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69625-4-I

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.

AMENDED BRIEF OF APPELLANTS

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I. ASSIGNMENTS OF ERROR

1. The trial court erred in failing to grant Appellants' Motion for Partial Summary Judgment, and rule that:

a. Under the securities industry's standard of due care, Respondent SagePoint Financial Services, f/k/a as AIG Financial Advisors, Inc. (referred to herein as "AIG"), owed Appellants a duty to supervise defendant Mark Garrison's activities in Appellants' brokerage accounts held at Wells Fargo Investments, LLC.

b. Respondent AIG was liable in *respondeat superior* for Mark Garrison's conduct as branch office manager of the AIG branch office in which he worked at the time of the events at issue here.

c. For purposes of RCW 21.20.430, Respondent AIG was a "control person" of Mark Garrison.

2. The trial court erred in granting AIG's Motion for Summary Judgment dismissing all of Appellants' claims.

3. The trial court erred in denying Appellants' Motion for Reconsideration of the court's summary judgment rulings, and failing to grant Appellants' Motion for Summary Judgment.

II. ISSUES PERTAINING TO ASSIGNMENTS OF ERROR

1. *Adequate supervisory system.* Did the undisputed evidence show that the securities industry's standard of care imposed on AIG a duty to Appellants to establish and maintain a system to supervise Mark's

activities that was reasonably designed to achieve compliance with applicable securities laws, rules and regulations?

1(a). If “no,” did AIG meet its burden of proving that no disputed issues of material fact existed on the question of whether it had a duty to Appellants to establish and maintain such a supervisory system?

2. *Duty to supervise.* Did the securities industry’s standard of care impose on AIG a duty to Appellants to supervise the activities of its stockbroker, Mark Garrison (“Mark”), when he acted as investment advisor for their Wells Fargo brokerage accounts, for compensation, and participated in effecting securities transactions in those accounts?

2(a). In light of the evidence before the trial court, could reasonable minds differ on whether AIG owed Appellants a duty to supervise Mark’s activities in their Wells Fargo Investments accounts?

2(b). If “yes,” did AIG show that no disputed issues of material fact existed on the question of whether it owed Appellants a duty?

2(c). If AIG proved NASD Conduct Rules 3040 and 3050 (full text in Appendix B) did not expressly impose on AIG a duty to supervise Mark’s conduct (which Appellants deny), did that meet AIG’s burden of proving, as a matter of law, that no duty to supervise could exist?

3. *Red flags.* Did undisputed facts show that AIG had notice of, or in the exercise of reasonable care should have known of, “red flags” indicating that Mark might be violating securities statutes, rules and regulations, or AIG’s own rules?

3(a). If “no,” did AIG meet its burden of proving as a matter of law that it did not know of, and in the exercise of reasonable care could not have known of, such red flags?

3(b). In light of the undisputed facts, could reasonable minds differ whether, upon becoming aware of such “red flags,” AIG had a duty to Appellants to follow up on and reasonably investigate those red flags?

3(c). If “yes,” did AIG meet its burden of showing, as a matter of law, that upon becoming aware of such red flags, it had no duty to Appellants to take any action?

4. *Statutory control person liability.* Did undisputed facts show that AIG was a control person of Mark under RCW 21.20.430?

4(a). If “no,” did AIG meet its burden of proving that no disputed issues of material fact existed on the question of whether it was a control person under that statute?

5. *Respondeat superior.* Did undisputed facts establish that AIG is liable in *respondeat superior* for Mark ’s conduct as AIG’s manager of the branch office in which he worked?

5(a). If “no,” did AIG meet its burden of proving that no disputed issues of material fact existed on the question of *respondeat superior* liability, precluding the trial court from dismissing Appellants’ claim on summary judgment?

6. Did the trial court abuse its discretion in denying Appellants’ Motion for Reconsideration despite newly-discovered

evidence, and serious discovery violations by AIG in withholding key documents from Appellants prior to the summary judgment rulings?

III. INTRODUCTION AND STATEMENT OF THE CASE

Mark Garrison¹ was a licensed stockbroker with AIG Financial Advisors, Inc. Mark was also a licensed investment advisor, employed as an investment advisor not by AIG, but (with AIG's express permission) by a registered investment advisor firm, Acumen Financial Group, Inc.

Mark was trustee of Appellant trusts and manager of Appellant Garrison Family LLC. The trusts and LLC owned brokerage accounts at Wells Fargo Investments, LLC ("Wells Fargo"), holding about \$26 million.² As long as he was an AIG stockbroker, Mark could not engage in any securities transactions in Appellants' Wells Fargo accounts without AIG's approval and express written permission. AIG approved, and gave Mark, that written permission. *See infra*, at pp. 11-12. Mark then hired himself and Acumen Financial Group to provide investment advisory services for Appellants. As IA, Mark engaged in wildly speculative securities purchases and sales in Appellants' Wells Fargo brokerage accounts. Between January 2007 and April 2009, he lost through unsuitable trading (or diverted to himself) Appellants' entire \$26 million.

¹ To distinguish him from Appellant Jack Garrison, Mark Garrison will be generally be referred to herein simply as "Mark." No disrespect is intended.

² Wells Fargo Investments is to be distinguished between Wells Fargo Bank.

AIG received, and AIG supervisors testified they reviewed all of the transactions shown on, duplicate copies of the monthly statements for Appellants' Wells Fargo brokerage accounts. AIG made no inquiry of Mark about, and took no action to investigate, any of Mark's transactions in Appellants' accounts. *Infra*, at p. 15. Appellants brought the underlying action against Mark and AIG³ alleging that AIG is liable to Appellants:

- for negligently failing to meet the securities industry's standard of care in supervising Mark;
- in *respondeat superior* for Mark's losses; and
- under RCW 21.20.430, as a "control person" of Mark.

Complaint, at CP 1-43. Both parties moved for summary judgment on the issue of whether, for purposes of Appellants' negligence claim, AIG owed Appellants a duty to supervise Mark's activities in their Wells Fargo brokerage accounts.⁴ Appellants also sought rulings that:

1. AIG was a control person of Mark for purposes of RCW 21.20.430. CP 96-123.
2. AIG was liable in *respondeat superior* for Mark's conduct as branch office manager of the branch office in which he worked.

AIG moved for summary judgment dismissing all of Appellants' claims. CP 213-217. Six weeks after oral argument the trial court entered

³ Bound by a mandatory arbitration clause, Appellants pursued a claim against Wells Fargo Investments in a FINRA arbitration proceeding. Second Declaration of Jason T. Dennett in Support of Plaintiffs' Opposition to SagePoint Financial, Inc.'s Motion for Summary Judgment ("Dennett 2nd Decl."), ¶ 9, CP 338. The arbitration panel in March 2012 denied Appellants' claims against Wells Fargo. *Ibid*.

⁴ No one moved for summary judgment against Mark and he is not involved in this appeal. Trial on Appellants' claims against Mark have been stayed pending this appeal. While the cross motions for summary judgment were pending, AIG moved for summary judgment on causation, which was not ruled on and is not at issue here.

AIG's proposed Order granting its motion. Although only Appellants' negligent supervision claim had a "duty" element, the sole ground articulated for the court's decision dismissing all of Appellants' claims was "the Court has concluded that SagePoint owed no duty to Plaintiffs and thus has no liability to the Plaintiffs."⁵

Discovery violation and motion for reconsideration. Four weeks after oral argument on the summary judgment motions, Appellants discovered that AIG had withheld critical documents in discovery: AIG's Supervisory Manual, which contained provisions that directly contradict AIG's "no duty" argument. CP 586-588. *Infra*, at pp. 32-35. Appellants moved for reconsideration, and sanctions for discovery violations based on the withheld evidence. CP 487-503. The trial court denied the motion for reconsideration without requiring a response from AIG, and declined to consider Appellants' motion on the discovery violations because it had not been set forth in a separate document ("Any discovery violations need to be stated in separate motion"). CP 612-613.

On the parties' joint motion (CP 614-622, 641-642) the trial court entered a final judgment (CP 643-645, 646-652) and this appeal followed.

⁵ Order Granting Sagepoint Financial, Inc.'s Motion for Entry of Final Judgment, CP 643-645; *see* Sagepoint Financial, Inc.'s CR 54(B) Motion for Entry of Judgment, CP 614-622; Declaration of Connie Sue Martin in Support of SagePoint Financial Inc.'s CR 54(B) Motion, etc., CP 623-640; *cf.* Order Granting Defendant SagePoint's Motion for Summary Judgment, CP 484-486.

This case raises an issue of first impression in Washington on a unique and somewhat complex issue—the proper construction of securities industry rules and regulations, and the standard of care required of brokerage firms like AIG in supervising their stockbrokers’ *investment advisory* activities away from their brokerage firm. There is little case law on point because brokerage firms universally require customers to sign a mandatory arbitration clause, requiring nearly all disputes between investors and brokerage firms to be resolved by arbitration (*see Ives v. Ramsden*, 142 Wn. App. 369, 395 fn. 10, 174 P.3d 1231 (2008)), so this court’s ruling is likely to become nationally important precedent.

IV. STATEMENT OF FACTS

Appellant Jack Garrison started a shipping company which he sold in the 1960s, leaving him and his wife, Charlotte, wealthy. Jack and Charlotte put all of their assets into the Jack M. Garrison and Charlotte L. Garrison Revocable Trust (“Revocable Trust”)⁶ and Garrison Family LLC (“Family LLC”). The Revocable Trust and Family LLC held those assets—about \$26,000,000—in brokerage accounts at the Seattle branch of non-party Wells Fargo. CP 127-129, Dennett 1st Decl. ¶¶ 12, 14 and 17. Jack and Charlotte were the trustees of the Trust and managers of the LLC.

⁶ During the time period at issue, assets from the Revocable Trust were used to fund several much smaller subtrusts, which were handled by Mark and by AIG in the same manner as the Revocable Trust, and which are also Appellants on this appeal.

Charlotte died in August 2006, and Jack was diagnosed with dementia in September 2006. Jack resigned as trustee of the Revocable Trust and Manager of the Family LLC on September 11, 2006, and appointed his grandson, defendant Mark Garrison, to each of those positions. CP 127, Declaration of Jason T. Dennett in Support of Plaintiffs' Motion for Partial Summary Judgment ("Dennett 1st Decl."), ¶¶ 12, 13. Mark had no personal financial or ownership interest in the Revocable Trust or Family LLC.⁷ The Revocable Trust owned all of the LLC's ownership units, and Appellants will most often be referred to simply as the trusts, below. Mark held bare legal title to trust assets solely for the benefit of Jack Garrison.⁸ Dennett 3rd Decl., ¶¶ 2, 3 and Ex. 1. Only Jack was a beneficiary of the Revocable Trust until his death. Upon his death, Mark and his sister would be remainder beneficiaries, but the trust was revocable and Jack could have changed that at any time. *Ibid.*

Mark was an AIG stockbroker. Stockbrokers are referred to in the industry and in the rules and regulations as "registered representatives." In the interest of readability the more colloquial term "stockbroker," or

⁷ AIG misstated to the trial court that Appellants and Wells Fargo said Mark had a *financial* interest in the accounts. SagePoint Financial, Inc.'s Motion for Summary Judgment, CP 213-237 ("SagePoint's Motion"), at CP 216; Defendant Sagepoint Financial, Inc.'s Reply Brief in Support of its Motion for Summary Judgment, CP 434-439 ("SagePoint's Reply"), at CP 433; AIG's Expert assumed that "Mark . . . and his sister. . . were the beneficiaries" of the Wells Fargo accounts. Declaration of David E. Paulukaitis ("Paulukaitis 1st Decl."), ¶ 21, CP 222. This was untrue. Appellants alleged, and Wells Fargo stated, that Mark had an *interest* in the accounts—not *financial* interest.

⁸ Mark and his sister *were* income beneficiaries of two subtrusts for their benefit, funded in January 2008, that contained a tiny portion of the total, in the order of \$70,000. CP 406, Third Declaration of Jason T. Dennett, CP 405-433 ("Dennett 3rd Decl."), at ¶4.

sometimes simply “broker,” is generally used below. In order to be a stockbroker one must be registered with a securities brokerage firm (“broker-dealer”), with the responsibility to supervise its broker’s securities transactions. Mark was also a licensed investment advisor representative (“IA,” “IAR,” or “investment advisor”) employed by Acumen Financial Group, a Registered Investment Advisor which he co-owned. *Dennett 1st Decl.* at ¶4, 6, 7, CP 125. (Commonly a firm rather than an individual registers as a Registered Investment Advisor, and licensed investment advisors are employed by the RIA as IARs.) Mark and two other AIG brokers operated their brokerage business out of the Acumen office, located in Bloomington, Minnesota, making it also an AIG branch office (the “Bloomington Branch”).

The distinction between stockbrokers and investment advisors is not generally understood. Stockbrokers are licensed to execute orders to buy and sell securities. They are not licensed to give investment advice for a fee. To give investment advice for a fee, one must be licensed by a state, and either be a Registered Investment Advisor (“RIA”) registered with the SEC (if client assets exceed \$25 million) or a state (if client assets under \$25 million) as a RIA, or be employed by an RIA as an investment advisor representative. All three AIG stockbrokers in the Bloomington office were employed by Acumen as investment advisors at the same time as they were AIG stockbrokers. *Ibid.*

Broker dealers can employ dually licensed stockbrokers/IAs solely as a stockbroker, while allowing them to be employed by a different firm as an investment advisor. That was the case here: AIG permitted Mark to be employed by Acumen as an investment advisor.

As has become the dominant practice in the industry,⁹ AIG uses a decentralized “independent contractor” business model, generally registering stockbrokers with it as independent contractors rather than employees. Its stockbrokers operate under their own business name out of small offices, brokering securities trades “through” AIG. A large proportion of the brokerage industry now operates with independent contractors, rather than statutory employees of their brokerage firms.

The individual offices out of which AIG’s independent contractor brokers work constitute AIG branch offices, which AIG is required to supervise.¹⁰ (For purposes of a broker-dealer’s duty to supervise its brokers, there is no distinction between an employee stockbroker and an independent contractor stockbroker. *See* pp. 54-55 *infra*.) Under NASD Rule 3010(a)(4), broker-dealers must establish clear lines of supervisory responsibility, and designate in writing:

- A specific individual to oversee and supervise each branch office; AIG designated Michelle Nielsen to supervise Mark’s

⁹ *See e.g.*, NASD Notice to Members 86-65, “Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel,” copy at Appendix A.

¹⁰ CP 405-422, Dennett 3rd Decl, Ex. 1, AIG memorandum to Mark Garrison “Re: 2007 OSJ Compliance Examination Report”, at p. 2.

office. CP 192-195, Declaration of Michelle R. Nielsen (“Nielsen 1st Decl.”), ¶ 2.

- A specific person *within* each branch office “with authority to carry out the supervisory responsibilities” assigned to that office; AIG appointed Mark the Bloomington branch office manager. CP 126, Dennett 1st Decl., ¶ 8, and Ex. 1.
- A specific person to supervise each individual AIG broker, “who shall be responsible for supervising that person’s activities.” NASD Rule 3010(a)(5). Ms. Nielsen was Mark’s specific supervisor. CP 192-195, Nielsen 1st Decl., ¶ 2.

A. AIG approval for Mark to conduct securities transactions in Appellants’ Wells Fargo accounts.

NASD Rules require stockbrokers to give notice to their firm before opening a personal account at another broker-dealer [NASD Rule 3050(c), discussed at pp. 23-24 *infra*], or placing orders to buy or sell securities on anyone’s behalf at another firm [NASD Rule 3040 (b), discussed at pp. 22-23 *infra*]. Rule 3050 also requires the firm at which the broker seeks to open the account (“the executing member”) to give notice to the broker’s employer firm. On October 6, 2006, Wells Fargo wrote to AIG at the Bloomington branch, advising that Mark had “requested to be appointed trustee, owner and manager” on accounts held at Wells Fargo, asking AIG’s approval, and stating that Wells Fargo would send AIG duplicate statements and confirmation slips. CP 129; Dennett 1st Decl., ¶18, Ex 4.

Mark’s office forwarded Wells Fargo’s letter to AIG’s Compliance Department with a cover letter explaining that these were “accounts held

in a trust for Mark's grandparents.” CP 337; 340-344, Dennett 2nd Decl., ¶ 3 and Ex. 1. On October 24, 2006 Mark’s assistant followed up with an e-mail to “Erin” in “Compliance,” attaching copies of the first page of a Wells Fargo monthly statement for each of Appellants’ accounts, repeating that Mark was the “trustee/owner/manager” of those accounts *on behalf of his grandfather. Ibid.*

On November 22, 2006 AIG approved Mark acting as “trustee/owner/manager” for Appellants’ Wells Fargo accounts, noting, the “firm will ensure that duplicate confirms and statements are being received by the FLS [First Line Supervisor] *for supervision purposes.*” (Emphasis added.) CP 129-130; 161-162, Dennett 1st Decl., ¶ 21 and Ex. 7.

B. Mark hired Acumen to act as investment advisor for Appellants and informed AIG that he was doing so.

Mark then provided investment advisory services for Appellants’ accounts, for which he was compensated. CP 125, Dennett 1st Decl. ¶ 6, CP 591-594 (Mark Garrison Dep. 161:14-164:23). In 2008, Mark spent about half of his work hours providing Appellants investment advice, and received half to a third of his income from those services. *Ibid.* Mark testified that if he hadn’t hired Acumen to provide investment advice, he would have hired another investment advisor firm to do so. *Ibid.* Mark held himself out to Wells Fargo as an IA providing professional services to Appellants. *Ibid.*

Stockbrokers are required to give their firm notice before engaging in outside business activities for compensation, or engaging in any securities transactions outside of their own firm. AIG's primary method for confirming that it received notice of its stockbrokers' outside business activities was an Outside Business Activity Questionnaire ("OBAQ"), which its brokers had to complete annually. CP 186-187; Dennett 1st Decl. Ex. 6; CP 595-597; 603-604 (Garrison Dep. 174:11-176:1 and Ex. 101); CP 190-191, Dennett 1st Decl. Ex. 7 (AIG Manual Section 1.2.1 re outside business). Mark reported in his 2007 Outside Business Activity Questionnaire that he was acting as investment advisor for Appellants, and receiving fees for that work. CP 186-187, Dennett 1st Decl. Ex. 6, CP 595-601, 604 (Garrison Deposition 178:24-181:13 and Ex. 101).

Michelle Nielsen reviewed Mark's 2007 Outside Business Activity Questionnaire for the first and only time on February 27, 2008. Declaration of Jason T. Dennett in Support of Motion to Reconsider ("Dennett 4th Decl.") Ex. 2 (Nielsen Deposition 34:1-34:15; 82:6-86:7; 133:16-135:9), CP 528-529; 533-537; 538-540. Ms. Nielsen acknowledged in her deposition that Mark's 2007 OBAQ did disclose that he was providing investment advisory services to the Appellants. *Id.*

C. Mark's violations of securities rules, regulations, and AIG's policies and procedures, in Appellants' Wells Fargo accounts.

Mark radically changed how Appellants' Wells Fargo brokerage accounts were invested (CP 128, Dennett 1st Decl., at ¶ 15), until by early

2008 they were invested 100% in extraordinarily risky, speculative, highly leveraged holdings. By the end of February 2008 Mark had borrowed \$17 million (nearly 100% of the accounts' value) on margin in Appellants' Wells Fargo accounts in order to buy more securities, which increases risk by leveraging the investor's gains and losses. CP 128. Mark soon after began to frenetically day trade in multimillion dollar lots of highly speculative securities. He maintained near 100% margin levels in Appellants' accounts continuously during 2008, and traded over \$1.1 billion in securities in their accounts that year. *Ibid.* The wild trading ended only at the end of 2008, when all of the money in Appellants' Wells Fargo accounts had been lost. *Ibid.*

During the same time, between January-September 2008, Mark transferred more than \$9.6 million out of Appellants' Wells Fargo accounts into his and his wife's personal brokerage accounts, first at AIG and then at Ameritrade. He appears to have lost that money with the same reckless trading as in Appellants' accounts. *Ibid.* at ¶ 17.

By the end of 2008, Mark was paid \$320,000 in trustee fees and \$580,000 in investment advisor fees from Appellants' accounts. Appellants' paid over \$1.4 million in commissions and margin interest due to Mark's trading. *Ibid.* By the Fall of 2008, Appellants' \$26 million was almost completely gone, leaving Jack Garrison with insufficient funds to cover his living expenses. He had to take out a reverse mortgage in order

to meet his immediate living expenses, until he was able to sell his house in 2011. CP 128-129, Dennett 1st Decl. at ¶ 17.

D. AIG's receipt and review of confirmation slips and monthly brokerage statements.

Wells Fargo sent AIG duplicate copies the monthly statements for each of Appellants' Wells Fargo accounts, and trading confirmation slips for every trade in those accounts. Declaration of Leslie N. Ayers (CP 245-247) ("Ayers' Decl."), ¶ 5. At the same time, AIG supervisors also received, and reviewed, the monthly brokerage account statements for Mark and his wife's *personal* brokerage accounts. *Ibid*, ¶¶ 5, 6. AIG supervisors actually reviewed all of those monthly statements and confirmation slips. *Ibid*, ¶ 6. Simply looking at those monthly statements would have made clear that millions of dollars was disappearing from Appellants' Wells Fargo accounts, and simultaneously appearing in Mark and his wife's personal accounts; that Mark had borrowed huge sums on margin in Appellants' accounts; that Mark was experiencing huge swings, and losses, in all of the accounts; and that the volume of Mark's trading was wildly unsuitable for fiduciary accounts.

V. AUTHORITY AND ARGUMENT

A. AIG Had a Duty to Supervise Mark Garrison's Transactions in Appellants' Wells Fargo Brokerage Accounts.

A negligent supervision claim has the same elements as any negligence claim—breach, duty, causation and damages. To avoid

confusion, it is critical to keep in mind that breach, causation, and damages are not at issue here. Appellants sought a ruling only on the issue of duty, and AIG moved to dismiss Appellants' negligence claim only on the ground that AIG owed them no duty.¹¹

A duty to supervise, supporting a cause of action for negligent supervision, can arise when:

- a special relationship exists between the defendant and the victim, in which the victim has entrusted his care to the other or has a right to be protected by the other (e.g., school district/pupil, innkeeper/guest, common carrier/passengers);
- the defendant acts or fails to act while knowing that doing so involves an unreasonable risk of harm to the plaintiff via the conduct of the tortfeasor; or
- a special relationship exists between the defendant and the tortfeasor, in which the defendant has supervisory responsibilities for, or control over, the tortfeasor.

Funkhouser v. Wilson, 89 Wn.App. 644, 950 P.2d 501 (1998), *aff'd in part and remanded sub nom. C.J.C. v. Corp. of Catholic Bishop of Yakima*, 138 Wn.2d 699, 985 P.2d 262 (1999); *Niece v. Elmview Group Home*, 131 Wn.2d 39, 929 P.2d 420 (1997); *Hutchins v. 1001 Fourth Ave. Associates*, 116 Wn.2d 217, 227-230, 802 P.2d 1360 (1991); *Petersen v. State*, 100

¹¹ SagePoint's Motion, at 220-227; SagePoint's Reply, CP 434-435.

Wn.2d 421, 426, 671 P.2d 230 (1983); *Youngblood v. Schireman*, 53

Wn.App. 95, 99-100, 765 P.2d 1312 (1988).

1. AIG had a duty to supervise Mark because their relationship had a “direct supervisory component” or provided some sort of legal authority for AIG to control his conduct. The issue of duty here turns on the third set of circumstances giving rise to a duty to supervise: AIG’s relationship with Mark, as the broker-dealer with which he was registered. The court in *Funkhouser* elaborated, in connection with a first party/tortfeasor relationship:

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. (Emphasis added.)

Accord, Webstad v. Stortini, 83 Wn. App. 857, 869 (1996):

A “special relationship” duty arises when the relationship has a *direct supervisory component*, but does not always require . . . a custodial relationship. See *Taggart v. State*, 118 Wash.2d 195, 219, 223, 822 P.2d 243 (1992) (supervisory relationship may arise when parole officers have taken charge of parolees they supervise, without custodial relationship). (Emphasis added.)

Hutchins, supra, at 229, identifies several relationships giving rise to a duty to supervise based on a supervisory/control relationship:

This concept that one may have a duty to control the actions of another (as opposed to a victim placed in the care of defendant) is described as also including, among others, the relationships between employer and employee, tavern keeper and intoxicated guest, physician and assistants, hospital and unqualified physician, and parents and children. [Citations.]

