Outside Business Activity*

By Paul B. Uhlenhop, John S. Monical and Mitchell B. Goldberg

Mr. Uhlenhop, Mr. Monical and **Mr. Goldberg** are all members of the law firm of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C., Chicago, Illinois. Mr. Uhlenhop is a member of the Illinois and New York bars. Mr. Monical is a member of the Illinois and Indiana bars. Mr. Goldberg is a member of the Illinois bar. The opinions expressed in this article are the individual views of the authors, but not the views of the firm of Lawrence, Kamin, Saunders & Uhlenhop, LLC, it clients, its other members or attorneys.

I. Introduction

The Financial Industry Regulatory Authority ("FINRA")[1] has adopted and proposed important changes to the current regulatory scheme and obligations relating to notice and supervision of outside business activities and private securities transactions. For a number of years, the National Association of Securities Dealers, Inc. ("NASD") rules 3030, 3040 and 3050 were the principal rules of the NASD with respect to outside business activities, personal securities transactions and personal transactions by account executives and associated persons.

NASD rule 3030 entitled "Outside Business Activity of Registered Persons" has been replaced by FINRA rule 3270.[2] FINRA has proposed that NASD rule 3050 be replaced by FINRA rule 3210,[3] but the rule has not been filed with the Securities and Exchange Commission ("SEC"). The authors expect that FINRA will re-propose the rule with some changes. FINRA has proposed that NASD rule 3040 be replaced by FINRA rule 3110(b)(3).[4] FINRA omitted these changes in a recent rule filing with the SEC with respect to FINRA rule 3110. FINRA intends to re-propose the substance of this withdrawn rule change as a separate rule.[5] Until these proposed FINRA rules are approved by the SEC, FINRA rule 3270 and NASD rules 3040 and 3050[6] govern outside business activity and selling away. Section II of this article discusses the language and interpretations of new FINRA rule 3270, describes the effect of recent proposed changes to NASD rules 3040 and 3050, and sets out considerations for registered representatives dually registered as investment advisors. Section III provides an overview of how and when mandatory arbitration applies to selling away cases and explains the legal theories which may impose civil or regulatory liability against a firm for outside business activity. Finally, Section IV sets forth some suggested compliance and supervisory procedures that firms should consider adopting as part of a reasonable system for supervision of outside activity.[7]

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II. FINRA's Current Outside Business Activity Rules

A. FINRA Rule 3270

FINRA rule 3270, entitled "Outside Business Activities of Registered Persons," and its supplementary material provide long-awaited clarification and changes. Rule 3270 reads as follows:

> No *registered person* may be an employee, independent contractor, sole proprietor, officer, director or partner of another person, *or* be compensated, *or* have the reasonable expectation of compensation, from any other person as a result of *any business activity outside* the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member, in such form as specified by the member. Passive investments and activities subject to the requirements of NASD Rule 3040 shall be exempted from this requirement. (Emphasis added.)

Like NASD Rule 3030, FINRA Rule 3270 can apply not only to business activity involving securities, but to *any business activity* of a *registered* associated person. Rule 3270 also requires that the registered person give written notice to the person's registered firm.[8] However, unlike Rule 3030, Rule 3270 requires "prior" as opposed to "prompt" written notice of the activity. Rule 3270 also applies to registered associated persons who have various described positions or relationships with another person or are "compensated" or have a reasonable expectation of compensation from the outside business activity. This is broader than the prior rule. A careful reading of the revised rule makes it clear that a registered person who falls within any of the described relationships with another person *whether or not compensated* is included within the scope of the rule. As quoted above, there is an "or" between "be compensated" and also an "or" before "have the reasonable expectation" as emphasized.

The Supplementary Material in IM rule 3270 provides additional clarification by imposing specific obligations on the member receiving notice from a registered person pursuant to rule 3270. The Supplementary Material in IM rule 3270 states:

> .01 Obligations of Member Receiving Notice. Upon receipt of a written notice under Rule 3270, a member shall consider whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the member and/or the member's customers or (2) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. Based on the member's review of such factors, *the member must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity*, including where circumstances warrant, prohibiting the activity. A member also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of NASD Rule 3040. A member must keep a record of its compliance with these obligations with respect to each written notice received and must preserve this record for the period of time and accessibility specified in SEA Rule 17a-4(e)(1).[9] (emphasis added)

Although a retail firm generally will require prior consent as a part of its supervisory procedures to carry out its obligations under IM 3270, consent by the member is not a requirement of Rule 3270 or IM 3270 and, for certain types of broker-dealers, prior written consent may not be a necessary part of a reasonable system of supervision.

