NO. 05-02-00305-CV

IN THE
FIFTH COURT OF APPEALS
AT DALLAS, TEXAS

ARDYTHE BARNES, ULYSSES BELL, EMMA BINGHAM, GENE BLACKBURN, GUY F. BOND, JOAN BOND, W.R. BOND, IMA BOND, BILL BRITTON, PATSY BRITTON, LOIS G. CATES, BARTON G. COPELAND, ALMA JEAN COPELAND, ROBERG THOMAS COPELAND, EARLINE R. COPELAND, GRACE J. DICKEY, MARY L. GRIGAR, MARVIN GRISHAM, OLIVIA GRISHAM, SYLVIA A. HARR, CHARLES C. HUCKABEE, MARGARET A. HUCKABEE, MABEL S. HUGHES, GEORGIA MAYOLA JORDAN, MARY L. KLEIN, INEZ LEACH, META S. PRIEST, WILMA L. RICHIE, FONCILLE BASSETT ROLING, MELVIN SMITH, REGINA SMITH, TROY L. SPEARS, GENA M. SPEARS, MARY R. STILLWELL, JUNE E. STOUT, INDIVIDUALLY AND AS TRUSTEE FOR STOUT CHILDREN JOINT VENTURE, JAMES TIGNER, BILLY TIGNER, AND BRENDA J. TRAVIS,

Appellants,

v.

SWS FINANCIAL SERVICES, INC.,

Appellee.

AMICUS CURIAE BRIEF OF
PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

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SWS FINANCIAL SERVICES, INC.,

Appellee.

BRIEF OF AMICUS CURIAE
PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

TO THE HONORABLE COURT OF APPEALS:

Public Investors Arbitration Bar Association ("PIABA"), amicus curiae in support of Appellants, file this brief in support of reconsideration of the Court's January 23, 2003 opinion in this case.

I.

INTRODUCTION AND INTEREST OF AMICUS CURIAE

PIABA is a national bar association whose member attorneys are dedicated to the representation of investors in disputes with the securities industry. PIABA was established in 1990 as an educational and networking organization for securities arbitration attorneys. While PIABA's main purpose is further educating securities arbitration attorneys, its members are involved in promoting the interests of the public investor in securities and commodities arbitration. The mission of PIABA is to promote the interests of the public investor in securities and commodities arbitration by protecting public investors from abuses in the arbitration process, such as those associated with document production and discovery; making securities and commodities arbitration as just and fair as systematically possible; and creating a level playing field for the public investor in securities and commodities arbitration.

Because most individual investor claims against the securities industry are subject to compulsory arbitration, the body of case law interpreting the state and federal securities laws applicable to those claims has become relatively sparse. Accordingly, PIABA has an interest in ensuring that, when courts are asked to interpret those laws, it has the benefit of full and complete briefing.

Counsel for Amici have paid all fees and costs associated with preparing and filing this brief.

PIABA asks the Court to reconsider its opinion in this case because the opinion suggests that the Court was not advised of (1) the long line of cases establishing that a broker-dealer is *always* a "control person" of its registered representatives in their sales of securities, regardless of whether the representative makes use of the broker-dealer's access to the securities markets to promote or effectuate the sales of those securities; and (2) the NASD regulations which *required* SWS to supervise its representative's sales of all securities, if it had reason to know of those sales. Without the benefit of this background, the Court has recognized an exception to control person liability which is contrary to the plain language of the statute and effectively imposes on investors the burden of proof on a control person's "good faith" defense. The Court's reasoning creates an immunity for broker dealers which is directly contrary to the supervisory requirements of the NASD and SEC, and imposes a serious impediment to the ability of the state securities board to regulate the unlawful sale of "private" securities.

PIABA takes no position on whether the appellate record contains other grounds for affirmance. PIABA simply asks the Court to reconsider whether its reasoning is consistent with the language of the securities act and the public policy which requires broker-dealers to be responsible for the securities frauds committed by their registered agents.

PIABA became aware of this case, and the Court's opinion of January 23, 2003, only shortly before the Court would have lost its plenary power over the case. Accordingly, the undersigned attorneys advise the Court that they have not had the opportunity to review even the briefs filed by the parties, much less the appellate record. PIABA respectfully offers this

brief because the Court's opinion suggests that it did not have the benefit of full and thorough briefing by the parties to this case.

II.

ARGUMENT AND AUTHORITIES

A.

