

## Outside Business Activity (Part 3 of 3)

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

### Introduction

This is Part 3 of a three-part article dealing with outside business activity. Part 1 described the applicable self-regulatory organization rules, particularly FINRA and NYSE rules. In addition, it discussed proposed revisions to those rules and applicable NASD Notices to Members dealing with personal outside business activities of associated persons of broker-dealers. Part 2 discussed arbitration and regulatory claims and theories of vicarious liability and defenses of broker-dealers. Part 3 deals with supervision and compliance procedures applicable to outside business activities, including the changes necessary to procedures as a result of the proposed FINRA rule changes.

### VII. Supervision and Compliance A. General

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

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

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

### B. Hiring and Background Investigation

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

---

*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 and Mr. Goldberg are members 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, its clients, its other members or attorneys.*

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

#### 1. Employment Questionnaire.

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

- (i) describe all business activities for a period of ten years;
- (ii) with respect to each outside business activity, provide details [dates of involvement, position, description of affiliates of the business, relationship with other individuals involved, etc...];
- (iii) list all of the types of products that the associated person has sold at his former firm(s);
- (iv) describe all outside volunteer or non-business activities [positions held in church, voluntary associations, clubs, family members, etc.] 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; and
- (vii) list names of persons that might be contacted regarding the above.

Firms generally should seek to obtain the consent of the associated person for the member to obtain additional

information, such as credit information, and to contact persons associated with any outside activity or otherwise related to information requested in the questionnaire.

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

- (a) tax returns for several years;
- (b) a detailed financial statement (if available);
- (c) a list of all bank accounts;
- (d) a list of investments; and
- (e) past and present sources of income for five years.

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

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

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

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

- (a) Contact former broker-dealer or other former employers Form U-4 (mandatory requirement for 3 years).
- (b) If the person is involved with

insurance, call the insurance agent with which he or she is associated and the insurance company or underwriter.

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

(d) Consider review of all other outside activities to determine if participation appears extensive or signals possible securities 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 for each organization and under some circumstances inquiring by call or by interview.

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

**6. Interviews.** Firms often conduct a final interview after all of the information, calls, questionnaires and data have been received. After the questionnaire has been completed, some firms will have at least two supervisory personnel review the questionnaire, including one that is independent. Based upon the questionnaire, firms often conduct two or more personal interviews. Discrepancies can be investigated and a firm can prepare a memorandum as to the resolution of any issues raised by the questionnaire to protect itself from negligent hiring claims. In some cases, it may be appropriate to adopt heightened procedures. It is a good practice if there are to be any waivers with respect to information to obtain permission by the hiring supervisor from a third independent supervisory person.

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

**OUTSIDE BUSINESS ACTIVITY***(Continued from page 13)*

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-back business. The various non-discrimination provisions of both state and federal law should be examined and the inquiries prepared carefully to ensure they are directed only to the possibility of other business activity or conflicts of interest and are not used to discriminate in the hiring process.

**C. Education**

**1. Education of All Associated Persons.** In many selling away cases, the associated person claims simply not to have known that the activity was prohibited. Education for associated persons concerning outside activities and the firm's policies can help prevent

these problems. Generally, firms create a documented program to educate all associated persons with respect to the firm's policy that:

(a) Any and all outside activities should be reported to the firm 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.**

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

**3. What is Securities and Investment Banking Business Activity?**

Firms generally include written policies in the compliance manual for employees that neither the associated person nor his supervisors are to make a decision on what does or does not constitute securities or investment business activity. These policies often warn associated persons that they are not to rely on letters from outside counsel and explain to associated persons that determining what is a security is so difficult that even the United States Supreme Court Justices have differed in their view as to what is a security. Products like indexed annuities, certain types of real estate investments, promissory notes, condominium vacation rental schemes and a variety of other types

of activities create difficult legal questions that can be far beyond the ability of associated persons or their supervisors to determine.

Furthermore, the determination of whether something is a security varies between the various states and between state and federal law. Likewise, there can be a significant difference between the definition of securities in other countries and the definition of a security for purposes of federal or state securities laws in the United States.