Under IM 3270, a member must perform an analysis of the proposed outside activities in two respects stated above and the analysis must include evaluating the possibility of imposing specific conditions or limitation on the registered person's outside business activity and/or prohibiting the activity, depending on the evaluation by the member of the criteria set forth above. Specific records must be maintained with respect to notices, the evaluation and the conditions. As discussed later in Sections II.B and C, if the activities involve securities or investment banking, transactions also should be effected through the firm and reflected on the firm's books and records.[10]

The rule does not define outside business activity. Because of the lack of definition, certain activities, such as volunteer activities associated with a corporate non-profit organization, could be found to be business activities included within the rule. As discussed later in this article, firms may wish to clarify the scope of outside business activities in their written supervisory and compliance procedures to encourage reporting of such activities. Many volunteer activities for non-profits (such as fundraising for the non-profit, voting on investment advisors or managers, and managing investments) could create conflicts of interest with a firm's other activities or other regulatory concerns.

B. NASD Rule 3040

NASD rule 3040, "Private Securities Transactions of an Associated Person," is complex and too lengthy to be quoted in its entirety. FINRA proposed to replace NASD rule 3040 with FINRA rule 3110(b)(3), but deleted the proposed change in connection with the filing of proposed changes to rule 3110 with the SEC. FINRA stated that it will re-propose the substance of proposed rule 3110(b)(3) as a separate rule.[11] *See* Section II.C. Rule 3040 complements rule 3270 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 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 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 3270 in that it only applies to "private securities transactions" (as opposed to any business activity). However, it is broader than 3270 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.[12]

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 also 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, gifts, lavish entertainment[13] and a host of other things that are connected to the private securities transaction.

A member who has received 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 was executed on behalf of the member. *See* Section II.C and D for further discussion. 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. The rule does not specifically say that the member may disapprove the transaction, but the new FINRA rule 3270 IM interpretation arguably provides support for a firm's right not only to prohibit or to impose conditions upon outside business activities, but also to evaluate proposed private securities transactions and prohibit or approve them with or without conditions. Most members also require approval of non-security transactions without selling compensation. Rule 3040 does not specifically require the member to record the non-compensation security transactions on its books or supervise them. However, if adopted, proposed rule 3110(b)(3) would have required all securities or investment banking activities to be carried on the firm's books and records and subject to supervision. As a practical matter, however, most members prohibit such a securities transaction without selling compensation and/or 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 would require, in many cases, the associated person to register as a separate broker-dealer under Section 15 of the Securities Exchange Act[14] ("Exchange Act") and applicable SEC staff interpretations and under certain state laws.

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

In RN 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." However, the proposed FINRA rule 3110(b)(3) was not included in the recent rule filing of FINRA rule 3110 with the SEC. FINRA stated that the provisions set forth in proposed rule 3110(b)(3) will be the subject of a separate rule to be noticed by FINRA in the not-too-distant future. The proposed rule 3110(b)(3) replacement is expected to include many of the provisions of proposed rule 3110(b)(3). The proposed rule change was designed to clarify the obligations of member firm supervisors of outside securities activities. The proposed rule provision, which was omitted, would have 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. (emphasis added.)

The proposed rule would have made two principal changes. First, the rule 3110(b)(3) proposal would have required that all securities and investment banking transactions previously outside the scope of the member's business be treated as if they were part of the firm's business. *The proposed rule would have eliminated the distinction between private securities transactions for which compensation is and is not received*. Similarly, the proposed rule also would have eliminated the exemption for personal transactions in investment companies and variable annuity securities. Because the proposed rule would have placed all outside business activities involving the investment banking or securities business under the member's business, the rule would have required the firm to record the transactions on its books and records and to supervise them as any other transaction.