A Broker-Dealer is Always a "Control Person" of its Registered Representatives

The Court's opinion states that Brooks was a "registered agent" of SWS. Amicus assumes that this means that Brooks was a "registered representative" of this broker-dealer. It is unlawful for any person to effectuate transactions in securities unless he is a registered representative of a licensed broker-dealer. Securities Exchange Act of 1934, 15 U.S.C. § 78o(a).

Courts have repeatedly held that broker-dealers are *always* the control persons of their registered representatives in the sale of *any* securities, even if they are "private" securities transactions of which the broker-dealer has no knowledge. *See Martin v. Shearson Lehman Hutton, Inc.*, 986 F.2d 242, 244 (8th Cir. 1993) ("Shearson's status as employer [of the registered representative] is sufficient to establish it as a controlling person. Once Martin established this . . . she had made her prima facie case. . . ."); *DelPorte v. Shearson, Hammill & Co., Inc.,* 548 F.2d 1149, 1152 (5th Cir. 1977), *cert. denied*, 499 U.S. 976 (1991); *Hollinger v. Titan Capital Corp.,* 914 F.2d 1564, 1573 (9th Cir. 1990); *Rivera v. Clark Melvin Securities Corp.,* 59 F.Supp.2d 280, 296 (D. Puerto Rico 1999) (finding claim for control liability sufficient as long as it alleges the broker was a registered representative of

a registered brokerage firm); *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F.Supp. 203, 212 (D. Mass. 1978) ("In the context of [§ 20(a)], brokerage firms control their brokers and registered representatives."); *Lavin v. A.G. Becker & Co., Inc.*, 60 F.R.D. 684, 685 (N.D. Ill. 1973). This is necessarily so because, by law, a broker-dealer has both the power and the *duty* to control the sales activities of its registered representatives.

A broker-dealer's responsibility for supervising the "outside" sales activities of its registered representatives is established by Conduct Rules 3030 and 3040 of the National Association of Securities Dealers ("NASD").[1] (Rules attached hereto at App. A.) Rule 3030 requires the broker-dealer to be aware of *all* of its registered representatives outside business activities. Rule 3040 specifically provides that, once a member firm is notified that one of its employees plans to receive compensation for participation in a private securities transaction, the member must notify the associated person in writing whether the member approves or disapproves. NASD Conduct Rule 3040(c)(2). If the member disapproves, the associated person "shall not participate in the transaction in any manner, directly or indirectly." On the other hand:

> If the member approves a person's participation in a transaction . . . the transaction shall be recorded on the books and records

---

[1] The NASD is one of a number of "self-regulatory organizations" (SROs) that share with the Securities and Exchange Commission ("SEC") regulatory jurisdiction over the United States securities markets. Under the Securities Exchange Act of 1934, 15 U.S.C. 78o-3(b)(6), the NASD is a "national securities organization" that must be registered with the SEC and that must have rules designed "to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade" in the purchase and sale of securities.

> 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 Conduct Rule 3040(c)(2).

Moreover, the record-keeping system used, and the supervisory procedures implemented, must enable the member to understand the suitability of the transactions and to detect and prevent misconduct that could violate the securities laws and NASD Rules. *See* NASD Notice to Members 96-33. (App. B.) As the NASD advertises, this rule "***prohibits individual brokers from participating in securities transactions that are not part of their job at their brokerage firm***," and "***protects investors by ensuring that brokerage firms are responsible for their brokers' securities business and so are aware of, approve, and supervise all of their activities***." NASD "Investor Alert," January 11, 2001. (App. C.) The NASD has repeatedly notified its members of their responsibility to implement supervisory systems that are designed to detect sales of "private" securities by their registered representatives, especially those sales that may be occurring "away" from the firm. As the NASD said as far back as 1986:

> 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 . . . . ***[T]he conduct of off-site representatives most frequently resulting in violations of NASD rules involves unauthorized private securities transactions .... [F]irms that employ [off-site personnel] 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 . . . .

NASD Notice to Members 86-65 (September 12, 1986) (emphasis added) (App. D); *see also* SEC Notice Concerning Independent Contractors (August 25, 1982) ("Broker-dealers may not shift their obligation to control and supervise the activities of their independent contractor salespersons who are associated persons, and contractual terms that attempt to limit broker-dealer liability for the acts of such persons under the federal securities laws are of no effect.")

B.

