Outside Business Activity (Part 2 of 3)

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Introduction

Part 1 of this article, published in last month's *NSCP Currents*, discussed in detail the applicable self-regulatory organization rules with respect to outside business activity, proposed revisions to those rules, and applicable Notices to Members. This Part 2 discusses arbitration, litigation, and statutory and common law theories of liability and defenses. Part 3, to be published in the next issue of *NSCP Currents*, will discuss compliance and supervisory procedures regarding outside business activity.

V. FINRA Mandatory Arbitration Requirements

A. The FINRA Rules

FINRA Rule 12101 requires that the Code of Arbitration Procedure ("Code") apply "to any dispute between a customer and a member or associated person of a member that is submitted to arbitration under Rules 12200 or 12201."[1] Rule 12200 reads as follows:

Parties *must arbitrate* a dispute under the Code if:

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

Given the mandatory language of Rule 12200, it is essential for members and associated persons to understand the scope of its application, and the breadth of the terms "customer" and "business activities." FINRA Rule 12100's only limitation on the term "customer" is that "a customer shall not include a broker or dealer."[2] 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[3]

1. "Customer." Several federal cases have recently set out the parameters of who is, and is not, a "customer." In so doing, circuit and district courts have recognized that the term "customer" must not be defined so broadly as to upset the reasonable expectations of FINRA members.[4] 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.[5] In such cases, the relationship is usually considered too tenuous to render the investor a "customer" of the member firm.[6]

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."[7] 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.[8] Further, if the associated person of the member firm induces, or shepherds, the investment, then the investor is likely a "customer" of that firm.[9] 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.[10] 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.[11] Indeed, courts have nearly universally found that disputes arising from a firm's lack of supervision over its brokers arises "in connection with" business activities of the member, so as to compel arbitration.[12]

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

VI. Outside Business Activities Claims and Defenses

A. Civil Claims

Theories of civil liability against

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

Theories of civil liability against the firm when a registered representative is engaged in outside business activity, however, are more limited. In many outside business activity cases, the member broker-dealer may not even know of the activity of the associated person. Notwithstanding, the member still may have potential liability under theories of vicarious liability. Those vicarious liability theories include respondeat superior, agency, and control person liability under federal and state law. These theories will each be discussed in turn below.

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

Where the registered representative is an independent contractor, the respondeat superior arguably is inapplicable because the doctrine generally applies only to employer-employee relationships. However, even where an employer-employee relationship does exist, respondeat superior 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." Rule 3040(e); Proposed Rule 3110(b)(3)(A) (applicable to "investment banking or securities business outside the scope of the member's business").

2. Agency (Actual and Apparent Authority). Because employees are agents of their employers within the scope of employment, agency is often confused with respondeat superior. However, agency is a doctrine distinct from respondeat superior, which can apply to both employees and non-employees. Generally, an agency relationship is created when a principal (the firm) grants either *actual* authority or *apparent* authority to an agent (the registered representative) to engage in the conduct which caused the harm. Firms generally prohibit private securities transactions without prior written approval. In selling away cases, approval has rarely been granted and, accordingly, actual authority to engage in selling away transactions rarely exists. Thus, most claimants in selling away cases rely upon apparent authority.

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

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

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exhaustive of the factors that affect apparent authority, but they do illustrate a pattern. Each factor considered in a determination of whether apparent agency exits relates either to the steps the firm took to cloak the registered representative with the appearance that the representative was acting on behalf of the firm or to the reasonableness of the claimant's reliance upon the appearance of authority during the selling away activity.

3. Control Person Liability under the Exchange Act. Control person liability is another argument for imposing liability upon a firm for the conduct of a registered representative. Control person liability can arise under Section 20 of the Securities Exchange Act of 1934 (the "Exchange Act"), which provides: Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.[13]

Section 20 control person liability differs from common law doctrines of respondeat superior and agency in several important respects. For example, the common law doctrines generally can be used to impose liability for any cause of action, whether it arises from common law or statute. Thus, Courts have held that a registered representative's violation of the federal securities law or violation of common law can be imputed to the firm through respondeat superior. By comparison, Section 20 control person imputes liability only for breaches of the Exchange Act. Thus, if a registered representative breaches a common law duty (common law fraud for example), Section 20 does not impute the representative's common law liability to control persons of the representative. The standard of conduct for imposing liability under Section 20 is also very different. Section 20 does impose liability based solely upon the control person's relationship with the primary violator. However, a control person can avoid liability under Section 20 if he acted in "good faith" and did not "directly or indirectly induce the act or acts" constituting the primary violation. Because the firm generally knows very little or nothing about the selling activity in a selling away case, the firm's direct or indirect inducement of the conduct is rarely an issue. Good faith, however, is the subject of a great deal of litigation. Courts have generally held that a firm acts in "good faith" if it has and enforces a reasonable system of supervision over the conduct of its registered representatives. Courts have also held that, to impose liability upon the control person, the failure in supervision must amount to *scienter* or recklessness – negligence generally is not enough. *Scienter* requires "an extreme departure from the standards of ordinary care" posing "a danger of misleading buyers that was either known to the control person or was so obvious that the control person must have been aware of it."