The second major change would have applied to "dual employees." Subsection (b) of the proposed rule was entitled "Dual Employees" and attempted 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 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 would not need to supervise the exempt bank's securities 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 would have been able to rely on a representation of a bank or its supervised affiliates with respect to (b)(2). *But, if a member received notice of a violation of the policies and procedures of a bank or its affiliates by the Dual Employee*, the member would have been required to assure itself that the bank or its affiliate's policies and procedures were reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws or had been subsequently amended to achieve such compliance. In the event the member could not obtain such assurance, the member would have to revoke its approval of the Dual Employee's relationship. The Dual Employee provision would have put 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 change did not deal with other conflicts arising from dual registration requirements such as conflicts between a registered representative who is also an individual registered investment advisor or affiliated with an investment advisor that is not affiliated with the associated person's broker-dealer employer. It also did 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). Hopefully, FINRA will

provide appropriate guidance in its new rule which is expected in the near future.

D. Considerations for Registered Representatives with Dual Registration as an Investment Adviser

NASD NTM 96-33 (May 1996) and NTM 94-44 (May 1994) 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 a dual RR/IA. In NTM 94-44, the NASD warned that rule 3040 conduct is triggered whenever a dual 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 NASD rule 3040 and the investment adviser's Codes of Ethics[15] that are required for IAs presents another interesting issue for a dual registrant. The ethics code of the IA may be more encompassing or less encompassing than the supervision required by rule 3040. The supervision of an affiliated IA where there is a dually registered representative should be carefully coordinated so that nothing is overlooked under the Investment Advisers Act[16] and its rules as well as the requirements for broker-dealers and 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.

The NASD specified in NTM 94-44 that an associated person 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. New proposed FINRA rule 3110(b)(3) would have required written notice of any outside business activity involving any security or investment banking and required that the activity be carried on the firm's books and records and supervised. If a member has approved a dual 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 dual 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 notice 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."[17]

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

E. 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 NASD 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.

F. NASD Rule 3050

NASD rule 3050, entitled "Transactions For or By Associated Persons," in a sense, also deals with outside business activities. It should be noted that rule 3050 is proposed to be changed by new FINRA rule 3210 as stated in RN 09-22 (April 2009). Nevertheless, NASD rule 3050 remains the controlling rule until such time as FINRA and the SEC approve new rule 3210. 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 IA, bank or *other financial 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 should request written 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 associated 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.[18] 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 an 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 either member firm. For example, if the associated person is regularly effecting transactions far beyond the person's means, such conduct may indicate a possible Ponzi scheme or outside business activities not approved by the member.

G. Proposed FINRA Rule 3210 – Personal Securities Transactions For or By Associated Persons

FINRA, in RN 09-22 (April 2009), proposed to revise NASD rule 3050 and replace it with a new FINRA rule 3210, "Personal Securities Transactions By or For Associated Persons."[19] The proposed rule simplifies and clarifies NASD rule 3050 which currently remains in effect. The proposed rule provides that an associated person may not open or otherwise establish at another member firm (referred to as the executing member) or any *other financial institution* any account in which securities transactions can be effected and in which the associated person has a personal financial interest. Financial institution is defined in NASD rule 3210.05 as any financial institution other than a member to include without limitation any broker-dealer that is registered pursuant to Section 15(b)(11) of the Exchange Act,[20] domestic or foreign non-member broker-dealer, investment adviser, bank, insurance company, trust company, credit union and investment company. It also appears from footnote 8 of the proposing release that commodities accounts would be included if securities transactions in connection with futures or commodities may be executed. The proposed rule, like the current rule, requires that as a condition to granting written consent to an associated person, the employer member must instruct the associated person to have the executing member provide duplicate account statements and confirmation to the member and requires the executing member to carry out the associated person's instruction. Subsection (b) of proposed rule 3210 requires any associated person prior to opening or otherwise establishing an account within the meaning of the rule must notify in writing the executing member or other financial institution of his/her association with the employer member. The proposed rule adds a requirement not included in NASD rule 3050 that the associated person must state in the notice provided to the executing member or financial institution whether he or she has a personal financial interest in the account. The rule notes that an account as a general matter would extend to a spouse's accounts. Subsection (c) of 3210 provides that if an executing member has actual notice that an associated person of an employer member has a personal financial interest in an account such member is prohibited from executing securities transactions in the account unless it has obtained the employer's prior written consent or requires the executing member to provide account statements and confirmations promptly to the employer member upon receipt of an instruction from the associated person. The supplementary material provides clarifications on several points, including the following: if the account is open prior to association with employer member, within 15 days the associated person and employer must comply with the rule. Subsection 02 provides that an account at a financial institution other than a member requires that the associated person instruct the financial institution to provide duplicate account statements and confirmation to the employer. The rule in 04 requires an employer member to revoke its consent if confirmations and account statements are not promptly received in a timely manner and shall notify the executing member or other financial institutions of the revocation. The employer member is also under an obligation to receive confirmation from the financial institution or member that the account was closed.

