funds. New products also can present a special risk.

Although financial firm's businesses vary greatly, so do the tools available to firms seeking to design supervisory and compliance procedures tailored to their business. Compliance and

supervisory systems can employ different procedures for hiring, education, reviews and approvals when an associated person notifies the firm of outside activity, on site inspections, and remote monitoring of known activity. Firms also tailor their procedures for investigating and responding to complaints from customers (and from others who may not even appear to be customers). Such complaints may signal an unapproved and unreported selling away activity.

Many firms control some of the risk by prohibiting all outside business activities and in some cases all outside activities that may present a risk of inadvertent business activities. Other firms include statements in their new account forms or account statements warning customers against engaging in any outside business with an associated person and against writing checks to the associated person as opposed to the firm. Even these firms, however, have additional supervisory procedures in place which are intended to help detect unreported outside business activity and especially activity that may involve securities.

Set forth below are suggestions of various elements that might be considered in developing supervisory procedures and controls and compliance procedures. The suggestions set forth below are not mandatory for good procedures and controls. To the contrary, many may be inappropriate for a specific firm depending upon the firm's business and structure. Many others may be too complex and/or expensive for some firms, especially small firms. The key thing is assessment of risk and practicality for supervisory procedures and controls and compliance procedures. The discussion below is a starting point – a place for a firm to look for ideas that may be incorporated, modified, or even rejected in the firm's design of a good supervisory system.

B. Hiring and Background Investigation

FINRA Rule 3010(e) states that a member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to submitting a U-4 for that person to associate with the firm. When performing due

diligence in the hiring process, firms today generally do much more than simply rely upon the U-4 signed by an account executive. A thorough background check is typical, and in some cases often includes (and may not be limited to) a credit report, financial statement, and tax return. Telephone calls or written requests for verification commonly are made not only to the associated person's former firm, but if there has been turnover in his employment, to all the firms in which he has been employed during the previous 10 years. In fact, some firms apply a higher level of diligence whenever they see a significant turnover in employment. It is wise for firms to obtain information about other outside organizations with which the person has been affiliated for the same period of time.

1. Employment Questionnaire. Firms often use a detailed background questionnaire completed by the proposed account executive prior to an interview. Some suggestions for the questionnaire are the following:

(i) describe all business activities for a period of ten years;

(ii) with respect to each outside business activity, provide details [dates of involvement, position, description of affiliates of the business, relationship with other individuals involved, etc...];

(iii) list all of the types of products that the associated person has sold at his former firm(s);

(iv) describe all outside volunteer or non-business activities [positions held in church, voluntary associations, clubs, family members, etc..]

(v) describe all activities not disclosed above that might involve securities [partnerships, joint venture agreements, leases, management contracts, property ownership];

(vi) list all personal web sites or other web sites where the applicant is listed; and

(vii) list names of persons that might be contacted regarding the above.

Firms generally should seek to obtain the consent of the associated person for the member to obtain additional information, such as credit information, and to contact persons associated with any outside activity or otherwise related to information requested in the questionnaire.

2. Financial Statements, Tax Returns, Bank Accounts, Sources of Income. It may be helpful to obtain from each proposed associated person one or more of the following:

(a) tax returns for several years;

(b) a detailed financial statement (if available);

(c) a list of all bank accounts;

(d) a list of investments; and

(e) past and present sources of income for five years.

If obtained, this information should be carefully reviewed both to consider the associated person's holdings and for conflicts with the possible business of the member or its clients.

3. Credit Check. Firms often find it useful to obtain and carefully review a credit report for the associated person. A credit report may give more account information than some of the items in (2) above, and could be a good alternative or a first step before asking for all of the information in (2) above. Firms may wish to further investigate significant loans, debits or poor credit before hiring. Depending upon the circumstances, unsatisfied debt or spending disproportionate to income may create financial pressures upon an associated person which, in turn, could create an incentive to seek additional income through inappropriate and concealed outside business activity.

4. Legal Check. Today it can be very easy to check electronically for pending litigation by or against a proposed account executive in federal and some state courts. If his or her name appears in litigation, a firm may wish to request and document full details of the litigation before hiring the associated person.

5. Reference Calls. For a new employee, firms may wish to:

(a) Contact former broker-dealer or other former employers Form U-4 (mandatory requirement for 3 years).

(b) If the person is involved with insurance, call the insurance agent with which he or she is associated and the insurance company or underwriter.

(c) Contact some or all other outside business organizations disclosed to the firm.

