The Resurgence of "Selling Away"

By: *Brian P. Nally*

With the market performing well in the last several years, there has been a resurgence of "selling away" claims. Selling away occurs when an investment professional sells securities not held, offered, or approved by his or her broker-dealer. This type of activity causes problems because broker-dealers, often unaware of these offerings, are unable to perform the due diligence necessary to protect investors. These investments are often unregistered securities, which means important disclosure requirements do not apply and investors often rely on the salesperson for relevant information.

Further, selling away often occurs with private placement opportunities and other limited investment offerings such that information about the investment (and the investment professional's affiliation with the investment) is not readily available to broker-dealers or the potential investors. This article attempts to address the applicable requirements for investment professionals and the supervisory obligations of broker-dealers relating to selling away activities.

Supervisory Duty of Broker-Dealers

The Financial Industry Regulatory Authority ("FINRA") is the self-regulatory agency charged with enforcing regulations in accordance with federal law. FINRA Rule 3110 governs a broker-dealer's supervisory obligations and provides that a firm has a duty to establish, implement, and maintain a system to supervise the activities of each registered representative and that the system be reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.

The duty to supervise includes, among other things, a duty to perform certain activities that would potentially detect undisclosed outside business activities of firm representatives. *McGraw v. Wachovia Sec., L.L.C.*, 756 F. Supp. 2d 1053, 1074 (N.D. Iowa 2009).

A broker-dealer's duty to supervise, however, is measured by a "reasonableness standard" and is not a matter of strict liability. Courts have stated that a brokerage firm is "not an insurer for its representatives" and "not necessarily liable for all actions taken by its registered representative[.]" *Asplund v. Selected Investments in Financial Equities, Inc.*, 86 Cal.App.4th 26, 42 (Cal. App. 2000).

Indeed, a broker-dealer can establish a good faith defense to a negligent supervision claim if it can establish that it "maintained and enforced a reasonable and proper system of supervision and internal controls." *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576 (9th Cir. 1990). In this regard, Section 15(b) of the 1934 Act defines reasonable supervision as: "[E]stablished procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any ... violation [of the Act] by [an associated person]." 15 U.S.C. § 78o(b)(4)(E)(i). A firm's supervisory system must comply with these standards but cannot guarantee firm-wide compliance with all applicable laws and regulation and FINRA rules. *See* FINRA Notice 14-10, fn. 4.

Supervision of Outside Business Activities and Private Securities Transactions

Pursuant to FINRA Rules 3270 and 3280 (formerly NASD Rules 303 and 3040), firms are responsible for educating representatives and associated persons about outside business activities and private securities transactions, as well as for implementing supervisory and compliance procedures to address these activities. *McGraw*, 756 F. Supp. 2d at 1074. "Outside activities" are employment or compensation of a representative by any person other than the employing brokerage firm as a result of any business activity outside the scope of the representative's relationship with his employer firm. *See Id.*; FINRA Rule 3270.

A representative engaged in any kind of business activity away from the brokerage firm must provide the firm with prompt written notice of such activity, and a representative's failure to do so is a violation of FINRA rules. FINRA Rule 3270. When reviewing written notices submitted under FINRA Rule 3270, members must consider:

1. Whether the activity will "interfere with or otherwise compromise the registered person's responsibilities to the member and/or the member's customers;"
2. Whether the activity will "be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered."

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If a brokerage firm denies this written request, the registered person may not engage in the outside business activity.

"Private securities transactions" are any securities transactions outside the regular course or scope of a representative's employment with a brokerage firm, which includes new and unregistered offerings. FINRA Rule 3280(d). Prior to participating in any private securities transaction, a representative must provide written notice to the brokerage firm describing in detail the proposed transaction and the person's proposed role in it and stating whether he or she has received or may receive selling compensation in connection with the transaction. *See* FINRA Rule 3280(b). The representative is prohibited from selling any security away from the brokerage firm unless that firm has authorized the associated person to make the sale. *See* NASD Notice to Members 01-79.

Brokerage firms generally are not responsible for supervising any outside business activities or private securities transactions engaged in by their representatives unless they have received notice of or have approved those activities. *McGraw*, 756 F.Supp.2d 1053, 1075 (2010). Firms, however, still have a duty monitor and investigate activities for which they have had no proper notice in an effort to detect "red flags" that would alert the brokerage firm to the possibility of undisclosed outside activities. Id. "Red flags" that would alert a firm to the possibility of undisclosed activities, and consequently give rise to a duty to monitor and investigate those activities, include:

(i) correspondence from customers or other individuals addressed to the broker at the firm's address referring to investments that are not reflected on the records of the brokerage firm;
(ii) inquiries from customers or other individuals to supervisory or administrative personnel relating to investments not reflected on the records of the brokerage firm; and
(iii) sales literature received in the firm's office or found in the broker's office relating to investments not approved for sale by the firm. In this regard, a firm's supervisory policies and procedures should be tailored according to these considerations and to the type of business in which the firm engages.

