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IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION I

GARRISON FAMILY LLC, a Washington limited liability company; LESA B. NEUGENT, individually, as Guardian of the Estate of Jack M. Garrison and as Trustee of the JACK M. GARRISON AND CHARLOTTE L. GARRISON REVOCABLE TRUST, the JACK M. GARRISON SURVIVOR'S TRUST, the CHARLOTTE L. GARRISON MARITAL TRUST, the CHARLOTTE L. GARRISON EXEMPT MARITAL TRUST, the CHARLOTTE L. GARRISON EXEMPT FAMILY TRUST FBO MARK GARRISON, and the CHARLOTTE L. GARRISON EXEMPT FAMILY TRUST FBO LESA NEUGENT,

Appellants,

v.

SAGEPOINT FINANCIAL, INC., a Delaware corporation licensed to business in Washington, f/k/a AIG FINANCIAL ADVISORS, INC.,

Respondents.

APPELLANTS' AMENDED REPLY BRIEF

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I. Introduction.

Respondent's Brief on Appeal[1] is convoluted and confusing, because it focuses on a myriad of shotgun arguments, often on minor points, while failing to deal with the most significant issues (*see infra,* at 2, 3, 4, 9, 20-21, 21), or Appellants' legal authority (see infra, at 5, 6, 10, 12, 14, 14-15, 17). At the same time, AIG's brief reflects a lack of basic understanding about how the securities industry works, resulting in nonsensical arguments, and an unfamiliarity with the record, resulting in frequent mistakes of fact.[2] Finally AIG repeatedly misstates the issue or Appellants' arguments, by omitting material elements, then proceeds to argue against the resulting non-issues. *E.g.,* AIG declares (RB at 20):

> The issue on review regarding the negligent supervision claim, therefore, is this: *simply because Mark was a registered AIG/SagePoint stockbroker*, did AIG/SagePoint have a sufficiently special relationship with Mark that created the responsibility to evaluate on behalf of strangers and non-AIG/SagePoint clients the suitability and conduct of trades Mark pursued for them in these

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[1] Cited below as "RB," followed by the page number where the reference occurs. Appellants' opening Brief on Appeal is cited as "AB," followed by the page number.

[2] It is a small point, but illustrates AIG's carelessness with facts: Appellants' Brief noted that "AIG misstated to the trial court that Appellants . . . said Mark had a financial interest in the accounts." AB at 14, n. 9. AIG claims this was a "false assertion." RB at 6. It was not false. Appellants' Complaint said that Mark had "an *interest*" in their Wells Fargo accounts (interest as trustee or manager)—not a "financial" interest. Appellants' Complaint *says* that *others* (Mark and Wells Fargo) used the term financial interest.

outside[3] transactions?

That is not the issue. No one claims "simply being a stockbroker registered with AIG" imposed a duty on AIG to supervise Mark's transactions "on behalf of strangers and non-customers." The issue is whether AIG had a duty to supervise Mark's transactions in Appellants' accounts because he was a *dually-registered AIG stockbroker employed by another firm as an investment advisor* ("IA"), who (1) gave Appellants investment advice and (2) participated in securities transactions in their accounts (3) in connection with which he received compensation. AIG never argues *this* issue. The scope of this duty is narrow, not a "broad duty to third parties" as AIG misleadingly cautions the court against adopting. RB at 18.

II. The court erred in failing to grant Appellants' motion for summary judgment holding that AIG owed a duty supervise Mark Garrison's trading in their brokerage accounts held at Wells Fargo.

A. AIG's superficial discussion of the nature of duty is wrong.

1. Issues of fact can exist when determining duty. In response to Appellants' argument that disputed issues of material fact precluded summary judgment in favor of AIG on the issue of duty (although no disputed facts precluded granting *Appellants* summary judgment on the issue of duty), AIG only argues that duty is a question of law (RB at 1, 15-

[3] "Outside" business activities or securities transactions means activity by a stockbroker outside of his role as a stockbroker for his broker dealer. Such activities are referred to as having been conducted "away" from the firm.

16)—before acknowledging that "where duty depends on proofs of facts that are disputed that summary judgment is inappropriate." RB at 16. In fact, courts frequently must make factual findings in order to determine whether a duty arises. See, *McGraw v. Wachovia*, 756 F. Supp.2d 1072-73 (N.D. Iowa, 2010) (in negligent supervision claim vs. broker dealer, "The fact-driven questions. . . are whether or not the circumstances giving rise to a duty to non-customers arose . . . and whether that duty was breached as to any of the plaintiffs"); *Washburn v. City of Fed. Way*, 169 Wn. App. 588, 610-11, 283 P.3d 567 (2012) *rev. granted,* 176 Wn. 2d 1010 (2013):

> [D]uty arises from the facts presented. . . . [A]ppellate courts have frequently reviewed whether sufficient evidence supports a finding that the alleged duty was owed in the particular circumstances of the case. . . . In such cases, the issue of duty does not present a pure question of law. [Footnotes omitted.]

2. AIG is wrong that standard of care is not related to defining a duty. AIG never addresses Appellants' argument that the securities industry's standard of care imposes a duty on it to supervise Mark's transactions in their accounts. AIG dismisses the issue with, "Appellants mistakenly conflate duty with standard of care"—without ever explaining why this is a mistake. In fact, duty and standard of care are "correlative, and one cannot exist without the other." *Prosser and Keeton on the Law of Torts* § 53, at 356 (5th ed. 1984):

> "[D]uty" is a question of whether the defendant is under any obligation for the benefit of the particular plaintiff; and in negligence cases, the duty is always the same—to conform to the

> legal standard of reasonable conduct. . . .What the defendant must do, or must not do, is a question of the standard of conduct required to satisfy the duty. The distinction is one of convenience only, and it must be remembered that the two are correlative, and one cannot exist without the other.

Standard of care establishes the nature, or scope, of a duty in a particular set of circumstances. Washington's Supreme Court explains in *Affiliated FM Ins. Co. v. LTK Consulting Servs.*, 170 Wn. 2d 442, 449, 243 P.3d 521 (2010), that standard of care defines the nature of a duty:

> [A] duty of care "is defined as 'an obligation, to which the law will give recognition and effect, to conform to a particular standard of conduct toward another.'" [Citation.]

A*ccord, Lewis v. Krussel,* 101 Wn. App. 178, 184, 2 P.3d 486 (2000) (Duty is "an obligation, to which the law will give recognition and effect, to conform to a particular standard of conduct toward another"); *Keller v. Spokane*, 146 Wn. 2d 237, 243, 44 P.3d 845 (2002).[4] Indeed, courts frequently refer to duty and standard of care as one and the same thing. *E.g., McKee v. Am. Home Products, Corp.*, 113 Wn. 2d 701, 706, 782 P.2d 1045 (1989) ("the *standard of care required* of professional practitioners. . . must be established by the testimony of experts who practice in the same field. The *duty* of physicians must be set forth by a physician, the duty of structural engineers by a structural engineer. . .").

