Experts Corner: Selling Away

Broker-Dealer Liability for Selling Away Transactions and the Responsibility of Supervisory Personnel

By: Robert D. Lawson, CFE®, AIF®, RFC®, LUTCF®
May 23, 2017

Executive Summary

In the securities brokerage industry, Selling Away is the prohibited practice by an Associated Person[1] soliciting or affecting the sale of securities or investment products not offered or held by their brokerage firm, and without prior written consent. Securities sold away often include alternative investments such as private placements, promissory notes, non-traded real estate investment trusts (REITs), viatical settlements and collateralized loan obligations. These investments generally possess higher risk characteristics such as insufficient liquidity, high fees, and commonly mislead investors with the promise of high-yields and principal protection. Associated Persons are often motivated to sell these securities due to large commissions - often two or three times higher than the sale of a traditional product or security transacted through the broker.

Although these investments may in fact be legitimate investment vehicles, sales transactions occur outside of the due diligence and compliance scrutiny of brokerage firms, lacking proper transparency and disclosure. Investors are often misled under the assumption the investment is approved by, and sold through, the Associated Person's brokerage firm. In reality, the investments are transacted directly by an issuer or through over-the-counter markets rather than national exchanges. In nefarious cases, these investments are entirely fraudulent in nature, representing shares in a Ponzi scheme or a fictitious issuing company.

Selling Away often occurs at independent branch or satellite offices of broker-dealers, away from the direct oversight and supervision of the firm's compliance department. In addition to violating FINRA[2] rules and regulations, brokers often do not fully understand the risks and complexities associated with these securities resulting in inadequate risk disclosures, if any, to the unsuspecting investor. Sales persons and marketers of these investments may also falsely or erroneously claim that the underlying product is not a security and exempt from registration.

FINRA Arbitration Claims & Responses

In FINRA Arbitration, Claimants and their counsel must demonstrate the member firm had direct or vicarious liability for the unauthorized transactions conducted by their Associated Person. Claimants will routinely allege they placed their trust and confidence in the broker and believed the transaction was executed through the representative's broker-dealer. Respondent firms generally assert they were

---

[1] FINRA defines an Associated Person as: "Any person engaged in the investment banking or securities business who is directly or indirectly controlled by a FINRA member, whether or not they are registered or exempt from registration with FINRA. An associated person includes, but is not limited to, every sole proprietor, partner, officer, director, or branch manager of any FINRA member."

[2] Financial Industry Regulatory Authority – Regulatory Body of the Securities Industry

unaware of the "off-the-books" sales and the Associated Person concealed the activities from their supervisory oversight and detection. An arbitration panel must determine whether the firm knew, should have known, or failed to prevent the conduct.

FINRA Rules 3270[3] and 3280[4] set forth Member Firms' regulatory requirements for the review, disclosure and approval of outside business activities and private securities transactions.

FINRA Rule 3270: Outside Business Activities of Registered Persons
Registered Persons are required to provide written disclosure of any business activity outside of the scope of their employment. Firms must maintain a record of each written notice received as specified in Rule 17a-4(e)(1) of the Securities Exchange Act of 1934.[5]

> *No registered person may be an employee, independent contractor, sole proprietor, officer, director or partner of another person, or be compensated, or have the reasonable expectation of compensation, from any other person as a result of any business activity outside the scope of the relationship with his or her member firm, unless he or she has provided prior written notice to the member, in such form as specified by the member.*

Upon receipt of a written notice of an Outside Business Activity, Member Firms shall consider whether the activity will: 1) interfere with or compromise the Associated Person's responsibilities to the firm and/or customers; or 2) be viewed by the public as part of the firm's business. Based on these factors, firms must evaluate the advisability of approving or imposing limitations on the Outside Business Activity.

FINRA Rule 3280: Private Securities Transactions of an Associated Person
Associated Persons are required to provide written notice for all securities transactions outside of the scope of their employment at the firm, regardless if compensation is to be received.