III. Outside Business Activity and Selling Away: Arbitration, Litigation, and Statutory and Common Law Theories of Liability and Defenses

A. The FINRA Arbitration Rules

FINRA rule 12101, the Code of Arbitration Procedure ("Code") applies "to any dispute between a customer and a member or associated person of a member that is submitted to arbitration under rules 12200 or 12201."[21] 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, members and associated persons should seek 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." 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 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[22]

1. *"Customer."* Several federal cases have 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.[23] 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.[24] In such cases, the relationship is usually considered too tenuous to render the investor a "customer" of the member firm.[25]

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 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."[26] 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.[27] Further, if the associated person of the member firm induces, or shepherds, the investment, then the investor is likely a "customer" of that firm.[28] 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.[29] 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.[30] Indeed, courts have nearly universally found that disputes arising from a firm's lack of supervision over its brokers arise "in connection with" business activities of the member, so as to compel arbitration.[31]

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.

C. Outside Business Activities Claims and Defenses

1. *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.[32] 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. 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.

a. *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 is arguably 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." NASD rule 3040(e).[33]

b. *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 exists 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.

c. *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 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*.[34] (emphasis added.)

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.[35]

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."

d. *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.[36]

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.[37]

e. *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 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.

f. *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 law of the jurisdiction and the facts presented by a specific case.

g. *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 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.

D. 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)[38] 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.[39]

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 FINRA rule 3210 and NASD rules 3040 and 3050, FINRA often pursues actions for violations of Conduct rule 2010 (Standards of Commercial Honor and Principles of Trade) and 2310 (Suitability)[40] 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 NASD rules 3010 and 3012 (Supervision) and/or FINRA 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.

IV. 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."[41] 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.[42]

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 must consider 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 locations is expected to have very different supervisory procedures than a firm with large relatively good sized branch offices or Offices 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 firms' 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 related 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

NASD rule 3010(e)[43] 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, or tax returns. Telephone calls or written requests for verification commonly are made not only to the associated person's former firm, but to all the firms in which he has been previously employed, sometimes reaching back for 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.] that may involve financial, securities or investment activities;
(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;
(vii) list all litigation including arbitrations and disciplinary matters; and
(viii) 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;
(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. The associated risks need to be evaluated and in some cases special supervisory procedures to minimize risks.

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 is usually very easy to check electronically for pending litigation (including arbitrations or regulatory proceedings or investigations) by or against a proposed account executive in federal and in some state courts and by regulators. FINRA's broker check should be accessed to ascertain pending complaints, investigations and litigation. If his or her name appears in litigation, a firm may wish to request and document full details of the litigation or investigation 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 for 10 years (mandatory requirement for 3 years).

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

(c) Depending upon the circumstance, 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 or investment 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 and/or confirmations of activity for each organization and under some circumstances inquiring by call or by interview.

(f) If warranted, call banks 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. 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 if there are to be any waivers with respect to information. It is a good practice to obtain permission by the hiring supervisor from a third independent supervisory person.

7. *Web Site and Social Media Checks*. In many situations, firms find it worthwhile to search for and review web site(s) and web-based social media (Facebook and Twitter) of the proposed associated person and his prior employers. The site search may uncover not only sites created or known to the applicant, but also a listing on any other web site or social media. 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 or application for all employees. 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 if the outside organization, with the help of the associated person, is or may be promoting particular types of investment products to raise funds. The organization may also have granted the 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-to-play business. On June 30, 2010, the SEC adopted its rules to curb pay-to-play practices in which investment advisers make campaign contributions to elected officials in order to influence the award of contracts to manage pension plan assets and other government investment accounts.[44] Under the pay-to-play rules, political

contributions by an outside business or other organization with which an associated person is affiliated or directly by an account executive or other employee may violate the pay-to-play rules. The full scope of the pay-to-play rules is beyond the scope of this article, but the pay-to-play rules should be taken into consideration in hiring new associated persons and also with respect to current associated persons' outside business activities.