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[4] "[I]n determining whether a duty is owed to the plaintiff, a court must not only decide who owes the duty, but also to whom the duty is owed, and *what is the nature of the duty owed.* [Citation.] The . . . *answer to the third question defines the standard of care." Id.* at 386, 936 P.2d 1201. (Emphases added.)

Judy v. Hanford Envtl. Health Found., 106 Wn.App. 26, 37-38, 22 P.3d 810 (2001) ("The accepted *standard of care imposes . . . a duty* to correctly diagnose manifestly abnormal conditions. . . ").

B. Broker dealers can have a duty to non customers to supervise a stockbroker's securities transactions away from the firm.

1. AIG does not address Appellants' authority holding that broker dealers can be liable to non customers for negligent supervision. AIG declaims over and over and over that a broker dealer simply can have no duty to non customers to supervise its brokers, period, end of discussion. AIG knows this is not true. AIG was the defendant in a recent (2008) federal case squarely holding otherwise. *As You Sow v. AIG Financial Advisors,* 584 F. Supp. 2d 1034, 1049 (M.D. Tenn, 2008). The federal court in *As You Sow*, dealing with a negligent supervision claim, rejected this same argument by AIG, noting,

> For this tort, numerous courts have ruled that broker dealers may be held liable under the common law for negligently supervising their registered representatives, even on dealings with investors who had no accounts with the firm. [Citations omitted].

The court in *Berthoud v. Veselik*, 2002 WL 1559594, Fed. Sec. L. Rep. (N.D. Ill. July 15, 2002), explained why AIG's position is wrong:

> Berthoud has alleged that Tower Square is liable under the common law doctrine of negligent supervision. Tower Square argues that this count should be dismissed because Berthoud cannot establish that Tower Square owed him a duty as he personally did not have an account with Tower Square. We disagree. . . .

> [A] plaintiff must show that the employer owed *some* duty to the plaintiff in order to state a cause of action for negligent supervision. The *Champion Parts* and *Emjayco* courts did not rule that the duty to account holders was the only duty sufficient to allege negligent supervision; rather it was merely one of many such duties which could sustain a negligent supervision count. . . . Berthoud has alleged that *the duty he was owed by Tower Square was to reasonably "supervise and control the activities of . . . Dermody* [the broker] to insure compliance with applicable laws and regulations governing the sale of securities." (Complt. at ¶ 44.) Therefore, we conclude that Berthoud has alleged a valid negligent supervision cause of action against Tower Square.

This is exactly the duty Appellants contend AIG owed to them: the duty to reasonably supervise and control Mark's activities in their securities accounts. Appellants' Brief cites five cases for the proposition that

> numerous courts have held broker-dealers may be held liable under the common law for negligently supervising their registered representatives, even on dealings with investors who had no accounts with the firm." AB at 73, n. 65.

AIG's doesn't mention any of that authority.[5] Appellants cited *McGraw v. Wachovia Sec.*, L.L.C., 756 F. Supp. 2d 1053 (N.D. Iowa, 2010), *As You Sow v. AIG*, *supra*, and *Colbert & Winstead, PC v. AIG*, 2008 U.S. Dist. LEXIS 53179, *Colbert & Winstead, PC v. AIG*, 2008 U.S. Dist. LEXIS 53179, 44 Employee Benefits Cas. (BNA) 2250 (M.D. Tenn. 2008)) as finding that

> the broker-dealer's supervisory/control relationship with the stockbroker . . . giv[es] rise to the duty to supervise in order to protect third party investors, including non-customers.

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[5] Except for citing *Javitch v. First Montauk Fin. Corp.* for the fact that "responsibility to assess suitability arises from what is known as the 'know your customer' regulations".

AB at 73-74. AIG does mention these three cases—but not to dispute Appellants' point. AIG just purports to distinguish them on factual grounds that had nothing whatsoever to do with the courts' rulings that broker dealers can owe a duty to non customers. *See* RB at 35-39.

2. AIG cites no authority for the proposition that a broker dealer can owe no supervisory duties to non-customers (RB at 53). AIG doesn't cite a single authority—other than its expert, David Paulukaitis, discussed below—for the proposition that a broker dealer has *no* duty to supervise one of its stockbrokers who, acting as an IA employed by another firm, provides investment advice to customers "away" from the firm, and participates in securities transactions in their account in connection with which he receives compensation.

Neither does AIG cite a single authority for the broader proposition that a broker dealer can have no duty to non customers in general [other than discussing *Bear Stearns and Co. v. Buehler*, 23 Fed.Appx. 773, 775 (9th Cir.2001) in order to try to distinguish it, (RB at 38-39)].

3. AIG is wrong in apparently thinking broker dealers don't *already* have a duty to supervise their stockbrokers' outside securities transactions. AIG repeatedly argues that the very idea of a broker dealer having a duty to supervise its stockbrokers' outside securities transactions

would be a startling development.[6] In fact, it has been clearly established for decades that broker dealers are under a duty to supervise a stockbroker's outside securities transactions. *See, e.g.,* NTM 86-65,[7] NTM 88-5,[8] and NTM 91-32[9] (all attached as Appendix A to Appellants' Brief on Appeal). Acknowledging this duty, AIG required its brokers to answer an Outside Business Activity Questionnaire annually. See AB at 20. "Private securities transactions," which NASD Rule 3040 ("Rule 3040") requires broker dealers to supervise, are *by definition* "outside the regular course or scope of an associated person's employment with a member."[10]

AIG exaggerates that Appellants' special relationship discussion "rel[ies] on *Funkhouser v. Wilson*,"

> which held that a church and church leader had a sufficiently special relationship with children of the church to prevent them from being sexually molested. . . .

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[6] "[Appellants] entreat this Court to make new law and expand ex post facto SagePoint's duties under the law and applicable regulations well beyond any recognized or sensible limits." RB at 18. "Despite that the Garrison Entities are not AIG/SagePoint customers and that the accounts and trading occurred 'outside' AIG/ Sage Point, the[y] audaciously look to recover from AIG. . . ." RB at 4.

[7] "Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel," September 2, 1986.

[8] "Request for Comments on Proposed NASD Rule of Fair Practice Regarding Outside Business Activities," February 14, 1988.

[9] "Request for Comments on Compensation Arrangements for Activities of Registered Representatives Who Are Also Registered With the Securities and Exchange Commission as Investment Advisers," July 1, 1991.

[10] Rule 3040 was amended in 1985 to expressly impose this duty (AB at 38).

RB at 19-20. Appellants' argument relied on far more than *Funkhouser,* which was cited (along with other authority) for the general rule that

> The duty to control "will be imposed only upon a showing of a definite, established and continuing relationship between the defendant and the [tort-feasor]." . . . Cases in which such a duty has been established . . . have uniformly involved situations where the person charged with the duty of control has *some sort of legal authority* to control *the tort-feasor's* conduct. (Emphases added.)

AB at 24-25. AIG does not address this explanation of what constitutes a "special relationship" giving rise to a duty to supervise. AIG then inexplicably and incorrectly claims that Appellants

> assert that Mark's role as a registered AIG/SagePoint stockbroker was sufficient to create such a relationship, but *offer no authority to support this assertion.* (Emphasis added.) RB at 21.