**D. Periodic Update Regarding Outside Business Activities**

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

(1) Compliance procedures can emphasize that the firm's policy requires that the associated person must report any outside activity to the firm prior to undertaking the activity within a very short period of time.

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

- (1) current financial statement;
- (2) list of bank accounts;
- (3) tax return; and
- (4) credit report.

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

A number of firms use written reminders to all supervisors and associated persons and other persons

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

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

## **E. Inspections and Reviews**

**1. Auditing and Inspection Procedures in General.** General supervisory procedures should provide for inspection of all offices as required under 3010(c) (which continues to be required under the proposed new supervisory Rule 3110). More frequent inspections may be appropriate for offices where there are complaints or where exception reports or past inspection deficiencies evidence other possible problems. *See* NTM 08-24; *see also* proposed Rule 3110(c). A pre-office inspection profile of the office should be prepared that may include, among many other things:

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

(2) complaints or exception reports; and

(3) past problems at the office.

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

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

In inspecting branch offices, the inspector may try to obtain some idea of the lifestyle of the associated person and consider whether that lifestyle is within the person's means. Reviewing files of the customers and, sometimes, even non-customers with which the office has business activities can be important. If problems of possible outside selling activity are detected, a firm may want to contact and interview broker-dealer customers as well as the outside business activity customers. Some firms require that all branch offices, particularly small branch offices, have a log-in for individuals that actually visit the office. Other firms compare telephone records of the associated person with the telephone numbers of clients to determine if and why there are a lot of calls being made to non-clients.

**2. Surprise Inspection.** Surprise inspections, especially with smaller offices, can be an effective tool for investigating outside business activity.

The surprise inspection is sometimes a problem for a single person office because the examiners may show up when the associated person is on vacation or is elsewhere. Some firms attempt to minimize these problems by requiring the associated person to provide notice to the firm if the person plans to be out of the office for a day or a longer period of time.

## **F. Complaints**

As mentioned above, one sign of impermissible selling away is complaints from customers or non-customers about products that are not within the scope of 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 Rule 3040 and/or the member's policy. In other cases, the account executive may have received no selling compensation, but the member has not been notified. In many cases, when a complaint is received it is already too late to prevent the selling away because the investment sold is worthless and in the case of Ponzi schemes or other out-and-out frauds, money may have been misappropriated by the account executive or third parties. 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.

*(Continued on page 16)*

**OUTSIDE BUSINESS ACTIVITY**

(Continued from page 15)

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

**H. Permission to Sell Away**

Under the current rule, if an associated person engages in securities or investment activities for compensation or without compensation the associated person must notify the firm. If the firm member grants permission, it must supervise the activities if the account executive receives any selling compensation. Even if no selling compensation is received, the firm may wish to consider supervising the non-compensated outside business activities involving investment products or investment banking business. Furthermore, as explained above, if there are securities activities for compensation, the transactions must be 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 it depends upon the scope of the non-permitted selling activities, the number of involved investors, the number of

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

**Conclusion**

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 in avoiding the liability.

**Where Are You on  
Regulatory Compliance  
Management?**

For information on  
compliance best practices  
contact [info@qumas.com](mailto:info@qumas.com)  
or visit [www.qumas.com](http://www.qumas.com) or  
call 1-800-577-1545

**QUMAS**



We've frozen our billing rates  
at 2008 levels. A gift in 2009.  
A happier New Year to everyone.

[www.lplegal.com](http://www.lplegal.com)

 **LEVENFELD  
PEARLSTEIN, LLC\***

Unusually Good®

[bingham.com](http://bingham.com)

**Bingham's Securities Area**

- Broker-Dealer
- Compliance/Reviews
- Consulting/Operations
- Investment Management
- Litigation and Private Defense/Arbitration
- Securities Enforcement and Investigations
- Securities Litigation
- Trading & Markets

**BINGHAM**

Attorney Advertising. © 2009 Bingham McCallister LLP  
One Federal Street, Boston, MA 02110-1000