> *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.*
>
> *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.*

Upon receiving an Associated Person's written request for a Private Securities Transaction with compensation the firm shall provide a written stating whether the proposed transaction is approved or denied. If approved, the sale must be executed, documented, and supervised in accordance with the firm's written supervisory policies and procedures.

---

[3] Previously NASD Rule 3030
[4] Previously NASD Rule 3040
[5] SEA Rule 17a-4 provides for the retention of all applicable client and firm records for a period of not less than six years, with the first two years in an easily accessible place.

In the event the proposed private securities transaction will not result in compensation, firms must only provide written acknowledgement of the request, but may still impose additional constraints where appropriate.

FINRA Rule 3110: Supervision

Member Firms must establish, maintain and enforce a supervisory system to monitor the activities of each Associated Person to achieve compliance with FINRA Rules, in addition to all applicable securities laws and regulations. This rule provides for the design of the firm's Written Supervisory Procedures ("WSP"), including provisions for the inspection of all internal communications, correspondence, transactions and customer complaints.

FINRA Rule 3130: Annual Certification of Compliance and Supervisory Processes

A Member Firm's supervisory system must be examined and certified as "reasonably designed" at least annually, as specified in FINRA Rule 3110. A Chief Executive Officer, or other equivalent officer(s), must conduct the annual review and certification of the Firm's compliance policies and Written Supervisory Procedures. Annual compliance meetings for Registered Representatives also must be held to discuss and review compliance-related matters.

Discussion: Potential for Firm Liability

Although FINRA Rules 3270 and 3280 place the obligation on behalf of Associated Persons to disclose Outside Business Activities and Private Securities Transaction for firm approval, the firm may not be indemnified if proper supervisory requirements were not upheld.

To determine a firm's liability in a Selling Away dispute, FINRA Arbitration Panels frequently base their decisions on whether the firm was aware of and failed to act upon, or "should have known" of the unauthorized activities. Establishing whether a firm should have been aware of Selling Away is based on an examination of three factors of the firm's supervisory control system. Arbitrators consider:

1) Whether the firm established a "reasonable" supervisory control system
2) Whether the firm implemented and maintained the supervisory control system
3) Whether the firm adequately acted upon and investigated "red flags"

If a Member Firm is found to be deficient in one or more of these areas, they may be held liable for the off-the-books activities of their Associated Person.

1. Whether the Firm Established a "Reasonable" Supervisory Control System

FINRA Arbitrators examine whether the firm had a reasonable supervisory control system in place that adequately enforced all FINRA and MSRB Rules and applicable securities laws and regulations. A Member Firm with an inadequate supervisory system may be found liable as Arbitrators may maintain that a reasonable supervisory system may have either prevented or detected Selling Away.

An example of such an instance is the matter of Pochat v. Merrill Lynch, Pierce, Fenner & Smith, Inc. In 2012, a U.S. District Court upheld a ruling by a FINRA Arbitration Panel that found Respondent Merrill

Lynch liable for failing to establish a reasonable supervisory control system. This ruling was based the existing system's limitations in enforcing compliance with FINRA Rules 3270 and 3280.

In the Ruling, the Arbitration Panel cites Merrill Lynch's failure to establish policies requiring the disclosure of Outside Business Activities and Private Securities Transactions within the firm's Argentinian division. As a result, a Registered Representative solicited and affected the sale of an off-the-books private placement to an established client, ultimately resulting in substantial losses due to financial duress experienced by the issuing company. Without policies enforcing FINRA's disclosure requirements, the Panel determined that a reasonable system would have prevented this instance of Selling Away and issued a monetary sanction upon the Respondent.

2. Whether the Firm Implemented and Maintained the Supervisory Control System

In addition to establishing an adequate supervisory control system, Member Firms are required to adhere and maintain the provisions of their Written Supervisory Procedures. FINRA Arbitrators examine whether these policies and procedures were implemented and maintained in regard to supervising the activities of their Associated Persons.