(d) Consider review of all other outside activities to determine if participation appears extensive or signals possible securities activity and if it is advisable to contact persons knowledgeable about such activities.

(e) If the associated person is involved in charitable or other community organizations, some firms ask for references for each organization and under some circumstances inquiring by call or by interview.

(f) If warranted, call bankers where the associated person has or had bank accounts for the last 3 to 5 years.

6. Interviews. Firms often conduct a final interview after all of the information, calls, questionnaires and data have been received. After the questionnaire has been completed, some firms will have at least two supervisory personnel review the questionnaire, including one that is independent. An independent supervisor is one that does not share in commissions or other compensation from the office which the associated person is proposed to be located. Based upon the questionnaire, firms often conduct two or more personal interviews. Discrepancies can be investigated and a firm can prepare a memorandum as to the resolution of any issues raised by the questionnaire to protect itself from negligent hiring claims. In some cases, it may be appropriate to adopt heightened procedures. It is a good practice if there are to be any

waivers with respect to information to obtain permission by the hiring supervisor from a third independent supervisory person.

7. Web Site Checks. In many situations, firms find it worthwhile to search for and review web site(s) of the proposed associated person and his prior employers. The web site search may uncover not only sites created or known to the applicant, but also a listing on any other web site. This some times will lead to disclosure of outside business activities involving other businesses or in some cases securities activities.

8. Overview of Hiring Process. The hiring process for an associated person is and should be different from that of other employees, particularly with respect to outside organizations and activities. Human relations departments tend to have a set questionnaire for all employees. Because of limitations of employment and anti-discrimination laws, certain types of questions on a pre-employment questionnaire may be prohibited, but with respect to an associated person in the financial services industry these same restrictions may not apply. Thus, while inquiries regarding participation in certain outside organizations [religious or political organizations for example] may be an unwise general employment practice which could subject an employer to potential scrutiny under discrimination laws, those same inquiries may be an important part of a firm's due diligence of an associated person. The outside organization, with the help of the associated person, may be promoting particular types of investment products to raise funds. The organization may have granted the associated person discretion to invest funds on its behalf outside the firm. Even if the organization is not involved in such activities, other conflicts could also arise if the associated person is soliciting clients for contributions to the outside organization. Political organizations present particular selling away problems and other conflicts that arise as a result of solicitations and pay-back business. The various non-discrimination provisions of both state and federal law should be examined and the inquiries prepared carefully to ensure they are

directed only to the possibility of other business activity or conflicts of interest and are not used to discriminate in the hiring process.

C. Education

1. Education of All Associated Persons. In many selling away cases, the associated person claims simply not to have known that the activity was prohibited. Education for associated persons concerning outside activities and the firm's policies can help prevent these problems. Generally, firms create a documented program to educate all associated persons with respect to the firm's policy that:

(a) Any and all outside activities should be reported to the firm, typically within no more than 10 days.

(b) Regardless of whether the employee thinks he or she is engaged in investment activity for the organization, the employee should let the firm make the determination as to whether the employee's activities involve a conflict of interest, investment or securities activities.

(c) The firm must pre-approve participation in organizations which involve the possibility of securities activities or other activities that might present a conflict of interest.

2. Education of Employees Who May See Outside Business Activity Information. Supervisors and others who may be reviewing or see outside business activity should attempt to be alert. Firms can help through education of supervisors and other persons who may come into contact with information suggesting outside business activities. There should be specific procedures for alerting compliance and alerting supervisors up-the-line if information points to unapproved outside business activity.

3. What is Securities and Investment Banking Business Activity? Firms generally include written policies in the compliance manual for employees that neither the

associated person nor his supervisors are to make a decision on what does or does not constitute securities or investment business activity. These policies often warn associated persons that they are not to rely on letters from outside counsel and explain to associated persons that determining what is a security is so difficult that even the United States Supreme Court Justices have differed in their view as to what is a security. Products like indexed annuities, certain types of real estate investments, promissory notes, condominium vacation rental schemes and a variety of other types of activities create difficult legal questions that can be far beyond the ability of associated persons or their supervisors to determine. Furthermore, the determination of whether something is a security varies between the various states and between state and federal law. Likewise, there can be a significant difference between the definition of securities in other countries and the definition of a security for purposes of federal or state securities laws in the United States.

D. Periodic Update Regarding Outside Business Activities

The member should have a policy that there be a periodic update of all outside activities of associated persons. Some suggestions include:

(1) Compliance procedures can emphasize that the firm's policy requires that the associated person must report any outside activity to the firm within a very short period of time (e.g. no more than 10 business days).