This is untrue: Appellants explained and provided authority for the rule that a duty to supervise can arise when there is a definite and existing relationship between a first party and a tortfeasor, in which the first party has some sort of legal authority to control the tortfeasor's conduct (AB at 23-26), and that the nature of the broker dealer/stockbroker relationship involves a "direct supervisory component." AB, at 25-28.

Finally, Appellants provided extensive authority, including a sequence of NASD Notices to Members, showing that the broker dealer/stockbroker relationship imposes on broker dealers the specific duty to supervise their stockbrokers who (1) provide investment advice in their capacity not as stockbrokers, but as IAs employed by a different firm, (2) to

investors with accounts outside of AIG, and (3) participate in securities transactions in that account (4) in connection with which they receive compensation. AB at 29-42. Other than repeating its mantra that the "plain language" of Rules 3040 and Rule 3050 control (*see* RB at 18, 19, 27, 31) and impose no supervisory duty on it, AIG does not respond to, much less try to contradict, any of this authority. The best that AIG can come up with in response to the NASD Notices to Members cited by Appellants is the bald declaration that "the guidance in these notices does not support their assertions regarding AIG/SagePoint's duty in the circumstances of this case." RB at 30. But AIG cannot seriously argue that Notice to Members ("NTM") 91-32 (*see* AB at 39-41) doesn't implicate the circumstances of this case, or facts of this case:

> The NBCC concluded that [Rule 3040], consistent with the policy announced when this section was adopted, should apply to [1] all investment advisory activities [2] conducted by registered representatives other than their activities on behalf of the member [3] that result in the purchase or sale of securities by the associated person's advisory clients. [4] If . . . the RR/IA receives compensation for, or as a result of, such advisory activities. . . . (Bracketed subnumbers added.)

Those are exactly the "circumstances of this case."

C. AIG had a duty to Appellants to supervise Mark Garrison's transactions in their account.

1. AIG misrepresents that Appellants base their negligent supervision claim on an employer/employee relationship. Appellants' Brief explained that courts impose a duty on a party to supervise a

tortfeasor's conduct for the benefit of third persons on various grounds, including when there is a "special relationship" between the first party and the tortfeasor which gives the first party "supervisory responsibilities for, or control over, the tortfeasor." AB at 23-24. Appellants clearly base their claim on the special relationship between a *broker dealer* and its *stockbrokers,* not on an employer/employee relationship. See AB at 71.

Despite this, AIG blatantly misstates that Appellants' claim is "premised on the special relationship between an *employer and an employee*," arguing that the "*employer/employee relationship* gives rise to a limited duty to 'prevent the tasks, premises, or instrumentalities entrusted to an employee from endangering others'" (RB at 21). AIG then spends 3 pages on distracting arguments that AIG didn't have notice that Mark posed a danger to others. *Ibid.* This all is irrelevant to the basis on which Appellants claim a duty existed: a broker dealer's duty to supervise its stockbrokers is inherent in the broker dealer/stockbroker relationship. The duty to supervise doesn't arise because the broker dealer has some notice of danger to others.

2. A broker dealer has a duty to take action upon detecting "red flags" suggesting wrongful conduct. There is a second, common law, basis for finding that AIG had a duty to take action to supervise Mark's activities in Appellants' accounts. Independent of the duty arising out of the securities industry's standard of care, broker dealers have a duty to

take action when they become aware of "red flags," or "indications of wrongdoing," suggesting that violations of securities rules and regulations may have occurred. *See* authorities at AB 47-52.

AIG doesn't dispute this statement of the law, nor does it challenge Appellants' authority on this issue. *See* RB at 23, 37-39. Rather, AIG argues the facts, asserting that Appellants don't "present any evidence of 'red flags' prior to the trades at issue," and that the red flags here *are* the very wrongful conduct at issue. RB at 27, 38-39. This is absurd. The conduct at issue didn't all happen at once; contrary to AIG's pronouncement, the undisputed evidence shows that red flags appeared in Appellants' Wells Fargo brokerage account statements beginning in February 2008 and continued until November 2008.[11] The undisputed facts—and AIG does not dispute these facts—show that reasonable minds cannot differ on whether AIG had notice of red flags. AIG supervisors testified they actually did review the monthly statements for Appellants' Wells Fargo accounts and Mark and his wife's accounts (CP 194, Declaration of Michelle Nielsen). Those brokerage account statements showed extraordinarily speculative and reckless trading in all accounts,

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[11] CP 128-129 (Dennett 1st Decl., ¶¶ 15-17). Mark transferred over $9.6 million from Appellants' accounts into his and his wife's accounts over time, then lost it through extraordinarily speculative trading. CP 128, Dennett 1st Decl., at ¶ 17. This had to have raised red flags that Mark might be violating securities rules and stealing from accounts AIG knew to belong to his grandfather's trusts. CP 337; 340-344, Dennett 2nd Decl., ¶ 3 and Ex. 1.

and millions of dollars flowing from Appellants' accounts into Mark and his wife's accounts. *Ibid.*; AB at 51. AIG justifies disregarding those red flags on the ground it was looking only for "transactions that adversely affected the interests of SagePoint or SagePoint's customers" (CP 194). One could hardly find a better reason for the rule that a broker dealer has the duty to take action upon becoming aware of red flags involving non customers.

In any event, at the very most, AIG's argument would raise a material disputed issue of fact over whether a duty to supervise was triggered by red flags. The trial court erred in dismissing the claims stated in Appellants' Complaint at ¶¶ 189, 191 and 194; see AB at 47.

3. Consistent with the securities industry's standard of care, the Court should adopt the NASD's rules and regulations (as interpreted by its Notices to Members) and find a duty for AIG to supervise Mark's transactions in Appellants' accounts. AIG argues the court should not consider the securities industry's rules here, particularly Rule 3040, in determining the nature of AIG's duty, arguing that Appellants aren't within the class of persons intended to be protected by them. AIG simply announces conclusorily, and with no further explanation,

> Nothing in Rule 3040 demonstrates an intent to protect third party non-customers of AIG/SagePoint's from allegedly unsuitable investment advice given outside of AIG/SagePoint. RB at 34.

This is contrary to everything Congress, the NASD and courts have said about the purpose of the securities industry's supervisory system, and Rule 3040 specifically. AB at 34-35. AIG does not discuss any of Appellants' authority. AIG argues that the class of persons intended to be protected by those rules is not "particular and circumscribed" enough (AB at 34), but offers no authority or standard for how particular and circumscribed a class must be. Courts hold very broad classes of parties to be within the scope of those intended to be protected by statutes or regulations. See *Halvorson v. Dahl*, 89 Wn. 2d 673, 676, 574 P.2d 1190 (1978); *Barrett v. Lucky Seven Saloon, Inc.*, 152 Wn. 2d 259, 273, 96 P.3d 386 (2004) (statute whose purpose was "the protection of the welfare, health, peace, morals, and safety of the people of the state," was sufficient to constitute a protected class).