An example of such an instance is the matter of Battle v. Northeast Securities, Inc. (2008)[6] where a Member Firm was found liable for failing to implement adequate supervisory procedures. In this dispute, a Registered Representative of Northeast Securities, Inc. solicited sales of promissory notes to a customer at the Member Firm, among others. However, the investments sold by the Representative were fraudulent and at the center a Ponzi scheme. Although it was determined that Northeast Securities, Inc. did have a reasonable supervisory system in place, the Arbitration Panel concluded that the firm's compliance department failed to implement these policies in a reasonable manner, rendering them liable for the prohibited activities.

As was the case for Northeast Securities, Inc., a FINRA Arbitration Panel may deem that a firm "should have known" of an Associated Person's Selling Away activities if a reasonable supervisory system had been implemented and enforced. Firms that fail to implement these policies effectively may be found liable in Selling Away disputes if it is determined that compliance personnel were "asleep at the wheel" – allowing for suspicious activities to occur undetected.

3. Whether the Firm Acted upon and Investigated "Red Flags"

Member Firms may be held liable if it is determined that compliance personnel failed to act upon and investigate or willfully turned a "blind eye" toward suspicious activities indicative of Selling Away. Here, the question is not whether the firm should have known of the unauthorized activity, but rather if the firm attempted to intervene and investigate.

The 2007 matter of Chandler v. FSC Securities Corporation[7] demonstrates an instance where a firm failed to investigate a serious of red flags and was found liable by a NASD Arbitration Panel for a Representative's Selling Away of fraudulent securities. Per the Panel's ruling, the firm's repeated failures to thoroughly investigate suspicious activities created "an extremely cozy environment" for the Registered Representative to defraud customers through the sale of fraudulent securities.

[6] FINRA Case Number 06-04110
[7] FINRA Case No. 05-04443

Here, the offending Registered Representative maintained a separate insurance office, in which he claimed to firm compliance to not to effect the sale of any securities. However, the Representative represented to firm customers through correspondence that his office was indeed registered as a branch of the broker-dealer and listed as such on his business cards. It was from this office that the Registered Representative sold the fraudulent securities to clients. As the misrepresentation of the registration status of an office is a violation of FINRA Rules, this should have prompted investigation from the firm's compliance department.

Additionally, the firm failed to conduct reasonable due diligence in the hire of the Registered Representative by failing to review his Form U5. Specifically, allegations made by the representative's former affiliated broker-dealer included a "bogus business" and "forgery". When questioned by the panel, the representative's former supervisor at FSC Securities Corporation admitted that he had not examined these allegations prior to hiring of the individual.

As a result of the firm's failure to act upon cumulative red flags, the firm was found liable for losses experienced by the defrauded investors. In such instances, it is the obligation of compliance personnel to sufficiently investigate suspicious activities and occurrences. Any activities that are indicative of Selling Away and that are detected by the firm's supervisory control system must be acted upon promptly – often observed through incoming and outgoing correspondence, trade blotters, and customer account statements.

Circumstances where Firms may not be Liable

Under certain circumstances, the off-the-books activities of an Associated Person cannot be detected by a reasonably designed and maintained supervisory control system. In these instances, the Associated Person's unauthorized activities occur outside of the scope of the compliance department at the firm, providing no opportunity to detect the violations.

An example of such an instance of undetectable activities is found in the matter of Bowman v. UBS Financial Services, Inc.[8]. This 2015 dispute involves a Registered Representative's solicitation of firm customers to invest in a now defunct lumber mill which he maintained an ownership stake. This Outside Business Activity was disclosed to the Registered Representative's employing firm, UBS Financial Services, and was approved under the explicit prohibition of involving firm customers. The Representative proceeded to sell interests of the lumber mill to firm customers by employing what the Panel deemed to be "deceptive strategies" in an effort to avoid detection by UBS Financial Services' compliance department. Most notably, the Registered Representative conducted all correspondence on a non-business email address and instructed the firm's customers to use personal bank accounts to purchase the investments. By undertaking such measures, the offending Representative was able to circumvent the oversight of the firm's compliance department. Ruling in favor of the Respondent, the Panel determined that the firm established and implemented an adequate and reasonable supervisory system and had no way of detecting the unauthorized activity.