The Court's Test Eviscerates the Securities Laws

The Court's opinion of January 23, 2003 correctly states the two well-established tests for "control person" liability under both the state and federal securities laws. First, "control" means "the possession, direct or indirect, of the power to direct or cause the direction of the management or policies of a person, whether through the ownership of voting securities, by contract, or otherwise." And second, "control" will be established if the defendant (1) exercised control over the operations of the subject business in general, and (2) had the power to control the specific transaction or activity upon which the primary violation is predicated. As shown above, courts hold that broker-dealers are *always* control persons of their registered representatives because they have not only the power but also the legal *duty* to control *all* sales of securities by their agents.

The Court error comes in analyzing "power to control" through four factors which do not logically relate, in any way, to the broker-dealer's power to control its registered representatives. The first two factors–that "the registered representatives did not make use of the broker-dealer's access to the securities markets to promote or effectuate the sales" and "the broker-dealer had no knowledge of the complained-of transactions"–go to the broker-dealer's knowledge. As the Court observed, however, the broker-dealer's lack of knowledge goes strictly to its affirmative defense, not its ability to control: "It is not necessary for the plaintiff to show culpable participation by the defendant in order to establish the defendant was a control person because '[l]ack of participation and good faith constitute an affirmative defense for a controlling person.' It is crucial to separate the issue of control from the issue of good faith because 'the burden of proof with respect to the latter is on the defendant while the burden of establishing control is on the plaintiff.'" *See also Busse v. Pacific Cattle Feeding Fund*, 896 S.W.2d 807, 815 (Tex. App.–Texarkana 1995, no writ) (control person liability requires no proof of scienter). Hence a broker-dealer cannot escape liability merely by showing lack of participation or knowledge. For example, the Fifth Circuit reversed a directed verdict granted to a broker-dealer in *Paul F. Newton & Co.,* 630 F.2d 1111, 1120 (5th Cir. 1980), because "the district court's finding that [the broker-dealer] neither participated in nor had knowledge of the fraudulent activities of its employees was insufficient to warrant the grant of a directed verdict . . . in the absence of evidence establishing as a matter of law that Pressman adequately supervised [the registered representative's] activities."

The Court's third factor–that "the partnership interests being sold by the registered representatives were unrelated to any securities sold or offered by the broker-dealer"–tells us nothing about the broker-dealer's power to control because the broker-dealer is required by law to take reasonable steps to detect and prevent the sales by its representatives of any securities which are "unrelated" to those it maintains on its books and records. Moreover, even before Rule 3040 was implemented, the Fifth Circuit specifically rejected this defense in *Lewis v. Walston & Co.*, 487 F.2d 617, 623-24 (5th Cir. 1973).

In *Lewis,* the broker-dealer defendant contended, like SWS here, that it was not responsible for its registered representative's sale of unregistered securities. The broker-dealer pointed out that it did not deal in unregistered securities, that the orders were not executed through its New York office (as with "normal" transactions), and it received no direct financial benefit from the transactions. The court rejected these "superficially supportive" contentions, holding that acts are generally within the course and scope of employment, even when they are unauthorized, if the conduct is of the same general nature as that authorized. *Id.* at 624 (citing the Restatement (2d) of Agency § 229).

> [W]e think it clear that there was an evidentiary basis for finding that [the representative] was acting within the scope of her employment in taking the actions the jury found constituted the proximate cause of the plaintiffs' purchases. Those actions included touting a stock, making recommendations, keeping customers informed of developments in a company whose securities the customers were considering buying, and arranging the mechanics of a purchase-and-sale transaction. These are "acts commonly done" by brokers, within the meaning of §§ 229(2)(a); at the very least, they would be "simila[r] in quality" to acts brokers are routinely authorized to perform.

Id. at 623.

Finally, and perhaps most egregiously, the Court reasoned that SWS did not have the "power to control" Brooks because "many of the appellants were unfamiliar with SWS and did not rely on SWS in deciding to purchase the interim church loan fund from Brooks and BFP." First, the investors' familiarity with SWS, or their reliance on SWS, does not have any logical relationship to SWS's power to control Brooks. Second, the Court recognizes that many investors *did* rely on SWS in deciding to purchase the securities from Brooks. These are exactly the investors for whom the NASD implemented Rule 3040 to protect.

III.

CONCLUSION

For the foregoing reasons, PIABA respectfully requests the Court to reconsider its opinion of January 23, 2003 in light of the argument and authorities cited herein.

