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SECURITIES AND COMMODITIES LITIGATION AND ARBITRATION

INVESTOR RIGHTS

STOCKBROKER MISCONDUCT

June 13, 2008

Via e-mail

pubcom@finra.org
Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: FINRA Regulatory Notice 08-24

Dear Ms. Asquith:

I am writing to comment on FINRA's Regulatory Notice 08-24, in which FINRA proposes to rewrite some of FINRA's existing supervision rules. First, we believe the proposal should be more specific with respect to the duty of brokerage firms to supervise their brokers and to detect and prevent the sale of unapproved investments, commonly known in the industry as "selling away." The proposed rule explicitly requires firms to supervise "approved" outside securities transactions but does not explicitly state that the duty to supervise registered representatives includes the duty to detect and prevent "unapproved" securities transactions. Second, allowing brokerage firms to inspect off-site locations every three years is inconsistent with the SEC pronouncements in cases such as Royal Alliance and SECO Securities that pre-announced compliance examinations once a year are insufficient for supervising off-site offices and that new offices should be kept under close surveillance. The proposed language may be misinterpreted by brokerage firms as allowing them to give off-site locations a "three-year pass," from inspection which is clearly inconsistent with SECO Securities and NASD Notice to Members 98-38 and 86-65.

A. The Duty to Supervise Selling Away Activities

In recent years, our firm has filed and prevailed on many selling away claims in arbitration against brokerage firms. When firms are negligent in failing to detect and prevent unapproved securities transactions, they can be liable for negligent supervision and can be liable as controlling persons under the securities laws.

In our practice, brokerage firms repeatedly attempt to defend these claims by arguing that, under NASD Rule 3040, the firms' obligation to supervise in the selling away context does not arise until the firms' representatives notify the firms that the representatives seek to sell the particular product in question. This argument is incorrect, because NASD Rule 3010(a) requires each NASD member to "establish and maintain a system to supervise the activities of each registered representative . . . that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules." This language in Rule 3010(a) is duplicated, with minor changes, in proposed Rule 3110(a). Rules 3010(a) requires brokerage firms to supervise their employees' compliance with all NASD rules, including the notification requirement of Rule 3040. The Rule 3040 notification provision is not an exception to the firms' duty to monitor their representatives' adherence to NASD requirements. See Lysiak v. SEC, 47 F.3d 1175 (9th Cir. 1995).

This principle follows from many SEC and NASD decisions and pronouncements. The SEC and the NASD have long required brokerage firms reasonably to supervise to detect and prevent selling away transactions, particularly by off-site personnel.

> 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.

NASD Notice to Members 86-65, 1986 WL 591919, at *3 (Sept. 12, 1986).

In SECO Sec., Inc., Exchange Act Release 26,054, 1988 WL 901591, at *2 (SEC Sept. 1, 1988), the SEC said:

> [The stockbrokers] engaged in numerous private securities transactions without obtaining prior approval from [the firm]. . . .
>
> We agree with the NASD that applicants were responsible for deficient supervision with respect to the violations at issue. Although no specific information came to their attention that alerted them to the misconduct that

> occurred, applicants fostered the violative activities . . . by abdicating their supervisory responsibility.

In PFS Investments, Inc., Exchange Act Release No. 40,269, 1998 WL 422161, at *6 (July 28, 1998), the SEC said that "the procedures in place at the compliance departments . . . were not reasonably designed to detect selling away activities. . . . [The firm therefore] failed reasonably to supervise . . . with a view towards preventing violations of the securities laws, within the meaning of Section 15(b)(4)(E) of the Exchange Act."

The NASD's and the SEC's statements and decisions are thus clear that brokerage firms are required reasonably to supervise to detect and prevent selling away activities that the firms have not expressly approved. Proposed Rule 3110(a), by broadly requiring firms to supervise to achieve compliance with FINRA rules, effectuates this requirement. Proposed Rule 3110(b)(3)(A), however, does not directly apply this requirement to private securities transactions until after firms give written approval of the transactions. As we have repeatedly experienced in our practice, firms might incorrectly continue to argue, based on this rule, that the duty to supervise their brokers with respect to this activity (i.e. "selling away") does not arise until after written approval is given. The FINRA/NASD supervision rule was never meant to lead to this misinterpretation.