The “established and continuing relationship” element is not at issue here: Mark registered as a stockbroker with AIG in 1999, and remained an AIG broker until 2009. Declaration of Gregory M. Curley, CP 238-224, Ex. 1.

Neither can reasonable minds differ on whether the securities industry’s standard of care imposed a duty on AIG to supervise the kind of activities Mark engaged in in Appellants’ Wells Fargo accounts: securities statutes, rules and regulations giving rise to a duty for AIG to control Mark are far more explicit and comprehensive than other statutes courts commonly rely on to find such a duty. E.g., in *Taggart v. State, supra*, the Court of Appeals determined that RCW 72.04A.080 was “sufficient to establish that parole officers have the requisite ‘definite, established and continuing relationship’” to give rise to a duty to control them, where that statute simply provided:

Each inmate hereafter released on parole shall be subject to the supervision of the department of corrections, and the probation and parole officers of the department shall be charged with the preparation of progress reports of parolees and to give guidance and supervision to such parolees. . .

And unlike in a typical negligent supervision case where duty is disputed, the court here need not rely by analogy on the nature of the relationships between the parties discussed in other cases, or dig to find evidence of a direct supervisory component. Securities industry rules and regulations, and AIG’s internal compliance and supervisory manuals, set forth in great detail AIG’s duty to supervise its stockbrokers, including the specific activity by Mark at issue here.

The securities industry’s supervisory system is unique. It requires that brokerage firms supervise a much broader range of conduct by their stockbrokers than is ordinarily expected of an employer. The Exchange Act of 1934 created a “comprehensive system of federal regulation of the securities industry,” *Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp.2d 1097, 1101-02 *amended*, 260 F. Supp.2d 979 (N.D. Cal. 2003), based on “supervised self-regulation,” by delegating government power to self-regulatory organizations (“SROs”)—the national securities exchanges—to supervise brokerage firms and stockbrokers. *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119, 1128 (9th Cir.2005). Congress reiterated in 1988¹² that “effective supervision of securities firms of their employees and agents is a foundation of the federal regulatory scheme of investor protection.” H.R. Rep. 100–910, at *17 (1988), quoted in *Bloemendaal v. Morgan Stanley Smith Barney PLLC*, 2011 WL 2161352 (C.D. Cal. 2011).

The Exchange Act requires securities industry SROs to have rules designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest.

15 U.S.C.A. § 78f(b). The two primary securities industry SROs were the National Association of Securities Dealers (“NASD”) and the enforcement

¹² When amending the Exchange Act with the Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78o.

arm of the New York Stock Exchange.¹³ Pursuant to Congress' mandate, the NASD adopted Rule 3010, requiring broker dealers to:

establish, maintain, and enforce written procedures to supervise . . . the activities of registered representatives. . . that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of this Association.¹⁴

All brokerage firms are required, as a condition of doing business, to be members of NASD/FINRA and comply with their rules and regulations.¹⁵

Appellants do not contend they were customers of AIG, or that AIG had a duty to supervise Mark's conduct as a *stockbroker* in their accounts. Mark was not the stockbroker for their accounts. Wells Fargo brokers handled all of the brokerage functions for Appellants' accounts.

However, when a broker-dealer permits one of its brokers to be employed by a different firm as an investment advisor¹⁶, the broker-dealer may be required by *securities industry* rules and standards to supervise the stockbrokers' *investment advisory* activities in accounts held at a different brokerage firm under certain circumstances. Discussed *infra*, at pp. 28-38.

¹³ Those two SROs merged in 2007 to form the Financial Industry Regulatory Authority ("FINRA"). The NASD and NYSE each had their own sets of rules. FINRA has undertaken to consolidate the NASD's rules and NYSE's rules into a single rulebook, but NASD and NYSE rules were controlling at the time of all events at issue here.

¹⁴ NASD Rule 3010 prescribes in some detail broker dealers' supervisory obligations; *see also* NTM 99-45, "NASD Provides Guidance On Supervisory Responsibilities" (June 1999); SEC Staff Legal Bulletin No. 17, "Remote Office Supervision" (March 19, 2004).

¹⁵ *Dennett 1st Decl.* ¶1, CP 124-191; *As You Sow v. AIG*, 584 F. Supp. 2d 1034, 1048-1049 (M.D. Tenn, 2008).

¹⁶ AIG had its own RIA affiliate, with which Mark was not associated.

As Appellants argued below¹⁷, that was the case here. Mark served as both (1) the investment advisor for a fee in Appellants' Wells Fargo accounts, and (2) as a fiduciary with discretionary control over these accounts as trustee and LLC manager. Mark acted as a licensed investment advisor for Appellants' Wells Fargo accounts, spending about half his time on such work during 2008, from which he derived a third to a half of his total revenue. Dennett 1st Decl. ¶¶ 6-7, 23-24, 29-31, CP 125-131; Dennett 4th Decl., Ex. 6, CP 504-611 (excerpts of Mark's deposition). If Mark hadn't hired Acumen to provide that investment advice, he would have hired another investment adviser firm to do so. *Ibid.* Mark held himself out to Wells Fargo as an IA providing professional services to Appellants. *Ibid.*

The securities industry has devoted considerable regulatory attention to the need for brokerage firms to be advised of, and in many cases to supervise, their stockbrokers' business activities conducted outside the scope of the broker's work for the brokerage firm—referred to in the industry as “outside business activities.”¹⁸ Mark's work as a licensed investment advisor for Acumen Financial Group was an “outside business activity.” At the time of the events at issue here, three NASD

¹⁷ Plaintiffs' Motion for Partial Summary Judgment, CP 96-123 (“Garrison Motion”), at CP 110-112, 115-119; Plaintiffs' Rely Brief in Support of Their Motion for Partial Summary Judgment, CP 387-399 (“Garrison Reply”), at CP 387-392; and Plaintiffs' Opposition to Sagepoint's Motion for Summary Judgment, CP 286-312 (“Garrison Opposition”), at CP 292-297.

¹⁸ See, NASD NTM 85-84, “New Rule of Fair Practice Relating to Private Securities Transactions.”

Rules dealt with outside business activities, none of which, on their face, addressed a stockbroker's activities as an investment advisor for non-customers at a different firm:

Rule 3030, "Outside Business Activities of Associated Person," addresses a stockbroker's outside business activities that are *unrelated to securities*.¹⁹ It requires the broker to give notice to the employer broker-dealer of the outside business, but imposes no duty on the employer to supervise that activity. Rule 3030 is irrelevant here, because this case involves only securities-related outside business activities.²⁰

Rule 3040, "Private Securities Transactions of Associated Persons," covers *securities transactions* outside the regular course of a stockbroker's employment with his or her broker-dealer. Brokers must notify their broker-dealer before engaging in any "private securities transaction." "Private securities transactions" are defined as:

any securities transaction outside the regular course or scope of an associated person's employment with a member. . . [except] transactions subject to the notification requirements of Rule 3050 [this exception is central to AIG's arguments], transactions among immediate family members (as defined in IM-2110-1. . .), for which no associated person receives any selling compensation . . .

¹⁹ Full texts of NASD Conduct Rules 3030, 3040 and 3050 at Appendix B.

²⁰ Yet AIG asserts, "Importantly" [sic] Rule 3030 "imposes no duty on SagePoint to approve or supervise those outside activities," SagePoint's Motion, CP 222. AIG and its expert set up a straw man to knock down: a stockbroker's outside business as a licensed investment advisor is covered by Rule 3030 *if* the IA doesn't participate in securities transactions for a fee, (e.g. estate planning). But when the RR/IA participates in *securities* transactions for his advisory client for compensation, Rule 3030 no longer applies. NTM 91-32, *infra* at pp. 28-29.

If a broker receives compensation in connection with private securities transaction(s), his broker-dealer must either approve, or disapprove, the broker's participation, and if the employer broker-dealer *approves*, then it must fully supervise the broker's securities transactions:

the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member. NASD Rule 3040(e)(2).

Appellants contend that Rule 3040, *as interpreted and applied by the NASD*, obligates broker-dealers to supervise their stockbrokers who (1) provide *investment advisory* services, (2) for which the broker is compensated, (3) for a non-customer an account at a different firm, *and* (4) participates in securities transactions in the account. As explained below, according to the NASD, it is the combination of participating in securities transactions and being compensated for providing investment advisory services, that triggers the application of NASD Rule 3040.

Rule 3050 ("Transactions for or by Associated Persons") covers a stockbroker's (and his family's) *own* securities accounts at another firm. Both the other firm ("the executing member") and the stockbroker must give notice to the employer firm of the broker's intent to open, or trade in, such an account. The employer firm can request duplicate copies of the statements for the broker's personal accounts, which the executing firm is required to provide. Rule 3050 doesn't say anything about the employer

broker-dealer's supervisory duties relating to these accounts, but AIG's compliance and supervisory manuals do (discussed below).

AIG contends that Rule 3050 applies to Mark's activities in Appellants' accounts, making them exempt from Rule 3040's definition of private securities transactions, excusing it from any duty to supervise.

Appellants do not allege that AIG violated any particular securities statute or NASD rule as the basis for their negligent supervision claim. Appellants allege that AIG failed to meet the securities industry's standard of reasonable care in supervising Mark. NASD rules are just one factor in determining standard of care. Other factors relied on by courts, are the NASD's interpretations of its own rules, brokerage firms' own compliance and supervisory manuals, and expert opinion.²¹

Courts may adopt as the standard of conduct of a reasonable person the requirements of a legislative enactment or administrative regulation whose purpose is wholly or in part to protect the class of persons to which an injured party belongs, against the kind of harm which was caused by the conduct from which the harm results. *Barrett v. Lucky Seven Saloon, Inc.*, 152 Wn.2d 259, 269-270 (2004). A primary purpose

²¹ The SEC, in "Study on Investment Advisers and Broker-Dealers" (January 2011) at 106, discussed sources that establish the securities industry's standard of care:

The overall legal standards of conduct for broker-dealers and investment advisers have differing and complex histories. . . . On the broker-dealer side, the standard has developed substantially through a number of specific [SEC] and FINRA rules, disclosure requirements, interpretations by the [SEC] and its staff and FINRA, as well as case law, numerous SRO disciplinary actions, and Commission enforcement actions. (Footnotes omitted.)

of the securities industry's rules requiring broker-dealers to supervise their stockbrokers is to protect the investing public,²² and it is universally accepted that those rules are an important factor in determining the securities industry's standard of care in negligence cases.²³

More to the point, courts and the SEC have stated that the purpose of NASD Rule 3040, specifically, is to protect investors from harm caused precisely by the kind of conduct at issue here—unsupervised securities transactions. *In re Application of Joseph Abbondante*, Exchange Act Rel. No. 53066, 2006 SEC LEXIS 23, 52-53 (2006), *pet. for review den.*, *Abbondante v. SEC*, 209 Fed. Appx. 6 (2d Cir. 2006) (“Rule 3040 is intended to protect investors from the hazards of unmonitored private securities transactions”); NTM 01-79,²⁴ citing *Robin Bruce McNabb*,

²² *Grunwald*, *supra*, 400 F.3d 1119, 1143 (9th Cir. 2005) (“the congressional aim in supervised self-regulation is to insure fair dealing and to protect investors from harmful or unfair trading practices”); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 886 (3d Cir. 1975) (“stringent duty to supervise employees” imposed in broker-dealer cases “to protect the investing public. . . .”); *Mayo v. Dean*, *supra*, 258 F. Supp. 2d at 1108-09 (“prior to approval of a proposed SRO rule the SEC must find that it is designed ‘to protect investors and the public interest’”); *Bloemendaal v. Morgan Stanley Smith Barney*, 2011 Dist. LEXIS 61772, at 11-14 (C.D. Cal. 2011) (“in requiring that ‘Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed. . . to prevent the misuse . . . of material, nonpublic information’ . . . Congress affirmed that ‘effective supervision of securities firms of their employees and agents is a foundation of the federal regulatory scheme of investor protection,’” quoting H.R. Rep. 100-910, at 17 (1988)).

²³ *E.g. Ives v. Ramsden*, *supra* (holding RCW 21.20.702, adopting NASD’s suitability rule, sets standard of care for stockbrokers). *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 461 (9th Cir. 1986); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 824 (9th Cir. 1980) (same); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. 1981); *Piper, Jaffray & Hopwood, Inc. v. Ladin*, 399 F. Supp. 292, 298 (S.D. Iowa 1975).

²⁴ “NASD Reminds Members of their Responsibilities Regarding Private Securities Transactions Involving Notes and Other Securities and Outside Business Activities.”

Exchange Act Rel. No. 43411 (October 4, 2000) (“As recently stated by the SEC, Rule 3040 ‘protects investors from the hazards of unmonitored sales . . .’”); *Siegel v. S.E.C.*, 592 F.3d 147, 158 (D.C. Cir. 2010):

The purpose of NASD Conduct Rule 3040 is to protect ‘investors from unsupervised sales and securities firms from exposure to loss and litigation from transactions by associated persons outside the scope of their employment.’ . . . The SEC thus found that Siegel’s suspension for the Rule 3040 violation “will protect the public interest by discouraging Siegel and others from selling away and from undermining the protections in place at firms.”

Ibid. The “express terms” of Rules 3030, 3040 and 3050 make no mention of stockbrokers acting also as licensed investment advisors. When the NASD adopted those rules, investment advisors were far less common, and few financial professionals were dually licensed as stockbrokers and investment advisors. That has changed. Today there are more than 11,000 RIAs registered with the SEC, another 15,000 RIAs registered with states, and 275,000 state-licensed investment adviser representatives. SEC Staff Report, *supra*, at p. 24, n. 21. As of mid-October 2010, approximately 18% of broker-dealers registered with FINRA were also registered as RIAs, and approximately 88% of investment adviser representatives were also stockbrokers with a FINRA registered broker-dealer. *Ibid.* As the role of dually-licensed brokers/IAs in the financial services industry increased, the NASD, beginning in 1991, issued a series of Notices to Members (“NTM”) instructing member firms how the its supervisory rules applied to stockbrokers who were also registered as investment advisors. Second Declaration of John H. Chung in Support of

Plaintiffs' Motion for Partial Summary Judgment, CP 400-404

(“Chung 2nd Decl.”) ¶ 5, at CP 401.

The NASD regularly issues “Notices to Members” (“NTMs”) with guidance on how its rules are to be interpreted and applied by its member firms. *Ibid.*, ¶ 4; *See, e.g.*, NTM 99-45, *supra*, n. 14. NTMs are controlling authority. In NTM 94-44,²⁵ discussed *infra*, at p. 30, the NASD declared:

Members and RR/RIAs are expected to be in compliance with the Board's Interpretation as clarified in this Notice. Those firms and RR/RIAs who have not been operating in accordance with the provisions of Notice to Members 91-32²⁶ must immediately conform their activities in order to ensure compliance with the concepts and requirements that have been clarified in this Notice.

The predecessor to Rule 3050 (NASD Rules of Fair Practice Article III, § 28), covering stockbrokers' personal accounts, required an executing broker-dealer to give notice to the other broker-dealer if it held or proposed to open an account in the name of the other broker-dealer's “partner, officer, registered representative or an employee”.²⁷ In 1982 the NASD expanded Rule 3050 to also cover outside accounts which a broker “has or will have a financial interest in, or discretionary authority over:”

[T]he Rule would be amended to apply to transactions or accounts over which associated persons exercise discretion, [or] in which

²⁵ “Board Approves Clarification on Applicability of Article III, Section 40 of Rules of Fair Practice to Investment Advisory Activities of Registered Representatives.”

²⁶ NTM 91-32 was a “Request for Comments on Compensation Arrangements for Activities of Registered Representatives who are Also Registered . . . as Investment Advisors,” discussed *infra*, at p. 28-29. *See* Appendix A for full copy of all referenced Notices to Members.

²⁷ *See* NTM 82-21, “Proposed Amendments to Rules Governing Transactions Executed for Persons Associated with Another Member,” for text of then-Article III, §28.

such associated persons have a financial interest. For example, an account for a relative of a registered representative of another member would be subject to the reporting requirements if the registered representative placed the orders for the account.

NTM 85-21, “Request for Comments on Proposed Rule on Private Securities Transactions.”

The precursor to NASD Rule 3040 was a *Private Securities Transactions Interpretation* promulgated in the mid-1970s,²⁸ simply requiring stockbrokers to notify their employer firm prior to participating in “private securities transactions.”²⁹ In 1985 the NASD replaced the *Interpretation* with Rule 3040,³⁰ adding the requirement that broker-dealers were not only to be notified of, but were to supervise, their stockbrokers’ “private securities transactions.”

The NASD first addressed the issue of stockbrokers engaging in investment advisory services in NTM 91-32.³¹ Explaining that it “has recently received several requests from members seeking advice on the applicability of” Rules 3010, 3040, and 3030³² “to the investment advisory activities of registered representatives who are also registered as

²⁸ Article III, § 27, Rules of Fair Practice, codified as NASD Rule 3010.

²⁹ See NTM 85-21; Freeman, David and Zambrowicz, Kevin, “Obligations of a Broker-Dealer to Supervise the Securities Activities of Its Affiliates,” *Investment Adviser* (2001) (at <http://www.arnoldporter.com/publications.cfm?action=view&id=379>).

³⁰ NASD Notice to Members 85-84, *supra*, n. 18.

³¹ “Request for Comments on Compensation Arrangements for Activities of Registered Representatives Who Are Also Registered. . . as Investment Advisers.”

³² The Notice to Members cited “Article III, Sections 27, 40, and 43,” which are NASD Rules 3010, 3040, and 3030, respectively.

investment advisers” conducted at a different firm. NTM 91-32 (*infra*, fn. 25) announced that Rule 3040 “*should be applied in such a manner as to cover these situations.*” The NASD’s discussion of the investment advisory transactions to which Rule 3040 applied is squarely on point with the facts of this case:

The NASD's National Business Conduct Committee (NBCC). . . considered the applicability of [Rule 3040]³³ to investment advisory activities. The NBCC concluded that [Rule 3040], consistent with the policy announced when this section was adopted, should apply to all investment advisory activities conducted by registered representatives other than their activities on behalf of the member that result in the purchase or sale of securities by the associated person's advisory clients. If . . . the RR/IA receives compensation for, or as a result of, such advisory activities. . . .

Undisputed evidence established that Mark conducted investment advisory activities, other than on behalf of AIG that resulted in the purchase or sale of securities by Appellants, for which, or as a result of such advisory activities, Mark received compensation. When those criteria were present, as they are here, the NASD continued, “the books, records, and supervision requirements of [Rule 3040] would apply.” The “books, records, and supervision requirements of Rule 3040” require the broker-dealer to “supervise the person’s participation in the transaction as if the transaction were executed on behalf” of the broker-dealer.

³³ Referred to in the NTM as NASD Rules of Fair Practice Article III, § 40.

The NASD subsequently elaborated on the “applicability of [Rule 3040] to the investment advisory activities of registered representatives” in NTM 94-44,

This Notice describes those investment advisory activities that constitute private securities transactions within the scope of Article III, Section 40.

In clarifying its previous position in Notice to Members 91-32, the Board focused primarily upon the RR/RIA's participation in the execution of the transaction—meaning participation that goes beyond a mere recommendation. Article III, Section 40 therefore, applies to any transaction in which the dually registered person participated in the execution of the trade. An example of a RR/RIA clearly participating in the execution of trades is where he or she enters an order on behalf of the customer for particular securities transactions . . . and receives any compensation for the overall advisory services. As a result, the “for compensation” provisions of Article III, Section 40 would apply, thereby requiring the RR/RIA adviser to provide notice to his or her firm and requiring that firm, if it approved the activities, to record the transactions and supervise the conduct of the RR/RIA.

This NASD interpretation of its own rules is squarely on point. Mark was executing trades in Appellants’ WFI accounts for compensation, *supra* at 12-13.

Two years later, the NASD issued NTM 96-33 (“NASD Clarifies Rules Governing RR/IAs”), “clarif[ying] the analysis that members must follow to determine whether the activity of an RR/IA falls within the parameters of [Rule 3040].” NTM 96-33 emphasized the role of the investment advisor’s “participation” in securities transactions, reiterating the applicability of Rule 3040 to the facts of this case:

Fundamental to this analysis [whether the activity falls within Rule 3040] is whether the RR/IA participates in the execution of a securities transaction such that his or her actions go beyond a mere recommendation, thereby triggering the recordkeeping and supervision requirements of [Rule 3040]. . . .

Where a member has approved an RR/IA's participation in private securities transactions for which he or she will or may receive selling compensation, the member must develop and maintain a recordkeeping system that . . . captures the transactions executed by the RR/IA in its books and records and facilitates supervision over that activity. . . . [T]he records created and recordkeeping system used, together with relevant supervisory procedures, must enable the member to properly supervise the RR/IA by aiding the member's understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA's authority, and the suitability of the transactions.

The court should accord substantial deference to these NASD's interpretations of its own rules, as it is the agency charged with administering the rules. *Blackfeet Indian Tribe v. Montana Power Co.*, 838 F.2d 1055, 1058 (9th Cir.), *cert. denied*, 488 U.S. 828 (1988). Deference is especially appropriate when the rules or regulations are highly technical, and when the agency was intimately involved in the drafting and consideration of the legislation at the time of its passage. *Dep't of Water & Power of City of Los Angeles v. Bonneville Power Admin.*, 759 F.2d 684, 691 (9th Cir. 1985). All of this applies to the NASD's Notices to Members. The trial court erred in failing to defer to the NASD's interpretations of its rules, and in ruling directly the opposite of the NASD's interpretation of its rules.

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. Dennett 4th Decl. CP 587-588. A brokerage firm's policies and procedures manuals, which firms are required under Rule 3010 to establish and enforce to ensure compliance with industry rules, are proper evidence of the standard of care to which a broker or the firm should be held. *Hendrickson v. Hendrickson*, 640 F.2d 880 (7th Cir. 1981); *Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817 (6th Cir. 1981).

AIG's Supervisory Manual § 23.8 ("Personal Securities Transactions") discusses how AIG supervisors are to supervise accounts in which an investment advisor representative acts as a trustee³⁴. AIG defines IAR accounts³⁵ as:

[A]ny account in which the IAR has a beneficial interest...[or] account where the IAR acts as custodian, *trustee*, executor, or in a similar capacity. (Emphasis added.)

CP 587. For IAR accounts held away from AIG, like Appellants' Wells Fargo accounts, AIG is to obtain duplicate confirmations and statements. AIG's Supervisory Manual then requires the First Line Supervisor

³⁴ AIG did not produce this manual in discovery until after the trial court's summary judgment ruling. See p. 63 *infra*.

³⁵ Section 23.8 refers to investment advisors as Investment Adviser Representatives, or IARs, as defined in Section 23.2.

(“FLS”) to review and supervise the brokers’ securities transactions in those accounts:

The FLS will review all account confirmations and statements for potential conflicts of interest and *for frequency and type of account activity*. . . .

The FLS will also review *each transactions for appropriateness, and determine if the transaction and/or the portfolio meet the clients risk tolerance and investment objectives*.

The FLS, or a delegated Principal, will *review all trades on a daily basis. The FLS will obtain additional information necessary to approve or reject the trades* based on any additional information that may be provided by the representative.

(Emphases added.) CP 588. Section 23.8 then sets out a procedure to approve or reject trades. Section 23.8 is consistent with, and reflects the NASD’s position, that the stockbroker’s broker dealer has a duty to supervise the broker’s activities in such an account. It directly contradicts the trial court’s conclusion that AIG had no duty to Appellants under the facts of this case.

AIG assumed that since Mark was the trustee of Appellants trusts, he could do what ever he wanted in their accounts regardless of whether or not he was acting as their investment advisor. AIG’s own Supervisory Manual squarely contradicts this. Dennett 4th Decl. AIG’s Supervisory Manual recognizes that Rule 3050 doesn’t apply to investment advisory activities by a firm’s stockbrokers, stating,

RRs must be aware that investment advisory business is classified under one of two NASD Rules (i.e. NASD Conduct Rule 3030 and 3040).³⁶ CP 579.