(2) The required update on outside business activities could include all of the things that were covered in the new employment questionnaire. Some firms also periodically obtain one or more of the following:

(1) current financial statement;

(2) list of bank accounts;

(3) tax return; and

(4) credit report.

Supervisory procedures may provide that when there is an update of outside activity and/or additional information such as financial statements, bank accounts, tax returns, credit report, are obtained, that they be promptly reviewed and assessed. If there are exceptions, the firm can protect itself by following up and documenting their resolution. It is also helpful for supervisors to assess the person's lifestyle and compare it to his income and its sources. The tax returns and financial statements could reveal sources of income that may need to be investigated and possibly supervised or prohibited.

A number of firms use written reminders to all supervisors and associated persons and other persons with need-to-know of the necessity of updating information regarding outside business activities. An annual or more frequent reminder may be helpful. Also, many firms use an annual questionnaire as part of their updating review. The annual questionnaire should request information concerning any personal web sites or web sites where the associated person is listed. Some firms may do a periodic check by running an associated person's name through a search engine to determine if the associated person has a personal web site or is listed on other web sites.

If there is new outside activity, a detailed description of the activity should be obtained either in writing or on-line from the associated person. In the event there are questions with respect to particular activities, personal interviews and further investigation may be warranted and a memorandum prepared regarding the outcome of the interview. A firm's compliance department plays an important role in such interviews and the result of the interviews. If there are any red flags, firms may consider conducting and documenting further interviews with two separate interviewers. One of the interviewers could be independent.

E. Inspections and Reviews

1. Auditing and Inspection Procedures in General. General supervisory procedures should provide for inspection of all offices as required under 3010(c) (which continues

to be required under the proposed new supervisory Rule 3110). More frequent inspections may be appropriate for offices where there are complaints or where exception reports or past inspection deficiencies evidence other possible problems. *See* NTM 08-24; *see also* proposed Rule 3110(c). A pre-office inspection profile of the office should be prepared that may include, among many other things:

(1) a listing of any activities, business or private, known to the member that are conducted in or outside the office that are not directly related to the member's business;

(2) complaints or exception reports; and

(3) past problems at the office.

Based upon the firm's pre-audit procedures, firms can develop a plan to review and sample business activities conducted by the associated person to determine if there are any activities that have not been reported to the member.

If there are other outside securities business activities conducted at the associated person's office, prudence may require some inspection of those activities. This may include reviewing files and other activities for inappropriate conduct, including the sale of investment products, particularly private placements, notes and other exotic securities, such as vacation condos with rental contracts and other investment schemes. If the associated person has a second office from which business activities are conducted, appropriate procedures can be prepared for at least a limited inspection of such office and potential outside business activities of that office. These procedures may include an on-site inspection of such office.

In inspecting branch offices, the inspector may try to obtain some idea of the lifestyle of the associated person and consider whether that lifestyle is within the person's means. Reviewing files of the customers and, sometimes, even non-customers with which the office has business activities can be important. If problems of possible outside selling activity are detected, a firm may want to

contact and interview broker-dealer customers as well as the outside business activity customers. Some firms require that all branch offices, particularly small branch offices, have a log-in for individuals that actually visit the office. Other firms compare telephone records of the associated person with the telephone numbers of clients to determine if and why there are a lot of calls being made to non-clients.

2. Surprise Inspection. Surprise inspections, especially with smaller offices, can be an effective tool for investigating outside business activity. The surprise inspection is sometimes a problem for a single person office because the examiners may show up when the associated person has gone on vacation or is elsewhere. Some firms attempt to minimize these problems by requiring the associated person to provide notice to the firm if the person plans to be out of the office for a day or a longer period of time.

F. Complaints

As mentioned above, one sign of impermissible selling away is complaints from customers or non-customers about products that are not within the scope of business. If a customer or non-customer complains about a transaction that has not been recorded on the firm's books and records, the firm may have a clear sign of selling away to investigate. One complaint may lead to the uncovering of relatively massive selling away activities, some of which are Ponzi schemes and others which are bona fide securities but being sold in contravention of Rule 3040 and/or the member's policy. In other cases, the account executive may have received no selling compensation, but the member has not been notified. In many cases, when a complaint is received it is already too late to prevent the selling away because the investment sold is worthless and in the case of Ponzi schemes or other out-and-out frauds, money may have been misappropriated by the account executive or third parties.