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

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12 [*15 USCS § 77k* or 77 l], shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.[14]

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.[15]

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

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

7. Practical Application. At hearing or trial, Claimants' attorneys focus on small details which, with Herculean effort, a firm could have investigated

to uncover the selling away activity. Because selling away cases are litigated after the selling away activity has come into the focused view of 20-20 hindsight, the connection between slight information and the outside business activity can appear much more obvious than it would or could have been to the firm at the time the activity was occurring. As a result, in many cases jurors and arbitration panels unintentionally impose liability against firms using standards significantly lower than those discussed above.

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

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

B. Regulatory Liability

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

2. SEC. Exchange Act §§15(b)(4)(E) and 15(b)(6) generally spell out the supervisory responsibility of broker-dealers and persons who may be supervisors. The Exchange Act *indirectly* mandates supervisory procedures by providing that the SEC may sanction a broker-dealer and its supervisory personnel, a broker-dealer or an associated person who has violated the securities laws, or who "has failed reasonably to supervise, with a view to preventing violations of the provision of such statutes, rules and regulations, another person who commits such a violation if such person is subject to his supervision." Subsection (E) further provides that no person shall be deemed to have failed reasonably to supervise any other person if:

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and systems without reasonable cause to believe that such procedures and systems were not being complied with.[16]

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

4. State Regulators. State securities departments or divisions generally have the independent authority to investigate and, where violations of state law

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have occurred, to issue temporary or permanent cease and desist orders, suspensions, or monetary sanctions against individuals, broker-dealers, investment advisers, or others. State regulators often impose sanctions even where FINRA or the SEC have already acted to punish the wrongdoer or the firm.

Conclusion

Most disputes with customers are arbitrated. In rare cases, a claimant's attorney chooses to file a claim in state or federal court under common law or statutory securities law. 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. However, even with the best procedures, outside business securities activities may occur and not be detected. If the procedures are reasonably adequate and reasonably enforced, the broker-dealer should have defenses under both federal and state law.

Part 3 of this article, which will be published in the next issue of *NSCP Currents*, will discuss supervision and compliance procedures that may be used by firms. Such procedures and policies need to be specifically adapted to the particular firm's operations as explained in Part 3.

1. The requirement of Rule 12101 applies to individual claims by customers. Rule 12204 prohibits arbitration of class action claims unless under specific provisions a party has opted out or the class is not certified and under certain other conditions. Further, shareholder derivative actions will not be arbitrated under 12205.
2. This mirrors FINRA Rule 0120(g) which defines customer by stating "the term 'customer' shall not include a broker or dealer."
3. 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.
4. *Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc.*, 264 F.3d 770, 772 (8th Cir. 2001) (holding that when the relationship between the parties is more tenuous, courts should determine if there is some form of business relationship that includes some brokerage or investment relationship between the parties); *Oppenheimer & Co. v. Neidhardt*, 56 F.3d 352, 357 (2d Cir. 1995); *Wheat, First Sec., Inc. v. Green*, 993 F.2d 814, 820 (11th Cir. 1993) (recognizing that courts are guided by the notion that the term "customer" should not be too narrowly construed, nor should the definition upset the reasonable expectations of FINRA members).
5. *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).
6. *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").
7. *Malak v. Bear Stearns & Co., Inc., 2004 U.S. Dist. LEXIS 1422 at *13 (S.D.N.Y. 2004).*
8. *Bensadoun v. Jobe-Riat*, 316 F.3d at 178.
9. *John Hancock Life Insurance v. Wilson*, 254 F.3d 48, 59 (2d Cir. 2001); *see also O.N. Equity Sales Company v. Thiers*, 2008 U.S. Dist. LEXIS 3765 (D. AZ 2008) (finding an investor a "customer" of a member firm for purposes of compelling arbitration where she alleged she was induced to invest in a ponzi scheme by an associated person at the time the associated person worked for the member). The court in *O.N. Equity Sales Company* did recognize, however, that courts may require that the "customer" status be determined at the time of the events providing the basis for the alleged cause of action. 2008 U.S. Dist. LEXIS 3765 at 11, fn. 5 (citing *Wheat, First Securities, Inc. v. Green*, 993 F.2d 814 (11th Cir. 1993).
10. *See Miller v. Flume*, 139 F.3d 1130 (7th Cir. 1998) (focusing on the "in connection" language of the rule to hold that the rule's scope should be "quite broad"); *First Montauk Securities Corp. v. Four Mile Ranch Development Company, Inc.*, 65 F. Supp. 2d 1371 (S.D. FL 1999) (same); *see also O.N. Equity Sales Company v. Thiers*, 2008 U.S. Dist. LEXIS 3765 at *11 (D. AZ 2008) (finding that a ponzi scheme by an associated person constituted a business "activity" to subject the claim to arbitration).
11. *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).
12. *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); *Homor, 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).
13. Exchange Act Section 20; 15 U.S.C. § 78t.
14. Securities Act of 1933 Section 15; 15 USCS § 77o.
15. *Swensen v. Engelstad*, 626 F.2d 421, Fed. Sec.L.Rep. (CCH) P97,639 (5th Cir. 1980).
16. Exchange Act, Section 15(b)(4)(E); Section 15(b)(6); 15 U.S.C. 78(o)(b)(4)(E) & (6).