

Outside Business Activity (Part 1 of 3)

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I. Introduction

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

This article focuses on outside business activities, particularly selling away issues. In Part I, we discuss the language and interpretations of FINRA Rules 3030, 3040 and 3050 describe the effect of the proposed amendments, and set out considerations for registered representatives dually registered as investment advisers. We provide in Part 2 an overview of how and when mandatory arbitration applies to selling away cases and set out the legal theories which may impose civil or regulatory liability against a firm for outside business activity. Finally, in Part 3 we will set forth some suggested procedures that firms could consider adopting as part of a reasonable system for supervision of outside activity.¹

II. FINRA's Current Outside Business Activity Rules

A. FINRA Rule 3030

Until proposed Rule 3110(b)(3) is adopted, FINRA Rules 3030, 3040 and 3050 govern outside business activity

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and selling away. Rules 3030, 3040, and 3050 dovetail in their application and apply separately to outside business activities depending upon whether the activities involve securities.

NASD current Rule 3030, entitled "Outside Business Activities of an Associated Person," reads as follows: No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member (emphasis added).

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

B. FINRA Rule 3040

Rule 3040, "Private Securities Transactions of an Associated Person," is more complex and is too lengthy to be quoted in its entirety. Rule 3040 compliments Rule 3030 and provides that no person associated with a member shall participate in any manner in a private securities transaction as defined, except in accordance with the Rule. Subsection (b) of the Rule 3040 states: Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

Rule 3040 is more limited than Rule 3030 in that it only applies to securities transactions (as opposed to any business activity). However, it is broader than 3030 in that it applies to all associated persons, not just registered associated persons. Although an "associated

person" under Rule 3040 includes unregistered individuals, it does not extend to every employee of the firm. Specifically, it does not include persons performing solely ministerial or clerical activities.

Subsection (c) of Rule 3040 deals with private securities transactions for compensation – what is traditionally thought of as "selling away." "Private securities transactions" is very broadly defined in subsection (e)(1) as follows: (1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in Rule 2790), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities shall be excluded (emphasis added).

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

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

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

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

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

C. FINRA Rule 3050

Rule 3050, entitled "Transactions For or By Associated Persons," in a sense, also deals with outside business activities. An associated person who opens an account or places an order for a securities transaction at another financial institution, including a broker-dealer, a notice-registered broker-dealer, an investment adviser, 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 may request in writing

assurances that the other financial institution will provide the employer member with duplicate copies of confirmation statements or any other necessary information concerning the account or the order.

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

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

In December 2001, the NASD issued NTM 01-79 (December 2001) to remind associated persons and firms of their responsibilities relating to Rules 3030 and 3040. The NASD stated that in the time period leading up to NTM 01-79, it had noticed an increase in

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

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

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

(3) Supervision of Outside Securities Activities

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

(B) Dual Employees

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

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

- a. have a comprehensive view of the dual employee's securities activities;
- b. employ policies and procedures reasonably designed to achieve compliance with the anti-fraud provisions of the federal securities laws; and
- c. give prompt notice to the member of any dual employee's violation of such policies and procedures.

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

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

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

The proposed rule makes two principal changes. First, under the proposed rule, all securities and

investment banking transactions outside the scope of the member's business are treated the same way and must be inside the firm's business. The proposed rule eliminates the distinction between private securities transactions for which compensation is and is not received. Similarly, the proposed rule eliminates the exemption for personal transactions in investment companies and variable annuity securities. Because the proposed rule places all outside business activities involving the investment banking or securities business under the member's business, the rule requires the firm to record the transactions on their books and records and to supervise them as any other transaction.

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

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

A member may rely on a representation of a bank or its supervised affiliates with respect to (b)(2). But, if a member receives notice of a violation of the policies and procedures of a bank or its affiliates by the Dual Employee, the member shall assure itself that the bank or its affiliate's policies and procedures are reasonably designed to achieve compliance with the anti-fraud

provisions of the federal securities laws or have been subsequently amended to achieve such compliance. In the event the member cannot obtain such assurance, the member must revoke its approval of the Dual Employee's relationship. The Dual Employee provision puts a new burden on broker-dealers to monitor the activities of Dual Employees that work in exempt securities activities of a bank or its affiliate as defined, such as trust services, custodial services and other securities activities of banks that are exempt from broker-dealer registration under the Exchange Act.