G. Additional Thoughts on Policies and Procedures

Policies and procedures, both supervisory and compliance, should include forms designed to elicit necessary information. Some of the forms are described above, such as pre-employment questionnaires and annual update questionnaires. The supervisory procedures should spell out for both supervisory and compliance personnel how to follow up, the chain to follow up and who is to follow up on information received.

Needless to say, procedures should be explicit as to who is reviewing what information and the procedures should also make clear that the primary responsibility is on the supervisory personnel. The role of the compliance department and its personnel should also be clearly defined.

H. Permission to Sell Away

Under the current rule, if an associated person engages in securities or investment activities for compensation or without compensation the associated person must notify the firm. If the firm member grants permission, it must supervise the activities if the account executive receives any selling compensation. Even if no selling compensation is received, the firm may wish to consider supervising the non-compensated outside business activities involving investment products or investment banking business. Furthermore, as explained above, if there are securities activities for compensation, the transactions must be effected through the books and records of the firm. If the activity is not for compensation, the member has the right to place conditions on the associated person's participation. In many cases, the firm simply prohibits the activity. Under the new proposed rule, any securities or investment banking activities are required to be supervised and on the books and records of the member whether for compensation or not.

I. Reporting to Authorities

If selling away is uncovered, we recommend the firm make an extremely rapid investigation using knowledgeable counsel and compliance experts. The question of when to

inform the regulators is always difficult. Unfortunately, there is no set answer as to when you should inform the regulators and which regulators you should inform. When to report it depends upon the scope of the non-permitted selling activities, the number of involved investors, the number of associated persons and supervisory personnel, and the extent of the losses. Reporting is less urgent when the selling away activity has ceased and there is no further possibility of damages to additional investors. However, if there is continuing fraudulent activity involving the selling away, it must be stopped immediately and if the firm is unable to stop it immediately the regulators must be contacted immediately so that they can take appropriate action to stop it. All of these and many other factors need to be considered. Another serious question is whether you report to FINRA, the SEC or both. In certain very serious cases, we have recommended that a firm report simultaneously both to the SEC and FINRA, and very promptly. Reporting to the SEC is more important when there are third parties outside the jurisdiction of FINRA, but not outside the jurisdiction of the SEC. If the problem involves an exchange transaction, which is unusual in connection with outside business activity, it should be reported to the exchange regulators. Firms should retain a knowledgeable counsel familiar with SEC and FINRA enforcement to advise them on how, when, and to whom to report.

EXHIBIT 1

3040. Private Securities Transactions of an Associated Person

Notices (9 links)

(a) Applicability

No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this Rule.

(b) Written Notice

Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he 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.

(c) Transactions for Compensation

(1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to paragraph (b) shall advise the associated person in writing stating whether the member:

(A) approves the person's participation in the proposed transaction; or

(B) disapproves the person's participation in the proposed transaction.

(2) If the member approves a person's participation in a transaction pursuant to paragraph (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.

(3) If the member disapproves a person's participation pursuant to paragraph (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.

(d) Transactions Not for Compensation

In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to paragraph (b) shall provide the associated person prompt written acknowledgment of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.

(e) Definitions

For purposes of this Rule, the following terms shall have the stated meanings:

(1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in Rule 2790), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.

(2) "Selling compensation" shall mean any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

Amended by SR-NASD-99-60 eff. March 23, 2004.
Adopted by SR-NASD-85-28 eff. Nov. 12, 1985.

Selected Notices: 75-34, 80-62, 82-39, 85-21, 85-64, 85-85, 91-32, 94-44, 95-53, 01-79, 03-79.

Selected SEC Decisions:
Allen S. Kloszowski and Jack D. Prosen, SEC Rel. No. 34-25487 (1988).
Zoltor Herbert Hatfield, SEC Rel. No. 34-25488 (1988).

EXHIBIT 2

3050. Transactions for or by Associated Persons

Notices (6 links)

(a) Determine Adverse Interest

A member ("executing member") who knowingly executes a transaction for the purchase or sale of a security for the account of a person associated with another member ("employer member"), or for any account over which such associated person has discretionary authority, shall use reasonable diligence to determine that the execution of such transaction will not adversely affect the interests of the employer member.