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 Regarding Outside Activities

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 before engaging in the activity.

(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 or Red Flags*. 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. Although supervisors should be trained to attempt to identify red flags indicating inappropriate outside business activities, in most cases it would be impossible to train them effectively to investigate them. Supervisors should not be held to the same level as a trained investigator. Investigation of red flags of outside business activities can require substantial investigative and business expertise beyond the experience or training of most supervisors. Supervisors should be trained when they see or suspect red flags indicating selling away to notify the compliance department or legal department who should use skilled investigators or outside counsel to investigate and pursue the red flags.

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 banking business activity. These policies often warn associated persons that they are not to rely on letters from outside counsel (other than the firm's 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 programs 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 requires 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 *prior to* undertaking the activity.

(2) Report any personal web site or social media.

(3) 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, and credit reports 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 a 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 or other social media where the associated person is listed or use. 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 or its firm counsel. 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 FINRA rule 3010(c) (which continues to be required under the proposed new supervisory FINRA 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.[45] 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;
(3) past problems at the office; and
(4) a search of web sites and social media for the associated person's activity.

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 unusual investment programs. 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 is on vacation or is elsewhere. Some smaller firms may 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 the firm's 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 possible selling away. 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 FINRA rule 3270 or NASD rule 3040[46] 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. Accordingly, complaints should be promptly and thoroughly investigated.

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 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 FINRA rule 3270, if an associated person engages in business activities for compensation as defined in the rule, the associated person must notify the firm in writing with respect to such activities. If the substance of FINRA rule 3110(b)(3) is proposed and adopted to replace NASD rule 3040, the associated person also would be required to report in writing any securities or investment banking activities whether with or without compensation. In either case, if the member firm grants permission to conduct the activities, it must supervise the activities and record them on its books and records that involve securities or investment banking. Furthermore, as explained above, if there are securities activities for compensation, the transactions must be reflected on 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 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.

The Dodd-Frank whistleblower provisions and copycat state whistleblower provisions are expected to substantially impact when to report. The Dodd-Frank Act[47] allows for both the SEC and the CFTC to pay rewards to eligible whistleblowers who provide the SEC with original information that leads to a successful enforcement action yielding monetary sanctions of over $1 million.[48] The effective date of the legislation was July 22, 2010.[49] If a firm reports to the SEC information available to it before a whistleblower reports information about a suspected problematic selling away case, it will most likely cut off the whistleblower from receiving rewards provided by the statute. Knowledge by a potential whistleblower that the firm has already reported information, although tentative, also may sway a potential whistleblower from going to the SEC. When a firm has tentative information that looks like it might possibly involve selling away and illegal transactions, ideally the firm would conduct an investigation by in-house counsel or outside counsel to ensure complete and accurate reporting to the regulators. However, if a whistleblower reaches the regulators with information as provided in the rule before the firm reports to the SEC, the whistleblower will be in line for a reward. Counsel representing an individual employee or associated person of a broker-dealer suspected of being involved or having relevant knowledge will necessarily ethically be required to explain to the witness that whistleblower rewards may be available if the witness reports to the SEC before the firm. Because of these rewards, many firms will elect to go to the SEC as soon as they have information of a possible outside business activity that involves potential illegal activity, before a thorough investigation and before the firm knows the scope of the problem or most of its details. The firm's counsel will approach the regulators, explain what information they have, explain that the firm is conducting an independent internal investigation and agree to report back to the regulators with respect to the activity and the investigation as soon as possible. If the whistleblower thereafter does contact the regulators, unless the whistleblower provides critical new information, there should be no whistleblower rewards. This is essentially what Congress expected: a race to the SEC any time possible illegal activity is discovered. Of course, if there is continuing fraudulent activity involving the selling away, it must be stopped immediately. If the firm knows that it is unable to stop the individual's conduct, the firm *must* contact the regulators immediately so that they can take appropriate action to stop it. All of these and many other factors need to be considered.

While timing is important, another serious question is whether a firm should report to FINRA, the SEC, applicable state regulators or all. In certain very serious cases, we have recommended that a firm report simultaneously to the SEC, FINRA, and the applicable states. 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, FINRA and state enforcement to advise them on how, when, and to whom to report.