4. AIG says not one word disputing Appellants' analysis of the NASD's Notices to Members showing that AIG had a duty to supervise the transactions at issue here. AIG does not respond to or dispute Appellants' authority (AB at 36) that NASD Notices to Members are controlling authority. Nor does it ever address Appellants' argument (AB 36-42) that the NASD's Notices to Members clearly establish a duty for AIG to supervise Mark's conduct at issue here.

5. AIG doesn't even try to refute Appellants' expert's opinions. Appellants argued that their expert, John Chung,

- demonstrated specific experience working with the NASD rules at issue here (AB at 56)—which AIG's expert didn't;
- dealt with the specific issue before the court: broker dealers' supervision of the *investment advisory activities* of their stockbrokers (AB at 57);
- discussed the evolution and NASD's interpretation and application of its Rules in support of his opinions (AB at 57); and
- expressed the opinion that AIG had a duty to supervise Mark's securities transactions in Appellants' accounts (AB at 57-58).

AIG offered nothing to the trial court challenging Mr. Chung's opinions (AB at 58), and it offers the same nothing to this court. AIG's entire discussion of Appellants' expert's report/opinions consists of: Mr. Chung's opinion (1) "is inconsistent with the plain text of these rules," and (2) suffers from "a host of impracticalities." RB at 32-33. The "impracticabilities" argument reflects AIG's apparent lack of familiarity with securities industry rules and regulations. AIG argues Mr. Chung's position is impracticable because it

- had no information about the Garrison Entities and their circumstances, so "As a practical matter. . . could not have evaluated the suitability of Mark's securities transactions; and

- "had no advance notice or real time ability to weigh in. The confirmations[12] and account activity reports were delivered to AIG/SagePoint . . . after Wells Fargo executed the transactions."

RB at 32-33. The first point is wrong: if the duty to supervise applies, then NASD rules require that

> the transaction shall be recorded on the books and records of the member [AIG] and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member. Rule 3040.

And supervising "as if the transaction were executed on behalf of a member" requires the broker dealer to obtain, before executing the first transaction in the account, the information necessary to enable it to evaluate whether transactions in the account are suitable. Rule 2310; [13] NASD Rule 3110(c).[14] Neither does the inability to weigh in before a transaction occurs make supervision "impractical." Supervisors are required to review *every single* transaction by every broker in an office, not just those occurring away from the firm. NASD Rule 3010(d)(1) (see

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[12] "Confirmations" refers to "confirmation slips," a report broker dealers are required to send a customer shortly after every securities trade giving the details of the transaction.

[13] Before executing any transaction recommended by a firm's stockbroker, the firm "shall make reasonable efforts to obtain information concerning: (a) the customer's financial status; (b) the customer's tax status; (c) the customer's investment objectives; and (d) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."

[14] NASD Rule 3110(c) ("Customer Account Information") requires broker dealers to make reasonable efforts to obtain, prior to the initial transaction in a customer account, the customer's occupation, name and address of employer, among other things.

Appendix A for rule.) Such supervision of transactions is necessarily after-the-fact. While it may not prevent a first violation, supervision requires the firm to follow up and take appropriate steps to prevent further violations.

6. AIG's policies and procedures manuals are proper evidence of the standard of care to which a broker or the firm should be held. AIG's Compliance and Supervisory Manuals evidence that the securities industry's standard of care required it to supervise Mark's activities in Appellants' accounts. AB at 42-47. Those manuals require AIG to supervise Mark's conduct at issue here. *E.g.*, see AB at 43-45. As AIG does repeatedly, instead of confronting and disputing that authority it just incorrectly announces that Appellants offered no authority on the issue, then moves on (RB at 55). The court should follow Appellants' undisputed authority and treat AIG's internal manuals as proper evidence of the standard of care required of it in supervising its brokers.

7. AIG's is wrong that because there is no "standard set of supervisory procedures" there is no industry standard of care. AIG argues that because "there is no standard set of compliance procedures or supervisory procedures to control outside business activities," Appellants "fail to establish that their reading of the NASD rules is the industry standard." RB at 30. This reflects a fundamental failure to understand the securities industry's supervisory structure. NASD Rule 3010 imposes a broad duty on all broker dealers to establish, maintain and enforce a

supervisory system reasonably designed to achieve compliance with laws and regulations. NASD Rule 3010 (Appendix A hereto). This establishes the basic duty to supervise. There is no standard set of *procedures*—but whatever procedures broker dealers have must "be reasonably designed to achieve compliance" with those laws and regulations. NTM 98-38:[15]

> Rule 3010(a) sets forth the basic duty of a member firm to establish and maintain a system to supervise properly the activities of each registered representative and associated person. Although the rule does not prescribe specific supervisory procedures to be followed by all firms, it sets forth minimum requirements for a supervisory system and mandates that the supervisory system adopted enable a firm to supervise properly the activities of each associated person to assure compliance with applicable securities laws, rules, regulations, and statements of policy and with NASD rules.

Accord, NASD NTM 99-45[16].

Here, AIG clearly failed to detect and prevent Mark's violations of securities laws, rules and regulations in his transactions in Appellants' accounts. That failure may have been the result of not having adequate written procedures (as alleged in Appellants' Complaint, ¶¶ 194-197) or due to a failure to enforce its procedures, both of which would constitute a negligent failure to supervise. The issue before this court is simply whether AIG had a duty to Appellants to have adequate procedures in place, and to enforce those procedures. Precisely what procedures are sufficient to *meet* these duties is an issue for trial.

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[15] "NASD Reminds Members Of Supervisory And Inspection Obligations".

[16] "NASD Provides Guidance On Supervisory Responsibilities".

8. AIG's claim that Appellants' argument "is inconsistent with the history of these rules" is backwards. AIG declares that imposing a duty to supervise Mark's transactions in Appellants' Wells Fargo accounts is "inconsistent with the history of" Rules 3040/3050. RB at 28. AIG's "history" omits everything that happened after the mid-1980s, when Rules 3040/3050 were first drafted/amended. It ignored the NASD's sequence of official interpretations those rules over the years in light of changing conditions in the industry. Compare Appellants' discussion of the history of those rules, AB at 35-42, with AIG's discussion, RB at 28-29.

III. The court erred dismissing Appellants' claims on the ground that AIG had no duty to them.

A. AIG's "plain language" argument is baseless. Appellants don't deny that the literal language of Rules 3040/3050 would exempt Mark's transactions in Appellants' accounts from Rule 3040, because Mark had discretion[17] over Appellants' accounts. AB at 67. Yet AIG devotes pp. 25-29 of its Brief to making that point. But AIG

- offers no authority or argument that NASD rules should be construed narrowly and limited to their literal terms; and
- cites only one authority in support of its argument that the literal language of Rules 3040/3050 is controlling: Mr. Paulukaitis, who offers nothing more than his personal opinion

[17] "Discretion" is when a broker/IA is given the authority to make the investment decisions in the investor's account.

that the plain language of those rules controls.