Further, Supervisory Manual § 23.8 contradicts AIG's expert, David Paulukaitis', view that having discretion as a trustee is the supervisory equivalent of personally owning the trusts' assets, subject only to Rule 3050. *Cf.* Second Declaration of David E. Paulukaitis, CP 276-285 ("Paulukaitis 2nd Decl."), at ¶ 7. Supervisory Manual § 23.8 recognizes that there is no difference in the need to supervise an IA who has discretion over another's investments as a trustee, and one who has discretion as an IA. In each capacity the IA has fiduciary duties, and AIG supervisors must supervise and approve or reject trades. § 23.8. Dennett 4th Decl. CP 587-588.

AIG's Supervisory Manual draws a distinction between the supervision of personal accounts of an ordinary registered representative, and one who is acting as an investment advisor. Supervisory Manual Section 2.4, "Employee and Employee Related Accounts," defines an employees personal brokerage accounts to include accounts in which an employee or affiliate. . . possess trading authority, which includes but is not limited to trustee, custodian, corporate officer, general partner, executor or power of attorney. Section 2.4 then specifies the appropriate supervision for those accounts (including many of the issues that

³⁶ Whether 3030 or 3040 applies depends on whether the investment advisor participates in executing the transaction, *see* NTM 94-44, *supra* at p. 30.

Paulukaitis stated were appropriate under Rule 3050), directing AIG supervisors to look for

very active trading, sizeable debit balances, bounced checks, high risk trading patterns, transfers between PBA(s) and client accounts, insider trading, review for any possible New Issues or Hot Issue purchases, cancellation of transaction if necessary, front running, tailgating, free riding, [and] proprietary product purchases.

CP 566-574, 4th Dennett Decl. Ex. 5, SP-RFP_018344-018352. Unlike § 23.8, § 2.4 (for registered representatives), does not include a suitability analysis for broker's personal accounts (including those for which they serve as trustee), does not require a daily review of transactions; and does not provide a procedure for the supervisor to approve or disapprove of trades, suggesting instead corrective action such as discussions with the representative and letters of caution.

The differences between AIG's Supervisory Manual §§ 2.4 and 23.8 show that Paulukaitis was applying the wrong rule: Rule 3050 applies to accounts in which one of its brokers acts as trustee, but does not apply to those where an investment advisor acts as trustee. This explains the contradiction between Paulukaitis' analysis and the NASD's NTMs 91-32, 94-44 and 96-33 on which Appellants' summary judgment materials relied: Paulukaitis was referring to ordinary stockbrokers while the NASD was discussing stockbrokers acting as investment advisors.

AIG's duty to supervise included a duty to take reasonable action when becoming aware of red flags indicating wrongful conduct is

detected. Appellants alleged that AIG's duties to supervise included the duty to have reasonable supervisory procedures designed to detect red flags indicating potential violations of securities industry rules and regulations, and, upon becoming aware of such red flags, taking reasonable steps to follow up and investigate to determine if violations are occurring. Complaint, CP 1-43, ¶¶ 189(d), 191, 194, 202. Broker-dealers' duty to supervise includes a duty not only to supervise their stockbrokers' known conduct, but to have and enforce procedures for *detecting* failures to comply with rules and regulations, and firm policies and procedures. Broker-dealers are further required to follow-up on, and investigate, red flags that come to its attention suggesting wrongdoing. NTM 94-44 (*supra*, at p. 37); *Bear Stearns & Co. v. Buehler*, 23 F. App'x 773, 775-76 (9th Cir. 2001) ("Once aware of troublesome 'red flags,' the broker-dealer may have a duty which runs to non-customers to monitor and investigate any unusual account activity"); *McGraw v. Wachovia Sec., L.L.C.*, 756 F. Supp. 2d 1053, 1075 (N.D. Iowa, 2010); *In re PFS Investments, Inc.*, Securities Exchange Act of 1934 Release No.40269 /July 28, 1998 Administrative Proceedings File No. 3-9658 ("the procedures in place at the compliance departments to investigate complaints were not reasonably designed to detect selling away activities"); *In the Matter of Prospera Financial Services, Inc. et al*, Securities Exchange Act of 1934 Release No. 43352 (September 26, 2000), Administrative Proceeding File No. 3-10306; *Consolidated Investment Services*, Exchange Act Rel. No. 36,687,

1996 SEC Lexis 83 (Jan. 5, 1996) (“The “most blatant and unexcusable evidence of a failure to supervise” was “failure to react to [firm’s] own on site files and records which contained obvious red flags”).

The SEC held, in *In the Matter of John H. Gutfreund*, 1992 SEC LEXIS 2939, 51 S.E.C. 93, Admin. Proc. File No. 3-7930 (1992), Securities Exchange Act of 1934, Release No. 34-31554:

The supervisory obligations imposed by the federal securities laws require a vigorous response even to indications of wrongdoing. Many of the [SEC’s] cases involving a failure to supervise arise from situations where supervisors were aware only of “red flags” or “suggestions of irregularity.” . . .

Even where the knowledge of supervisors is limited to “red flags” or “suggestions” of irregularity. . . , as the Commission has repeatedly emphasized, “[t]here must be adequate follow-up and review when a firm’s own procedures detect irregularities or unusual trading activity. . . .” (Footnotes omitted.)

In NTM 94-44, *supra*, at pp. 30-31, the NASD explained that Rule 3010, setting forth broker-dealers’ overall supervisory obligations, requires members to conduct an annual review of their branches,

reasonably designed to assist members in detecting and preventing violations of the securities laws. The “*reasonably*” designed standard means, for example, that indications of problems, or “red flags,” must be investigated. (Emphasis added.)

In *McGraw v. Wachovia Sec., L.L.C.*, 756 F. Supp. 2d 1053, 1075 (N.D. Iowa, 2010), the court held that broker-dealers have a duty that extends to non-customers, to monitor and investigate a broker’s activities “if there is evidence of “red flags” that would alert the brokerage firm to the possibility of undisclosed outside activities. . .”:

[T]hese duties do extend to “customers or other individuals,” not just to customers, as they arise from the licensing of brokers, not just from a customer relationship. . . .

[P]laintiffs have generated genuine issues of material fact that “sufficiently suspicious” circumstances here may have placed the defendants on notice that Lovegren was engaged in improper conduct as to them, *giving rise to a duty to monitor and investigate Lovegren's outside activities or private securities transactions*. (Emphasis added.)

Here the undisputed facts established that AIG supervisors actually received, and reviewed, all of the monthly brokerage statements for Appellants’ Wells Fargo accounts, as well as all of the monthly brokerage statements for Mark and his wife’s personal brokerage accounts. Nielsen 1st Decl., *supra* (CP 192-195, 270-275); Ayers’ Decl., *supra*. AIG actually argued in its defense that its supervisors reviewed those statements with blinders on:

SagePoint's receipt and review of confirmation slips and account statements for the Plaintiffs' Wells Fargo Accounts and [Mark and his wife's] TD Ameritrade Personal Accounts was limited to monitoring the transactions pursuant to applicable NASD Conduct Rule 3050 to ensure that Mark was not executing transactions that adversely affected the interests of SagePoint and SagePoint's customers.

SagePoint’s Motion, at CP 223-224; *accord*, Paulukaitis 2nd Decl., ¶ 6; Ayers Decl., ¶ 6, CP 246. The securities industry’s standard of due care does not permit a broker-dealer to “limit” its responsibilities in the face of red flags—regardless of how those red flags come to its attention.³⁷

³⁷ See also, SagePoint’s Opposition, at CP 247 (“SagePoint monitored all of those transactions solely for purposes of complying with NASD Conduct Rule 3050.”)

AIG's supervisory and compliance personnel could not have missed, in reviewing those statements, evidence that millions of dollars were flowing out of Appellants' accounts and into Mark and his wife's personal accounts; that Appellants' trusts' accounts, which AIG had given Mark permission to manage at an outside firm, were being invested in a staggeringly reckless manner; and that those fiduciary accounts were fluctuating wildly and losing millions of dollars.

Undisputed evidence before the trial court established that AIG was put on notice of red flags or "suggestions of irregularity"—*i.e.* the trading and other activities taking place in Appellants' accounts. Those facts gave rise to a duty on the part of AIG, under the securities industry's standard of reasonable care, to investigate and follow up to determine the facts. Appellants did not seek to prove on summary judgment that AIG had *breached* its duty to supervise Mark by taking reasonable action in response to red flags. They sought only a ruling that, as a matter of law, AIG had a duty to meet the securities industry's standard of care in supervising Mark's activities in their accounts, which included a duty not to ignore, but to investigate and follow up on suggestions of irregularity.

2. The trial court erred in failing to rule as a matter of law that AIG had a duty to supervise Mark's acts in Appellants accounts.

Appellants presented evidence to the trial court of the legislative

history of the relevant NASD rules³⁸ (discussed *supra*, pp.21-31), the NASD's official interpretations of those rules (*Ibid.*), portions of AIG's internal compliance³⁹ and supervisory⁴⁰ manuals, and expert testimony,⁴¹ showing that the securities industry's standard of due care required AIG to supervise Mark's conduct at issue here.

There were no disputed issues of material fact about the contents or validity of the NASD's interpretation of its rules, or announcements directing how Rule 3040 was to be applied by AIG. AIG's own internal manuals were consistent with the NASD's interpretations of its rules, requiring it to supervise both Mark's investment advisory activities, as well as activities in Appellants' accounts in his role as trustee.

Neither AIG nor its expert addressed any of the NASD's interpretations of Rule 3040, nor disputed any of Appellants' expert opinions about the nature or effect of those NTMs.

AIG failed to offer any evidence disputing the evidence on which Appellants relied in order to show the securities industry's standard of care for supervising stockbrokers in the specific circumstances present here:

³⁸ Declaration of John H. Chung in Opposition to Defendant's Motion for Summary Judgment and in Support of Plaintiffs' Motion for Partial Summary Judgment, CP 324-335 (Chung 1st Decl.), ¶¶ 8-11; Chung 2nd Decl., *supra*, ¶¶ 4-11; Garrison Reply, CP 387-390.

³⁹ Dennett 1st Decl., Exs. 3, 6, 10, 14; Dennett 2nd Decl., Ex. 6; Declaration of Carl J. Carlson in Support of Plaintiffs' Opposition, Etc., CP 313-323, Ex. 1.

⁴⁰ Dennett 4th Decl., Exs. 5, 7, and 8.

⁴¹ Chung 1st Decl.; Chung 2nd Decl.

when a stockbroker (1) provides investment advisory services (2) for a non-firm customer holding an account at a different firm (3) for which the broker/investment advisor is compensated and (4) in connection with which he participates in securities transactions. The trial court erred in failing to rule, as a matter of law, that AIG owed a duty to Appellants to supervise Mark's activities in their Wells Fargo brokerage accounts.

B. The Trial Court Erred in Granting AIG Summary Judgment on the Issue of Duty.

The only ground on which AIG moved to dismiss Appellants' negligence claim was that it had no duty to supervise Mark in order to protect investors in Appellants' position.⁴² AIG's only argument why no duty existed was its own interpretation of the supposedly "plain language" NASD Rules 3040 and 3050. And the only evidence in support of AIG's interpretation was its expert's opinions, discussed below, which were insufficient to prove a prima facie case that no duty existed.

1. The parties expert declarations precluded the trial court from entering summary judgment in AIG's favor, and established as a matter of law that AIG had a duty to supervise here.

Expert testimony is required in order to establish the securities industry's standard of care. *McKee v. Am. Home Products, Corp.*, 113 Wn.2d 701, 706-07, 782 P.2d 1045, 1048 (1989) ("to establish the standard of care

⁴² SagePoint's Motion, at CP 220-227; SagePoint's Reply, at CP 434-435; and SagePoint's Opposition at CP 240-250, 251-255.

required of professional practitioners, that standard must be established by the testimony of experts who practice in the same field); *McGraw v. Wachovia Sec., L.L.C.*, 756 F. Supp. 2d 1053, 1070 (N.D. Iowa, 2010) (“the standard of care, if any, of a brokerage firm to monitor or investigate the outside activities of its brokers is not so obvious as to be within the comprehension of a layperson, so that expert testimony on the applicable standard of care and its breach are required in this case”).

Further, it is the general rule that when each side's evidence is sufficient standing alone to make a prima facie showing of the fact in question, conflicts in expert testimony must be resolved by the trier of fact and not on summary judgment.⁴³ Appellants' expert, John Chung, provided expert testimony on the issue of duty, discussed below, which was uncontradicted, and which compels a conclusion that AIG did have a duty to Appellants on the facts of this case. AIG did not. It offered incompetent testimony based on erroneous assumptions, that failed to take into account key facts, consisted of purely conclusory assertions about matters that are not the proper subject of expert testimony, and failed to contradict Appellants' experts' testimony.

⁴³ See, e.g., *Goldman v. Standard Ins. Co.*, 341 F.3d 1023, 1035 (9th Cir. 2003); *TFWS, Inc. v. Schaefer*, 325 F.3d 234, 241-43 (4th Cir. 2003); *Leggett & Platt, Inc. v. Hickory Springs Mfg. Co.*, 285 F.3d 1353, 1362 (Fed. Cir. 2002); *Klein v. Tabatchnick*, 610 F.2d 1043, 1048 (2d Cir. 1979); *ID Sec. Sys. Canada, Inc. v. Checkpoint Sys., Inc.*, 198 F. Supp.2d 598, 605 (E.D. Pa. 2002); *Telecomm Technical Serv., Inc. v. Siemens Rolm Communications, Inc.*, 66 F. Supp.2d 1306, (N.D. Ga. 1998).

Appellants' expert. John Chung, who is also an attorney, spent 15 years in the securities industry before becoming an the industry consultant. Mr. Chung was the Chief Compliance Officer—the person who ensures compliance throughout a firm's operations—for three different broker-dealers, during which time he also served a 2-year term (1999-2001) as Chair of the NASD District Business Conduct Committee (District 1). The NBCC advises NASD senior management and staff on issues and trends affecting the District's membership and provided comment and feedback on draft rule proposals, NTMs, Compliance Alerts, and Regulatory Alerts. Chung—*unlike Paulukaitis*—demonstrated specific experience working with and applying the NASD rules at issue here. As Chief Compliance Officer Chung was responsible for overseeing compliance with FINRA Rules 3030, 3040 and 3050. Chung 1st Decl., ¶ 2, 3 and Ex. 1, at CP 324, 334. As a securities industry consultant, he “reviewed and assessed the quality of supervisory regimens at a number of FINRA member firms with respect to Rule 3030/3040/3050 compliance.” And in those capacities, Chung

had occasion to review, analyze and apply the guidance provided in FINRA Notices to Members 94-44 (“Board Approves Clarification on Applicability of Article III, Section 40 of Rules of Fair Practice to Investment Advisory Activities of Registered Representatives”), 96-63 (“NASD Clarifies Rules Governing RRs/IAs”) and 01-19 (“Selling Away and Outside Business Activities”) to the activities of registered representatives who are also investment advisers.

Chung's Declaration discussed the history of NASD's rules for broker-dealers supervising their stockbrokers' *investment advisory activities*, and specifically the NASD's interpretation and application of its Rules to investment advisory services. Chung 1st Decl., ¶¶ 6-11 (CP 324-335); Chung 2nd Decl., ¶¶ 3-13 (CP 400-404). Chung expressed the unqualified opinion, based on his personal experience working with the NASD's rules *and its interpretative Notices to Members* that:

6. NASD Rule 3040. . . sets forth the nature and extent of a FINRA member firm's obligation to supervise the activities of its registered representatives who engage in ". . . securities transactions outside the regular course or scope of an associated person's employment with a member. . . ." *A registered representative receiving "selling compensation" from such transactions must be supervised by the member firm employer "... as if the transaction were executed on behalf of the member."*

7. Investment advisory fees received by an RR qualify as "selling compensation" for purposes of triggering a member firm's supervisory obligations. (Footnote quoting NTM 91-32 omitted.)

8. The NASD has addressed the issue of registered representatives acting as investment advisers in connection with securities transactions at a different firm in NASD Notices to Members (NTM) 91-32, 94-44, 96-33 and 01-79. *These Notices consistently apply Rule 3040, and mandate that member firms supervise such activities.*

11. In NTM 94-44, the NASD makes clear that when a registered representative registered. . . *participates as an investment adviser in the execution of trades* in an account over which he or she has discretion at a different firm, *and receives compensation* for that activity, Rule 3040 applies. (All emphases added.)

AIG offered nothing to contradict Chung's opinions. Its expert never mentions those opinions, never discusses the NTMs Chung cites, and offers

no response to Chung's explanations why those NTMs control here. The terms "NTM" or "Notice to Members" do not appear, not even once, in any of AIG's three summary judgment memoranda.

AIG's expert, David Paulukaitis. Mr. Paulukaitis appears to have experience qualifying him to express expert opinions, but he is vague about how much of his experience was management and administrative as opposed to working with the issues here—the supervision of stockbrokers' investment advisory activities—or whether he ever had occasion to deal with brokers' conduct as investment advisors employed by another firm. Instead, he claimed vaguely only that he had "became very familiar" with "the various NASD Conduct Rules applicable to broker/dealers and to their registered persons and supervisors," and "the supervisory obligations of broker/dealers in monitoring the activities of their registered persons." Paulukaitis 1st Decl., ¶¶ 7, 12.

Paulukaitis failed to based his opinions on the facts in evidence. Paulukaitis (1) erroneously assumed that Mark and his sister were *the* beneficiaries of Appellant trusts ("The alleged supervisory failures. . . pertained to two brokerage accounts over which Mark was appointed trustee and for which he and his sister . . . were the beneficiaries. . . " Paulukaitis 1st Decl., ¶ 15)); and (2) never acknowledged the undisputed fact that Mark acted as an investment advisor for compensation for Appellants and at the same time participated in securities transactions in their accounts. An expert's testimony for summary judgment must be

supported by the specific facts underlying the opinion. *Rothweiler v. Clark County*, 108 Wn. App. 91, 100-01, 29 P.3d 758 (2001). Obviously opinions based on inaccurate facts, or which fail to take into account material facts, are of no value in assisting a trier of fact.

Paulukaitis offered non-expert testimony. Paulukaitis offered his opinion only of what the “plain language” of Rules 3040 and 3050 said:

22. NASD Conduct Rule 3050 governs instances in which a registered person of a broker/dealer establishes and/or maintains a securities brokerage account with an unrelated broker/dealer (the “executing broker/dealer”). Specifically, Conduct Rule 3050 is applicable to accounts for which “...a person associated with an employer member has or will have a financial interest in, or discretionary authority...”

20. NASD Conduct Rule 3040 *expressly* does not apply to transactions affected by a registered person in a personal brokerage account. Specifically, Conduct Rule 3040 states: [Quoting express language of rule.]

That is not the proper subject of expert testimony. The court needs no expert to assist it in reading “express terms.”

Paulukaitis’ offers bare conclusory statements: Paulukaitis opined,

21. *Because* the transactions. . . were effected by Mark in accounts he controlled and in which he and his sister held a beneficial interest, those transactions were subject to the notification requirements of NASD Conduct Rule 3050.

Thus, SagePoint had no duty to treat the transactions effected by Mark in those accounts as “private securities transactions” and had no duty to supervise those transactions in accordance with . . . NASD Conduct Rule 3040. (Paulukaitis 1st Decl., ¶ 21).

No additional analysis or explanation precedes or follows these conclusory assertions. They reflect nothing but Paulukaitis’ own layperson’s reading

of the plain language of Rules 3040 and 3050, without regard to how the NASD has interpreted and applied those rules. He offers no explanation how his experience in the industry, his expertise, or anything the NASD has said, contributed to his ability to read the rules' plain language, or his opinion of what their "express written terms," standing alone, mean.

Paulukaitis' opinions are squarely contradicted by Appellants' expert. Paulukaitis devoted an entire Declaration (Paulukaitis 2nd Decl., CP 276-285) to parsing the effect of the placement of a comma in Rule 3040, to express his opinion—despite having no qualifications as a grammarian—as to *which* preceding clauses a dependent clause modified:

4. Importantly . . . NASD Conduct Rule 3040(e)(1) includes a comma after "Rule 3050" at the end of the fifth line of the text of subsection (1) above. This comma connotes that there are actually three categories of transactions that are expressly excluded from the definition of "private securities transaction" for purposes of NASD Conduct Rule 3040: . . .

In other words, the phrase "for which no associated person receives selling compensation" modifies "transactions among immediate family members"; it does not modify or relate to the first category of excluded transactions, i.e., "transactions subject to the notification requirements of Rule 3050."

Paulukaitis' point is that it makes no difference in applying Rule 3040 whether or not a transaction involves compensation. But the NASD itself addressed and rejected that position in NTMs 91-32, 94-44 and 96-33.

Paulukaitis' interpretation of what the comma signifies is neither self-evident nor logical: if the intent were to modify only the immediately preceding clause, as Paulukaitis announces, there should have been *no*

comma; by inserting a comma, it becomes entirely ambiguous whether the dependent clause modifies the sequence of preceding clauses, or just the immediately preceding clause. Secondly, Chung—citing NASD Notices to Members that Paulukaitis failed to address—directly disputed with Paulukaitis’ reading of the comma’s placement:

Further, the ‘exclusionary’ language cited by Mr. Paulukaitis in NASD Rule 3040 (e)(1) is immediately followed by the modifying clause; ‘for which no associated person receives any selling compensation,’ language that is consistent with the emphasis placed by the NASD (in NTM 91-32) on "selling compensation" in determining whether transactions qualify as "private securities transactions" for purposes of triggering the rule's supervisory requirements. (Chung 1st Decl., ¶ 14)

Paulukaitis’ opinions failed to take into account critical facts: the existence of NASD Notices to Members. Commentators consider NTMs 96-33 and 94-44—relied on by Chung⁴⁴—“particularly important when an associated person registered representative (RR) is also. . . associated with an investments advisor,” as “in these Notices, the NASD gives particular attention to the supervision of securities transactions conducted by a dual RR/IA.”⁴⁵ But Paulukaitis does not appear to have even been aware of NTMs 91-32 or 94-44 (*see* Paulukaitis 1st Decl. ¶ 13, at CP 199), and while he claimed to have “reviewed” NTM 96-33, after identifying it as

⁴⁴ Chung 1st Decl., ¶¶ 8,9, 18; Chung 2nd Decl., ¶¶ 8-11.

⁴⁵ Uhlenhop, Paul B. , Monical, John S. and Goldberg, Mitchell B., “Outside Business Activity,” *Practical Compliance & Risk Management for the Securities Industry* (November-December 2011). Available at http://lksu.com/pdf/Uhlenhop-Monical-Goldberg_PCRM_06-11.pdf.

among the materials he reviewed (CP 199-200, Paulukaitis 1st Decl., ¶ 13) he never mentioned it again.⁴⁶

Finally, Paulukaitis' idea of how to determine the meaning of the "express terms" of a law or rule—by just looking at the words on the paper before him—is not how Washington courts apply the law. *State, Dep't of Ecology v. Campbell & Gwinn, L.L.C.*, 146 Wn. 2d 1, 11, 43 P.3d 4, 10 (2002) (when determining "plain meaning" of a statute, court must consider the context, background facts of which legislature would be aware, policies underlying the statute, and its relationship to other statutes).

2. AIG failed to negate the possibility of a duty to supervise

Mark. AIG's argument that the express terms of NASD Rules 3040 and 3050 did not impose a duty on AIG to supervise Mark's activity in Appellants' accounts proves nothing except: *the express terms of Rules 3040 and 3050* don't impose such a duty. It is similar to proving that the Seattle Municipal Code did not impose a duty on AIG to supervise Mark's activities. True as that may be, proof that the Seattle Municipal Code and the express terms of NASD Rules 3040 and 3050 impose no duty on AIG to supervise Mark's conduct does not meet AIG's burden of establishing as a matter of law that no duty existed. If AIG wanted to rely solely on the absence of a duty emanating from that express language, it had to prove

⁴⁶ Paulukaitis did discuss two NTMs: NTM 96-60 "(Clarification of Members' Suitability Responsibilities Under NASD Rules with Special Emphasis on Member Activities in Speculative and Low-Priced Securities," and NTM 05-50 "(Equity-Indexed Annuities)"—neither of which have a thing to do with Rule 3040, brokers' investment advisory activities, or anything else relevant to the issues in this case.

that the only source from which a duty *could* have arisen was the express language of those two rules. AIG failed to even attempt to do so.