Respectfully submitted,

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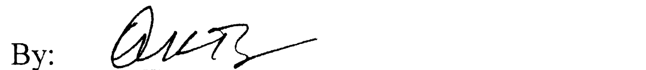
By: 
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I hereby certify that a true and correct copy of the foregoing instrument was served upon counsel of record on this 21st day of February, 2003, by certified mail, return receipt requested, addressed as follows:

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APPENDIX

A. NASD Rules of Conduct 3030, 3040

B. NASD Notice to Members 86-65 (Sept. 12, 1986)

C. NASD Notice to Members 96-33

D. NASD "Investor Alert," January 11, 2001

APPENDIX A

the circumstances or nature of the member's business that results in a lower net capital requirement. The NASD may issue an exemption subject to any condition or limitation upon a member's bonding coverage that is deemed necessary to protect the public and serve the purposes of this Rule.

(d) Notification of Change

Each member shall report the cancellation, termination or substantial modification of the bond to the Association within ten business days of such occurrence.

(e) Definitions

For purposes of fidelity bonding the term "employee" or "employees" shall include any person or persons associated with a member firm (as defined in Article I, paragraph (q) of the By-Laws) except:

(1) Sole Proprietors

(2) Sole Stockholders

(3) Directors or Trustees of member firms who are not performing acts coming within the scope of the usual duties of an officer or employee.

[Added eff. Mar. 15, 1974; amended eff. July 11, 1979; Nov. 19, 1982; deleted and replaced with former Appendix C by SR-NASD-93-48 eff. Mar. 8, 1994; amended by SR-NASD-98-33 eff. Sept. 15, 1998.]

Selected Notices to Members: 83-56.

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 eff. Oct. 13, 1988.]

Selected Notices to Members: 88-45, 88-86, 89-39, 90-37, 94-44, 94-93, 96-33.

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

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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 eff. Nov. 12, 1985.]

Selected Notices to Members: 85-54, 85-84, 94-44, 96-33.

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).

[The next page is 4861.]

APPENDIX B

*1986 NASD LEXIS 386, *; 1986 Notice to Members 65*

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NASD Notices to Members

NTM Number **86-65**

1986 NASD LEXIS 386; 1986 Notice to Members 65

September 12, 1986

[*1] Nasd Notice to Members

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

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 **[*2]** 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

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 **[*6]** 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 **[*7]** 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:

o The individual and the security involved; **[*8]**

o The amount and source of compensation;

o The names of the investors and the amounts and dates of the investments;

o The issuer, syndicator or any other broker-dealer involved; and

o 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, **[*9]** 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 **[*10]** 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 customers 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 [*11] 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 **[*12]** 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 **[*13]** 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. n1 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.

- - - - - - - - - - - - - - - - - -Footnotes- - - - - - - - - - - - - - - - - -

n1 Refer to the statement by the SEC Division of Market Regulation, dated June 18, 1982, forwarded to all NASD members on August 25, 1982.

- - - - - - - - - - - - - - - - -End Footnotes- - - - - - - - - - - - - - - - - **[*14]**

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

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APPENDIX C

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*1996 NASD LEXIS 39, *; 1996 Notice to Members 33*

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NASD Notices to Members

NTM Number **96-33**

1996 NASD LEXIS 39; 1996 Notice to Members 33

May 1996

[*1] NASD Notice to Members

SUBJECT: NASD Clarifies Rules Governing RR/IAs

Executive Summary

On May 15, 1994, the NASD (R) 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 **[*2]** 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 **[*3]** 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 **[*4]** 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, **[*5]** 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 **[*6]** 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. **[*7]** 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 **[*8]** 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 **[*9]** 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 **[*10]** 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 **[*11]** 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 **[*12]** 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 **[*13]** 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 **[*14]** 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 **[*15]** 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 **[*16]** 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, 35 **[*17]** 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 **[*18]** 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 D

NASD Investor Alert

NASD

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Promissory Notes Can Be Less Than Promised

January 11, 2001

Investors who consider buying promissory notes need to check them out thoroughly.

Unlike many investments today, promissory notes sound simple and safe, and appear to be an attractive alternative to volatile stocks and bonds. However, while promissory notes can be legitimate investments, some promissory notes sold widely to individual investors are not. Investors need to be informed and understand the investment they are considering.

What Is A Promissory Note?

A promissory note is a form of debt that companies sometimes use, like loans, to raise money. The company, through the notes, promises to return the buyer's funds (principal), and to make fixed interest payments to the buyer in exchange for borrowing the money. Promissory notes have set terms, or repayment periods, ranging from a few months to several years.

Even legitimate promissory notes involve risks — the company issuing them may have such as competition, bad management, or severe market conditions, that make it impossible for the company to carry out its promise to pay interest and principal to note buyers. Investors also need to know that bona fide notes are marketed almost exclusively to corporate and other sophisticated investors, who have the expertise and information to determine if the investment is a good one.