1. AIG's only authority in support of its position is its expert, and AIG cannot and does not try to defend its expert's opinions. Appellants attacked AIG's expert's report and opinions on the grounds that they

- are contradicted by AIG's Supervisory Manual (AB at 45);
- failed to take into account critical authority—the existence of NASD Notices to Members on the subject (AB at 53, 62);
- did not dispute Appellants' expert's analysis the NASD's Notices to Members (AB at 53);
- are based on erroneous facts (AB at 59);
- constituted non-expert testimony (AB at 59-60);
- consisted of bare conclusory statements (AB at 60);
- are contradicted by Appellants' expert's opinion (AB at 61-62);
- employed a rigid plain language analysis rejected by the courts in interpreting laws and written instruments (AB at 63).

AIG's *entire discussion* in defense of Mr. Paulukaitis' report/opinion is:

> The testimony of AIG/SagePoint's expert is persuasive that AIG/ SagePoint had no duty to supervise the suitability of the trades in the Wells Fargo accounts. See CP 196-212 *(Decl. of Paulukaitis);* CP 277-79 *(Second Decl. of Paulukaitis).* This conclusion is consistent with the plain language of Rules 3040 and 3050.

In short, the only authority AIG offers for its argument that no duty exists is its expert's opinion the plain language of Rules 3040/3050 doesn't expressly

impose a duty, and AIG supports its expert's opinions on the ground they are "consistent with the plain language of Rules 3040 and 3050."

AIG does not even acknowledge that a conflict exists between its expert's opinions and Appellants' expert, or discuss how the court should deal with that conflict. AIG never addresses Appellants' arguments that a conflict exists between the plain language of Rules 3040 and 3050 and the plain language of NASD Notices to Members (AB at 67-69).

Neither does AIG respond to Appellants' argument that the court should read Rules 3040/3050 and the NASD's NTMs discussing those rules together, and construe them so as to give maximum effect to all.

2. AIG's discussion about monitoring a broker's transactions in accounts away from the firm in order to protect against frontrunning, etc., is irrelevant. AIG and Mr. Paulukaitis repeatedly talk about a broker dealer's duty to review its stockbrokers' personal accounts for frontrunnng, insider trading and other violations that could harm the firm. *See* RB at 8, 10-11, 29, 31, 35; Paulukaitis 1st Decl., ¶¶ 11-12, 32-39, at CP 199, 207-209. Appellants agree a broker dealer has such an obligation. But neither Rule 3040 nor 3050 impose it. Paulukaitis finds it to be "implicit" in the NASD's Rules requiring supervision generally, Rules 3010 and 2010, which he opines, "are both intended to be broad." *Ibid.*, Paulukaitis 1st Decl., at ¶31. But the fact that a broker dealer has the obligation to look out for such risks is not an argument that Rule 3050

applies, nor does it in any way imply that a broker dealer doesn't also have a duty to supervise the account to protect the investor.

3. Wells Fargo's and AIG's conduct is no evidence that the literal language of Rule 3050 is controlling. AIG argues (RB at 31) that the exchange of "Rule 407 letters" between it and Wells Fargo shows that Wells Fargo and AIG "treated the transactions as subject to Rule 3050, not Rule 3040," constituting "evidence that Rule 3050 and not 3040 applies." Wells Fargo was the "executing broker;" clearly only Rule 3050 applies to an executing broker. This implies nothing about AIG's duties. Secondly, NYSE Rule 407 provides that when an NYSE member executes a transaction "in which a[n] . . . employee associated with another member . . . is directly or indirectly interested . . . All such accounts and transactions periodically *shall be reviewed* by the member or member organization employer."[18] (Emphasis added.) This contradicts AIG's position.

Much more importantly, when AIG and Wells Fargo initially exchanged those letters, Mark hadn't given notice that he was receiving compensation as IA for Appellants' accounts.[19] Mark disclosed that fact in October 30, 2007, (Ibid., at 288). *When the facts changed, AIG's duty to supervise changed.* NASD NTM 96-33:[20]

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[18] Copy of NYSE Rule 407 attached in Appendix A.

[19] *See* Plaintiffs' Opposition to AIG's motion, CP at 288-289, 292-293.

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

4. Policy and other considerations support imposing a duty on AIG here. AIG asserts that Wells Fargo had the duty to supervise Mark's transactions (RB at 40), so supervision by AIG would be unnecessary. This is incorrect. Broker dealers have a duty to supervise the suitability only of transactions *which their stockbrokers recommend.* NASD Rule 2310.[21] Mark made the investment decisions for Appellants on his own, without recommendations from Wells Fargo brokers.

The NASD singles out discretionary accounts particularly for review "at frequent intervals." NASD Rule 2510(c). Appendix A. Yet AIG's most fundamental argument is that *having* discretion is the factor that *exempts* the broker's transactions from Rule 3040. If that were the case, a large number of transactions by stockbrokers in discretionary accounts would go unsupervised (AB at 69-70), undermining a fundamental purpose of the securities industry's supervisory system—

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[20] "NASD Clarifies Rules Governing RR/IAs."

[21] "In recommending to a customer the purchase. sale or exchange for any security, a member shall have reasonable ground for believing that the recommendation is suitable for such customer. . . ."

protecting investors. See AB at 26-28, 34-36, 39-40. Policy considerations support finding a duty for AIG to supervise Mark's acts.

AIG argues that imposing a duty to supervise Mark on our facts would both be "impractical" (re Mr. Chung's opinion, RB at 32-33), and "unworkable" (policy argument, RB at 39-42), because (1) the broker dealer wouldn't have information enough about the customer's financial circumstances to evaluate whether transactions in his account were suitable, and (2) the broker dealer couldn't review them until after they had already taken place. This is nonsense. See discussion *supra*, at 15-16. AIG's other "policy" arguments (interferes with investor's access to the markets, ability to pursue investment strategies and ability to hire IAs; delays executing their trades; "meddling" in Wells Fargo's business). AIG explains nothing about why any of this would follow. *All s*upervision happens after the fact; it would delay nothing. AIG would deal directly with Mark if it saw violations, not Wells Fargo.

IV. AIG was a control person under RCW 21.20.430 as a matter of law, and because NASD *required* AIG to control Mark's transactions in Appellants' Wells Fargo accounts.

Broker-dealers "are virtually always considered control persons, even in selling away cases because of the *respondeat superior* or inherent agency power relationship." Lipner, Seth E., Long, Joseph C. and Jacobsen, William A., *Securities Arbitration Desk Reference* (2011-2012 Ed., West Publishing) at p. 592.

In addition, AIG's Supervisory Manual § 23.8 (CP 586-588), discussed in Section VI below, shows that AIG had the power and responsibility to control Mark's recommendations to Appellants, even if it only considered him the trustee for Appellants. But certainly once AIG learned in Mark's 2007 Outside Business Activity Questionnaire that Mark was also acting as IA for Appellants, Rule 3040 required it to approve or disapprove each trade[22] as if it were carried on the books of AIG. CP 186-187, Dennett 1st Decl. Ex. 6, CP 595-601, 604. AIG had the power to control the specific activity underlying Appellants' claims, satisfying the test from *Herrington v. Hawthorn*, 111 Wn. App. 824, 835-36, 47 P.3d 567 (2002).