3. AIG's analysis failed to address key facts and authority.

AIG tried to limit the discussion of duty to a tiny piece of what can establish an industry standard of care, and then, to just the literal terms of that tiny piece.⁴⁷ AIG urged that whether it had a duty to supervise Mark's activities in Appellants' accounts depended entirely on the literal terms of two NASD Rules,⁴⁸ and thus limited, AIG's argument in support of its motion to dismiss due to lack of a duty consisted of: (1) Rule 3050 by its express terms applies to all outside accounts over which a stockbroker has "discretionary authority;" (2) Mark had discretionary authority over Appellants' accounts so Rule 3050 applies; (3) Rule 050 doesn't impose

⁴⁷ SagePoint's Opposition, at CP 249 ("Plaintiffs disregard the plain text of the categories of transactions excluded from Rule 3040"); *Ibid*, at CP 252-253 ("Plaintiffs. . . make this argument notwithstanding the plain language of subsection (e)(1) of the rule;" "Plaintiffs' argument. . . is . . . unsupported by the plain text of NASD Conduct Rule 3040(e)(1);" Paulukaitis 1st Decl., at CP 205 (Complaint "does not, and . . . cannot allege that there was any violation of the express provisions of Conduct Rule 3050"); Paulukaitis 2nd Decl., at CP 278 ("comma connotes that. . . three categories of transactions. . . are expressly excluded . . . for purposes of NASD Conduct Rule 3040"); SagePoint's Motion, at CP 212-213 (Rule 3040 doesn't apply "because by its terms it expressly excludes. . .;" "Rule 3050 by its express terms imposes no obligations. . ."); "Rule 3050 . . . [b]y its express terms. . . imposes no duties or obligations;" SagePoint's Reply, at CP 434 ("Rule 3040 expressly excludes transactions subject to Rule 3050. . .").

⁴⁸ Sagepoint's Reply, at CP 434 ("The parties agree that the decision on whether SagePoint owed Plaintiffs a duty. . . turns solely on whether NASD Conduct Rule 3050 applies to Plaintiffs' Wells Fargo Accounts"); SagePoint's Opposition, at CP 249-250 ("Plaintiffs disregard the plain text of the categories of transactions excluded from Rule 3040"); CP 252 ("Plaintiffs . . . make this argument notwithstanding the plain language of subsection (e)(1) of the rule); CP 253 ["Plaintiffs' argument that Rule 3040 applies. . . is erroneous and unsupported by the plain text of NASD Conduct Rule 3040(e)(1)"].

any obligations on AIG;⁴⁹ (4) the express terms of Rule 3040 (which requires supervision) exempts transactions covered by Rule 3050; therefore, (5) Mark's trading in Appellants' Wells Fargo accounts was exempted from Rule 3040's supervisory duties.⁵⁰

4. The trial court failed to apply proper rules of construction, and its ruling leads to absurd results. The trial court appears to have accepted AIG's simplistic "plain language" argument. Maybe the trial court was concerned that Appellants weren't AIG customers, or that Mark was an independent contractor instead of an AIG employee, or that his conduct was outside the scope of his duties for AIG. But contrary to the rule that an employer ordinarily doesn't have a duty to supervise an employee in such situations, as explained above, the securities industry imposes upon broker-dealers exactly that duty in certain situations, including the situation at issue here.

a. The trial court erred in failing to apply proper rules of construction. The literal language of Rule 3040(e)(1) would—as AIG argues—exclude from supervision every transaction, in every account away from a broker's own firm, over which any stockbroker had discretionary authority. But at the same time, the express terms of the

⁴⁹ SagePoint's Motion, CP 223 ("Rule 3050 by its express terms imposes no obligations on SagePoint. . ."); Paulukaitis 1st Decl., ¶ 25, at CP 205 ("Rule 3050 does not impose any specific obligations on the employer-broker/dealer (SagePoint) with respect to accounts . . . maintained at an executing broker/dealer (Wells Fargo. . .).")

⁵⁰ SagePoint's Motion, at CP 212-213; Paulukaitis Decl., ¶¶ 18-21; SagePoint's Reply, at CP 433.

NASD's own NTM 91-32 require broker-dealers to supervise a stockbroker's activities in an account at a different firm when the broker (1) provides services for an account away from the firm as an investment advisor, (2) "participates in securities transactions" in that account, and (3) is compensated for the advisory services:

The NASD's National Business Conduct Committee . . . believes that [Rule 3040] should apply to [1] all investment advisory activities conducted by registered representatives other than their activities on behalf of the member that [2] result in the purchase or sale of securities by the associated person's advisory clients. . . [3] if . . . the RR/IA receives compensation for, or as a result of, such advisory activities. . . . [Sub numbers added.]

The NASD later "clarified" NTM 91-32, reiterating in NTM 94-44:

In clarifying its previous position in Notice to Members 91-32, the Board focused primarily upon the RR/RIA's participation in the execution of the transaction. . . . Article III, Section 40 [Rule 3040] therefore, applies to any transaction in which the dually registered person participated in the execution of the trade.

An example of a RR/RIA clearly participating in the execution of trades is where he or she enters an order on behalf of the customer for particular securities transactions either with a brokerage firm other than the member they are registered with, . . . or with any other entity, . . . and receives any compensation for the overall advisory services.

How does AIG square its argument with these "express terms?" We don't know, because AIG entirely ignored the NASD's Notices to Members.

When statutes governing the same subject matter appear to conflict, the courts must construe them together and give effect to each, as well as the statutory scheme. *State v. Breazale*, 144 Wn.2d 829, 837, 31 P.3d 1155 (2001). As Chung explained (Chung 2nd Decl., ¶ 13),

Reading Rule 3050 without reading Rule 3040 and relevant NTMs will result in, at best, an incomplete and misleading analysis of the facts or, at worst, an erroneous conclusion as to the applicability of Rule 3050. Defendant's expert does not appear to have considered NTMs 91-32, 94-44 and 01-79 in arriving at his opinion.

The trial court erred by making a ruling that entirely negates the NASD's interpretations of its rules rather than reconciling them with the "express language" of the rules. Chung's Declaration explains how the two can and do, as a practical matter, coexist such that both are applied in a reasonable manner. Chung 2nd Decl., ¶ 12. But it is impossible to reconcile AIG's theory with the NASD's interpretation of its rules.⁵¹

b. The trial court's ruling will lead to absurd results.

Courts must construe statutes and regulations to avoid absurd results. In 2010 over 90% of assets under management with SEC-registered RIAs were in discretionary accounts. SEC Staff Report, *supra*, at p. 24, n. 21.

The trial court's ruling leads to absurd results:

- if an investor keeps control of his or her account, and doesn't give their investment advisor discretion, the IA's brokerage firm would have to supervise the account, but if the investor gives the IA discretion to make investments without consulting the investor—when supervision would be most needed—none would be required;

⁵¹ E.g., in NTM 96-33 (*supra*, at p. 30-31), the NASD lists examples of the kinds of books and records broker-dealers should maintain in order to supervise transactions covered by Rule 3040, including "*copies of discretionary account agreements.*" This would seem to make as clear as possible that Rule 3040 can apply when a broker has discretion over an account. AIG and Paulukaitis are wrong in their fundamental premise that the mere fact that a broker has discretion in an account excludes it from Rule 3040's coverage.

- a huge number of investors' accounts would be exempt from any broker-dealer supervision; and
- the RR/IA activities that the NASD says in NTM 91-32 are covered by Rule 3040 would not be covered by Rule 3040.

The only way to read Rules 3040, 3050 and NTMs 91-32, 94-44, and 96-33 together, without leading to absurd results, is that Rule 3050 applies to family and other accounts over which a broker has discretion but handles for no fee, while if the broker is exercising discretion as a investment advisor for a fee, Rule 3040 applies. CP 400-404, Chung 2nd Decl. ¶12.

5. Mark's status as an independent contractor is irrelevant to the issue of duty. Whether Mark was an employee or independent contractor could be relevant to the issue of AIG's *respondeat superior* liability for Mark's acts. But it is not relevant to the issue of duty. AIG misstated below that Appellants' claim was for

negligent supervision *of employees*, which is based on the special relationship *between employer and employee*." Sagepoint's Opposition at p. 11, CP 258. (Emphases added.)

Based on that incorrect premise AIG argued that no duty could arise because Mark was "merely an independent contractor." SagePoint's Motion, CP 225-227; SagePoint's Opposition, CP 257-259. A broker-dealer/broker relationship imposes very different duties does an employer/employee relationship. It is *the broker-dealer/stockbroker relationship*—

AIG's status as the broker-dealer with whom Mark was registered—that imposes a duty on AIG to supervise. CP 104; CP 298-299.

More than a quarter century ago, in NTM 86-65 (“Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel”), the NASD made clear that broker-dealers have the same duty to supervise their stockbrokers regardless of whether they are associated with the firm as employees or as independent contractors. After noting that “A significant number of NASD members” employ “registered persons who engage in securities-related activities” at remote locations, “often classified for compensation purposes as independent contractors,” NTM 86-65 stated:

[A]ll associated persons are considered to be employees of the firm with which they are registered for purposes of compliance with NASD rules governing . . . the supervisory responsibilities of the member. The fact that an associated person . . . is compensated as an independent contractor does not alter the obligations of . . . the firm to comply fully with all applicable regulatory requirements.

6. It is well established that a broker-dealer can be liable for negligent supervision of its stockbrokers conduct with non-customers. Numerous courts have held broker-dealers may be held liable for negligently supervising their stockbrokers on dealings with investors who had no accounts with the firm.⁵² Recent cases applying NASD Rule

⁵² E.g., *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750 (3d Cir. Cir. 1990); *Vucinich v. Paine, Webber, Jackson & Curtis Inc.*, 803 F.2d 454 (9th Cir. 1986); *Berthoud v. Veselik*, 2002 U.S. Dist. LEXIS 12858, * 17-18 (N.D.Ill., June 15, 2002); *Javitch v. First Montauk Fin. Corp.*, 279 F. Supp. 2d 931, 940 (N.D. Ohio 2003) (denying motion to dismiss claims that brokerage firm had negligently supervised its

3040 have found that a broker-dealer's supervisory/control relationship with its brokers give rise to the duty to supervise in order to protect third party investors, including non-customers. *McGraw v. Wachovia Sec., L.L.C.*, 756 F. Supp. 2d 1053 (N.D. Iowa, 2010); *As You Sow v. AIG*, 584 F. Supp. 2d 1034, 1048 (M.D. Tenn., 2008); *Colbert & Winstead, PC v. AIG*, 2008 U.S. Dist. LEXIS 53179, 44 Employee Benefits Cas. (BNA) 2250 (M.D. Tenn. 2008).

As You Sow involved an AIG stockbroker, Stokes, who like Mark operated an outside investment advisory firm. The plaintiffs alleged that AIG failed to supervise Stokes activities when he stole money they had deposited with his RIA firm. AIG moved to dismiss the claim on the ground it had no duty to the plaintiffs. *As You Sow*, at 1037. The federal court held that NASD Rule 3040 established a duty for AIG to supervise Stokes, in an analysis that is squarely on point and warrants extensive citation:

[As] a condition of their right to engage in the securities business, broker dealers. . . are required to abide by the NASD's rules and regulations. . . . NASD Rule 3040 provides that when a broker dealer becomes aware that an affiliated agent is engaging in a "private securities transaction," the broker dealer must either supervise as if the transaction were executed on behalf of the broker dealer, [or] disapprove it . . .

As the Defendants agreed to supervise Stokes under NASD standards, the Defendant share a responsibility for these securities transactions under NASD standard. . . Broker dealers may not enjoy the benefits of their relationships with affiliated agents

broker); *Bums v. Prudential Secs., Inc.*, 857 N.E.2d 621 (Ohio App. 2006) (affirming dollar verdict in investor suit alleging negligent supervision by broker-dealer).

without discharging their supervisory duties, including the supervision of private securities transactions. . . .

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.]

Colbert & Winstead, supra, involved investor claims against AIG, also based on Stokes conduct away from the firm. Again, AIG moved to dismiss on the ground that (among other things) it owed no duty to plaintiffs. A different federal court denied this motion, ruling that plaintiffs stated a cause of action for common law failure to supervise because:

the relationships defined and governed by the NASD may define the scope of a duty of a broker dealer, . . . particularly since, for purposes of negligence claims, “[p]rofessionals are judged according to the standard of care required by their profession.”

2008 U.S. Dist. LEXIS 53179, at 27.

C. The trial court erred in failing to rule that AIG was a control person of Mark under RCW 21.20.430.

Appellants allege that Mark violated RCW 21.20.010,⁵³ and that AIG is secondarily liable for those violations as a control person of Mark under RCW 21.20.430(3), which imposes secondary liability on certain

⁵³ “It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly: (1) To employ any device, scheme, or artifice to defraud; . . . or (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.”

parties, including “Every person who directly or indirectly controls a seller or buyer liable under” RCW 21.20.010.

The trial court erred in failing to rule as a matter of law that AIG was a “control person” of Mark. Washington law, following 9th Circuit precedent, holds that as a matter of law, a broker-dealer is a control person of its stockbrokers. In *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1573 (9th Cir. 1990), after extensive discussion of the relationship between a broker dealer and its stockbrokers, the Ninth Circuit of Appeals held, “Today we hold that a broker-dealer is a controlling person under § 20(a) with respect to its registered representatives”). Washington courts “often look to federal court decisions interpreting analogous provisions of federal securities law to inform their interpretation of the WSSA,” *Helenius v. Chelius*, 131 Wn. App. 421, 448 (2007), and the court in *Stewart v. Estate of Steiner*, 122 Wn. App. 258, 278 (2004), noted that the defendant in that case “correctly acknowledges that the Ninth Circuit in *Hollinger* established a general rule that broker-dealers are ‘controlling persons’ with respect to their registered representatives.” The trial court erred in failing to follow *Stewart*.

D. Disputed issues of material fact precluded the trial court from dismissing Appellants’ control person claims on summary judgment.

The evidence before the trial court established as a fact that, at a minimum, AIG had considerable control over Mark. *See* Independent Contractor Agreement, Ex. 1 to Declaration of Gregory M. Curley, CP

238-224. In addition, AIG controlled whether or not Mark *could* act as trustee or manager for those accounts. AIG's Policies and Procedures Manual (titled, "Sales Practice Manual") prohibited its brokers from serving as trustees without the firm's permission (except for immediate family members, which does not include grandparents). CP 313-323:

9.12.1 Acting as a Fiduciary. No RR may act in the capacity of a trustee, executor, administrator, conservator or guardian for any customer who is not an immediate family member.

1.2.1 Prohibited Outside Business Activities. (Prohibiting all outside business activities, including acting in the capacity of a Trustee, without AIG permission).

21.8.4.1.3 Trustee/Executor. . . . AIG Financial Advisors prohibits RRs or their Advisers from acting as a trustee or executor for any client.

AIG controlled whether Mark could act as trustee, and where he, as trustee, could hold a securities account. Further, AIG's Supervisory Manual, at § 23.8, imposed on it a duty to ensure that its stockbrokers who also acted as investment advisors, whether through AIG or an Independent RIA firm,⁵⁴ did not breach their fiduciary duties or make unsuitable investments. *Supra* at pp. 32-35.

The trial court was obliged to (1) follow Washington law that "Because the primary purpose of the WSSA is to protect investors, we construe it liberally," *Stewart v. Estate of Steiner*, 122 Wn. App. 258, 264

⁵⁴ Section 23.0, Investment Advisors, discusses both independent advisers and SagePoint corporate advisers, and places the same supervisory burden on Sagepoint supervisors with respect to both throughout. CP 504-611, Ex.5. This means it applied to Mark.

(2004); *Douglas v. Stanger*, 101 Wn. App. 243, 254 (2000), and (2) construe this evidence, and grant all inferences, in favor of Appellants on AIG's motion to dismiss their control person claim. The trial court failed to follow these fundamental principles of summary judgment.

RCW 21.20.430 provides a defense to control person liability if the defendant can establish that it did not know, and in the exercise of reasonable care could not have known, of the facts giving rise to the primary wrongdoer's liability. But AIG failed to establish this defense as a matter of law. Substantial evidence was presented to the trial court showing that that AIG knew, or could have known, of Mark's violations of RCW 21.20.010. AIG received notice directly from Mark, in his October 2007 Outside Business Activities Questionnaire, that he was engaging in private securities transactions in Appellants' accounts. CP 124-191, Ex. 7-10; 13. AIG supervisors actually received, *and reviewed*, all of the monthly account statements for Appellants' Wells Fargo accounts, which showed unsuitable trading in those trust accounts, along with staggering losses, and millions of dollars flowing out of the accounts. *Supra*, at p. 15. At the same time, AIG supervisors received, and reviewed, Mark's personal brokerage account statements, which showed millions of dollars flowing into their accounts at the same times. *Ibid*. At minimum there existed disputed issues of material fact over what AIG knew, or could have known.

E. The court erred in failing to rule that as a matter of law AIG was liable in *respondeat superior* for Mark's acts as its branch office manager, and in dismissing Appellants' *respondeat superior* claims.

The doctrine of *respondeat superior* "provides, generally, that the master is liable for the acts of his servant committed within the scope or course of his employment." *Nelson v. Broderick & Bascom Rope Co.*, 53 Wn.2d 239, 241, 332 P.2d 460 (1958). The test for determining whether an employee was acting within the course of his employment,

is whether the employee was, at the time, engaged in the performance of the duties required of him by his contract of employment, or by specific direction of his employer; or, as sometimes stated, whether he was engaged at the time in the furtherance of the employer's interest.

Dickinson v. Edwards, 105 Wn.2d 457, 467, 716 P.2d 814 (1986) (citing *Elder v. Cisco Constr. Co.*, 52 Wn.2d 241, 245, 324 P.2d 1082 (1958)).

Whether an employee was acting within the scope of employment is an issue of fact, *Ibid.* at 466-467.

It was undisputed that AIG designated Mark the branch office manager of the Bloomington branch, to supervise AIG's brokers in that office. CP 124-191, Ex.1. AIG gave Mark the most important supervisory position, that of a front line, in-office branch manager.⁵⁵ A branch

⁵⁵ The Director of the SEC's Division of Enforcement stated that "[o]f all the supervisory personnel governed by [the duty to exercise reasonable supervision], none occupies a more critical position than the branch office manager, and it is with the branch office manager that customer protection truly begins." McLucas, William R. and Morse, William E., "Liability of a Branch Office Manager for Failure to Supervise," 23 *Review of Securities & Commodities Regulation* 1, 1 (1990).

manager is responsible for supervising all daily transactions in the branch, and all incoming and outgoing correspondence, in order to detect potential violations of securities laws, industry regulations, and AIG's internal rules. CP 124-191, Ex. 2.

Appellants moved for a ruling, as a matter of law, that Mark's supervision of his own activities as AIG's branch office manager was within the scope of the duties that AIG had assigned to him, making AIG liable in *respondeat superior* for his acts as its agent. This was just one of several issues Appellants sought to resolve before trial; it would not, standing alone, establish AIG's liability for anything. Appellants would still have to prove at trial what Mark did as branch office manager, and whether that constituted negligent supervision for which AIG was liable. AIG did not dispute that Mark's conduct as manager of the Bloomington branch were within the scope of his employment. Instead, AIG argued that because Mark was an independent contractor, by definition it could not be held liable in *respondeat superior* for his acts. First, AIG failed to fully state the controlling law, asserting

But in general, an employer who hires an independent contractor is not vicariously liable for the actions of its independent contractor. *Kelley v. Howard S. Wright Constr. Co.*, 90 Wn.2d 323, 330, 582 P.2d 500 (1978) (citation omitted)

SagePoint's Motion, at CP 233. AIG neglected to fully explain the court's discussion in *Kelley v. Wright*, which continued,

A common law exception to the general rule of nonliability exists where the employer of the independent contractor, the general

contractor in this case, retains control over some part of the work. . . . [Citations.] The test of control is not the actual interference with the work of the subcontractor, but the right to exercise such control.

The evidence below demonstrated that AIG had the right to exercise control over Mark *in performing his duties as AIG's branch office manager*. As discussed above, NASD rules and AIG's internal procedures manuals set out in detail the manner in which Mark was to carry out his duties as supervisor, stockbroker, and investment advisor. AIG did not dispute—or even address—whether it had the right to control Mark's acts as branch office manager. *See SagePoint's Motion*, at CP 232-234; *SagePoint's Reply*, at CP 437. Instead AIG argued that it was not liable in *respondeat superior* for Mark's conduct as trustee of Appellant trusts (*SagePoint's Motion*, at CP 233) which was never the basis of Appellants' *respondeat superior* claim. The trial court erred in ruling that no disputed issues of material fact existed, and granting AIG's motion to dismiss Appellants' *respondeat superior* claims.

F. AIG wrongfully withheld key documents in discovery, and the trial court erred in denying Appellants' Motion for Reconsideration.

Appellants moved for reconsideration based on newly discovered evidence, misconduct of AIG in wrongfully withholding that evidence in discovery, and that substantial justice was not done.⁵⁶ A denial of a motion for reconsideration is reviewed for abuse of discretion. *Lilly v. Lynch*, 88

⁵⁶ Appellants' motion for reconsideration transposed cites to CR 59 and 60, but the body of the motion makes clear that these are the grounds for reconsideration.

Wash.App. 306, 321, 945 P.2d 727 (1997). Abuse of discretion occurs when the trial court bases its decision on untenable grounds or reasons, or when its decision is manifestly unreasonable. *Lian v. Stalick*, 106 Wn.App. 811, 823-24, 25 P.3d 467 (2001). In light of the extreme facts here, this court should rule that the trial court abused its discretion in failing to reconsider its summary judgment rulings. First, the discovery violations were egregious.

In December 2011 AIG stated that it had produced all requested compliance manuals and supervisory procedures, including any separate or supplemental manuals governing the duties and responsibilities of [AIG's] associated persons and supervisors. CP 517-518, 4th Dennett Decl. Ex.1.

The central issue in this case was the reasonableness AIG's supervision of Mark Garrison. There could be no more important single document than AIG's supervisory manuals. But contrary to its representation, AIG had produced only a "Sales Practice Manual" prepared for use by AIG's salespeople, and wrongfully withheld the Supervisory Manual quoted extensively at pp. 32-35, *supra*.⁵⁷ Appellants discovered the existence AIG's Supervisory Manual in a September 5, 2012 deposition of an AIG supervisor conducted after oral argument on the parties' summary judgment motions. Shortly thereafter Appellants demanded, and

⁵⁷ Questioned about provisions in AIG's Sales Practice Manual during her deposition, Ms. Nielsen said that manual was "for the field force," while supervisors operated under a different manual—which she referred to as AIG's "supervisory manual." CP 530-531, 4th Dennett Decl. Ex. 2 (Nielsen Dep. 42:1-44:11).

AIG produced, the 450 page Supervisory Manual. CP 543-545; 4th Dennett Decl., Exs. 3 and 4.

Secondly, the withheld materials were critical on the key issue before the trial court: whether AIG had a duty to supervise the transactions in Appellants' Wells Fargo account in order to ensure that Mark did not breach his fiduciary duties to Appellants, or make unsuitable securities transactions in their accounts. Dennett 4th Decl., CP 405-433.

One of the requirements to justify granting a new trial based on newly discovered evidence is that the new evidence would probably change the result, if a new trial is granted. *Nelson v. Placanica*, 33 Wash.2d 523, 206 P.2d 296 (1949). Here, the new evidence would have done exactly that: according to AIG's own written supervisory procedures, AIG had a duty to supervise Appellants' accounts; the supervisory manual directly contradicted AIG's sole evidence on its motion, the Paulukaitis declarations. The trial court erred in failing to grant Appellant's Motion for Reconsideration.