What's The Problem?

Problems with promissory notes fall into three main categories: deception of investors, unregistered securities, and unregistered sellers.

Deception Of Investors
The promissory note programs that are scams are often sold with the following deceptive statements: 1) investors would receive very high, double digit returns, 2) returns were guaranteed, and 3) the notes were backed by collateral to guarantee them. Frequently, a fraudulent promoter will persuade an independent life insurance agent, by offering very large commissions, to sell the notes to the agent's trusting customers. Often, promissory note schemes target the elderly and their retirement savings.

Unregistered Securities
Although those selling them may not know or admit it, these promissory notes are usually securities and must be registered with the SEC or the State they are sold in - or they must have a specific exemption from registration under the law. If the note is not registered, it will not be subject to review by regulators before it is sold, and investors have to do their own investigation to confirm that the company can pay its debt.

Unregistered Sellers
These promissory notes are usually securities, but those selling them often do not have the required securities sales license. If registered individual brokers are involved, they may be selling the notes without their firms' approval.

What Regulators Are Doing To Protect You

Recently, the Securities and Exchange Commission (SEC), working with 28 state securities regulators, conducted a joint enforcement sweep against fraudulent promissory note programs. The regulators brought actions against hundreds of individuals and firms selling fraudulent promissory notes to thousands of investors. In the SEC cases alone, over $300 million was raised from unsuspecting investors. There were many and varied deceptive statements used to sell these notes. View the SEC press release for more, as well as statistical data and case summary information.

NASD has also brought disciplinary actions against individual brokers who sold promissory notes. In 2000, NASD brought cases against 39 individual brokers who sold more than $12 million in notes to more than 300 investors.

NASD cases are mainly based on our "selling away" rule, which prohibits individual brokers from participating in securities transactions that are not part of their job at their brokerage firm. This rule protects investors by ensuring that brokerage firms are responsible for their brokers' securities business and so are aware of, approve, and supervise all of their activities. It also protects investors by providing that your investment can be held for you by your broker and protected by the Securities Investor Protection Corporation (SIPC) and that the broker only makes recommendations that are suitable for you.

How To Protect Yourself

If you are thinking about investing in a promissory note, you should carefully consider the following:

Ask why the seller wants to sell to *you*.
Bona fide corporate promissory notes generally are sold to sophisticated buyers who can do their own research on the company issuing the notes to determine whether the notes are a good deal. The fact that promissory notes are being sold to individual investors is itself a danger signal.

Check Check Check Check
Check with the SEC's EDGAR Database to see if the notes are registered. (Remember that most promissory notes are securities and have to be registered with the SEC and the state they are sold in, unless they are specifically exempt from registration under law.) Check with your state securities regulators whether the investment and the salesperson are in compliance with your state's securities laws. Check with the NASD Public Disclosure toll free number at (800) 289-9999 or visit the Web Page to see if your broker is registered or has a disciplinary history. Check with the Better Business Bureau where the company issuing the notes is located to find any complaints against the company.

Broker Role
If you are buying through a broker, ask if the note is being sold through the broker's firm. If not, it is being "sold away" and you will miss important investor protections that flow from the broker's and the firm's regulatory obligations.

Guaranteed Returns
Know that a salesperson cannot guarantee a particular return. Even if the note has a fixed interest return, the investment may not pay that amount - or return your principal - to you. Moreover, the seller may say the notes are insured, but not mention that the insurer may not be legitimate - and outside the US and beyond the reach of our laws.

High Returns
Recognize that these notes usually offer double-digit returns – those greater than 10% - while, at the current time, legitimate safe investments have a much lower return. Remember that the higher the return, the greater the risk.

Exorbitant Commissions

Ask specifically how much compensation the salesperson is getting. Normal commissions rarely exceed 5%; these notes offer much more, as high as 30% or even 50%.

Issuing Company
Ask how the company issuing the notes will generate the returns to pay you your interest. Find out what part of the money that the company will be getting will be used up by marketing and promoter's costs, which may hurt the company's chances of paying you back.

If you don't get good answers to all of your inquiries, walk away from the offer and keep your money.

Already Invested?

If you think you are involved in a promissory note scam, act quickly, since the law limits the time for you to take legal action.

You can complain to NASD, the SEC, your state securities administrator, and, if an insurance agent sold the notes to you, your state insurance commissioner.

Remember: regulators - or lawyers you hire and pay for - can sometimes help you get your money back from a problem deal, but the best way to keep your money is to not participate in the first place.

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