Selling away and outside business activities have become hot topics for regulators. The NASD, in particular, has brought numerous formal disciplinary actions against registered representatives for selling securities without prior notice to and approval from the representative’s employer firm and for engaging in outside business activities without prior notice to the employer firm. In addition, the SEC has brought numerous enforcement actions of late against firms for failure to supervise outside business activities.

The NASD, in December 2001, issued Notice to Members 01-79 warning firms to remember their responsibilities pursuant to NASD Rules 3030 and 3040. According to the Notice to Members, “a registered person who sells a security away from his or her firm without first obtaining written approval from the firm violates NASD Rule 3040, and a registered person who engages in an outside business activity without prior notice to his or her firm, including the sale of non-securities products, violates NASD Rule 3030.” The NASD stated that because some confusion exists among associated persons as to whether particular financial instruments are securities, associated persons should provide written notice to their firms before they engage in the sale of any financial instrument.

According to the NASD Notice to Members 01-79, if a firm approves an associated person’s participation in securities transactions, the firm assumes certain critical regulatory responsibilities associated with offering and selling securities. For example, the NASD stated that, in addition to recording the transaction on the firm’s books and records, the firm must exercise appropriate supervision over the associated person.

The NASD also “reminded” members that they should: (1) review their supervisory procedures to make sure that they are reasonably designed to achieve compliance with NASD Rules 3030 and 3040 regarding outside business activities and private securities transactions; and (2) appropriately educate their associated persons regarding the requirements of Rule 3030 and 3040.

On May 15, 2002, the SEC affirmed an NASD disciplinary action in In the Matter of John P. Goldsworthy. Rel. No. 45926. The SEC, after finding that the promissory notes sold by the registered representative were securities, concluded that the representative had in fact violated NASD Rules 3040 and 2110. According to the SEC, “NASD Conduct Rule 3040 prohibits a person associated with a member firm from participating in any manner in securities transactions outside the regular course or scope of the associated person’s employment without providing written notice to the firm. The rule requires that such notice be provided prior to participating in the transaction and describe in detail the contemplated transactions.”

In In the Matter of John P. Goldsworthy, the SEC found that “[b]ecause Goldsworthy received selling compensation,…he was required not only to notify his employer in writing of each securities transaction but also to secure its written approval.” The SEC further noted that Rule 3040 can be violated even when the associated person’s only role in the transaction was limited to a client introduction if the associated person receives a finder’s or referral fee.

The SEC has brought numerous enforcement actions over the past year against firms for, among other violations, failing to monitor outside business activities. See, e.g., In the Matter of Delta Equity Services Corp., Release No. 45465 (Feb. 21, 2002); and In re Quest Capital Strategies, Release No. 44935 (Oct. 31, 2001). In In the Matter of Delta Equity Services Corp., certain of the firm’s registered representatives, without the firm’s approval, sold $6.4 million of promissory notes to public investors. The firm consented, without admitting or denying the findings, to an order which censured the firm, imposed a $45,000 civil monetary penalty and required the firm to heighten its supervisory and inspection practices.
In addition, the firm’s president and sole shareholder consented, without admitting or denying the findings, to an order which censured him, imposed a $15,000 civil monetary penalty and barred him from association in a supervisory capacity with any broker or dealer, with a right to reapply for such association after fifteen months.

The SEC and NASD have made it very clear that firms should review their procedures regarding outside business activities and, if necessary, take appropriate actions to strengthen those procedures. With the rise in enforcement and disciplinary actions of late, firms should heed the regulators’ warnings.

If you would like additional information regarding the topics discussed in this memorandum, please contact Jennifer Wilson, or any of the following Gardner Carton & Douglas attorneys.