AIG asserts that RCW 21.20.430 (3) requires a showing that it materially aided Mark. This is incorrect. RCW 21.20.430 lists four categories of actors who may be secondarily liable for violations of RCW 21.20.010. Two of those categories (employees, and brokerage-dealers or securities salespersons) are modified by the clause, "who materially aids in the transaction." The other two categories (control persons, and partners/officers/directors) are not. The statute does not require that control persons materially aid a transaction in order to have liability.

[22] AIG's claim at p. 47 of its brief that "Rule 3040 does not specifically allow disapproval" appears to be based on a mistaken citation. It seems it intended to cite Rule 3050. Rule 3040(c) requires approval or disapproval of a transaction.

V. AIG had complete control over of the manner in which Mark executed his duties as AIG branch manager and supervisor, and is liable under Appellant's *respondeat superior* claim for his actions.

AIG fundamentally misunderstands Appellants' *respondeat superior* claim. Appellants' allege that AIG is liable in *respondeat superior* for Mark's acts as AIG's *branch office manager.* Not for his conduct as Appellants' trustee, or activities in Appellants' accounts. AIG's entire discussion of *respondeat superior* is irrelevant. AIG also claims that it had no control over the details of Mark's work as branch office manager because in was an independent contractor. This is nonsense. AIG published a 450-page manual detailing the procedures that its managers were required to follow, which controlled Mark's conduct in detail. CP 545; Ex. 4 to 4th Dennett Decl. The 1934 Exchange Act and NASD rules required AIG to establish and enforce written procedures to ensure that its supervisors properly performed their duties in accordance with securities laws and regulations. 15 U.S.C.A. § 78f(b); Rule 3010. AIG's supervisory manual alone is sufficient to establish as a matter of undisputed fact AIG's control of Mark's work as branch office manager. At very least, it raises serious issues of material fact, precluding the trial court from dismissing Appellants' control person claims on summary judgment.

By appointing Mark branch manager of his office, AIG put him in the position to perpetrate his fraudulent activities, and now wants to disavow those activities. Had AIG appointed any other person branch

manager, they would have recognized Mark's multiple violations of industry rules and put a stop to them. Any other decision by a supervisor would have put AIG at enormous risk. It is just not credible that AIG recognized what Mark was doing at the time and looked the other way. Its argument that it had no duty to Appellants is an after-the-fact justification for AIG's monumental failure to detect Mark's red flags.

VI. Appellants' Motion for Reconsideration raised a crucial issue justifying a different outcome, and the trial court's refusal to reconsider was an abuse of discretion.

As discussed at above and in Appellants' Brief, Rule 3040 and the NASD's NTMs interpreting that rule require AIG to supervise a broker also acting as an IA whether the broker is associated with an independent adviser or AIG's corporate adviser. AIG argues that it only had a duty to supervise the investment advisory activities of its brokers associated with AIG's investment advisory arm. This is a radical notion, for which AIG offers no authority. It appears reflect a misreading the first paragraph of § 23 of it own manual, stating "This chapter shall be followed by all personnel in the conduct of their responsibilities on behalf of AIG Financial Advisors, Inc." CP 575. AIG incorrectly interprets this to mean that § 23 requires supervision only of brokers associated with AIG's corporate advisers[23]. But "AIG Financial Advisors, Inc.", as shown in the

[23] AIG incorrectly quotes its own name as "AIG Financial Advisers, Inc." The difference in spelling is not insignificant because the securities industry typically refers to RIAs as

caption of this case, is the broker-dealer Respondent in this case. Chapter 23 explains how that broker-dealer's supervisors must supervise its brokers who also act as Investment Adviser Representatives ("IAR"). CP 575. § 23.2 defines an IAR as one who represents an investment adviser's contact with clients, without distinguishing between independent investment advisers or AIG's own investment advisers:

> An investment adviser, as defined in the Investment Advisers Act of 1940, includes anyone who, for compensation, engages in the business of advising others.

CP 575. An IAR, as defined in Chapter 23, can work for an independent adviser or for AIG's corporate adviser.

Chapter 23 only draws a distinction between independent advisers and AIG's corporate adviser where there are actual differences, and explicitly states where differences exist. For example, Chapter 23 speaks specifically to registration differences for independent advisers (§ 23.4.12) and AIG's corporate adviser (§ 23.4.13). CP 581.

However, § 23.8 draws no distinction between independent IAs and AIG corporate investment advisers regarding supervision of any account in which any IAR acts as a trustee. CP 586-588. Rather it refers to

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"advisers" while the word "advisors" is often used to describe ordinary broker-dealer representatives. This is reflected by comparing the name of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, with the full name of the broker-dealer Respondent here, AIG Financial Advisors, Inc.

"advisers" (as defined in § 23.3, CP 575) and "IARs", without mention of independent or corporate advisers. *Id.*

AIG doesn't dispute that it approved in writing Mark acting as trustee for Appellants in accounts at Wells Fargo, as § 23.8 allows. CP 588. Having approved, AIG's supervisors were required to:

> [R]eview each transaction for appropriateness and determine if the transaction and/or the portfolio meet the clients risk tolerance and investment objectives . . . the [supervisor] will obtain additional information necessary to approve or reject the trades . . ." CP 588.

Section 23.8 required AIG supervisors to supervise Appellants' account in the exact manner Appellants have alleged throughout this case. It is directly on point, and the trial court abused it discretion in denying the motion to reconsider.

DATED: September 10, 2013

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Appendix A

Rule	***Title***
NYSE 407	Transactions—Employees of Members, Member Organizations and the Exchange
NASD Rule 2310	Recommendations to Customers (Suitability)
NASD Rule 3010	Supervision
NASD Rule 3110	Books and Records

3010. Supervision

(a) Supervisory System

Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) The establishment and maintenance of written procedures as required by paragraphs (b) and (c) of this Rule.

(2) The designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker/dealer is required.

(3) The designation as an office of supervisory jurisdiction (OSJ) of each location that meets the definition contained in paragraph (g) of this Rule. Each member shall also designate such other OSJs as it determines to be necessary in order to supervise its registered representatives and associated persons in accordance with the standards set forth in this Rule, taking into consideration the following factors:

(A) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;

(B) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;

(C) whether the location is geographically distant from another OSJ of the firm;

(D) whether the member's registered persons are geographically dispersed; and

(E) whether the securities activities at such location are diverse and/or complex.

(4) The designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.

(5) The assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities.

(6) Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

(7) The participation of each registered representative, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the member at which compliance matters relevant to the activities of the representative(s) are discussed. Such interview or meeting may occur in conjunction with the discussion of other matters and may be conducted at a central or regional location or at the representative's(') place of business.

(8) Each member shall designate and specifically identify to the Association one or more principals who shall review the supervisory system, procedures, and inspection

implemented by the member as required by this Rule and take or recommend to senior management appropriate action reasonably designed to achieve the member's compliance with applicable securities laws and regulations, and with the Rules of this Association.