Dated: May 29, 2013

TOUSLEY BRAIN STEPHENS, PLLC

By: 
Carl J. Carlson, WSBA 7157
Jason T. Dennett, WSBA 30686
Attorneys for Appellants

Appendix A

Tab	NTM No.	Description
1.	82-21	Proposed Amendments to Rules Governing Transactions Executed for Persons Associated with Another Member
2.	85-21	Request for Comments on Proposed Rule on Private Securities Transactions
3.	85-41	Request for Comments on Amendment Concerning Associated Persons' Accounts with Investment Advisers, Bank, and Other Financial Institutions
4.	85-84	New Rule of Fair Practice Relating to Private Securities Transactions
5.	86-65	Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel
6.	88-5	Request for Comments on Proposed NASD Rule of Fair Practice Regarding Outside Business Activities
7.	88-86	Approval and Immediate Effectiveness of Article III, Section 43 of the NASD Rules of Fair Practice Regarding Outside Business Activities
8.	91-27	SEC Approval of Amendment to Article III, Section 28 of the Rules of Fair Practice Re: Associated Person Notifying Employer Prior to Opening Securities Account with Another Members
9.	91-32	Request for Comments on Compensation Arrangements for Activities of Registered Representatives Who are also Registered with the Securities and Exchange Commission as Investment Advisers; Last Date for Comments: July 1, 1991
10.	94-44	Board Approves Clarification on Applicability of Article III, Section 40 of Rules of Fair Practice to Investment Advisory Activities of Registered Representatives
11.	96-33	NASD Clarifies Rules Governing RR/IAs



NOTICE TO MEMBERS: 82-21
Notices to Members should be
retained for future reference.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
1735 K STREET NORTHWEST • WASHINGTON, D.C. 20006 • (202) 833-7200

TO: All NASD Members and Interested Persons

DATE: April 1, 1982

RE: Proposed Amendments to Rules Governing Transactions
Executed for Persons Associated with Another Member

Attached hereto are proposed amendments to Article III, Section 28 of the Rules of Fair Practice, which have been authorized for publication by the Board of Governors. Section 28 addresses the responsibilities of members to avoid adversely affecting the interests of other members when executing transactions for persons associated with such other members. It requires written notice to "employer members" as well as the provision of duplicate confirmations and/or statements, if requested.

The proposed amendments are intended to accomplish several distinct results. First, the Rule would be amended to apply to transactions or accounts over which associated persons exercise discretion, as well as accounts in which such associated persons have a financial interest. For example, an account for a relative of a registered representative of another member would be subject to the reporting requirements if the registered representative placed the orders for the account.

Secondly, the Rule would specify an affirmative obligation on persons associated with another member to notify the "executing member" of such association. This would facilitate compliance by such executing members with the notification requirements of Section 28, as well as the "Free-Riding and Withholding" Interpretation and the requirement, in Article III, Section 21(b) of the Rules of Fair Practice, that such association be recorded. The amended Rule would specify that this notification requirement applies even if the associated person has another occupation or affiliation. The amended Rule would also make clear that the notification requirement applies to accounts which exist at the time the person becomes associated with a member, as well as to new accounts.

Third, the Rule would be amended to provide an exemption from the notification requirements for transactions in redeemable securities of registered investment companies (e.g. mutual funds, unit investment trusts and variable contracts). It does not appear that such transactions present the same potential for adverse impact on an employer member as might exist with respect to other transactions and the notification requirement appears to be unnecessarily burdensome with respect to such transactions. A measure of control by employer members would be retained, however, by reason of the reporting requirements of the Private Securities Transaction Interpretation of Article III, Section 27 of the Rules of Fair Practice. This Interpretation, which requires persons associated with a member to notify such member

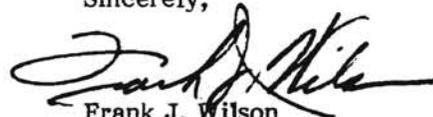
of a private securities transaction outside the regular course or scope of association with the member, contains an exemption for transactions subject to the reporting requirements of Section 28. Since transactions in redeemable investment company securities would no longer be subject to the reporting requirements of Section 28, associated persons would be required to report such transactions directly to the member with which they are associated and to supply duplicate copies of confirmations and other documents if so requested by the member.

Finally, in accordance with the Association's continuing project of updating rules and codifying interpretations, the proposed amendments would incorporate the basic provisions of the existing Board of Governors' Interpretation of Section 28, which Interpretation would be repealed.

Comments from members and other interested persons on the proposed amendments are requested. Such comments must be in writing and received by the Association on or before May 1, 1982 in order to receive consideration. After the comment period has closed, the proposed amendments must again be reviewed by the Board, taking into consideration the comments received. Thereafter, upon approval by the Board, they must be submitted to the membership for a vote. If approved they must be filed with and approved by the Securities and Exchange Commission prior to becoming effective.

Comments on the proposed amendments should be addressed to S. William Broka, Secretary of the Association, 1735 K Street, N.W., Washington, D.C. 20006. All communications will be considered available for inspection. Questions about the proposed amendments should be directed to Robert L. Butler at the above address (Telephone Number (202) 833-7272).

Sincerely,



Frank J. Wilson
Executive Vice President
Legal and Compliance

Proposed Amendment to Article III, Section 28
of the Rules of Fair Practice

(New Material underlined; deleted material scored through)

Determine Adverse Interest

(a) A member (~~herein called an "executing member"~~) who knowingly executes a transaction for the purchase or sale of a security for the account of a ~~partner, officer, registered representative or employee of~~ person associated with another member (~~herein called an "employer member"~~), or for any account over which such associated person has discretionary authority, shall use reasonable diligence to determine that the execution of such transaction will not adversely affect the interests of the employer member.

Obligations of Executing Member

The obligations implicit in the preceding paragraph may be fulfilled by an executing member requesting instruction from an employer member at any time prior to the execution of such a transaction with respect to

- (1) ~~the giving of notice, or~~
- (2) ~~the mailing or delivery of duplicate confirmations or statements to such employer member relating to~~
 - (a) ~~such transaction individually, or~~
 - (b) ~~to such transactions generally~~

~~which instructions shall be followed.~~

Notice to employer member

An executing member shall, prior to the execution of any such transactions, advise the person requesting such execution of the executing member's intent to give notice or information relating to such transaction to the employer member.

(b) Where an executing member knows that a person associated with an employer member has or will have a financial interest in, or discretionary authority over, any existing or proposed account carried by the executing member, the executing member shall:

- (1) notify the employer member in writing, prior to the execution of a transaction for such account, of the executing member's intention to open or maintain such an account;
- (2) upon written request by the employer member, transmit duplicate copies of confirmations, statements, or other information with respect to such account; and
- (3) notify the person associated with an employer member of the executing member's intention to transmit the information required by paragraphs (1) and (2) of this subsection (b).

Exemption for Transactions in Investment Company Shares

(c) The provisions of subsection (b) of this section shall not be applicable to transactions in redeemable securities of companies registered under the Investment Company Act of 1940, as amended, or to accounts which are limited to transactions in such securities.

Obligations of Person Associated with a Member

(d) A person associated with a member who opens an account or places an order for the purchase or sale of securities with any other member, shall, where such associated person has a financial interest in such transaction and/or any discretionary authority over such account, notify the executing member of his or her association with an employer member, regardless of any other function, capacity, employment or affiliation of such associated person. If the account is established prior to the association of such person with an employer member, the associated person shall notify the executing member promptly after becoming so associated.

Interpretation of the Board of Governors

Transactions Effected for Personnel of Other Members

The exercise of reasonable diligence by the executing member to determine that the execution of a transaction will not adversely affect the interest of the employer member is deemed to require that the executing member send notice promptly in writing to the employer member that the executing member proposes to open an account in the name of a partner, officer, registered representative or an employee of the employer member, or, where such an account is open on the date of this interpretation and notice has not been given to the employer member to this effect, the executing member shall send notice in writing, prior to executing a transaction, that it carries such an account for a partner, officer, registered representative, or employee of such employer member.

The above is not intended to limit in any way the obligation of the executing member under the rule to comply with the instructions of the employer member to send such member copies of confirmations of individual transactions, or of monthly statements, or of both or neither, depending on the instructions given.



Print

85-21 Request for Comments on Proposed Rule on Private Securities Transactions

TO: All NASD Members and Other Interested Persons

The National Association of Securities Dealers ("Association" or "NASD") is publishing for comment by members and all other interested persons a proposed rule which would establish new requirements for the private securities transactions of persons associated with member firms. The rule would replace in its entirety the Private Securities Transactions Interpretation under Article III, Section 27 of the NASD Rules of fair practice.^{1/}

The text of the new rule and the present interpretation are attached. A discussion of the background of the rule and its proposed provisions follows below.

BACKGROUND

The Association has long been concerned about private securities transactions of persons associated with broker-dealers. These transactions can be generally grouped into two categories: first, transactions in which an associated person is selling securities to public investors on behalf of another party, e.g., as part of a private offering of limited partnership interests, without the participation of the person's employer firm; and second, transactions in securities owned by the associated person. The first category of transactions presents serious regulatory concerns because securities may be sold to public investors without the benefits of any supervision or oversight by a member firm and perhaps without adequate attention to various regulatory protections such as due diligence investigations and suitability determinations. In some cases, investors may be misled into believing that the associated person's firm has analyzed the security being offered and "stands behind" the product and transaction when in fact the firm may be totally unaware of the person's participation in the transaction. Under some circumstances, a firm may be held civilly liable for the actions of their associated person even though the firm was not aware of such person's participation in the transaction.^{2/}

In view of these concerns, the NASD promulgated the Private Securities Transactions Interpretation several years ago. The Interpretation requires associated persons to notify their employer firms prior to participating in private securities transactions. A significant number of associated persons have been disciplined by the NASD for violation of the Interpretation over recent years. It is believed that the existence of the Interpretation has resulted in greater protection as firms have been able to exercise better supervision over their associated persons.

The Interpretation has been a source of substantial confusion, however, because it speaks only to associated persons' responsibilities in notifying member firms and does not specifically address responsibilities of those firms. The Board of Governors' Advisory Council and several District Business Conduct Committees have requested that the Interpretation be amended to clarify firms' responsibilities. After careful study and analysis, the Board has decided to propose a new rule of fair practice to replace the Interpretation.

ANALYSIS OF PROPOSED RULE

The proposed rule, the text of which is attached, would replace in its entirety the Private Securities Transactions Interpretation and would set forth specific responsibilities for associated persons and member firms regarding the handling of such persons' private securities transactions. On the basis of an analysis of regulatory problems regarding private securities transactions, the rule will treat transactions differently depending upon whether the associated person receives selling compensation. In either case, the rule specifies a member firm's responsibilities.

Applicability — The new rule would apply to any situation in which an associated person of a member proposes to participate in any manner in a private securities transaction. "Private securities transaction" is defined broadly and generally parallels the concept in the present Interpretation. Transactions subject to Article III, Section 28 of the Rules of Fair Practice^{3/} and personal transactions in investment company and variable annuity securities are excluded. Because the most frequent regulatory problems occur in connection with private placements of new offerings, those transactions are specifically identified as included within the definition of "private securities transaction."

Written Notice — The rule requires an associated person to provide written notice to the member with which he is associated prior to participating in any private securities transaction. The notice would be required to include a detailed

description of the proposed transaction and the individual's proposed role therein. Because the rule treats compensatory transactions differently, it would also be necessary for an associated person to state whether he will receive selling compensation in connection with the transaction.

The present Interpretation requires associated persons to provide written notice to their employers. The new rule, however, would require more detail concerning the transaction and the person's involvement in it.

Transactions for Compensation — As noted above, the Board of Governors has concluded that it is important to draw a distinction between transactions in which persons receive selling compensation and those handled as an accommodation or under some other non-compensatory arrangement. The most serious regulatory concerns relate to situations in which associated persons are receiving selling compensation and therefore have an incentive to execute sales, perhaps without adequate supervision and without adequate attention to suitability and due diligence responsibilities. The rule would require that, in the case of transactions in which an associated person has or may receive selling compensation, a member receiving written notice from one of its associated persons shall respond to the person in writing indicating whether the firm approves or disapproves of the person's participation in the proposed transaction. If the firm approves of the person's participation, the firm is then required to treat the transaction as a transaction of the firm, to record the transaction on the firm's books and records, and to supervise the person's participation in the transaction to the same extent as if the transaction were executed on behalf of the firm.

If the firm disapproves of a person's participation, the associated person is prohibited from participating in the transaction in any manner.

Transactions Not For Compensation — The Board believes that there may be some transactions in which associated persons participate without compensation which should not be subjected to the same level of scrutiny as other transactions. For example, a salesperson may own stock in a closely held family corporation and wish to transfer that stock to another family member. While his or her firm should be made aware of such a transaction, it appears unnecessary to treat that type of transaction as a transaction of the employer firm.

Accordingly, the new rule would require a member receiving notice that a person proposes to participate in a transaction without compensation to provide that person with written acknowledgment of said notice. The NASD has consistently taken the position that firms must be able to supervise and regulate effectively each associated person's securities activities. The rule would therefore provide the employer firm with the right to impose conditions upon each person's participation in non-compensatory transactions and would require that any person adhere to such conditions. It is intended that a firm would have full discretion to utilize this authority to restrict its associated persons' private securities activities, including activities performed on a non-compensatory basis.

Definition of Selling Compensation — The definition of "selling compensation" plays a key role in the proposed rule. Because the treatment of transactions varies significantly depending upon whether selling compensation is to be received, the definition of "selling compensation" is deliberately broad in its scope. The definition includes "any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security." Certain examples are provided, including commissions, finder's fees, securities, and rights of participation in profits, tax benefits or dissolution proceeds as a general partner or otherwise. While these examples are intended to include some of the most common forms of compensation, the definition is not intended to be restricted to those examples but rather to include any item of value received or to be received directly or indirectly.

It is important to note that the definition of "selling compensation" includes compensation received or to be received by one acting in the capacity of either a salesperson or in some other capacity, specifically including the capacity of a general partner. The definition is intended specifically to address a practice in which associated persons function as general partners in forming limited partnerships and then sell limited partnership interests in private securities transactions. Any involvement in a securities transaction by an associated person of an NASD member firm may be subject to the panoply of regulatory requirements to which one subjects himself upon becoming associated with a broker-dealer. Participation in transactions as a general partner therefore carries with it significant regulatory responsibilities.

* * * *

The Association encourages all members and other interested persons to comment on the rule proposal. Comments should be directed to:

James M. Cangiano
Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Comments must be received no later than April 29, 1985. All comments will be made available for public inspection.

Questions concerning this notice may be directed to Dennis C. Hensley, Vice President and Deputy General Counsel, at (202) 728-8245.

Sincerely,

Gordon S. Macklin
President

Attachment

PROPOSED NEW RULE OF FAIR PRACTICE

Sec. ____ Private Securities Transactions

- (a) Applicability — No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this section.
- (b) Written Notice — Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated, describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction.
- (c) Transactions for Compensation —
- (1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to Subsection (b) shall advise the associated person in writing stating whether the member:
 - (A) approves the person's participation in the proposed transaction; or
 - (B) disapproves the person's participation in the proposed transaction.
 - (2) If the member approves a person's participation in a transaction pursuant to Subsection (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.
 - (3) If the member disapproves a person's participation pursuant to Subsection (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.
- (d) Transactions Not for Compensation — In the case of a transaction in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to Subsection (b) shall provide the associated person written acknowledgment of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.
- (e) Definitions — For purposes of this section, the following terms shall have the stated meanings:
- (1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission; provided however, that transactions subject to the notification requirements of Article III, Section 28 of the Rules of Fair Practice and personal transactions in investment company and variable annuity securities shall be excluded.
 - (2) "Selling compensation" shall mean any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

National Association of Securities Dealers, Inc.,
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

March 28, 1985

TO: All NASDAQ Companies

RE: Request for comment on Proposed Corporate Governance Requirements for NASDAQ National Market System

Companies

LAST DATE FOR COMMENT: APRIL 28, 1985

The National Association of Securities Dealers, Inc., is requesting comment on proposed rule amendments which would require that companies with securities included in the NASDAQ National Market System (NASDAQ/NMS) adhere to certain standards of corporate governance. This notice contains a discussion of the background of these rules and a section-by-section analysis. The text of the proposed rules is attached.

HISTORY AND BACKGROUND

The publication of the proposed rules is a result of an effort of several months by the NASD Corporate Advisory Board. The Corporate Advisory Board is a body consisting principally of the chief executive officers of NASDAQ companies, chaired by Wilson C. Wearn, Chairman and Chief Executive Officer of Multimedia, Inc., which reports to the NASD Board of Governors. The Advisory Board has played an important role in the evolution of NASDAQ as the fastest-growing and second-largest securities market in the United States, and in the development of NASDAQ/NMS.

Since its inception in 1982, NASDAQ/NMS has grown steadily in size and stature. In November 1984, the Securities and Exchange Commission approved a change to NASDAQ/NMS inclusion criteria which has resulted in a further enhancement in the quality of NASDAQ/NMS companies. As of the end of 1984, the average NASDAQ/NMS company had assets of over \$570 million and equity in excess of \$84 million. Their revenues averaged \$181 million with net income of over \$8 million. The average price per share for NASDAQ/NMS issues was in excess of \$15 and the average issue had almost 8 million shares outstanding with a public float of 5.8 million shares and a market value in excess of \$120 million. NASDAQ/NMS issues had an average of 11.5 market makers in the system.

As NASDAQ/NMS has matured, the Corporate Advisory Board has come to believe that it is appropriate to consider the quality of corporate governance of NASDAQ/NMS companies. This concern has been heightened by numerous state securities administrators who have noted the differences in approach to corporate governance by NASDAQ/NMS and certain of the exchanges. The Corporate Advisory Board believes that the likelihood of achieving a "blue-sky" exemption for NASDAQ/NMS companies in all 50 states will be greatly improved by the implementation of corporate governance criteria.

A special subcommittee of the Corporate Advisory Board chaired by B. Lee Karns, President and Chief Executive Officer of Comprehensive Care Corporation, devoted considerable time during the fall of 1984 to an analysis of corporate governance principles and the propriety of adopting corporate governance standards for NASDAQ/NMS. In January, the subcommittee reported its conclusions to the Corporate Advisory Board and recommended that numerous corporate governance rules be proposed for NASDAQ/NMS and that a survey be conducted of NASDAQ companies concerning additional aspects of corporate governance.

After careful consideration, the Corporate Advisory Board accepted the subcommittee's recommendations and in turn recommended to the NASD Board of Governors that the following corporate governance rules be proposed and that a survey on other possible rules be conducted. The NASD Board of Governors concurred in these recommendations.

SUMMARY OF PROPOSED RULES

The proposed rules, as drafted, would be added to Schedule D to the NASD By-Laws and would become additional criteria for eligibility in NASDAQ/NMS. The rules contain requirements generally similar to those of the New York Stock Exchange and the American Stock Exchange. The proposed rules are summarized below. The text of the rules appears as Exhibit A.

Applicability — The rules would apply to any issuer with a security traded in the NASDAQ/NMS market.

Eligibility — The Corporate Advisory Board contemplates that compliance with the corporate governance rules would be a requirement for a company to be eligible for continued inclusion in NASDAQ/NMS.^{1/}

Distribution of Annual and Interim Reports — The rules would require issuers to distribute both annual and interim reports to shareholders. Annual reports will be required to be distributed within "a reasonable period of time prior to the company's annual meeting," whereas interim reports would be distributed "within a reasonable time" following filing of required interim financial reports with the SEC or other regulatory authority. For companies required to file Form 10-Q with the SEC, quarterly reports to shareholders (on Form 10-Q or otherwise) would be required. Other companies would be required to provide shareholders with reports reflecting information contained in interim financial reports filed with the appropriate regulatory body.

Independent Directors — The rules would require issuers to maintain a minimum of two independent directors on each company's board. "Independent director" is defined so as to exclude officers or employees of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. The determination of independence of any

particular director would therefore be left to the judgment of each company's board.

Audit Committees — The rules require an issuer to establish and maintain an audit committee, a majority of the members of which shall be independent directors.

Shareholder Meetings — Companies will be required to hold an annual meeting of shareholders.

Quorum — The rules would require companies to establish a quorum requirement of at least 50% of the outstanding shares for any meeting of the holders of common stock.

Solicitation of Proxies — Issuers would be required to solicit proxies and distribute proxy statements for all meetings of shareholders and file copies of proxy solicitations with the NASD.

Conflicts of Interest — The rules would address situations in which companies may have a conflict of interest in transactions with persons related to the company. The rules would require that companies conduct "an appropriate review" of all related party transactions on an ongoing basis and that the audit committee be utilized for the review of potential conflicts where appropriate.

Listing Agreement — As drafted, the rules would require each NASDAQ/NMS issuer to execute a listing agreement as prescribed by the NASD. A listing agreement would establish a contractual relationship between each issuer and the NASD.

Effective Date — The rules provide a 12-month "grandfather" period for any NASDAQ/NMS issuer in the system at the time the rules are approved. They would immediately apply to all companies entering the system after they became effective. In addition, the effectiveness of the rules could be delayed for securities entering the system until some reasonable period following approval of the rules.

In view of the fact that some companies may be required to change their corporate charters, comments are specifically requested with respect to the issues of grandfathering and an appropriate phase-in period for the rules.

SANCTIONS FOR NON-COMPLIANCE

The Corporate Advisory Board believes that the appropriate sanction for a NASDAQ/NMS company which fails to meet corporate governance criteria should be deleted from NASDAQ/NMS. Under such an approach, companies deleted from NASDAQ/NMS would remain in NASDAQ. Under present SEC rules, however, any NASDAQ security meeting Tier 1 criteria is mandated to be included in NASDAQ/NMS and cannot be deleted from NASDAQ/NMS while remaining in NASDAQ. The NASD is submitting Section 2 of the proposed rules for comment with the expectation that these rules will be amended.

SURVEY ON VOTING RIGHTS AND CHANGE OF CORPORATE CONTROL

As noted above, the NASD Board of Governors has also approved a survey of NASDAQ companies on two other aspects of corporate governance. That survey will be sent to all NASDAQ companies in the near future.

The first topic addressed by the survey concerns voting rights. The NASD is not proposing at this time to restrict the voting rights assigned to various classes of stock issued by NASDAQ/NMS companies. As the question of voting rights has assumed greater importance in recent years, the New York Stock Exchange has undertaken a review of its policies in this area. The California Corporations Department is also conducting a review of that state's policies on voting rights. In this environment, it was concluded that the Association should survey NASDAQ companies to determine their views on this important issue.

The second matter included in the survey concerns possible restrictions on a corporation's issuance of stock in connection with a change of control. Certain exchanges restrict the percentage of new shares which a company may issue without shareholder approval. In view of the multiplicity of issues related to such restrictions and the continuing evolution of practices concerning mergers and acquisitions, it was concluded that the Association should obtain more information with respect to NASDAQ companies' views prior to developing specific rule proposals on this question.

NASDAQ companies are urged to review the survey carefully when it is received and return it to the Association with a complete expression of their views.

REQUEST FOR COMMENTS

The Association is requesting comments on the proposed rules prior to final Board consideration. All comments received during this comment period will be reviewed by the Corporate Advisory Board and changes will be recommended as deemed appropriate. The Board of Governors will then reconsider the proposal. If the Board approves the rules or an amended version, they must be filed with, and approved by, the Securities and Exchange Commission before becoming effective.

All written comments should be addressed to:

James M. Cangiano, Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

All comments must be received by April 28, 1985. Any questions regarding this notice should be directed to either Dennis C. Hensley or T. Grant Callery at (202) 728-8294.

Sincerely,

Gordon S. Macklin
President

Attachment

DRAFT CORPORATE GOVERNANCE PROVISIONS AS APPROVED BY THE CORPORATE ADVISORY BOARD

Add new Part II D to Schedule D to the NASD By-Laws as follows; existing sections D and E to be redesignated as E and F respectively.

D. Rules for Issuers of NASDAQ National Market System Securities

1. Applicability

- a. This Part II D shall apply to any NASD/NMS issuer.
- b. For purposes of this Part II D, "NASDAQ/NMS issuer" shall mean the issuer of a security included in the NASDAQ System which has been designated as a national market system security pursuant to Rule HAa2-I under the Securities Exchange Act of 1934.

2. Eligibility

No security shall be eligible for inclusion in the NASDAQ National Market System unless the issuer of said security is in compliance with this Part II D.

3. Distribution of Annual and Interim Reports

- a. Each NASDAQ/NMS issuer shall distribute to shareholders copies of an annual report containing audited financial statements of the company and its subsidiaries. The report shall be distributed to shareholders a reasonable period of time prior to the company's annual meeting of shareholders and shall be filed with the Corporation at the time it is distributed to shareholders.
- b.
 - (i) Each NASDAQ/NMS issuer which is subject to SEC Rule 13a-13 shall distribute copies of quarterly reports including statements of operating results and financial position to shareholders within a reasonable time following the company's filing of Form 10-Q with the Securities and Exchange Commission. If the form of such quarterly report differs from Form 10-Q, copies of the report shall also be provided to the Corporation. The financial statements contained in quarterly reports shall be prepared in a manner consistent with generally accepted accounting principles but are not required to be audited.
 - (ii) Each NASDAQ/NMS issuer which is not subject to SEC Rule 13a-13 and which is required to file on a periodic basis with the Securities and Exchange Commission, or another federal or state regulatory authority reports relating primarily to operations and financial position shall distribute to shareholders reports which reflect the information contained in such interim reports. Such reports shall be distributed to shareholders within a reasonable period of time following filing with the appropriate regulatory authority. If the form of the interim report provided to shareholders from that filed with the regulatory authority, copies of such report shall also be provided to the Corporation.