(b) Obligations of Executing Member

Where an executing member knows that a person associated with an employer member has or will have a financial interest in, or discretionary authority over, any existing or proposed account carried by the executing member, the executing member shall:

(1) notify the employer member in writing, prior to the execution of a transaction for such account, of the executing member's intention to open or maintain such an account;

(2) upon written request by the employer member, transmit duplicate copies of confirmations, statements, or other information with respect to such account; and

(3) notify the person associated with the employer member of the executing member's intention to provide the notice and information required by subparagraphs (1) and (2).

(c) Obligations of Associated Persons Concerning an Account with a Member

A person associated with a member, prior to opening an account or placing an initial order for the purchase or sale of securities with another member, shall notify both the employer member and the executing member, in writing, of his or her association with the other member; provided, however, that if the account was established prior to the association of the person with the employer member, the associated person shall notify both members in writing promptly after becoming so associated.

(d) Obligations of Associated Persons Concerning an Account with a Notice-Registered Broker/Dealer, Investment Adviser, Bank, or Other Financial Institution

A person associated with a member who opens a securities account or places an order for the purchase or sale of securities with a broker/dealer that is registered pursuant to Section 15(b)(11) of the Act ("notice-registered broker/dealer"), a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall:

(1) notify his or her employer member in writing, prior to the execution of any initial transactions, of the intention to open the account or place the order; and

(2) upon written request by the employer member, request in writing and assure that the notice-registered broker/dealer, investment adviser, bank, or other financial institution provides the employer member with duplicate copies of confirmations, statements, or other information concerning the account or order;

provided, however, that if an account subject to this paragraph (d) was established prior to a person's association with a member, the person shall comply with this paragraph promptly after becoming so associated.

(e) Paragraphs (c) and (d) shall apply only to an account or order in which an associated person has a financial interest or with respect to which such person has discretionary authority.

(f) Exemption for Transactions in Investment Company Shares and Unit Investment Trusts

The provisions of this Rule shall not be applicable to transactions in unit investment trusts and variable contracts or redeemable securities of companies registered under the Investment Company Act of 1940, as amended, or to accounts which are limited to transactions in such securities.

Amended by SR-NASD-2002-40 eff. Oct. 15, 2002.
Amended by SR-NASD-90-56 eff. June 1, 1991.
Amended by SR-NASD-89-29 eff. Dec. 15, 1989; Mar. 14, 1991.
Amended by SR-NASD-82-25 eff. Feb. 28, 1983.

Selected Notices: 82-21, 82-44, 83-17, 85-41, 87-2, 91-27, 97-26, 02-73.

EXHIBIT 3

NASD NOTICE TO MEMBERS 96-33

NASD Clarifies Rules Governing RR/IAs

Suggested Routing

- ■ Senior Management
- ☐ Advertising
- ☐ Corporate Finance
- ☐ Government Securities
- ☐ Institutional
- ■ Internal Audit
- ■ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☐ Operations
- ☐ Options
- ■ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ■ Training

Executive Summary

On May 15, 1994, the NASD® issued *Special Notice to Members 94-44*, which clarified the applicability of Article III, Section 40 of the NASD Rules of Fair Practice to investment advisory activities of registered representatives (RRs) who also are investment advisers (RR/IAs). In particular, the Notice addressed the supervision of securities transactions conducted by RR/IAs away from the NASD members with which they are associated. Since the issuance of *Notice to Members 94-44*, the NASD has responded to questions concerning the types of records that may be used and recordkeeping systems that may be established by an NASD member to ensure that investment advisory transactions subject to Article III, Section 40 are properly recorded and the RR/IA adequately supervised. The NASD also has responded to other general compliance and interpretive questions relating to Article III, Section 40. To further facilitate member firm compliance with Article III, Section 40, this Notice discusses recordkeeping approaches and presents the answers to some of the most frequently asked questions regarding Section 40 since the release of *Notice to Members 94-44*.

Questions regarding this Notice may be directed to Daniel M. Sibears, Director, Regulation, at (202) 728-6911; or Mary Revell, Senior Attorney, Regulation, at (202) 728-8203.

Background

As reviewed in *Notice to Members 94-44*, Article III, Section 40 requires that any person associated with an NASD member who participates in a private securities transaction must, before participating in the transaction, provide written notice to the member with which he or she is associated. The written notice must describe the transaction, the associated person's role, and disclose whether the associated person will or may receive selling compensation. Thereafter, the NASD member must advise the individual in writing whether it approves or disapproves the associated person's participation in a private securities transaction. If the member approves the transaction, the transaction must be recorded on the member's books and records, and the member must supervise the associated person's participation as if the transaction were executed on behalf of the member.