Selling Away in Ohio

Ohio maintains its own legislation and enforcement structure designed to protect investors and to provide clear guidance to investment professionals. Many of the selling away activities involve investments made through promissory notes. While generally thought of as simple debt obligations, Ohio law includes promissory notes within the definition of "security" such that engaging in this type of transaction may subject a registered representative and his or her broker to liability for selling away. *See* Ohio Revised Code § 1707.01(B); *see also Williams v. Guarnieri*, 2005-Ohio-4044, ¶ 21 (Ohio App. 11th Dist. Aug. 5, 2005) (if sold, a promissory note must be registered as it is a security and not merely a debt obligation); Williams v. Waves, Cuts, Colour & Tanning, 92 Ohio App. 3d 224, 230 (1st Dist. 1994) (promissory note providing for the issuance of stock in satisfaction of a debt is a sale of a security and must be registered even if no shares are issued).

Under R.C. § 1707.01(B), which discusses a real estate exemption, a promissory note may not always constitute a security under Ohio law, although any such analysis begins with the presumption that a promissory note is a security. *See* Bank One, N.A. v. Demmler, 2009-Ohio-3848 (Ohio App. 5th Dist. Aug. 3, 2009) (noting that R.C. § 1707.01(B) exempts real estate transactions from security legislation); *Perrysburg Twp. v City of Rossford*, 2004-Ohio-4362, ¶ 12 (2004) citing *Reves v. Ernst & Young*, 494, U.S. 56, 65-66 (1990).

Specifically, the following factors tend to demonstrate that a promissory note is a security in Ohio:

1) if the parties refer to the note as an investment or intend for the note to be an investment;
2) if the note is long-term;
3) if the note is not a collateralized loan;
4) if the note was intended to generate capital and/or business development; and
5) if the note carries high risk. *See Perrysburg Twp. v. Rossford Arena Amphitheater Auth.*, 175 Ohio App.3d 549, 559 (6th Dist. 2008).

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The Ohio Department of Commerce, Division of Securities has brought enforcement actions against investment professionals for "selling away" activities. *See e.g., In the Matter of Michael J. Rudolph*, Division Order No. 02-029; *In the Matter of John E. Prokop*, Division Order 02-037; *In the Matter of Bari L. Courts*, Division Order 02-035; *In the Matter of Kevin R. Ostrowski*, Division Order 00-479.

In addition to civil and professional penalties, investment professionals may face criminal charges in connection with "selling away" activities. *See State v. Ostrowski,* Case No. 02CR059706 (Lorain C.P. 2002) (sentenced to three years community control for false representation under 1707.44(B)(4)); *State v. Nemchik*, 2000 Ohio App. LEXIS 836 (9th Dist. 2000) (12 years in prison and restitution for grand theft by deception, false representation under 1707.44(B), selling unregistered securities under 1707.44(C), and selling away).

However, both of these Ohio legislative provisions impute a knowledge requirement on the investment professional such that analogous to federal law, if an investment professional possesses a good faith belief that he or she is acting in accordance with applicable laws and regulations, no criminal punishment will be instituted. *See e.g. Williams v. Guarnieri*, 2005-Ohio-4044, ¶ 21 (Ohio App. 11th Dist. Aug. 5, 2005) (registered representative sold unregistered promissory note but actions were in reliance on other professionals and without knowledge that promissory notes were required to be registered as securities).

Conclusion

The risk of selling away should be understood by everyone in the investment industry. Broker-dealers and investment professionals must work together to ensure all investments, even promissory note offerings, are properly classified as "securities" and processed through the appropriate entity. In the end, this will help protect the investing public, as well as help protect members of the investment industry from adverse regulatory action and private litigation.

Brian Nally is a Partner out of the Cleveland and Indianapolis offices of Reminger Co., L.P.A. He focuses his practice on securities litigation and arbitration, and has experience representing clients in state and federal court, as well as arbitration before the Financial Industry Regulatory Authority (FINRA) and American Arbitration Association (AAA). Brian also has experience representing clients in government regulatory investigations and enforcement actions brought by FINRA, the Securities and Exchange Commission, professional boards (e.g., the CFP Board), state departments of securities, and state departments of insurance. For three consecutive years (2014, 2015 and 2016), Brian has been recognized as a "Rising Star" by Ohio Super Lawyers Magazine, a recognition given to less than 2.5% of lawyers in the State of Ohio.