4. Independent Directors

Each NASDAQ/NMS issuer shall maintain a minimum of two independent directors on its board of directors. For purposes of this section, "independent director" shall mean a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

5. Audit Committee

Each NASDAQ/NMS issuer shall establish and maintain an Audit Committee, a majority of the members of which shall be independent directors.

6. Shareholders Meetings

Each NASDAQ/NMS issuer shall hold an annual meeting of shareholders and shall provide notice of such meeting to the Corporation.

7. Quorum

Each NASDAQ/NMS issuer shall provide in its by-laws for a quorum for any meeting of the holders of common stock of at least 50% of the outstanding shares of the company's common voting stock.

8. Solicitation of Proxies

Each NASDAQ/NMS issuer shall solicit proxies and provide proxy statements for all meetings of shareholders and shall provide copies of such proxy solicitation to the Corporation.

9. Conflicts of Interest

Each NASDAQ/NMS issuer shall conduct an appropriate review of all related party transactions on an ongoing basis and shall utilize the company's Audit Committee as a forum for the review of potential conflict of interest situations where appropriate.

10. Listing Agreement

Each NASDAQ/NMS issuer shall execute a Listing Agreement in the form designated by the Corporation.

11. Effective Date

This Part n D shall apply to any issuer which first has a security designated as a national market system security after _____, and shall become effective as to any other NASDAQ/NMS issuer on [twelve months after approval].

^{1/} NASD Manual (CCH), p, 2109-2,

^{2/} This concern has been addressed in earlier NASD notices. See Notices to Members 82-39 (June 15, 1982), and 80-62 (December 1, 1980).

^{3/} Section 28 requires associated persons who handle personal securities transactions through a member (the "executing member") other than their employer to notify the executing member of their regulated status. That member is then required to notify the employer member of each person's activity. See NASD Manual (CCH), paragraph 2178.

^{1/} This approach is discussed further on in connection with sanctions.



Print

85-41 Request for Comments on Amendment Concerning Associated Persons' Accounts with Investment Advisers, Banks, and Other Financial Institutions

TO: All NASD Members and Other Interested Persons

LAST DATE FOR COMMENT IS JULY 10, 1985

The National Association of Securities Dealers, Inc. is soliciting comments from members and other interested persons on a proposed amendment to Article III, Section 28 of the NASD's Rules of Fair Practice ("Section 28"), ^{1/} which would impose certain requirements on associated persons of members in connection with their securities accounts with investment advisers, banks, and other financial institutions. The text of the proposed amendment is attached to this notice.

Section 28 presently provides that an associated person who opens an account or places an order with a member other than the person's employer member is required to notify the executing member of his or her association with the employer member if the associated person has a financial interest in or discretionary authority over the account or order. The provision also requires that the member with which such an associated person opens the account or places the order must notify the person's employer member and provide the member with duplicate confirmations and statements upon request. Section 28 is intended to assure that each associated person's employer member is provided with the necessary information to properly supervise all of the person's securities transactions. A member firm's ability to enforce compliance by its associated persons with certain important NASD rules, (e.g., the Free-Riding Interpretation) is significantly hampered unless the member is provided information on each associated person's securities transactions.

As banks and other financial institutions have come to offer a broader range of securities-related services, there is a greater likelihood that associated persons will establish securities accounts with such institutions. Banks are not required to become registered as broker-dealers with the Securities and Exchange Commission and are not eligible for membership in the NASD. Therefore, they are not subject to Section 28. Investment advisers and certain other financial institutions are likewise not members of the NASD and therefore are not subject to Section 28.

The National Business Conduct Committee and Board of Governors have become concerned that the inapplicability of Section 28 to securities accounts of associated persons with non-members may undermine members' ability to supervise their associated persons and possibly lead to abuses. Accordingly, the NASD is proposing to amend Section 28 to require any associated person to notify the person's employer member when opening a securities account with an investment adviser, bank, or other financial institution or before placing an order to buy or sell securities with such an organization. The amendment would apply to any account or transaction in which the person has a financial interest or discretionary authority. The amendment would also require associated persons to arrange for the employer member to receive duplicate confirmations and account statements upon request.

• All members and other interested persons are invited to submit comments on the proposed amendment. Comments should be received no later than July 10, 1985, and should be directed to:

James M. Cangiano
Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Comments received by the indicated date will be considered by the National Business Conduct Committee and the Board of Governors. If the amendment is approved by the Board of Governors, it must thereafter be submitted to the membership for a vote. Any rule change approved by the Board and the membership must be filed with and approved by the Securities and Exchange Commission before becoming effective.

Questions concerning this notice may be directed to Dennis C. Hensley or John F. Mylod at (202) 728-8245 or (202) 728-8288.

Sincerely,

Frank J. Wilson
Executive Vice President and General Counsel

Attachment

PROPOSED AMENDMENT TO ARTICLE III, SECTION 28 OF THE NASD RULES OF FAIR PRACTICE*

Sec. 28

Transactions for [Personnel of Another Member] or by Associated Persons

Determine Adverse Interest

- (a) A member ("executing member") who knowingly executes a transaction for the purchase or sale of a security for the account of a person associated with another member ("employer member"), or for any account over which such associated person has discretionary authority, shall use reasonable diligence to determine that the execution of such transaction will not adversely affect the interests of the employer member.

Obligations of Executing Member

- (b) Where an executing member knows that a person associated with an employer member has or will have a financial interest in, or discretionary authority over, any existing or proposed account carried by the executing member, the executing member shall:
- (1) notify the employer member in writing, prior to the execution of a transaction for such account, of the executing member's intention to open or maintain such an account;
 - (2) upon written request by the employer member, transmit duplicate copies of confirmations, statements, or other information with respect to such account; and
 - (3) notify the person associated with the employer member of the executing member's intention to [transmit] provide the notice and [the] information required by paragraphs (1) and (2) of this subsection (b).

Obligations of Associated Persons [Associated] Concerning an Account with a Member

[(d)]

- (c) A person associated with a member who opens an account or places an order for the purchase or sale of securities with [any other] another member, shall[, where such associated person has a financial interest in such transaction and/or any discretionary authority over such account! notify the executing member of his or her association with [an] the employer member [regardless of any other function, capacity, employment or affiliation of such associated person. If]; provided, however, that if the account [is] was established prior to the association of [such] the person with [an] the employer member, the associated person shall notify the executing member promptly after becoming so associated.

Obligations of Associated Persons Concerning an Account with an Investment Adviser, Bank, or Other Financial Institution

- (d) A person associated with a member who opens a securities account or places an order for the purchase or sale of securities with a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall;
- (1) notify his or her employer member in writing, prior to the execution of any transaction, of the intention to open the account or place the order; and
 - (2) upon written request by the employer member, request in writing that the investment adviser, bank, or other financial institution provide the employer member with duplicate copies of confirmations, statements, or other information concerning the account or order;
- provided, however, that if an account subject to this subsection (d) was established prior to a person's association with a member, the person shall comply with this subsection promptly after becoming so associated.
- (e) Subsections (c) and (d) of this section shall apply only to an account or order in which an associated person has a financial interest or with respect to which such person has discretionary authority.

Exemption for Transactions in Investment Company Shares

[(c)]

- (f) The provisions [of subsection (b)] of this section shall not be applicable to transactions in variable contracts or redeemable securities of companies registered under the Investment Company Act of 1940, as amended, or to accounts which are limited to transactions in such securities. entered here. The billing number will assist the firm in identifying, by office, charges which may be associated with the individual's termination.

Multiple Terminations (Item 8)

The Form U-5 (4/85) has been revised to incorporate a new item to facilitate a multiple termination with one or more firms under common ownership or control on a single form submission. This should be used when the individual is terminating registrations in the same self-regulatory organizations (SROs) and states with all the affiliated firms entered on the form.

Full/Partial Terminations (Item 9 & Item 10)

The new U-5 has been expanded to require terminations to be specifically identified as a full or partial termination and the complete date of termination is required for each category. To accomplish a full termination (NASD), check the appropriate box under Item 9 and do not complete Item 10. If the form is being filed as a partial termination, (selected state(s) or SROs other than NASD), check the appropriate box under Item 9 and identify only the states/SROs under Item 10 in which the individual is terminating.

Reason For Termination (Item 12)

This category has been changed to address the reason and, in certain cases, require an explanation for an individual's termination. If a box with an asterisk to its left is checked, a brief explanation for the reason must be provided on the adjacent line. Remember, this information must be provided for both full and partial terminations. **Answers to Item 12 will no longer have an effect on an individual's disciplinary status in the CRD.**

Items 13,14 and 15

The disciplinary questions have been reworked to correspond to Form U-4. An affirmative response to any of these questions will require a special review of the record. Details to "yes" answers must be provided on the reverse of the form, after identifying the item number in question.

Amendments to Form U-5 Disciplinary Questions

Amendments to Form U-5 disciplinary questions should be filed to report the disposition of items pending at the time of initial submission of the form. To amend, complete Items 1 through 4 for identification purposes and amend Items 13 through 15 as appropriate. Include relevant details on the reverse side of the form. Remember, when submitting a U-5 amendment, ONLY Items 13 through 15 may be amended. The CRD will not effect changes to any other item on the form. The form must be manually signed by the appropriate signatory.

IMPLEMENTATION DATES OF FORMS U-4 AND U-5

Form U-4

Beginning on July 1, 1985, and throughout the month of July, the CRD System will accept both Form U-4 (1/81) (the old form) as well as the revised Form U-4 (4/85). Each version of the form is identified by the effective date found in the lower left-hand corner of each page. This dual processing period has been arranged to ensure a smooth transition to the revised form. However, old (1/81) forms received by the CRD after July 31, 1985, will be returned without being processed.

Form U-5

The revised Form U-5 (4/85) will be processed by the CRD effective July 1, 1985. Unlike the Form U-4, the CRD will not accept the Uniform Termination Notice for Securities Industry Registration, the old Form U-5 (2/81), after June 28, 1985. Any old (1/81) forms received after this date will be returned to the firm without being processed. The forms can be identified by the effective date in the lower left-hand corner of the form.

Copies of the revised Forms U-4 and U-5 are enclosed for your information and use. Mechanical reproductions of these forms which are clear, legible and of identical type and size will be accepted. Also, additional supplies of Forms U-4 and U-5 can be ordered through CRD Information Services at (202) 728-8800.

GUIDE FOR CRD FORM FILINGS

The Guide For CRD Form Filings has been revised to incorporate the revisions to Forms U-4 and U-5 and can be ordered for a fee through the CRD Information Services (202) 728-8800.

Questions regarding this notice should be directed to Raymond Heffron at(202) 728-8367.

Sincerely,

John T. Wall
Executive Vice President
Member and Market Services

Attachments

^{1/} NASD Manual (CCH) ¶2178.

* Deleted language is bracketed; new language is underlined.

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Print

85-84 New Rule of Fair Practice Relating to Private Securities Transactions

TO: All NASD Members and Other Interested Persons

On November 12, 1985, the Securities and Exchange Commission approved a new Article III, Section 40 of the NASD Rules of Fair Practice (SEC Release No. 34-22617). The rule establishes new requirements for the private securities transactions of persons associated with members, and entirely replaces the Private Securities Transactions Interpretation under Article III, Section 27 of the rules. The new rule became effective upon approval by the SEC.

The text of the new rule is attached.

BACKGROUND

The NASD has long been concerned about private securities transactions of persons associated with broker-dealers. These transactions can generally be grouped into two categories:

1. Transactions in which an associated person sells securities to public investors on behalf of another party (e.g., as part of a private offering of limited partnership interests, without the participation of the individual's employer firm); or
2. Transactions in securities owned by an associated person.

The first category of transactions presents serious, regulatory concerns because securities may be sold to public investors without the benefit of supervision or oversight by a member firm and, perhaps, without adequate attention to such regulatory protections as due-diligence investigations and suitability determinations. In some cases, investors may be misled into believing that the associated person's firm has analyzed the security being offered and "stands behind" the product and transaction. The firm, in fact, may be unaware of the associated person's participation in the transaction. Under some circumstances, the firm may be liable for the actions of the associated person even though the firm was not aware of his or her participation in the transaction.

In view of these concerns, the NASD promulgated the Private Securities Transactions Interpretation several years ago. The Interpretation required associated persons to notify their employer firms before participating in private securities transactions. A significant number of associated persons have been disciplined by the NASD for violation of this Interpretation in recent years. The Interpretation enabled firms to exercise better supervision over their associated persons.

At the same time, the Interpretation was a source of substantial confusion, because it addressed only the responsibility of associated persons to notify their member firms of these transactions and did not specifically address the supervisory and oversight responsibilities of the firms. The Board of Governors' Advisory Council and several District Business Conduct Committees requested that the Interpretation be amended to clarify the firms' responsibilities in this area. After careful study, the Board adopted a new rule of fair practice to replace the Interpretation.

The NASD published the proposed rule on private securities transactions for comment in Notice to Members 85-21 (March 29, 1985). In response to the comments received, and following further consideration of the proposed rule by the Board of Governors, the NASD published a slightly revised version for membership vote in Notice to Members 85-54 (August 13, 1985). The new rule was approved by the membership and filed with the SEC, which approved the new rule on November 12, 1985.

Based on an analysis of regulatory problems regarding the handling of private securities transactions, the rule distinguishes between transactions in which the associated person will receive compensation for selling the securities and those for which no compensation will be received. The most serious regulatory concerns relate to situations in which associated persons receive selling compensation and, therefore, have an incentive to execute sales, perhaps without adequate supervision or adequate attention to suitability and due-diligence responsibilities. Some transactions in which associated persons participate without compensation need not be subjected to the same level of scrutiny as other transactions — for example, a salesperson owning stock in a closely held family corporation may wish to transfer that stock to another family member. Whether or not compensation is involved, the new rule specifies the recordkeeping and supervisory responsibilities of member firms.

ANALYSIS OF NEW RULE

Applicability — The new rule, which is attached, applies to any situation in which an associated person of a member proposes to participate in any manner in a private securities transaction.

"Private securities transaction" is defined broadly and generally parallels the concept in the now-deleted Interpretation. Transactions subject to Article III, Section 28 of the NASD Rules of Fair Practice^{1/} and personal transactions in investment company and variable annuity securities are excluded, as are transactions among immediate family members (as defined in the Interpretation of the Board of Governors on Free-Riding and Withholding^{2/}) for which no associated person receives any selling compensation. Because regulatory problems most frequently occur in connection with private placements of new offerings, those transactions are specifically included within the definition of "private securities transaction."

Written Notice — The rule requires associated persons to provide written notice to the employer member before participating in any private securities transaction. The notice must include a detailed description of the proposed transaction and the associated person's proposed role. As the rule treats compensatory and noncompensatory transactions differently, the notice also must state whether the associated person will receive compensation for selling the securities.

Transactions for Compensation — For transactions in which an associated person has or may receive selling compensation, the rule requires that a member firm that receives written notice from an associated person of his or her intent to participate in a private securities transaction must indicate in writing whether the firm approves or disapproves of the associated person's participation in the proposed transaction. If participation is approved, the firm must supervise the associated person's participation to the same extent as if the transaction were executed on behalf of the member firm itself, and record the transaction on the firm's books and records.

If participation is not approved, the associated person is prohibited from participating in the transaction in any manner.

Transactions Not For Compensation — The rule requires that a member receiving notice that an associated person proposes to participate in a transaction, or a series of related transactions, without compensation, provide that associated person with written acknowledgment of the submitted notice.

The rule also gives the employer firm the right to impose conditions on each associated person's participation in noncompensatory transactions. The intention is to give a member firm full discretionary authority to restrict its associated persons' private securities activities, including activities performed on a noncompensatory basis, and to require the associated person to adhere to any condition imposed.

Definition of Selling Compensation — The definition of "selling compensation" plays a key role in the rule. Because the treatment of transactions varies significantly depending upon whether selling compensation is to be received, the definition of "selling compensation" is deliberately broad in its scope.

The definition includes "any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security." Certain examples are provided, including: commissions; finder's fees; securities; and rights of participation in profits, tax benefits, or dissolution proceeds as a general partner or otherwise. While these examples include some of the most common forms of compensation, the definition is not restricted to these examples. It includes any item of value received or to be received directly or indirectly.

It is important to note that the definition of "selling compensation" includes compensation received or to be received by anyone acting as a salesperson or in some other capacity, specifically including the capacity of a general partner. The definition is intended to address a practice in which associated persons function as general partners in the formation of limited partnerships and then sell limited-partnership interests to the public through private securities transactions. Any involvement in a securities transaction by an associated person of an NASD member firm may be subject to the panoply of regulatory requirements applicable to persons associated with a broker-dealer. Participation in transactions as a general partner, therefore, carries with it significant regulatory responsibilities.

Questions concerning this notice may be directed to Dennis C. Hensley or Phillip A. Rosen, NASD Office of the General Counsel, at (202) 728-8446.

Sincerely,

Frank J. Wilson
Executive Vice President
Legal and Compliance

Attachment

NEW RULE OF FAIR PRACTICE*

Section 40: Private Securities Transactions

- (a) Applicability — No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this section.
- (b) Written Notice — Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction, provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.
- (c) Transactions for Compensation —
- (1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to Subsection (b) shall advise the associated person in writing stating whether the member:
 - (A) approves the person's participation in the proposed transaction; or
 - (B) disapproves the person's participation in the proposed transaction.
 - (2) If the member approves a person's participation in a transaction pursuant to Subsection (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.
 - (3) If the member disapproves a person's participation pursuant to Subsection (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.
- (d) Transactions Not For Compensation — In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to Subsection (b) shall provide the associated person prompt written acknowledgment of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.
- (e) Definitions — For purposes of this section, the following terms shall have the stated meanings:
- (1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Article III, Section 28 of the Rules of Fair Practice, transactions among immediate family members (as defined in the Interpretation of the Board of Governors on Free-Riding and Withholding) for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.
 - (2) "Selling compensation" shall mean any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

^{1/} Section 28 requires associated persons who handle personal securities transactions through a member other than their employer (the "executing member") to notify the executing member of their employment with another member of the NASD. The executing member is then required to notify the employer member of activity in the associated person's account. See NASD Manual (CCH) ¶2178

^{2/} NASD Manual (CCH) p. 2045.

* All language is new. This rule replaces the Private Securities Transactions Interpretation under Article III, Section 27 of the NASD Rules of Fair Practice.



Print

86-65 Compliance with the NASD Rules of Fair Practice in the Employment and Supervision of Off-Site Personnel

TO: All NASD Members, Associated Persons and Other Interested Persons

EXECUTIVE SUMMARY

NASD rules and policies consider associated persons of a member to be employees of the member, regardless of their locations or compensation arrangements. The notice addresses regulatory issues that relate to off-site employment of registered persons, including supervisory procedures, private securities transactions, fair dealings with customers and communications with the public.

Because of the significance of the issues discussed in this notice, the NASD strongly urges that it be distributed to all associated persons and recommends that it be included in the compliance manual of all firms employing off-site personnel.

INTRODUCTION

A significant number of NASD members employ registered persons who engage in securities-related activities, on a full- or part-time basis, at locations away from the offices of the members. These off-site representatives, often classified for compensation purposes as independent contractors, may also be involved in other business enterprises such as insurance, real estate sales, accounting or tax planning. They may also operate as separate business entities under names other than those of the members. The NASD, in the course of its disciplinary proceedings, has observed a pattern of rule violations and other regulatory problems stemming from factors inherent in these arrangements and the manner in which they are effectuated.

Irrespective of an individual's location or compensation arrangements, all associated persons are considered to be employees of the firm with which they are registered for purposes of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the member. The fact that an associated person conducts business at a separate location or is compensated as an independent contractor does not alter the obligations of the individual and the firm to comply fully with all applicable regulatory requirements.

To provide guidance to the membership in meeting these obligations, this notice discusses certain regulatory issues that frequently arise in the context of off-site employment. Because of the importance of these issues, the NASD urges each member to duplicate this notice and distribute it individually to all associated persons. In addition, it is suggested that this notice be included in the compliance manual of firms employing off-site representatives. **The NASD, in the course of its member examinations, will make inquiries to ascertain that this notice has been provided to all appropriate personnel.**

Article III, Section 27, NASD Rules of Fair Practice: Supervision

Section 27(a) sets forth the basic duty of a member firm to:

"... establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association."

Although the rule does not prescribe specific supervisory procedures to be followed by all firms, it clearly mandates that the adopted procedures enable a firm to supervise **properly** the activities of **each** associated person to **assure** compliance. Thus, firms employing off-site representatives are responsible for establishing **and carrying out** procedures that will subject these individuals to effective supervision designed to monitor their securities-related activities and to detect and prevent regulatory and compliance problems.

This can include:

1. Educating off-site personnel regarding their obligations as registered persons to the firm and to the public, including

prohibited sales practices.

2. Maintaining regular and frequent contact with such individuals.
3. Implementing appropriate supervisory practices, such as records inspections and compliance audits at the representatives' places of employment, to ensure that their methods of business and day-to-day operations comply with applicable rules and requirements.

For greatest effectiveness in preventing and detecting violations, visits should be unannounced and include, for example, a review of on-site customer account documentation and other books and records, meetings with individual representatives to discuss the products they are selling and their sales methods, and an examination of correspondence and sales literature.

To fulfill these obligations, a firm should consider whether the number and location of its registered principals provides the capability to supervise its off-site representatives effectively.

Section 27(c) includes the requirement that a member:

"...review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction."

This requirement applies equally in the case of off-site representatives. Firms whose off-site personnel also engage in non-securities businesses should remind these individuals that correspondence pertaining to such businesses, unless submitted for review, may not include material related to securities transactions.

Section 27(d) imposes upon a member the obligation to:

"...review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities and abuses and at least an annual inspection of each office of supervisory jurisdiction."

An office of supervisory jurisdiction (OSJ) is defined in Section 27(f) as:

"...any office designated as directly responsible for the review of the activities of registered representatives or associated persons in such office and/or in other offices of the member."

If a member has designated an individual as responsible for reviewing the activities of other registered persons within the firm, the office of that individual must be inspected annually, regardless of whether such person is compensated as an employee or as an independent contractor.

Article III, Section 40, NASD Rules of Fair Practice: Private Securities Transactions

Past experience of the NASD in examining members indicates that the conduct of off-site representatives most frequently resulting in violations of NASD rules involves unauthorized private securities transactions, or "selling away." The NASD expects that the promulgation of Section 40 and the clarification of the obligations of members and associated persons in such transactions will reduce the instances of selling away among all associated persons, including off-site representatives.

Several aspects of Section 40, and certain related issues, merit emphasis in the context of off-site personnel. **Section 40 cannot accomplish its objectives unless member firms communicate the substance of the rule to their associated persons and take affirmative steps to ensure that these requirements are understood and observed.** This is especially true in the case of off-site representatives whose day-to-day access to compliance personnel and individuals experienced in the securities industry may be limited and whose participation in non-private securities transactions may be infrequent and restricted in scope.

Because of their location and other circumstances of their employment, off-site personnel have a greater opportunity than on-site personnel to engage in undetected selling away. Consequently, firms that employ such persons are responsible for monitoring their activities in a manner reasonably intended to detect violations. Further, the obligations imposed upon the firm and the associated person under the rule are neither altered nor lessened in any way by the fact that the individual is compensated as an independent contractor.

The rule requires a member that approves an associated person's involvement in private securities transactions for compensation to record the transactions on its books and records and supervise the individual's participation "as if the transactions were executed on behalf of the member." Although the rule does not specify the manner of recordation, the firm may wish to maintain records that provide information regarding:

- The individual and the security involved;
- The amount and source of compensation;

The names of the investors and the amounts and dates of the investments;
The issuer, syndicator or any other broker-dealer involved; and
The manner in which the firm undertook to supervise the associated person's participation.

These records should be in a form that would permit the NASD to ascertain, upon examination, all relevant information regarding the participation of associated persons in private securities transactions.