The proposed rule does not deal with other conflicts arising from dual registration requirements such as conflicts between a registered representative who is also an individual registered IA or affiliated with an investment adviser that is not affiliated with the associated person's broker-dealer employer. It does not deal with potential conflicts of a broker-dealer registered under §15b-11 of the Exchange Act that engages in futures activities as an FCM but is a notice-registered broker-dealer (to be able to transact certain types of single stock futures and/or narrow securities index futures). Hopefully, these issues will be raised in comment letters and FINRA will provide appropriate guidance.

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

NASD NTM 96-33 (May 1996) and NASD NTM 94-44 are particularly important when an associated person registered representative ("RR") is also a registered investment adviser or associated with an investment adviser ("IA"). In these Notices, the NASD gives particular attention to the supervision of securities transactions conducted by an RR/IA. In NTM 94-44, the NASD warned that Rule 3040 conduct is triggered whenever a RR/IA participates in the execution of a security transaction to the extent that his or her actions go beyond a mere recommendation. Implementing any sort of recommendation by phone calls or placing orders would be included within the definition of execution of a private securities transaction, triggering the recordkeeping and supervision requirements of FINRA

for the transaction by the RR's member firm even though the transaction is not executed through the RR's member firm.

The interplay between Rule 3040 and the investment adviser's Codes of Ethics⁵ that are required for investment advisers presents another interesting issue for a dual registrant. The ethics code of investment adviser may be more encompassing or less encompassing than the supervision required by Rule 3040. The supervision of an affiliated investment adviser where there is a dually registered representative should be carefully coordinated so that nothing is overlooked under the Investment Advisers Act requirements as well as the requirements for a broker-dealer and its applicable rules. There also may be the same type of differences between the broker-dealer's system of supervision and the ethics code of a state-registered broker-dealer.

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

- dated notifications from the RR/IA detailing the services to be performed by the RR/IA and the identity of each RR/IA customer serviced at another firm in a private securities transaction;
- dated responses from the NASD member to the RR/IA acknowledging and approving or disapproving the RR/IA's intended activities;
- a list of RRs who also are IAs;

- a list of RR/IAs approved to engage in private securities transactions;
- a list of RR/IA customers, including those that are customers of both the member firm and the RR/IA, with a cross reference to the RR/IA;
- copies of customer account opening cards to determine, among other things, suitability;
- copies of discretionary account agreements;
- duplicate confirmation statements;
- duplicate customer account statements;
- a correspondence file for RR/IA customers;
- investment advisory agreements between the RR/IA and each advisory client;
- advertising materials and sales literature used by the RR/IA to promote investment advisory services wherein the RR/IA holds himself or herself out as a broker/dealer, complemented by a process that shows whether proper filings have been made with FINRA and whether the RR/IA is using any electronic means, such as the Internet, to advertise services or correspond with customers;
- exception reports, where feasible, based on various occurrences or patterns of specified activity, such as frequency of trading, high compensation arrangements, large numbers of trade corrections, and cancelled trades; and
- supervisory procedures fully responsive to Article III, Section 27 requirements and designed to address Section 40 compliance. The procedures may include such items as the identity of persons responsible for Section 40 compliance, the recordkeeping system to be used and followed, and memoranda or compliance manuals that notify RR/IAs of the member's procedural requirements for Section 40 compliance.

The Questions and Answers of NTM 96-33 provide a wealth of additional detail that should be reviewed in any case by a FINRA member involving RR/IAs and the supervisory procedures should be adjusted accordingly. In the answers to Frequently Asked Questions which is part of NTM 96-33, the NASD clarified that a RR/IA does not need to give prior notice of each transaction for which investment advisory services will be provided. Rather, the RR/IA must receive approval to conduct investment

advisory activities for a fee on behalf of his advisory clients. The rule specifies what must be included in the notice and members have the right to approve or disapprove. If it is approved, "the employer member must thereafter record subsequent transactions on its books and records and supervise activity in the affected accounts as if it were his own."

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

Conclusion

FINRA's proposed Rule 3110(b)(3) makes important changes to a broker-dealer firm's supervision responsibilities for outside business activities, combines treatment of previously distinct outside business transactions and specifies responsibilities of a broker-dealer for "dual employees." Firms should be encouraged to review the proposed rule and update their procedures where necessary.

Part 2 of this article, which will be published in the next issue of *NSCP Currents*, will discuss how and when arbitration applies to selling away claims and will explore various legal theories often advanced to impose civil and regulatory liability in selling away cases.

1. We encourage firms reviewing their supervisory procedures also to review Chapter 5 "Supervision of Registered Representative's Outside Business Activities," *Broker-Dealer Regulation*, Practising 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.

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

3. 15 U.S.C. §78(o).

4. See NTM 97-25 (May 1997).

5. 17 CFR 275.204A-1.