Rule 3040 is the product of many years of tweaking to address repeated problems with supervising registered representatives who are selling away. Registered representatives are required to request approval in writing of the outside securities activity and to describe the activity in writing. As firms needed guidance on how to respond to such requests, the rule explicitly requires firms to approve or deny the request in writing.

Proposed Rule 3110(b)(3) unfortunately recedes from these requirements of Rule 3040. Proposed Rule 3110(b)(3)(A) in fact seems to be less specific than Rule 3040 in this regard, because, unlike Rule 3040, Rule 3110(b)(3)(A) only implicitly requires representatives to notify their firms of their request to sell securities not otherwise approved by the firms, and does not require representatives to provide details concerning the proposed outside securities activity. Unlike Rule 3040, Rule 3110(b)(3) does not require firms either to approve or to disapprove these requests in writing.

FINRA should still require representatives to request approval in writing of outside activities and to provide a written description of the proposed outside activity. FINRA should also still require that firms approve or disapprove such requests in writing. Further, proposed

Rule 3110(b)(3)(A) should include explicit language stating what is already required of brokerage firms, namely, that the duty to supervise registered representatives includes the duty to devise and implement procedures reasonably designed to detect and prevent unapproved activities.

The duty to supervise the broker and the duty to supervise approved outside activities are two discrete requirements, and we fear that firms could misinterpret the proposed language and conclude that the former is now substituted by the latter. FINRA should provide guidance to brokerage firms and modify its proposal to make explicit what is required–that the duty to supervise applies to all securities and investment activities of the firms' representatives, not merely those activities for which the firms have provided written approval.

B. Inspection Requirement for Remote Offices

We also have concerns with the inspection requirements in proposed Rule 3110(c) for remote branch offices and non-branch locations. Supervision of remote offices is particularly important, because these offices often are distant from the firms' main offices and commonly do not have supervisors on-site.

> Some broker-dealer firms have geographically dispersed offices staffed by only a few people, and many are not subject to onsite supervision. Their distance from compliance and supervisory personnel can make it easier for registered representatives . . . and other employees in these offices to carry out and conceal violations of the securities laws. The supervision of small, remote offices, therefore, can be especially challenging.

Staff Legal Bulletin No. 17 (Remote Office Supervision), 2004 WL 3711970, at *2 (SEC Mar. 22, 2004). <u>See also</u> NASD Notice to Members 86-65 ("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.").

An important supervisory tool to detect and prevent selling away activities is on-site inspections. In NASD Notice to Members 98-38, 1998 WL 1707928, at *3 (May 1998), the NASD cited <u>Royal Alliance Associates</u>, Exchange Act Release No. 38,174, 1997 WL 13023 (Jan. 15, 1997), which sanctioned a brokerage firm in part for inspecting its offices only annually on a pre-announced basis.

> Members should note that, in . . . In re Royal Alliance Associates, Inc., Release No. 34-38174 (January 15, 1997), . . . the SEC stated that it harbored grave doubts that a practice of conducting a pre-announced compliance examination only once a year would necessarily discharge the supervisory obligations of any firm that incorporates a structure in which smaller offices are operated by only one or two representatives. Royal Alliance emphasized the need for close attention to supervision of small, dispersed offices. In that decision, which members are encouraged to read in its entirety, the SEC stated that:
>
>> The securities industry should be on notice … that where a firm employs branch offices made up of only one or two registered representatives and those individuals engage in misconduct, the Commission will, as it does for all firms, closely examine the responsibility of individuals charged with the duty to design and implement an adequate system of supervision.
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>> . . . .
>>
>> . . .Royal Alliance operates 1,500 offices with 2,700 registered representatives. Some 49 of these are one-person Offices. Here, Royal Alliance's failure to scrutinize adequately the securities-related businesses of its registered representatives, which were conducted beyond the direct aegis of the firm, was a certain recipe for trouble. Further, Royal Alliance's practice of conducting a pre-announced compliance examination only once a year was inadequate to satisfy its supervisory obligations….
>>
>> We do not here suggest that firms which employ offices consisting of one or two registered representatives cannot devise an adequate system of supervision, nor do we discourage such offices. . . . Nevertheless, such arrangements necessarily entail greater supervisory challenges and the Commission requires firms organized in such a fashion, and individual supervisors at those firms, to meet the same high standards of supervision as at more traditionally organized firms

In accordance with the SEC's and the NASD's views stated in Royal Alliance, Staff Legal Bulletin No. 17, NASD Notices to Members 86-65 and 98-38, and many other pronouncements, the Supplementary Material in proposed Rule 3110.14 properly establishes the general principle that supervision of remote locations must be "particularly diligent" and may necessitate "more frequent reviews."