Several issues arise in connection with supervising the involvement of off-site representatives in private securities transactions. The NASD has observed that some firms permit such persons to form and sell interests in limited partnerships for which they serve as general partners. While this is not an impermissible activity, members and registered persons are reminded that such transactions are **securities** transactions, and therefore subject to Section 40 and all other rules and regulations governing such transactions. Thus, the member is responsible for ensuring that the formation of these partnerships and the solicitation and sale of interests therein are conducted in compliance with all applicable requirements, including those pertaining to documentation, due diligence, disclosure, suitability determinations, and the handling of customer funds.

There have been instances in which associated persons have engaged in private securities transactions without notifying the firm, due to the belief or the advice of third parties that the product involved was not a security. Under federal securities laws, the definition of a security includes the commonly understood products, such as stocks and bonds, as well as other investment products, such as an "investment contract" in which one or more individuals invest in a common venture with the expectation of receiving a monetary return on their investment from or through the efforts of a third party.

Because questions frequently arise as to whether a particular investment instrument is a security, a registered person should not sell any product offered by an entity outside the firm without consulting the member to determine the product's status as a security.

Article III, Section 2, NASD Rules of Fair Practice: Recommendations to, and Fair Dealings with, Customers

Article III, Section 2 of the NASD Rules of Fair Practice requires that:

"[i]n 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 the customer as to his other security holdings and as to his financial situation and needs."

The policy of the NASD Board of Governors pertaining to Section 2 sets forth specific guidelines in the areas of recommending speculative, low-priced securities, excessive trading activity, trading in mutual fund shares, fraudulent activity, and recommending purchases beyond the customer's capability.

The actions of an associated person in dealing with customers and customer accounts, regardless of whether he or she is compensated as an employee or an independent contractor, are actions on behalf of the firm. The firm is responsible for supervising in a manner designed to detect and prevent violations of Section 2. Members should take affirmative steps to ensure that off-site personnel understand and abide by NASD and firm policies regarding dealings with customers, customer accounts and customer funds.

Article III, Section 10, Rules of Fair Practice: Influencing or Rewarding Employees of Others

Article III, Section 10 of the NASD Rules of Fair Practice prohibits members and associated persons from giving:

"...anything of value, including gratuities, in excess of fifty dollars per individual per year to any person... where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity"

unless such payments or gratuities are pursuant to a written agreement between the payor and the recipient to which the recipient's employer has consented.

It is, therefore, a violation of Section 10 for a member to compensate an associated person of another member in connection with securities transactions without the employer firm's consent. A member's obligations under Section 10 are not affected by the fact that the recipient is compensated by his or her NASD employer member as an independent contractor.

Article III, Section 35, Rules of Fair Practice: Communications with the Public

Article III, Section 35(b) of the NASD Rules of Fair Practice requires that every item of advertising and sales literature, as defined in Section 35(a):

"...be approved by signature or initial, prior to use, by a registered principal (or his designee) of the

member."

Paragraph (2) of Section 35(b) requires further that a separate file of such items be maintained for a period of three years.

This rule applies to all materials originated or distributed by off-site representatives that meet the definition of "advertisement" or "sales literature," including those prepared or used by persons compensated as independent contractors. In particular, firms must approve any materials referencing that securities are sold by the off-site representative through the member, even though such materials may be intended to promote the non-securities businesses of the off-site personnel.

Article III, Section 35(d)(2)(A) further requires that all advertisements and sales literature contain the name of the member, as well as certain other information under specified circumstances. The fact that an associated person may operate under a business name other than that of the member does not alter this requirement. The NASD has received inquiries regarding the need to include the name of the member in promotional materials that do not include references to the associated person's securities-related activities. Particular materials should be considered individually, preferably by the firm's compliance department, to determine whether they fall within the scope of Section 35.

Unregistered Broker-Dealers

The Securities and Exchange Commission has taken the position that an individual who operates as an independent contractor must be registered as a broker-dealer unless he or she is under the control of a registered broker-dealer.^{1/} The question of "control" must be evaluated in light of the facts and circumstances of each situation and is not susceptible to a test of general application. There are, however, circumstances inherent in off-site employment and independent contractor compensation arrangements that may give rise to potential liability for operating as unregistered broker-dealers. Thus, registered persons and member firms may want to consider registering of off-site locations as broker-dealers.

Any questions regarding this notice should be directed to either Dennis C. Hensley, NASD Vice President and Deputy General Counsel, at (202) 728-8245, or Jacqueline D. Whelan, Attorney, NASD Office of the General Counsel, at (202) 728-8270.

Sincerely,

Frank J. Wilson
Executive Vice President and General Counsel

^{1/} Refer to the statement by the SEC Division of Market Regulation, dated June 18, 1982, forwarded to all NASD members on August 25, 1982.



Print

88-5 Request for Comments on Proposed NASD Rule of Fair Practice Regarding Outside Business Activities

TO: All NASD Members and Other Interested Persons

LAST DATE FOR COMMENT: FEBRUARY 14, 1988.

EXECUTIVE SUMMARY

The NASD requests comments on a proposed NASD Rule of Fair Practice that would require all persons associated with a member firm to provide prior written notice to the firm of certain outside business activities.

The NASD Board of Governors believes the proposed rule is necessary to inform member firms of the nature and extent of the outside activities of their principals, associated persons, and employees so the firms can more effectively carry out the supervisory responsibilities mandated by the NASD Rules of Fair Practice and the federal securities laws.

The text of the proposed rule is attached.

BACKGROUND

The growing diversification of the financial services industry has provided increased business opportunities for persons associated with member firms, both within the scope of their employment and otherwise. The NASD Board of Governors has noted that in recent disciplinary cases, prior notice to a member firm of an associated person's outside business activities could have prevented the firm's entanglement in legal difficulties and harm to the investing public. The Board concluded that it is imperative that member firms receive prior notification of all outside business activities of their associated persons so that the member's objections, if any, to such activities may be raised at a meaningful time and so that appropriate supervision may be exercised as necessary under applicable law.

The internal rules of many member firms already include limitations on outside business activities and notification requirements. In addition, both the New York Stock Exchange and the American Stock Exchange require associated persons of member firms to notify their firms of outside business activities.^{1/}

The proposed NASD Rule of Fair Practice would not distinguish between supervisors and other associated persons and would impose an obligation upon principals, associated persons, and employees to notify their member firms prior to engaging in outside business activities. The NASD Board of Governors believes that the adoption of the proposed rule would serve to protect investors and the public interest by involving member firms in the prior review of all business activities of their associated persons.

PROPOSED RULE

The proposed rule would prohibit any person associated with a member firm from being employed by, or accepting compensation from, any other person for any outside business activity unless the individual has provided his employer firm with advance written notice. The rule also would apply to business activities that are outside the scope of an associated person's relationship with the employer firm.

The NASD encourages all members and other interested persons to comment on the proposed rule. Comments should be directed to:

Mr. Lynn Nellius
Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1506

Comments must be received no later than February 14, 1988. Comments received by this date will be considered by the

NASD National Business Conduct Committee and the NASD Board of Governors. If the proposed rule is approved by the Board, it will be submitted to the membership for a vote. If approved by the membership, the rule must be filed with and approved by the Securities and Exchange Commission before becoming effective.

Questions concerning this notice can be directed to Norman Sue, Jr., Senior Attorney, NASD Office of General Counsel, at (202) 728-8117.

Sincerely,

Frank J. Wilson
Executive Vice President and General Counsel

Attachment

PROPOSED NASD RULE OF FAIR PRACTICE

Outside Business Activities

Sec. __. No person associated with a member shall be employed by, or accept compensation from, any other person pursuant to any business activity outside the scope of his relationship with his employer firm unless he has provided written advance notice to that firm.

^{1/} New York Stock Exchange Rule 346(b), (e), and Supplementary Material .10; American Stock Exchange Rule 342(a), (b), and Commentary .20. Both organizations also require persons in supervisory positions to devote their entire time during business hours to the business of their firms and allow such persons to obtain permission from the exchange to devote less than full time to the business of their firm when it will not impair the protection of investors or the public interest.

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Print

88-86 Approval and Immediate Effectiveness of Article III, Section 43 of the NASD Rules of Fair Practice Regarding Outside Business Activities

SUGGESTED ROUTING*

Senior Management
Legal & Compliance
Operations
Trading
Training

*These are suggested departments only. Others may be appropriate for your firm.

EXECUTIVE SUMMARY

The SEC has approved new Section 43 to Article III of the NASD Rules of Fair Practice. The new section prohibits all persons associated with a member in any registered capacity from accepting employment or compensation from any other person as a result of business activity outside the scope of the employment relationship with a member unless prompt written notice to the member firm is provided. This provision does not apply to compensation from passive investments and activities subject to the requirements of Article III, Section 40 of the Rules of Fair Practice. The text of the rule follows this notice.

BACKGROUND

On October 13, 1988, the Securities and Exchange Commission (SEC) approved new Section 43 to Article III of the NASD Rules of Fair Practice (see SEC Release No. 34-26178 (dated October 13, 1988)). The section is intended to improve the supervision of registered personnel by providing information to member firms concerning outside business activities of their representatives.

On January 14, 1988, the NASD issued Notice to Members 88-5, which solicited comments on a proposed NASD Rule of Fair Practice prohibiting any person associated with a member firm from being employed by, or accepting compensation from, any other person based on any business activity outside the scope of the employment relationship with a member firm, unless such person had provided prior written notice to that firm.

When requesting comments concerning the proposed rule, the NASD Board of Governors observed that the expansion of the financial services industry had provided increased business opportunities for persons associated with a member firm, both within the scope of their employment with a member and otherwise. The Board noted that, in recent disciplinary cases, prior notice to a member firm of an associated person's outside business activities might have prevented harm to the investing public or the firm's entanglement in legal difficulties.

The Board further observed that the internal rules of many member firms already included limitations on outside business activities and notification requirements, and that both the New York Stock Exchange and the American Stock Exchange require associated persons of member firms to notify their firms of outside business activities.¹ The Board concluded that it was appropriate for member firms to receive prompt notification of all outside business activities of their associated persons so that the member's objections, if any, to such activities could be raised at a meaningful time and so that appropriate supervision could be exercised as necessary under applicable law.

After reviewing comments submitted by the membership, the NASD Board concluded that the proposed rule should be adopted with certain modifications limiting the rule's application to persons associated with a member in a registered capacity and exempting passive investments and activities subject to the requirements of Article III, Section 40 of the NASD Rules of Fair Practice from the proposed rule's notice requirements. The Board determined that prompt, rather than prior, notice should be required under the proposed rule, and that the form of the written notice should be determined by the

employer-member and could therefore include using Form U-4. The proposed rule, as modified, was approved after a member vote (see Notice to Members 88-45 dated July 1, 1988) and was filed with the SEC on July 27, 1988.

Questions concerning this notice can be directed to Norman Sue, Jr., Senior Attorney, Office of the General Counsel, at (202) 728-8117

OUTSIDE BUSINESS ACTIVITIES

Sec. 43. No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. Activities subject to the requirements of Article III, Section 40 of the Rules of Fair Practice shall be exempted from this requirement.

¹ New York Stock Exchange Rule 346(b), (e), and Supplementary Material .10; American Stock Exchange Rule 342(a), (b), and Commentary .20. Both organizations also require persons in supervisory positions to devote their entire time during business hours to the business of their firms and allow such persons to obtain permission from the exchange to devote less than full time to the business of their firm when it will not impair the protection of investors or the public interest.

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Print

91-27 SEC Approval of Amendment to Article III, Section 28 of the Rules of Fair Practice Re: Associated Person Notifying Employer Prior to Opening Securities Account With Another Member

SUGGESTED ROUTING:*

Senior Management
Internal Audit
Legal & Compliance
Registration

*These are suggested departments only.
Others may be appropriate for your firm.

EXECUTIVE SUMMARY

The Securities and Exchange Commission (SEC) has approved an amendment to Article III, Section 28 of the NASD Rules of Fair Practice requiring an associated person to notify the employer member in writing prior to opening an account or placing an initial order with the executing member and to notify the executing member in writing of the employment relationship that exists with the employer member. The text of the amendment, which takes effect June 1, 1991, follows this notice.

BACKGROUND

Prior to the approval of this amendment by the SEC, Article III, Section 28(c) required a registered representative, before opening an account or executing trades at a firm other than his or her employer, to inform the executing member firm of his or her status as an associated person. This provision did not, however, require the notice to be in writing. In addition, there was no specific provision in the Association's Rules of Fair Practice that required the registered representative to inform his or her employer member that he or she was executing trades through another firm.¹ Section 28(c) placed the burden on the executing member to notify the employer member and to provide duplicate confirmations or such other information as is required by the employer member.

The NASD believes that requiring such notification by the associated person will provide additional assurances that the registered representative, the employer member firm, and the executing member firm have satisfied their respective obligations under the federal securities laws and the Rules of Fair Practice. Furthermore, the NASD believes that placing the burden of notification on the employee will prevent the likelihood that the notification inadvertently will be overlooked by the executing member in light of other existing regulatory obligations. The NASD acknowledges that there may be circumstances dictating that an associated person hold an account with someone other than his or her employer member, and this amendment would not serve to prevent that. On the contrary, it would merely require notification of the existence of such an account.

EXPLANATION

The amendment requires an associated person to provide notice *in writing* (1) to his or her employer prior to opening or placing an initial order in a securities account with another member, and (2) to the executing member of his or her association with the employer member. This amendment will require notice only prior to the opening of an account and the execution of the initial order. Written notification will not be required for any subsequent trades.

The NASD believes that the amendment will prevent instances in which trades may be made by associated persons on inside information because the employer member was not aware of the existence of the account with another member. The amendment will assist in lessening the occurrence of insider trading by providing the employer member with more complete knowledge of its associated persons' trading activities and consequently an enhanced ability to protect material nonpublic information. The amended notification requirement will assist employer members in creating and enforcing internal

compliance procedures and will facilitate more direct and early detection of the existence of potential rule violations.

The SEC approved the amendment on March 6, 1991, in SEC Release No. 34-28945. However, in order to provide sufficient time for members to establish internal procedures to process the information provided in the written notification, the NASD is delaying implementation of the amended notification requirement. Therefore, an associated person's obligation to comply with the amended notification requirement will not start until June 1, 1991. Any accounts opened prior to that date will be subject to the requirements of Section 28(c) prior to this amendment.

Questions concerning this notice may be directed to P. William Hotchkiss, Director, Surveillance, at (202) 728-8235.

SECTION 28 TO ARTICLE III OF THE NASD RULES OF FAIR PRACTICE

(Note: New text is underlined; deleted text is in brackets.)

Transactions for or by Associated Persons Sec. 28

Obligations of Associated Persons Concerning an Account with a Member.

(c) A person associated with a member, prior to opening [who opens] an account or placing [places] an initial order for the purchase or sale of securities with another member, shall notify both the employer member and the executing member, in writing, of his or her association with the [employer] other member; provided, however, that if the account was established prior to the association of the person with the employer member, the associated person shall notify both [the executing] members in writing promptly after becoming so associated.

¹ The transactions subject to Section 28 are not considered to be private securities transactions that need to be approved by the employing member pursuant to Article III, Section 40 of the Rules of Fair Practice.

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91-32 Request for Comments on Compensation Arrangements for Activities of Registered Representatives Who Are Also Registered With the Securities and Exchange Commission as Investment Advisers; Last Date for Comments: July 1, 1991

SUGGESTED ROUTING:*

Senior Management
Internal Audit
Legal & Compliance
Registration
Training

*These are suggested departments only.
Others may be appropriate for your firm.

EXECUTIVE SUMMARY

The NASD requests comments on the compensation arrangements for investment advisory activities of registered representatives who are also registered as investment advisers and are conducting their advisory activities outside the scope of their association with the employing member.

BACKGROUND

The NASD has recently received several requests from members seeking advice on the applicability of Article III, Sections 27, 40, and 43 of the Rules of Fair Practice to the investment advisory activities of registered representatives who are also registered with the Securities and Exchange Commission (SEC) as investment advisers ("RR/IA") where such activity is not undertaken through the member with which the RR/IA is registered.

Article III, Section 40 provides that any person associated with a member who participates in a private securities transaction must, prior to such participation, provide written notice to the member with which the person is associated, describing the proposed transaction and stating whether he or she will receive selling compensation. The member must then respond in writing whether it approves or disapproves the proposed transaction. If the registered person is to receive selling compensation, the member, if it approves the transaction, must record the transaction on its books and records and supervise this transaction under Article III, Section 27 of the Rules of Fair Practice as if the transaction were its own. If the registered person will not receive selling compensation and the member approves the transaction, the member may, at its discretion, require the registered person to adhere to specified conditions in connection with his or her participation in the transaction.

Section 40 defines "private securities transaction" as any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities that are not registered with the SEC. Selling compensation is defined as any compensation paid directly or indirectly, from whatever source, in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds; as a general partner or otherwise; or expense reimbursements.

In *Notice to Members 85-84*, which announced the approval of Article III, Section 40, attention was directed to what constitutes selling compensation. The notice stated that this definition was deliberately broad in its scope and was meant to include the receipt of any item of value whether directly or indirectly from the execution of any such securities transaction. The notice also discussed the fact that Article III, Section 40 was specifically designed to apply not only to situations where registered persons were acting in a sales capacity outside of their association with the member but also to any situations where the registered person was involved in securities transactions including but not limited to acting in the capacity of a general partner.

The NASD's National Business Conduct Committee (NBCC), at its May 1991 meeting, considered the applicability of Article III, Section 40 to investment advisory activities. The NBCC concluded that Section 40, consistent with the policy announced when this section was adopted, should be applied in such a manner as to cover these situations. The NBCC believes that Section 40 should apply to all investment advisory activities conducted by registered representatives other than their activities on behalf of the member that result in the purchase or sale of securities by the associated person's advisory clients. The NBCC believes that if the RR/IA receives no compensation from any source whatever in connection with the outside activities, the books, records, and supervisory obligations of Article III, Section 40 would not apply. If, however, the RR/IA receives compensation for, or as a result of, such advisory activities, from a person or entity other than the member, the books, records, and supervision requirements of Section 40 would apply. The Committee believes that to conclude otherwise would permit registered persons to participate in securities transactions outside the scope of the oversight and supervision of the employer member and of a self-regulatory organization to the potential detriment of customers.

The NBCC also examined the issue of whether the receipt of management or advisory fees for activities conducted away from the member would constitute the receipt of selling compensation under the rule. The Committee determined that the receipt of any compensation by RR/IAs outside the scope of their employment with a member, whether that compensation is directly related to the transactions (e.g., a portion of the commission) or in the form of an asset- or performance-based advisory fee, constitutes the receipt of selling compensation. Members that allow their registered persons to conduct such activities are fully subject to the requirements of Section 40 and must, therefore, record all such transactions on their books and records and supervise them as if these transactions had occurred at the member.

The NBCC believes that Article III, Section 43 is inapplicable to these situations since this section specifically excludes from its coverage activities subject to the requirements of Article III, Section 40.

The NBCC is concerned that there may be compensation arrangements including "wrap" fees other than those discussed above that have not been considered, and solicits comments on any such compensation arrangements to help it determine which, if any, of the provisions of Article III, Section 40 should be applied to those arrangements. In addition, the NBCC would like to receive comments on whether broader-based amendments to the NASD's supervision rule (Article III, Section 27) should be considered in addition to the application of Article III, Section 40. Prior to making any final determinations on these other arrangements, the Committee believes that it should have information concerning other arrangements that may be affected by its conclusions.

The NASD encourages all members and other interested parties to comment on these compensation arrangements. Comments should be forwarded to:

Stephen D. Hickman,
Secretary National Association of
Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506.

Comments should be received by **July 1, 1991**.

Questions concerning this notice should be directed to John E. Pinto, Executive Vice President, at (202) 728-8233, T. Grant Callery, Vice President and Deputy General Counsel, at (202) 728-8285, or Craig L. Landauer, Assistant General Counsel, at (202) 728-8291.

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94-44 Board Approves Clarification On Applicability Of Article III, Section 40 Of Rules Of Fair Practice To Investment Advisory Activities Of Registered Representatives

SUGGESTED ROUTING

Senior Management
Internal Audit
Legal & Compliance
Registration
Training

Executive Summary

The Board of Governors, acting on the recommendation of a special Ad Hoc Committee, is clarifying the applicability of Article III, Section 40 of the NASD Rules of Fair Practice to the investment advisory activities of registered representatives. This Notice describes those investment advisory activities that constitute private securities transactions within the scope of Article III, Section 40.

Summary Of Article III, Section 40

Article III, Section 40 provides that any person associated with a member who participates in a private securities transaction must, prior to participating in the transaction, provide written notice to the member with which he or she is associated. The required notice must describe the transaction, the associated person's role, and state whether the associated person has received or may receive selling compensation. The member must respond to the notice in writing indicating whether it approves or disapproves the proposed transaction. Where the registered person has received or may receive selling compensation, the member approving the transaction must record the transaction in its books and records and must supervise the registered person's participation in the transaction as if it was the member's own under Article III, Section 27 of the Rules of Fair Practice.

Section 40 defines "private securities transaction" as any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the U.S. Securities and Exchange Commission (SEC).

"Selling compensation" is defined as any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

Notice to Members 85-84, which announced the approval of Article III, Section 40, broadly defined the scope of selling compensation and deliberately meant to include the receipt of any item of value received or to be received, directly or indirectly, from the execution of any such securities transaction. The Notice also discussed that Article III, Section 40 was specifically designed to apply to situations where the registered person was acting as a salesperson or in some other capacity.

Background Of The Application Of Section 40 To RR/RIAs

The National Business Conduct Committee (NBCC), at its May 1991 meeting, considered the issue of the applicability of Article III, Section 40 of the Rules of Fair Practice to certain activities of individuals who are registered both as representatives of an NASD member firm and with the SEC as a Registered Investment Adviser ("dually registered person" or "RR/RIA"), and who conduct their investment advisory activities "away from" their NASD member employer. The issue was considered by the NBCC as a result of a number of requests for interpretations relating to programs under which registered representatives directed securities transactions for their investment advisory clients to a broker/dealer other than

the firm with which they are registered.

The NBCC concluded that Article III, Section 40, consistent with the policy announced when the section was adopted, applied in such a manner as to cover certain activities of individuals who are registered both as a representative of an NASD member and with the SEC as an investment adviser. The NBCC stated that Section 40 should apply to all investment advisory activities conducted by these dually registered persons that result in the purchase or sale of securities by the associated person's advisory clients, with the exception of their activities on behalf of the member. The NBCC also determined that the receipt of compensation as a result of investment advisory activities constituted the receipt of selling compensation as defined in Section 40.

The NBCC then issued *Notice to Members 91-32*, explaining its position and soliciting comments on other advisory compensation arrangements, including "wrap" fees, that had not been before the Committee. In response to *Notice to Members 91-32*, the NASD received over 150 comment letters. Few of the letters addressed the NBCC's request for information on other compensation arrangements but rather sought to clarify the NBCC's view on the application of Section 40 to various factual scenarios involving the activities of dually registered persons. After reviewing the comments, the NBCC and the Board appointed an Ad Hoc Committee of the Board to examine this entire area. This special committee met numerous times to review the comment letters, the history and intent of Section 40, and to receive input from various segments of the securities industry, including those most affected by the NBCC's position.

Following extensive discussions and deliberations, the Ad Hoc Committee formulated a clarification which the Board considered and adopted. The following discussion explains the Board's clarification of its position on the scope of transactions that would be deemed to be "for compensation" under Article III, Section 40 with respect to registered representatives/registered investment advisers.

Clarification

In clarifying its previous position in *Notice to Members 91-32*, the Board focused primarily upon the RR/RIA's participation in the execution of the transaction—meaning participation that goes beyond a mere recommendation. Article III, Section 40, therefore, applies to any transaction in which the dually registered person participated in the execution of the trade.

An example of a RR/RIA clearly participating in the execution of trades is where he or she enters an order on behalf of the customer for particular securities transactions either with a brokerage firm other than the member they are registered with, directly with a mutual fund, or with any other entity, including another adviser, and receives any compensation for the overall advisory services. As a result, the "for compensation" provisions of Article III, Section 40 would apply, thereby requiring the RR/RIA adviser to provide notice to his or her firm and requiring that firm, if it approved the activities, to record the transactions and supervise the conduct of the RR/RIA. The Board has determined to exclude from Section 40 coverage arrangements under which the account is "handed off" to unaffiliated third-party advisers that make all investment decisions. This, and most other advisory activities, would fall under and be subject to the requirements of Article III, Section 43 of the Rules of Fair Practice.