V. Conclusion

Regulations of outside business activities are undergoing significant change. New FINRA rule 3270 is effective and members already should have considered it and updated their supervisory procedures (if necessary). Member firms also should take into consideration the substance of the changes that FINRA proposed for replacement of NASD rules 3040 and 3050. These proposals reflect policies and procedures that FINRA is considering for adoption and which some may argue reflect industry best practices, even though they have not yet been formally approved.

Even with the best procedures, outside business securities activities may occur and not be detected. Unapproved outside business activity can create substantial civil liability in selling away cases. Establishing liability requires, in most selling away cases, a showing of agency or of control person liability. Robust supervisory procedures with respect to outside business activities diminish the likelihood that a claimant can establish apparent agency and bolster a defense of good faith. If the procedures are reasonably adequate and reasonably enforced, the broker-dealer should have defenses under both federal and state law.

A broker-dealer's key to avoiding civil and regulatory liability is a robust supervisory and compliance program with respect to outside business activities. Such a program must be tailored to the firm's unique business activities and personnel if it is to be successful.

ENDNOTES

* This article is a substantial revision and updated presentation presented at the National Society of Compliance Professional National Membership meeting on October 21, 2008 and three articles published in the NSCP Currents in 2008.

1 In 2007, the NASD changed its name to FINRA and assumed responsibility of certain regulatory functions of the New York Stock Exchange ("NYSE"). At the present time, FINRA is combining the former NASD rulebook with the NYSE rules with a goal of having a consolidated rulebook, which project should be completed in the next several years. At this time, there are some NYSE rules that have been integrated, consolidated, updated or changed with former NASD rules and are referred to herein as FINRA Rules. In other cases, NASD rules remain in effect and there are proposed amendments to them and they will continue in effect until they are approved by the SEC and are included in the consolidated rulebook. In this article NASD rules will be referred to as NASD rules if they remain effective or are proposed to be revised. Former NASD Notices to Members will be referred to as NTMs and FINRA Regulatory Notices will be referred to as RNs.

2 RN 10-49 (Oct. 2010); effective December 15, 2010.

3 See RN 09-22 (April 2009).

4 RN 08-24 (May 2008).

5 76 F.R. 38245 (June 29, 2011).

6 These rules have been interpreted by NTM 94-44 (1994), NTM 96-33 (May 1996), NTM 01-79 (December 2001), and NTM 03-79 (December 2003).

7 We encourage firms reviewing their supervisory procedures to also 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.

8 Cf. NYSE Rule 346(b), requiring prior written consent.

9 IM Rule 3270; RN 10-49 (Oct. 2010).

10 75 F.R. 53362 (Aug. 31, 2010); see also 76 F.R. 38245 (June 29, 2011).

11 RN 08-24 (May 2008).

12 NASD rule 1011(b).

13 See also FINRA Rule 3220.

14 15 U.S.C. §78(o).

15 17 CFR 275.204A-1.

16 15 USC §80b.

17 NTM 96-33, p. 2 (May 1996).

18 See NTM 97-25 (May 1997).

19 It should be noted that the proposed rule has not been filed with the SEC and may be changed by FINRA.

20 15 USC §78(o)(b)(11).

21 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 Rule 12205.

22 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.

23 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 must include some brokerage or investment services 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).

24 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).

25 Id.; see 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").

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

27 Bensadoun v. Jobe-Riat, 316 F.3d at 178.

28 John Hancock Life Insurance v. Wilson, 254 F.3d 48, 59 (2d Cir. 2001); see also O.N. Equity Sales Company v. Thiers, 590 F. Supp. 2d 1208 (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. 590 F. Supp. 2d at 1212-13, fn.5 (citing Wheat, First Securities, Inc. v. Green, 993 F.2d 814 (11th Cir. 1993).

29 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, 590 F. Supp. 2d. 1208, 1213 (finding that a ponzi scheme by an associated person constituted a business "activity" to subject the claim to arbitration).

30 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).

31 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).