Most notably, *Notice to Members 94-44* clarifies the analysis that members must follow to determine whether the activity of an RR/IA falls within the parameters of Section 40. Fundamental to this analysis is whether the RR/IA participates in the execution of a securities transaction such that his or her actions go beyond a mere recommendation, thereby triggering the recordkeeping and supervision requirements of Section 40.

Where the RR/IA does not participate in the execution of securities transactions, *Notice to Members 94-44* reminds members and their RR/IAs that while Section 40 may not apply, the activity, nonetheless, may be subject to the notification provisions of Article III, Section 43. That section requires an RR to provide written notice to the NASD member with which he or she is associated of any proposed employment or outside business activity pursuant to which he or she will receive compensation from others. The form and content of an Article III, Section 43 notice is to be determined by the NASD member.

Article III, Section 40 Books And Records Relating To Investment Advisory Transactions

Where a member has approved an RR/IA's participation in private securities transactions for which he or she

will or may receive selling compensation, the member must develop and maintain a recordkeeping system that, among other things, captures the transactions executed by the RR/IA in its books and records and facilitates supervision over that activity. Recordkeeping systems that simply record all transactions will not result in adequate supervision under Article III, Section 27 of the Rules of Fair Practice. Rather, the records created and recordkeeping system used, together with relevant supervisory procedures, must enable the member to properly supervise the RR/IA by aiding the member's understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA's authority, and the suitability of the transactions.

Since the transactions subject to Section 40 by definition occur at and through another member or directly with a product sponsor, the NASD member licensing the RR/IA is not required to record the activity in the same manner it records transactions executed on behalf of its own firm (i.e., on its purchase and sales blotter). Rather, members may develop and use alternative approaches that meet their specific needs and business practices, such as special blotters, separate Section 40 recordation forms and files, and unit systems, for capturing the RR/IA activity that occurs through other firms. In this regard, Section 40 recordkeeping systems may involve many of the following books and records:

- dated notifications from the RR/IA detailing the services to be performed by the RR/IA and the identity of each RR/IA customer serviced at another firm in a private securities transaction;

- dated responses from the NASD member to the RR/IA acknowledging and approving or disapproving the RR/IA's intended activities;

- a list of RRs who also are IAs;

- a list of RR/IAs approved to engage in private securities transactions;

- a list of RR/IA customers, including those that are customers of both the member firm and the RR/IA, with a cross reference to the RR/IA;

- copies of customer account opening cards to determine, among other things, suitability;

- copies of discretionary account agreements;

- duplicate confirmation statements;

- duplicate customer account statements;

- a correspondence file for RR/IA customers;

- investment advisory agreements between the RR/IA and each advisory client;

- advertising materials and sales literature used by the RR/IA to promote investment advisory services wherein the RR/IA holds himself or herself out as a broker/dealer, complemented by a process that shows whether proper filings have been made at the NASD and whether the RR/IA is using any electronic means, such as the Internet, to advertise services or correspond with customers;

- exception reports, where feasible, based on various occurrences or patterns of specified activity, such as frequency of trading, high compensation arrangements, large numbers of trade corrections, and cancelled trades; and

- supervisory procedures fully responsive to Article III, Section 27 requirements and designed to address Section 40 compliance. The procedures may include such items as the identity of persons responsible for Section 40 compliance, the recordkeeping system to be used and followed, and memoranda or compliance manuals that notify RR/IAs of the member's procedural requirements for Section 40 compliance.

Neither the federal securities laws nor the NASD Rules of Fair Practice mandate the supervisory system or structure that a member must use. Rather, each member can develop and implement its own supervisory system that is reasonably designed to detect and prevent violations. In this regard, no single document or combination of the referenced documents is specifically required or necessarily adequate to comply with Section 40 requirements. Rather, each member that determines to permit its associated persons to transact securities business through another broker/dealer must decide which tailored combination of records is necessary to develop an adequate supervisory system that addresses the allowable activities of RR/IAs. For example, obtaining duplicate confirmation statements directly from the RR/IA alone would permit a member to fulfill recordation requirements for the trades represented by confirmations received, but would not necessarily permit a member to reasonably ensure that it is capturing all trades. However, an arrangement under which the member obtains duplicate confirmation statements directly from the firm (or firms) that executes transactions for the RR/IA should be sufficient to ensure that the member captures all trades.