(b) Written Procedures

(1) Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of this Association.

(2) Tape recording of conversations

(A) Each member that either is notified by NASD Regulation or otherwise has actual knowledge that it meets one of the criteria in paragraph (b)(2)(H) relating to the employment history of its registered persons at a Disciplined Firm as defined in paragraph (b)(2)(J) shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered persons.

(B) The member must establish and implement the supervisory procedures required by this paragraph within 60 days of receiving notice from NASD Regulation or obtaining actual knowledge that it is subject to the provisions of this paragraph.

A member that meets one of the criteria in paragraph (b)(2)(H) for the first time may reduce its staffing levels to fall below the threshold levels within 30 days after receiving notice from NASD Regulation pursuant to the provisions of paragraph (b)(2)(A) or obtaining actual knowledge that it is subject to the provisions of the paragraph, provided the firm promptly notifies the Department of Member Regulation, NASD Regulation, in writing of its becoming subject to the Rule. Once the member has reduced its staffing levels to fall below the threshold levels, it shall not rehire a person terminated to accomplish the staff reduction for a period of 180 days. On or prior to reducing staffing levels pursuant to this paragraph, a member must provide the Department of Member Regulation, NASD Regulation with written notice, identifying the terminated person(s).

(C) The procedures required by this paragraph shall include tape-recording all telephone conversations between the member's registered persons and both existing and potential customers.

(D) The member shall establish reasonable procedures for reviewing the tape recordings made pursuant to the requirements of this paragraph to ensure compliance with applicable securities laws and regulations and applicable rules of the Association. The procedures must be appropriate for the member's business, size, structure, and customers.

(E) All tape recordings made pursuant to the requirements of this paragraph shall be retained for a period of not less than three years from the date the tape was created, the first two years in an easily accessible place. Each member shall catalog the retained tapes by registered person and date.

(F) Such procedures shall be maintained for a period of three years from the date that the member establishes and implements the procedures required by the provisions of this paragraph.

(G) By the 30th day of the month following the end of each calendar quarter, each member firm subject to the requirements of this paragraph shall submit to the Association a report on the member's supervision of the telemarketing activities of its registered persons.

(H) The following members shall be required to adopt special supervisory procedures over the telemarketing activities of their registered persons:

• A firm with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been associated with one or more Disciplined Firms in a registered capacity within the last three years;

• A firm with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been associated with one or more Disciplined Firms in a registered capacity within the last three years;

• A firm with at least twenty registered persons, where 20% or more of its registered persons have been associated with one or more Disciplined Firms in a registered capacity within the last three years.

For purposes of the calculations required in subparagraph (H), firms should not include registered persons who:

(1) have been registered for an aggregate total of 90 days or less with one or more Disciplined Firms within the past three years; and

(2) do not have a disciplinary history.

(I) For purposes of this Rule, the term "registered person" means any person registered with the Association as a representative, principal, or assistant representative pursuant to the Rule 1020, 1030, 1040, and 1110 Series or pursuant to Municipal Securities Rulemaking Board ("MSRB") Rule G-3.

(J) For purposes of this Rule, the term "disciplined firm" means either a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer; or a futures commission merchant or introducing broker that has been formally charged by either the Commodity Futures Trading Commission or a registered futures association with deceptive telemarketing practices or promotional material relating to security futures, those charges have been resolved, and the futures commission merchant or introducing broker has been closed down and permanently barred from the futures industry as a result of those charges; or a futures commission merchant or introducing broker that, in connection with sales practices involving the offer, purchase, or sale of security futures is subject to an order of the Securities and Exchange Commission revoking its registration as a broker or dealer.

(K) For purposes of this Rule, the term "disciplinary history" means a finding of a violation by a registered person in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the provisions (or comparable foreign provision) listed in IM-1011-1 or rules or regulations thereunder.

(L) Pursuant to the Rule 9600 Series, the Association may in exceptional circumstances, taking into consideration all relevant factors, exempt any member unconditionally or on specified terms and conditions from the requirements of this paragraph upon a satisfactory showing that the member's supervisory procedures ensure compliance with applicable securities laws and regulations and applicable rules of the Association.

(3) The member's written supervisory procedures shall set forth the supervisory system established by the member pursuant to paragraph (a) above, and shall include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the Rules of this Association. The member shall maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective. Such record shall be preserved by the member for a period of not less than three years, the first two years in an easily accessible place.

(4) A copy of a member's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the member. Each member shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws and regulations, including the Rules of this Association, and as changes occur in its supervisory system, and each member shall be responsible for communicating amendments through its organization.

(c) Internal Inspections

Each member shall conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations, and with the Rules of this Association. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses and at least an annual inspection of each office of supervisory jurisdiction. Each branch office of the member shall be inspected according to a cycle which shall be set forth in the firm's written supervisory and inspection procedures. In establishing such cycle, the firm shall give consideration to the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location. Each member shall retain a written record of the dates upon which each review and inspection is conducted.

(d) Review of Transactions and Correspondence

(1) Supervision of Registered Representatives

Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and for the review by a registered principal of incoming and outgoing written and electronic correspondence of its registered representatives with the public relating to the investment banking or securities business of such member. Such procedures should be in writing and be designed to reasonably supervise each registered representative. Evidence that these supervisory procedures have been implemented and carried out must be maintained and made available to the Association upon request.

(2) Review of Correspondence

Each member shall develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing written (i.e., non-electronic) and electronic correspondence with the public relating to its investment banking or securities business, including procedures to review incoming, written correspondence directed to registered representatives and related to the member's investment banking or securities business to properly identify and handle customer complaints and to ensure that customer funds and securities are handled in accordance with firm procedures. Where such procedures for the review of correspondence do not require review of all correspondence prior to use or distribution, they must include provision for the education and training of associated persons as to the firm's procedures governing correspondence, documentation of such education and training, and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

(3) Retention of Correspondence

Each member shall retain correspondence of registered representatives relating to its investment banking or securities business in accordance with Rule 3110. The names of the persons who prepared outgoing correspondence and who reviewed the correspondence shall be ascertainable from the retained records and the retained records shall be readily available to the Association, upon request.

(e) Qualifications Investigated

Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association. Where an applicant for registration has previously been registered with the Association, the member shall review a copy of the Uniform Termination Notice of Securities Industry Registration (Form U-5) filed with the Association by such person's most recent previous NASD member employer, together with any amendments thereto that may have been filed pursuant to Article V, Section 3 of the Association's By-Laws. The member shall review the Form U-5 as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. In conducting its review of the Form U-5 and any amendments thereto, a member shall take such action as may be deemed appropriate.

Where an applicant for registration has been previously registered with a registered futures association ("RFA") member that is or has been registered as a broker/dealer pursuant to Section 15(b)(11) of the Act ("notice-registered broker/dealer") with the SEC to trade security futures, the member shall review a copy of the Notice of Termination of Associated Person (Form 8-T) filed with the RFA by such person's most recent previous RFA member employer, together with any amendments thereto. The member shall review the Form 8-T as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. In conducting its review of a Form 8-T and any amendments, a member shall take such action as may be deemed appropriate.