32 For example, though Congress specifically provided for private rights of action for violations of select securities laws (e.g., Section 10b of the Securities Exchange Act), regulatory rule violations do not automatically create a private right of action. Fernea v. Merrill Lynch, Pierce,

Fenner & Smith, Inc., 2001 Tax. App. LEXIS 172 at *15; see also, Jablon v. Dean Witter & Co., 614 F.2d 677, 682 (9th Cir. 1980) (dismissed claims of misconduct and improper coercive security purchase claims because "there is no implied right of action for an NASD rule violation" and absent Congressional intent, the Securities Exchange Act "does not expressly authorize private actions for stock exchange rule violations.")

[33] NASD Rule 3040(e) is proposed to be amended by proposed FINRA Rule 3110(b)(3) (RN 08-24 (May 2008)) (applicable to "investment banking or securities business outside the scope of the member's business"). See Section II.B and C.

[34] Exchange Act §20; 15 U.S.C. §78t.

[35] It should be noted, however, that even if "bad faith" can be established against a firm with respect to an established primary violation of the Exchange Act, the Private Securities Litigation Reform Act ("PSLRA") specifically limits liability against a firm to a percentage of loss, representing the firm's proportionate share of fault compared to the total fault of everybody involved. Subsection (f) of the PSLRA states:

2. Liability for damages

A. Joint and several liability

Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws.

B. Proportionate liability

i. In general

Except as provided in paragraph (A), a covered person against whom a final judgment is entered in a private action shall be liable solely for the proportion of the judgment that corresponds to the percentage of responsibility of that covered person….

PSLRA §21(D)(f)(2); 15 U.S.C. §78u-4(f)(2). Indeed, in any private action, before imposing any liability upon a firm, even after determining liability exists, a trier of fact is required to make findings with respect to whether the firm violated the securities laws knowingly, and the percentage of responsibility (if any) for the loss "measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by plaintiff." PSLRA §21(D)(f)(3); 15 U.S.C. §78u-4(f)(3).

[36] Securities Act of 1933 Section 15; 15 USCS § 77o.

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

[38] 15 USC § 78(o)(b)(4)(E) and 78(o)(b)(6).

[39] Exchange Act, § 15(b)(4)(E); § 15(b)(6); 15 U.S.C. 78(o)(b)(4)(E) & (6).

[40] Rule 2310 will be replaced by FINRA rule 2111 (January 2011) currently scheduled to become effective July 9, 2012.

[41] See FINRA Rule 3010.

[42] NTM 99-45.

[43] Proposed changes to NASD Rule 3010(e) have been approved by FINRA and await SEC approval. See Section II for further information.

[44] Under the rule adopted by the SEC, investment advisers may not provide investment services for corporations directly or indirectly through a pooled investment vehicle two years after the adviser or certain executives or employees make political contributions to an elected official or candidate for political office who is in a position to influence the government entities' selection of the adviser. It also prohibits an investment adviser and certain of its employees from paying or agreeing to pay a third party placement agent or finder to solicit business from the government entity on the adviser's behalf unless the third party is a registered broker-dealer or SEC investment adviser subject to the pay-to-play restrictions. It prohibits an investment adviser and certain of its executives and employees from soliciting or coordinating campaign contributions from others to a political official candidate or political party in a state or locality where the adviser provides or is seeking to provide advisement services. When a proposed employee has been associated with an outside organization whose activities may fall within any of the above limitations or prohibitions, the rules would be retroactively applicable in some cases. See 17 CFR 206(4)-(5) and amendments to Rules 204-2 and 206(4)-3 to the Investment Advisers Act of 1940, 15 USC 80b; see also IA Release 3043. The rules are effective September 13, 2010.

[45] See RN 08-24 (April 2008); see also proposed Rule 3110(c).

[46] FINRA rule 3110(b)(3) was proposed to replace rule 3040, but was not included in a recent SEC rule filing and is expected to be revised and renumbered.

[47] See Dodd-Frank Wall Street Reform and Consumer Protection Act §922 (SEC), §748 (CFTC); see further CFTC Proposed Regulation 165 to implement the amended Section 23 of the Commodities Exchange Act.

[48] The award amount is set at between 10% and 30% of the total monetary sanctions collected in the Commission action or any related action such as in a criminal case.

[49] However, whistleblower rules have been proposed by the SEC and the CFTC but have not yet become effective. When the whistleblower rules which are currently proposed are finalized, they will be retroactive to July 22, 2010.

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