Member firms have tremendous flexibility to develop and implement recordkeeping and supervisory systems that meet the unique nature and scope of their own operations, and the permitted activities and services provided by their dually registered persons. In all circumstances, however, recordkeeping and supervision

must be adequate to ensure that full and complete transaction information is captured, and be reasonably designed to detect and/or prevent misconduct that could violate the federal securities laws and NASD Rules.

Answers To Frequently Asked Questions Concerning The Application Of Article III, Section 40 To Investment Advisory Activities

Question #1: Does Article III, Section 40 require prior approval of each transaction executed by an RR/IA away from his or her NASD member firm if the compensation received by the RR/IA is not transaction based?

Answer: An RR/IA may be involved in numerous transactions on a daily basis for which he or she receives asset-based or performance-based fees. Requiring prior notice of each trade effected under these conditions may hinder investors from properly receiving the investment advisory services provided by RR/IAs. Accordingly, the Board of Governors, acting on the recommendation of a special Ad Hoc Committee, has interpreted Article III, Section 40 to require prior notice of the investment advisory services that will be provided by the RR/IA for an asset-based or a performance-based fee, rather than prior notice of each trade effected by an RR/IA for a particular customer. This interpretation is intended to vigorously apply the investor protection concepts of Article III, Section 40 to investment advisory activities in a practical manner.

A member must receive prior written notice from an RR/IA requesting approval to conduct investment advisory activities for an asset-based or performance-based fee on behalf of each of his or her advisory clients. This notice must include details such as:

- a declaration that the individual is involved in investment advisory activities;
- the identity of each customer to whom the notice would apply;
- the types of securities activities that may be executed away from the firm;
- a detailed description of the role of the RR/IA in the investment advisory activities and services to be conducted on behalf of each identified customer;
- information regarding the RR/IA's discretionary trading authority, if any;
- compensation arrangements;
- the identity of broker/dealers through which trades away will be executed; and
- customer financial information.

Only after written approval from the NASD member may the RR/IA engage in the disclosed activities. If there is a change in the RR/IA's proposed role or activities for any customer from what the member initially approved, the RR/IA must provide the member with a subsequent written notice that details the changes and requests the member's further approval to conduct advisory activities on behalf of the customer. The employer member must thereafter record subsequent transactions on its books and records and supervise activity in the affected accounts as if it were its own.

Members are reminded, however, that if the RR/IA receives transaction-based compensation, the member's prior approval of each trade is required.

Question #2: Does Article III, Section 40 apply to persons employed by or associated with registered investment advisory firms if such persons are not registered in an individual capacity with the Securities and Exchange Commission (SEC) or various states?

Answer: Yes. Article III, Section 40 of the Rules of Fair Practice applies to all of an associated person's private securities transactions, regardless of whether or not such associated persons are also registered with other regulatory authorities such as the SEC or the states. The reference to registered investment advisers in *Notice to Members 94-44* does not limit the applicability of Article III, Section 40 to only those persons individually registered as such with other regulatory entities. In addition, if the advisory service is not registered with any regulatory agency, a member should ensure that such registration is not required.

Question #3: Is it appropriate for a limited principal (i.e., a Series 26 Investment Company Principal) to supervise Article III, Section 40 transactions in products such as equity securities that are not covered by that registration category?

Answer: Limited principals may not supervise Article III, Section 40 transactions in products not covered by their registration category. Therefore, if a firm only has principals registered in a limited capacity, associated persons engaging in Article III, Section 40 transactions may do so only in products covered by the licenses of the firm's principals.

Question #4: Is it appropriate for a limited representative (i.e., a Series 6 Investment Company Representative) to execute Article III, Section 40 transactions in products such as equity securities that are not covered by that registration category?

Answer: A limited RR who is otherwise in compliance with applicable

federal and state registration requirements, such as the SEC's investment adviser registration requirements, may not execute transactions in securities not covered by his or her NASD registration. Registration with the NASD as a representative subjects an individual to all NASD rules, regulations, and requirements, including qualification requirements. Those rules preclude a limited representative from acting as a representative in any area not covered by his or her registration category. A limited representative who wishes to execute transactions in securities not covered by his or her registration category is required to pass an appropriate qualification exam.

Question #5: If an RR/IA is registered with more than one NASD member, must all members approve, supervise, and record the Article III, Section 40 transactions?

Answer: All members with whom a person is registered are responsible for the registered representative's involvement in Section 40 transactions. Members may develop a detailed, formal allocation arrangement whereby at least one member agrees and is able to provide the supervision and recordkeeping required by Article III, Section 40. However, the other members would be required to take the reasonable steps necessary to ensure that Section 40's recordkeeping and supervisory requirements are being carried out since members cannot delegate, by contract or otherwise, their ultimate responsibility for compliance with regulatory requirements.