Activities that would fall under either Sections 40 or 43 of the Rules of Fair Practice can be generally categorized as follows:

1. Transactions executed on behalf of the customer in which the RR/RIA participated in the execution would be subject to the full "for compensation" provisions of Section 40, thereby requiring the member to record and supervise the transactions. This would be the case whether the RR/RIA received transactionally related, commission-type compensation, asset-based management fees, wrap fees, hourly, yearly, or per-plan fees, as long as fees paid include execution services by the RR/RIA. Also included are situations where the dually registered person has an arrangement with a third-party money manager to handle the customer's account and the RR/RIA makes individual investment decisions for the client, based on recommendations or alternatives provided by the third-party manager.
2. Only transactions executed on the customer's behalf without any form of compensation would be subject to the "non-compensation" provisions of Section 40. It is unlikely that activity of this sort would exist to any substantial degree outside of a familial type relationship.
3. All other investment advisory activities that do not include the RR/RIA's participation in the execution would be subject to the notification provisions of Article III, Section 43. These activities would include securities transactions executed by customers independently through another broker/dealer or directly with a fund or other entity based on specific recommendations of the dually registered person, timing services where the service makes the investment decision, the utilization of unaffiliated third-party advisers where the RR/RIA does not participate in investment decisions for the client, financial plan creation and other such activities.

Analysis Of Various Scenarios Under The Clarification

The following are issues raised in correspondence from members and the results under this interpretation.

1. A service offered by many discount brokerage firms includes the firm providing "back office" services for the dually registered person which include collection of the asset-based advisory fee. Here, the RR/RIA has opened an account on behalf of a customer and has discretionary authority to execute transactions on the customer's behalf. Under these facts, the "for compensation" of Section 40 would apply.
2. Some RR/RIAs engage in activities limited to the writing of financial plans for a fee which do not include specific securities purchase recommendations or executions. Under this approach, such activities would be governed by Section 43.
3. Some asset management firms offer "wrap fee" programs to registered investment advisers. The "wrap fee" includes a fee for management, accounting, and reporting. This fee is shared with the investment adviser who is also a registered representative. Portfolio transactions are handled through a broker/dealer firm at substantial discounts and are not known to or handled by the RR/RIA. Investment advisers receive a part of the asset management fee only and receive no part of any transaction fee. The adviser is registered with the SEC and any states as necessary. This activity would be subject to Section 43 rather than Section 40 of the Rules of Fair Practice.
4. There are firms offering market timing services where the firm, operating as an independent investment adviser, directs the switches within a family of mutual funds, either load or no-load. There are no transaction charges and the investment adviser, also a registered representative, is not involved in handling switches among funds. The dually registered person does receive some part/percentage of the market timing fee. If the customer or timing firm effects the switches with no involvement by the RR/RIA, this fact pattern would be considered as falling under Section 43.
5. Investment advisers who are also registered representatives often charge an advisory fee to "time" a group of load or no-load mutual funds for clients. This process could also be described as asset allocation or a monitoring service. The exchange of funds is handled directly by the investment adviser with the fund group. This pattern differs from number 4 in that the adviser effects the transactions. These are "for compensation" transactions pursuant to Section 40.
6. There are several firms which provide asset allocation models, software, computer hardware, and direct linkup and execute the transactions as necessary. Each adviser can produce statements for clients based on downloaded information. The RR/RIA receives a portion of the asset-based fee for his or her monitoring of the account. The firm to which the account is referred actually handles all implementation, and the dually registered person has no part in the actual transactions. These third-party arrangements are covered by Section 43.
7. Institutional advisers offer services to individual investment advisers which include permitting the adviser to implement, via computer, purchases and sales in institutional funds. Assets are held at banks and the RR/RIA produces statements and confirms for a client. The RR/RIA also handles the allocation of assets and places transactions. The client can pay one combined fee or two separate fees. One is paid to the mutual fund (internal fee) and the second is paid separately to the dually registered person for handling the account. To the degree that the RR/RIA participates in the execution of the transactions, this would produce a "for compensation" Section 40 result.
8. Investment advisers may advise clients on assets held and transacted at another broker/dealer without being involved in implementation or execution. The RR/RIA may receive copies of statements and charges an advisory fee which is for investment advice and monitoring not related to any transactions in the account. This scenario does not involve either the recommendation or execution of transactions. Since the service is solely advice and monitoring "not related to any transactions in the account," the activities would fall under Section 43.
9. Varying situation number 8, such that the adviser calls the representative of the other broker/dealer to implement or execute transactions but receives no fee or commission for the handling thereof, results in "for compensation" transactions under Section 40.

Members and RR/RIAs are expected to be in compliance with the Board's Interpretation as clarified in this Notice. Those firms and RR/RIAs who have not been operating in accordance with the provisions of *Notice to Members 91-32* must immediately conform their activities in order to ensure compliance with the concepts and requirements that have been clarified in this Notice. NASD district examiners will be closely reviewing for compliance with this Interpretation during the course of their field examinations, and violations will be reviewed by DBCCs for consideration of disciplinary action. This clarification should enhance members' abilities to design internal policies and procedures to protect customers who deal with dually registered persons and to prevent potential violations of NASD rules and regulations, particularly Article III, Section 40 of the Rules of Fair Practice. directed to Daniel Sibears, Director. Any questions or inquiries concerning the applicability of Article in, Section 40 to the activities of RR/RIAs may be directed to Craig Landauer, Associate General Counsel at (202) 728-8291. Questions relating to members' general compliance and recordkeeping responsibilities under Article III, Section 40 may be Regulatory Policy at (202) 7286911.

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96-33 NASD Clarifies Rules Governing RR/IAs

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NASD Clarifies Rules Governing RR/IAs

Suggested Routing
Senior Management
Internal Audit
Legal & Compliance
Registration
Training

Executive Summary

On May 15, 1994, the NASD[®] issued *Special Notice to Members 94-44*, which clarified the applicability of Article III, Section 40 of the NASD Rules of Fair Practice to investment advisory activities of registered representatives (RRs) who also are investment advisers (RR/IAs). In particular, the Notice addressed the supervision of securities transactions conducted by RR/IAs away from the NASD members with which they are associated. Since the issuance of *Notice to Members 94-44*, the NASD has responded to questions concerning the types of records that may be used and recordkeeping systems that may be established by an NASD member to ensure that investment advisory transactions subject to Article III, Section 40 are properly recorded and the RR/IA adequately supervised. The NASD also has responded to other general compliance and interpretive questions relating to Article III, Section 40. To further facilitate member firm compliance with Article III, Section 40, this Notice discusses recordkeeping approaches and presents the answers to some of the most frequently asked questions regarding Section 40 since the release of *Notice to Members 94-44*.

Questions regarding this Notice may be directed to Daniel M. Sibears, Director, Regulation, at (202) 728- 6911; or Mary Revell, Senior Attorney, Regulation, at (202) 728-8203.

Background

As reviewed in *Notice to Members 94-44*, Article III, Section 40 requires that any person associated with an NASD member who participates in a private securities transaction must, before participating in the transaction, provide written notice to the member with which he or she is associated. The written notice must describe the transaction, the associated person's role, and disclose whether the associated person will or may receive selling compensation. Thereafter, the NASD member must advise the individual in writing whether it approves or disapproves the associated person's participation in a private securities transaction. If the member approves the transaction, the transaction must be recorded on the member's books and records, and the member must supervise the associated person's participation as if the transaction were executed on behalf of the member.

Most notably, *Notice to Members 94-44*, clarifies the analysis that members must follow to determine whether the activity of an RR/IA falls within the parameters of Section 40. Fundamental to this analysis is whether the RR/IA participates in the execution of a securities transaction such that his or her actions go beyond a mere recommendation, thereby triggering the recordkeeping and supervision requirements of Section 40.

Where the RR/IA does not participate in the execution of securities transactions, *Notice to Members 94-44*, reminds members and their RR/IAs that while Section 40 may not apply, the activity, nonetheless, may be subject to the notification provisions of Article III, Section 43. That section requires an RR to provide written notice to the NASD member with which he or she is associated of any proposed employment or outside business activity pursuant to which he or she will receive compensation from others. The form and content of an Article III, Section 43 notice is to be determined by the NASD member.

Article III, Section 40 Books And Records Relating To Investment Advisory Transactions

Where a member has approved an RR/IA's participation in private securities transactions for which he or she will or may receive selling compensation, the member must develop and maintain a recordkeeping system that, among other things, captures the transactions executed by the RR/IA in its books and records and facilitates supervision over that activity. Recordkeeping systems that simply record all transactions will not result in adequate supervision under Article III, Section 27 of the Rules of Fair Practice. Rather, the records created and recordkeeping system used, together with relevant supervisory procedures, must enable the member to properly supervise the RR/IA by aiding the member's understanding of the nature of the service provided by an RR/IA, the scope of the RR/IA's authority, and the suitability of the transactions.

Since the transactions subject to Section 40 by definition occur at and through another member or directly with a product sponsor, the NASD member licensing the RR/IA is not required to record the activity in the same manner it records transactions executed on behalf of its own firm (i.e., on its purchase and sales blotter). Rather, members may develop and use alternative approaches that meet their specific needs and business practices, such as special blotters, separate Section 40 recordation forms and files, and unit systems, for capturing the RR/IA activity that occurs through other firms. In this regard, Section 40 recordkeeping systems may involve many of the following books and records:

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

Neither the federal securities laws nor the NASD Rules of Fair Practice mandate the supervisory system or structure that a member must use. Rather, each member can develop and implement its own supervisory system that is reasonably designed to detect and prevent violations. In this regard, no single document or combination of the referenced documents is specifically required or necessarily adequate to comply with Section 40 requirements. Rather, each member that determines

to permit its associated persons to transact securities business through another broker/dealer must decide which tailored combination of records is necessary to develop an adequate supervisory system that addresses the allowable activities of RR/IAs. For example, obtaining duplicate confirmation statements directly from the RR/IA alone would permit a member to fulfill recordation requirements for the trades represented by confirmations received, but would not necessarily permit a member to reasonably ensure that it is capturing all trades. However, an arrangement under which the member obtains duplicate confirmation statements directly from the firm (or firms) that executes transactions for the RR/IA should be sufficient to ensure that the member captures all trades.

Member firms have tremendous flexibility to develop and implement recordkeeping and supervisory systems that meet the unique nature and scope of their own operations, and the permitted activities and services provided by their dually registered persons. In all circumstances, however, recordkeeping and supervision must be adequate to ensure that full and complete transaction information is captured, and be reasonably designed to detect and/or prevent misconduct that could violate the federal securities laws and NASD Rules.

Answers To Frequently Asked Questions Concerning The Application Of Article III, Section 40 To Investment Advisory Activities

Question #1: Does Article III, Section 40 require prior approval of each transaction executed by an RR/IA away from his or her NASD member firm if the compensation received by the RR/IA is not transaction based?

Answer: An RR/IA may be involved in numerous transactions on a daily basis for which he or she receives asset-based or performance-based fees. Requiring prior notice of each trade effected under these conditions may hinder investors from properly receiving the investment advisory services provided by RR/IAs. Accordingly, the Board of Governors, acting on the recommendation of a special Ad Hoc Committee, has interpreted Article III, Section 40 to require prior notice of the investment advisory services that will be provided by the RR/IA for an asset-based or a performance-based fee, rather than prior notice of each trade effected by an RR/IA for a particular customer. This interpretation is intended to vigorously apply the investor protection concepts of Article III, Section 40 to investment advisory activities in a practical manner.

A member must receive prior written notice from an RR/IA requesting approval to conduct investment advisory activities for an asset-based or performance-based fee on behalf of each of his or her advisory clients. This notice must include details such as:

- a declaration that the individual is involved in investment advisory activities;
- the identity of each customer to whom the notice would apply;
- the types of securities activities that may be executed away from the firm;
- a detailed description of the role of the RR/IA in the investment advisory activities and services to be conducted on behalf of each identified customer;
- information regarding the RR/IA's discretionary trading authority, if any;
- compensation arrangements;
- the identity of broker/dealers through which trades away will be executed; and
- customer financial information.

Only after written approval from the NASD member may the RR/IA engage in the disclosed activities. 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.

Members are reminded, however, that if the RR/IA receives transaction-based compensation, the member's prior approval of each trade is required.

Question #2: Does Article III, Section 40 apply to persons employed by or associated with registered investment advisory firms if such persons are not registered in an individual capacity with the Securities and Exchange Commission (SEC) or various states?

Answer: Yes. Article III, Section 40 of the Rules of Fair Practice applies to all of an associated person's private securities transactions, regardless of whether or not such associated persons are also registered with other regulatory authorities such as the SEC or the states. The reference to registered investment advisers in *Notice to Members 94-44*, does not limit the applicability of Article III, Section 40 to only those persons individually registered as such with other regulatory entities. In

addition, if the advisory service is not registered with any regulatory agency, a member should ensure that such registration is not required.

Question #3: Is it appropriate for a limited principal (i.e., a Series 26 Investment Company Principal) to supervise Article III, Section 40 transactions in products such as equity securities that are not covered by that registration category?

Answer: Limited principals may not supervise Article III, Section 40 transactions in products not covered by their registration category. Therefore, if a firm only has principals registered in a limited capacity, associated persons engaging in Article III, Section 40 transactions may do so only in products covered by the licenses of the firm's principals.

Question #4: Is it appropriate for a limited representative (i.e., a Series 6 Investment Company Representative) to execute Article III, Section 40 transactions in products such as equity securities that are not covered by that registration category?

Answer: A limited RR who is otherwise in compliance with applicable federal and state registration requirements, such as the SEC's investment adviser registration requirements, may not execute transactions in securities not covered by his or her NASD registration. Registration with the NASD as a representative subjects an individual to all NASD rules, regulations, and requirements, including qualification requirements. Those rules preclude a limited representative from acting as a representative in any area not covered by his or her registration category. A limited representative who wishes to execute transactions in securities not covered by his or her registration category is required to pass an appropriate qualification exam.

Question #5: If an RR/IA is registered with more than one NASD member, must all members approve, supervise, and record the Article III, Section 40 transactions?

Answer: All members with whom a person is registered are responsible for the registered representative's involvement in Section 40 transactions. Members may develop a detailed, formal allocation arrangement whereby at least one member agrees and is able to provide the supervision and recordkeeping required by Article III, Section 40. However, the other members would be required to take the reasonable steps necessary to ensure that Section 40's recordkeeping and supervisory requirements are being carried out since members cannot delegate, by contract or otherwise, their ultimate responsibility for compliance with regulatory requirements.

Question #6: What is a member's responsibility with regard to supervising Section 40 securities transactions where an advisory client of an RR/IA refuses to provide information to the member, citing the confidentiality of client information provisions of an investment advisory agreement?

Answer: Article III, Section 40, which was adopted in 1985, and its predecessor Interpretation of the Board of Governors have always stipulated that a member that allows an associated person to participate in a Section 40 transaction is responsible for supervising that transaction as if it were its own. If a member determines that in order to meet its supervisory obligations under Section 40, it must have certain information from the customer and if the customer refuses to provide the information, the member should deny the associated person's request who would then be precluded from participating in the Section 40 activity.

Question #7: Are there circumstances under which income received as salary payments may be deemed selling compensation as defined by Article III, Section 40?

Answer: As explained in *Notice to Members 94-44*, , selling compensation is broadly defined to include any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security. If salary payments are direct or indirect compensation for an RR/IA's participation in the execution of securities transactions away from his or her member firm, the salary payments would be deemed "selling compensation," and the activities would be subject to Article III, Section 40.

Question #8: Where investment seminars are conducted by RR/IAs away from their employing NASD member and seminar participants are charged a fee for attendance, would any income derived from the seminar for this investment advisory activity be governed by Article III, Section 40 or Section 43 of the Rules of Fair Practice?

Answer: If an investment seminar itself does not result in the execution of securities transactions, Article III, Section 43 would govern the investment advisory activity. In determining whether Article III, Section 40 applies, the NASD has focused primarily upon the RR/IA's participation in the execution of securities transactions and whether the participation goes beyond a mere recommendation. If after an investment seminar, however, participants decide to engage in securities transactions with the participation of the RR/IA, that subsequent activity and any compensation received in connection therewith would be subject to Section 40.

Question #9: Must a member review performance reports produced by RR/IAs to properly discharge its supervisory responsibilities under Article III, Section 40?

Answer: It has come to the NASD's attention that some RR/IAs use information supplied by the broker/dealer through which they conduct private securities transactions or by the investment advisory service corporations with which they are associated to create performance reports for their advisory clients. These reports may be individualized performance reports that provide customized information for a specific client or standardized performance reports that provide general information to multiple clients. With regard to this practice, members and RR/IAs are cautioned that in creating or recreating performance reports, a risk is taken that calculations for securities transactions may be inaccurate, incomplete, or misleading, thus resulting in material misrepresentations being made or material facts being omitted. NASD member supervisory responsibilities should include a determination as to whether to permit associated persons to develop performance reports for securities transactions. If this activity is permitted, the member firm must review the performance reports. Standardized reports sent to multiple clients are considered sales literature and must be reviewed by a registered principal at the member firm before distribution by the RR/IA to clients. If the RR/IA uses the same standardized format for different clients, principal approval before use is required only on the performance report prototype. This review must ensure that the reports are accurate, not misleading, or otherwise in violation of NASD or SEC Rules. In particular, members should review the standards set forth in Article III, Section 35 of the NASD Rules governing member communications with the public, as well as applicable SEC regulations.

Individualized performance reports are considered correspondence. As such, review by the member firm before RR/IA distribution to clients is not required. However, the firm must have appropriate procedures in place, as required by Article III, Section 27 of the NASD Rules of Fair Practice, for review and retention of individualized performance reports and other correspondence.

Question #10: Must NASD members that employ RR/IAs provide training to this segment of their associated persons under the Firm Element of the Continuing Education requirements?

Answer: The Firm Element of the Continuing Education requirements (see Schedule C of the NASD By-Laws) is designed to be flexible and to permit firms to develop tailored educational programs based on their business practices and needs. In this regard, each member that permits its associated persons to conduct securities transactions through another firm should assess the need to provide specific Firm Element training with regard to Section 40 requirements. Where the assessment establishes a need for educational initiatives for all or some portion of the covered persons conducting business away from the member, the firm's written training plan should include defined and scheduled Section 40 training for specified individuals.

Although this Notice and previously issued *Notices to Members* [91-32](#) and [94-44](#) clarify the application of Article III, Section 40 to investment advisory activities, Section 40 has been in effect since November 12, 1985 (see *Notice to Members* [85-84](#)). Accordingly, members and their RR/IAs are expected to be in compliance with Article III, Section 40.

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Appendix B

3030. Outside Business Activities of an Associated Person

No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member. Activities subject to the requirements of Rule 3040 shall be exempted from this requirement.

[Adopted by SR-NASD-88-34 eff. Oct. 13, 1988.]

Selected Notices to Members: 88-5, 88-45, 88-86, 94-44, 94-93, 96-33, 01-79.

3040. Private Securities Transactions of an Associated Person

(a) Applicability

No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this Rule.

(b) Written Notice

Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.

(c) Transactions for Compensation

(1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to paragraph (b) shall advise the associated person in writing stating whether the member:

- (A) approves the person's participation in the proposed transaction; or
- (B) disapproves the person's participation in the proposed transaction.

(2) If the member approves a person's participation in a transaction pursuant to paragraph (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.

(3) If the member disapproves a person's participation pursuant to paragraph (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.

(d) Transactions Not for Compensation

In the case of a transaction or a series of related transactions in which an associated person has not and will not receive any selling compensation, a member which has received notice pursuant to paragraph (b) shall provide the associated person prompt written acknowledgment of said notice and may, at its discretion, require the person to adhere to specified conditions in connection with his participation in the transaction.

(e) Definitions

For purposes of this Rule, the following terms shall have the stated meanings:

(1) "Private securities transaction" shall mean any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission, provided however that transactions subject to the notification requirements of Rule 3050, transactions among immediate family members (as defined in IM-2110-1, "Free-Riding and Withholding"), for which no associated person receives any selling compensation, and personal transactions in investment company and variable annuity securities, shall be excluded.

(2) "Selling compensation" shall mean any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

[Adopted by SR-NASD-85-28 eff. Nov. 12, 1985.]

Selected Notices to Members: 75-34, 80-62, 82-39, 85-21, 85-54, 85-84, 91-32, 94-44, 96-33, 01-79.

Selected SEC Decisions

Allen S. Klosowski and Jack D. Prosen, SEC Rel. No. 34-25467 (1988).

Zester Herbert Hatfield, SEC Rel. No. 34-25488 (1988).

3050. Transactions for or by Associated Persons**(a) Determine Adverse Interest**

A member ("executing member") who knowingly executes a transaction for the purchase or sale of a security for the account of a person associated with another member ("employer member"), or for any account over which such associated person has discretionary authority, shall use reasonable diligence to determine that the execution of such transaction will not adversely affect the interests of the employer member.

(b) Obligations of Executing Member

Where an executing member knows that a person associated with an employer member has or will have a financial interest in, or discretionary authority over, any existing or proposed account carried by the executing member, the executing member shall:

(1) notify the employer member in writing, prior to the execution of a transaction for such account, of the executing member's intention to open or maintain such an account;

(2) upon written request by the employer member, transmit duplicate copies of confirmations, statements, or other information with respect to such account; and

(3) notify the person associated with the employer member of the executing member's intention to provide the notice and information required by subparagraphs (1) and (2).

(c) Obligations of Associated Persons Concerning an Account with a Member

A person associated with a member, prior to opening an account or placing an initial order for the purchase or sale of securities with another member, shall notify both the employer member and the executing member, in writing, of his or her association with the other member; provided, however, that if the account was established prior to the association of the person with the employer member, the associated person shall notify both members in writing promptly after becoming so associated.

(d) Obligations of Associated Persons Concerning an Account with a Notice-Registered Broker/Dealer, Investment Adviser, Bank, or Other Financial Institution

A person associated with a member who opens a securities account or places an order for the purchase or sale of securities with a broker/dealer that is registered pursuant to Section 15(b)(11) of the Act ("notice-registered broker/dealer"), a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall:

(1) notify his or her employer member in writing, prior to the execution of any initial transactions, of the intention to open the account or place the order; and

(2) upon written request by the employer member, request in writing and assure that the notice-registered broker/dealer, investment adviser, bank, or other financial institution provides the employer member with duplicate copies of confirmations, statements, or other information concerning the account or order;

provided, however, that if an account subject to this paragraph (d) was established prior to a person's association with a member, the person shall comply with this paragraph promptly after becoming so associated.

(e) Paragraphs (c) and (d) shall apply only to an account or order in which an associated person has a financial interest or with respect to which such person has discretionary authority.

(f) Exemption for Transactions in Investment Company Shares and Unit Investment Trusts

The provisions of this Rule shall not be applicable to transactions in unit investment trusts and variable contracts or redeemable securities of companies registered under the Investment Company Act of 1940, as amended, or to accounts which are limited to transactions in such securities.

[Amended by SR-NASD-82-21 eff. Feb. 28, 1983; amended by SR-NASD-86-29 eff. Dec. 15, 1986; Mar. 14, 1991; amended by SR-NASD-90-58 eff. June 1, 1991; amended by SR-NASD-2002-49 eff. Oct. 15, 2002.]

Selected Notices to Members: 82-21, 82-44, 83-17, 87-2, 85-41, 91-27, 97-25, 02-73.

3060. Influencing or Rewarding Employees of Others

(a) No member or person associated with a member shall, directly or indirectly, give or permit to be given anything of value, including gratuities, in excess of one hundred dollars per individual per year to any person, principal, proprietor, employee, agent or representative of another person, where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity. A gift of any kind is considered a gratuity.

(b) This Rule shall not apply to contracts of employment with or to compensation for services rendered by persons enumerated in paragraph (a) provided that there is in existence prior to the time of employment or before the services are rendered, a written agreement between the member and the person who is to be employed to perform such services. Such agreement shall include the nature of the proposed employment, the amount of the proposed compensation, and the written consent of such person's employer or principal.

(c) A separate record of all payments or gratuities in any amount known to the member, the employment agreement referred to in paragraph (b) and any employment compensation paid as a result thereof shall be retained by the member for the period specified by SEC Rule 17a-4.

[Amended eff. Sept. 1, 1969; June 20, 1984; Dec. 28, 1992.]