Supervisory control systems are designed to monitor firm-related activities of Associated Persons and client accounts. In instances where an Associated Person has exclusively conducted all unauthorized

[8] FINRA Case No. 13-01962

activities outside of the Firm and the reasonable scope of its supervision, it cannot necessarily be established that the Firm "should have known" of the activities.

FINRA Sanctions

In addition to damages owed to the Claimant, FINRA has the authority to issue monetary sanctions upon offending Member Firms. Sanctions are often issued as a response to repetitive and increasingly severe violations. FINRA imposes sanctions as a strong deterrent to prevent repeat violations by Member Firms in order to protect investors and strengthen market integrity.

FINRA may promulgate sanctions when Member Firms have been found negligent in their supervisory requirements in disputes involving Selling Away. A recent example of such an action can be found in the Securities & Exchange Commission and FINRA's joint enforcement action against Signator Investors, Inc[9]. The firm was censured and fined $450,000 for a failure to enforce the firm's WSP to maintain compliance with FINRA Rule 3110, allowing a Registered Representative to sell fraudulent securities to firm customers. When determining whether sanctions are warranted, FINRA considers the following factors:

1) Whether the unauthorized activity involved customers of the firm
2) Whether the unauthorized activity resulted directly or indirectly in injury to customers of the firm, and if so, the nature and extent of the injury
3) The duration of the unauthorized activity, the number of customers, and the dollar volume in sales
4) Whether the responding registered person misled their employer about the existence of the unauthorized activity or otherwise concealed the activity from the firm
5) Whether the product involved in the unauthorized has been found to involve a violation of federal, state, or Self-Regulatory Organization (SRO) rules
6) Whether the Member Firm has a history of disputes involving unauthorized activities
7) The general severity of the violation

[9] FINRA Case No. 3-16753

Conclusion

The provisions of FINRA Rule 3110 require Member Firms to establish a reasonable supervisory system to enforce compliance with FINRA and MSRB Rules and all applicable securities laws and regulations. In addition, FINRA Rule 3130 requires Member Firms to annually review and certify their internal policies and procedures, as well as conduct annual compliance meetings to educate Associated Persons of firm policies. In turn, Member Firms are required to monitor for instances of unauthorized Outside Business Activities and Private Securities Transactions and to act upon them accordingly.

Although FINRA Member Firms often claim that they are not liable for the actions of an Associated Person Selling Away, the Firm may be held accountable if they should have been aware of the unauthorized activities. If the Associated Person's Selling Away was affected within the scope of their Member Firm's surveillance system, and it was neither detected nor acted upon by compliance personnel, there may be sufficient grounds for firm liability and/or sanctions.

The Author

Robert D. Lawson serves as the President and Chief Investment Officer of Barrington Capital Management, Inc., a Registered Investment Advisory Firm and Insurance Agency. Mr. Lawson has over 30 years of experience in the financial services industry during which time he has served as a FINRA Registered Securities & Options Principal, Registered Representative, Investment Adviser Representative, Compliance Officer, Insurance Agency Principal, and Insurance Producer. As a Securities & Insurance Expert Witness and Litigation Support Consultant, Mr. Lawson is retained by both claimants and respondents for FINRA arbitrations, mediations, and court settings. Additionally, Mr. Lawson serves as a FINRA and NFA Dispute Resolution Arbitrator where he presides over industry disputes pertaining to monetary losses, business damages, and employees of securities firms.

Mr. Lawson holds the following credentials: Accredited Investment Fiduciary (AIF®), Certified Fraud Examiner (CFE®), Registered Financial Consultant (RFC®), and Life Underwriter Training Council Fellow® (LUTCF®). He is also the Membership Chair for the Minnesota State Bar Association (MSBA) ADR Section, Board Member for Securities Experts Roundtable, and Board Member of Little Brother Friends – Friends of the Elderly®

The information in this white paper was published with reasonable care and attention and does not constitute legal advice.