(f) Applicant's Responsibility

Any applicant for registration who receives a request for a copy of his or her Form U-5 from a member pursuant to this Rule shall provide such copy to the member within two (2) business days of the request if the Form U-5 has been provided to such person by his or her former employer. If a former employer has failed to provide the Form U-5 to the applicant for registration, such person shall promptly request the Form U-5, and shall provide it to the requesting member within two (2) business days of receipt thereof. The applicant shall promptly provide any subsequent amendments to a Form U-5 he or she receives to the requesting member.

(g) Definitions

(1) "Office of Supervisory Jurisdiction" means any office of a member at which any one or more of the following functions take place:

(A) order execution and/or market making;

(B) structuring of public offerings or private placements;

(C) maintaining custody of customers' funds and/or securities;

(D) final acceptance (approval) of new accounts on behalf of the member;

(E) review and endorsement of customer orders, pursuant to paragraph (d) above;

(F) final approval of advertising or sales literature for use by persons associated with the member, pursuant to Rule 2210(b)(1); or

(G) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

(2) "Branch Office" means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding:

(A) any location identified in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised;

(B) any location referred to in a member advertisement, as this term is defined in Rule 2210, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised; or

(C) any location identified by address in a member's sales literature, as this term is defined in Rule 2210, provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised.

(D) any location where a person conducts business on behalf of the member occasionally and exclusively by appointment for the convenience of customers, so long as each customer is provided with the address and telephone number of the branch office or OSJ of the firm from which the person conducting business at the non-branch location is directly supervised.

(3) A member may substitute a central office address and telephone number for the supervisory branch office or OSJ locations referred to in paragraph (g)(2) above provided it can demonstrate to the Association's District Office having jurisdiction over the member that it has in place a significant and geographically dispersed supervisory system appropriate to its business and that any investor complaint received at the central site is provided to and resolved in conjunction with the office or offices with responsibility over the non-branch business location involved in the complaint.

[Amended eff. June 12, 1989: Apr. 30, 1992; amended by SR-NASD-97-41 eff. Sept. 4, 1997; amended by SR-NASD-97-24 eff. Feb. 15, 1998; amended by SR-NASD-98-10 postponed eff. date; amended by SR-NASD-98-31 eff. Apr. 7, 1998, postponed eff. date of provision in Notice to Members 98-11; amended by SR-NASD-98-45 postponed eff. date of provision in Notice to Members 98-11; amended by SR-NASD-97-69 eff. Aug. 17, 1998; amended by SR-NASD-98-86 eff. Nov. 19, 1998; amended by SR-NASD-98-52 eff. March 15, 1999; amended by SR-NASD-99-28 eff. Aug. 16, 1999; amended by SR-NASD-2002-04 eff. Oct. 14, 2002; amended by SR-NASD-2002-40 eff. Oct. 15, 2002.]

Selected Notices to Members: 86-65, 88-84, 89-34, 89-57, 92-18, 96-33, 96-59, 96-82, 98-11, 98-52, 99-03.

NYSE Rule 407. Transactions—Employees of Members, Member Organizations and the Exchange

(a) No member or member organization shall, without the prior written consent of the employer, open a securities or commodities account or execute any transaction in which a member or employee associated with another member or member organization is directly or indirectly interested.

In connection with accounts or transactions of members and employees associated with another member or member organization, duplicate confirmations and account statements shall be sent promptly to the employer.

(b) No member (associated with a member or member organization) or employee associated with a member or member organization shall establish or maintain any securities or commodities account or enter into any securities transaction with respect to which such person has any financial interest or the power, directly or indirectly, to make investment decisions, at another member or member organization, or a domestic or foreign non-member broker-dealer, investment adviser, bank, other financial institution, or otherwise without the prior written consent of another person designated by the member or member organization under Rule 342(b)(1) to sign such consents and review such accounts.

Persons having accounts or transactions referred to above shall arrange for duplicate confirmations and statements (or their equivalents) relating to the foregoing to be sent to another person designated by the member or member organization under Rule 342(b)(1) to review such accounts and transactions. All such accounts and transactions periodically shall be reviewed by the member or member organization employer (see also Rule 342.21).

(a) Requirements

Each member shall make and preserve books, accounts, records, memoranda, and respondence in conformity with all applicable laws, rules, regulations, and statements of cy promulgated thereunder and with the Rules of this Association and as prescribed by Rule 17a-3. The record keeping format, medium, and retention period shall comply with Rule 17a-4.

(b) Marking of Customer Order Tickets

(1) A person associated with a member shall indicate on the memorandum for the sale of any security whether the order is "long" or "short," except that this requirement shall not apply to transactions in debt securities. An order may be marked "long" if (A) the customer's account is long the security involved or (B) the customer owns the security and agrees to deliver the security as soon as possible without undue inconvenience or expense.

(2) A person associated with a member shall indicate on the memorandum for each transaction in a non-Nasdaq security, as that term is defined in the Rule 6700 Series, the name of each dealer contacted and the quotations received to determine the best inter-dealer market; however, the requirements of this subparagraph shall not apply if two or more priced quotations for the security are displayed in an inter-dealer quotation system, as defined in Rule 2320(g), that permits quotation updates on a real-time basis for which NASD Regulation has access to historical quotation information.

(c) Customer Account Information

Each member shall maintain accounts opened after January 1, 1991 as follows:

(1) for each account, each member shall maintain the following information:

(A) customer's name and residence;

(B) whether customer is of legal age;

(C) signature of the registered representative introducing the account and signature of the member or partner, officer, or manager who accepts the account; and

(D) if the customer is a corporation, partnership, or other legal entity, the names of any persons authorized to transact business on behalf of the entity;

(2) for each account, other than an institutional account, and accounts in which investments are limited to transactions in open-end investment company shares that are not recommended by the member or its associated persons, each member shall also make reasonable efforts to obtain, prior to the settlement of the initial transaction in the account, the following information to the extent it is applicable to the account:

(A) customer's tax identification or Social Security number;

(B) occupation of customer and name and address of employer; and

(C) whether customer is an associated person of another member; and

(3) for discretionary accounts, in addition to compliance with subparagraphs (1) and (2) above, and Rule 2510(b) of these Rules, the member shall:

(A) obtain the signature of each person authorized to exercise discretion in the account;

(B) record the date such discretion is granted; and

(C) in connection with exempted securities other than municipals, record the age or approximate age of the customer.

(4) For purposes of this Rule and Rule 2310 the term "institutional account" shall mean the account of:

(A) a bank, savings and loan association, insurance company, or registered investment company;

(B) an investment adviser registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like functions); or

(C) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

* * *

2310. Recommendations to Customers (Suitability)

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(1) the customer's financial status;

(2) the customer's tax status;

(3) the customer's investment objectives; and

(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

(c) For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

[Amended May 2, 1990 eff. for accounts opened and recommendations made after Jan. 1, 1991; amended by SR-NASD-95-39 eff. Aug. 20, 1996.]

Selected Notices to Members: 96-60.