Question #6: What is a member's responsibility with regard to supervising Section 40 securities transactions where an advisory client of an RR/IA refuses to provide information to the member, citing the confidentiality of client information provisions of an investment advisory agreement?

Answer: Article III, Section 40, which was adopted in 1985, and its predecessor Interpretation of the Board of Governors have always stipulated that a member that allows an associated person to participate in a Section 40 transaction is responsible for supervising that transaction as if it were its own. If a member determines that in order to meet its supervisory obligations under Section 40, it must have certain information from the customer and if the customer refuses to provide the information, the member should deny the associated person's request who would then be precluded from participating in the Section 40 activity.

Question #7: Are there circumstances under which income received as salary payments may be deemed selling compensation as defined by Article III, Section 40?

Answer: As explained in *Notice to Members 94-44*, selling compensation is broadly defined to include any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security. If salary payments are direct or indirect compensation for an RR/IA's participation in the execution of securities transactions away from his or her member firm, the salary payments would be deemed "selling compensation," and the activities would be subject to Article III, Section 40.

Question #8: Where investment seminars are conducted by RR/IAs away from their employing NASD member and seminar participants are charged a fee for attendance, would any income derived from the seminar for this investment advisory activity be governed by Article III, Section 40 or Section 43 of the Rules of Fair Practice?

Answer: If an investment seminar itself does not result in the execution of securities transactions, Article III, Section 43 would govern the investment advisory activity. In determining whether Article III, Section 40 applies, the NASD has focused primarily upon the RR/IA's participation in the execution of securities transactions and whether the participation goes beyond a mere recommendation. If after an investment seminar, however, participants decide to engage in securities transactions with the participation of the RR/IA, that subsequent activity and any compensation received in connection therewith would be subject to Section 40.

Question #9: Must a member review performance reports produced by RR/IAs to properly discharge its supervisory responsibilities under Article III, Section 40?

Answer: It has come to the NASD's attention that some RR/IAs use information supplied by the broker/dealer through which they conduct private securities transactions or by the investment advisory service corporations with which they are associated to create performance reports for their advisory clients. These reports may be individualized performance reports that provide customized information for a specific client or standardized performance reports that provide general information to multiple clients. With regard to this practice, members and RR/IAs are cautioned that in creating or recreating performance reports, a risk is taken that calculations for securities transactions may be inaccurate, incomplete, or misleading, thus resulting in material misrepresentations being made or material facts being omitted. NASD member supervisory responsibilities should include a determination as to whether to permit associated persons to develop performance reports for securities transactions. If this activity is permitted, the member firm must review the performance reports.

Standardized reports sent to multiple clients are considered sales literature and must be reviewed by a registered principal at the member firm before distribution by the RR/IA to clients. If the RR/IA uses the same standardized format for different clients, principal approval before use is required only on the performance report prototype. This review must ensure that the reports are accurate, not misleading, or otherwise in violation of NASD or SEC Rules. In particular, members should review the standards set forth in Article III, Section 35 of the NASD Rules governing member communications with the public, as well as applicable SEC regulations.

Individualized performance reports are considered correspondence. As such, review by the member firm before RR/IA distribution to clients is not required. However, the firm must have appropriate procedures in place, as required by Article III, Section 27 of the NASD Rules of Fair Practice, for review and retention of individualized performance reports and other correspondence.

Question #10: Must NASD members that employ RR/IAs provide training to this segment of their associated persons under the Firm Element of the Continuing Education requirements?

Answer: The Firm Element of the Continuing Education requirements (see Schedule C of the NASD By-Laws) is designed to be flexible and to permit firms to develop tailored educational programs based on their business practices and needs. In this regard, each member that permits its associated persons to conduct securities transactions through another firm should assess the need to provide specific Firm Element training with regard to Section 40 requirements. Where the assessment establishes a need for educational initiatives for all or some portion of the covered persons conducting business away from the member, the firm's written training plan should include defined and scheduled Section 40 training for specified individuals.

Although this Notice and previously issued *Notices to Members 91-32* and *94-44* clarify the application of Article III, Section 40 to investment advisory activities, Section 40 has been in effect since November 12, 1985 (see *Notice to Members 85-84*). Accordingly, members and their RR/IAs are expected to be in compliance with Article III, Section 40.