> The procedures established and reviews conducted must provide that the quality of supervision at remote locations is sufficient to ensure compliance with applicable securities laws and regulations and with FINRA and MSRB rules. A member must be particularly diligent in establishing procedures and conducting reasonable reviews with respect to a non-branch location where a registered representative engages in securities activities. . . . [M]embers may need . . . to provide for more frequent reviews of certain locations.

The Supplementary Material in proposed Rule 3110.15 establishes a presumption that non-branch locations will be inspected "at least" every three years. It allows firms to establish longer periodic inspection cycles if they document the factors used to determine that a longer cycle is appropriate. Proposed Rule 3.110(c)(1)(B) likewise requires members to inspect non-supervisory branch offices "at least" every three years.

Although an inspection requirement "at least" every three years is consistent with the SEC's "grave doubts" about pre-announced inspections of remote offices only once per year, and although proposed Rule 3.110.14 correctly states that more frequent reviews may be required for remote locations, I believe the Rule would be improved–and the SEC's and FINRA's regulatory interests would be better served–if the Rule and its Supplementary Material explained that pre-announced annual inspections for remote locations generally are insufficient. In our experience, fraudulent securities swindles, such as Ponzi schemes, commonly are promoted and completed and then collapse in less than one year. A three-year inspection cycle manifestly allows rogue brokers in remote offices to perpetrate multiple Ponzi schemes undetected. The Rule and its Supplementary Material should therefore be more specific about implementing the inspection requirements stated in Royal Alliance and in many other SEC and NASD pronouncements.

Our concern that brokerage firms will misinterpret the proposed language as giving them a "three-year pass" is heightened by the fact that, in our experience, selling away most frequently occurs with brokers recently hired by the firm. Selling away typically occurs with registered representatives who bounce around from firm to firm; it is not typical for a broker who has been with the same firm for five to ten years to suddenly start selling away.

This is why the SEC has indicated, in cases like SECO Securities, that firms should keep new off-site brokers under close surveillance. In SECO, the representative was new to the firm, had his own outside business, was permitted, with another representative, to head a branch office for the firm at an off-site location, and, unbeknownst to the hiring firm, was selling unapproved investments at the time of his association. The SEC agreed with the NASD'S findings of supervisory failings, stating as follows:

> During the twelve months that . . . [the representatives] managed the San Diego office, they . . . engaged in numerous private securities transactions without obtaining prior approval from SECO [, the firm].
>
> . . . Although no specific information came to their attention that alerted them to misconduct that occurred, . . . [SECO] fostered the violative activities in the San Diego branch office by abdicating their supervisory responsibility.
>
> . . . Despite the obvious need to keep the new office with its semi-independent status and untried personnel under close surveillance, . . . [SECO] was content with a laissez faire policy. No systems were established to monitor the new office's activities . . . While [SECO'S president] paid monthly visits to San Diego during the first seven months of the new office's operation, . . . his discussions with . . . [the representatives] focused on the products SECO was offering and the need to augment the branch's sales force, not compliance matters. . . . It was not until April 1984, nearly a year after the branch office opened, that . . . SECO'S sales manager made a cursory inspection of office records, the first such inspection by anyone from SECO headquarters.

Seco Sec., Inc., 1988 WL 901592, at *2-3 (SEC Sept. 1, 1988)(emphasis added).

The SECO opinion was an appeal from a NASD disciplinary action. The NASD recognized that new offices should be inspected earlier rather than later. We are concerned that the proposed rule will lead firms to mistakenly adopt three-year inspection cycles for all off-site locations, irrespective of their age.

Thank you for allowing our firm to submit these comments.

Sincerely,

Kalju Nekvasil, Esq.

KN/sgb