

## Outside Business Activity

### Form U4 - Item 13 "Other Business"

*Engaged in any other business as a proprietor, partner, officer, director, employee, trustee, agent or otherwise. (Exclude non-investment-related activity that is exclusively charitable, civic, religious, or fraternal and is recognized as tax exempt.*

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## Outside Business Activity

### FINRA Rule 3270

*Registered reps must provide written notice to their member firm. The member firm will consider if the activity will: (1) interfere with or otherwise compromise the reps responsibilities to the member or member's customers. (2) be viewed by customers or the public as part of the members business.*

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## Outside Business Activity

### Investment Adviser Representatives

*Investment adviser representatives are under the same obligation to disclose "outside business." Advisers should consider what, if any, conflicts of interest might be present in connection with their fiduciary duty to clients.*

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## Private Securities Transactions

### FINRA Rule 3280

*Requires written notice to the member firm describing in detail the proposed transaction to include whether there is any compensation to be received. Member firm will approve or disapprove the person's participation in writing.*

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## Private Securities Transactions

### Most Common Transactions

1. Promissory notes.
2. Direct Investments.
3. Viaticals/Life Settlements.
4. Resale/cross trades.

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## Private Securities Transactions

### Red Flags

1. May require a broker dealer.
2. Recordkeeping requirements.
3. Exempt versus non exempt securities.
4. Omission of material facts.
5. Basic liability.

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## UNIFORM APPLICATION FOR SECURITIES INDUSTRY REGISTRATION OR TRANSFER

INDIVIDUAL NAME:	INDIVIDUAL CRD #:
FIRM NAME:	FIRM CRD #:

**13. OTHER BUSINESS**

Are you currently engaged in any other business either as a proprietor, partner, officer, director, employee, trustee, agent or otherwise? (Please exclude non *investment-related* activity that is exclusively charitable, civic, religious or fraternal and is recognized as tax exempt.) If YES, please provide the following details: the name of the other business, whether the business is *investment-related*, the address of the other business, the nature of the other business, your position, title, or relationship with the other business, the start date of your relationship, the approximate number of hours/month you devote to the other business, the number of hours you devote to the other business during securities trading hours, and briefly describe your duties relating to the other business.

Yes  No

If "Yes," please enter details below.



## 3270. Outside Business Activities of Registered Persons

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. Passive investments and activities subject to the requirements of [Rule 3280](#) shall be exempted from this requirement.

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••• Supplementary Material: -----

**.01 Obligations of Member Receiving Notice.** Upon receipt of a written notice under Rule 3270, a member shall consider whether the proposed activity will: (1) interfere with or otherwise compromise the registered person's responsibilities to the member and/or the member's customers or (2) be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered. Based on the member's review of such factors, the member must evaluate the advisability of imposing specific conditions or limitations on a registered person's outside business activity, including where circumstances warrant, prohibiting the activity. A member also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of [Rule 3280](#). A member must keep a record of its compliance with these obligations with respect to each written notice received and must preserve this record for the period of time and accessibility specified in SEA Rule 17a-4(e)(1).

Amended by SR-FINRA-2015-030 eff. Sept. 21, 2015.

Amended by SR-FINRA-2009-042 eff. Dec. 15, 2010.

Adopted by SR-NASD-88-34 eff. Oct. 13, 1988.

**Selected Notices:** [88-5](#), [88-45](#), [88-86](#), [89-39](#), [90-37](#), [94-44](#), [94-93](#), [96-33](#), [01-79](#), [10-49](#).



## **3280. 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 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 NASD Rule 3050, transactions among immediate family members (as defined in FINRA Rule 5130), 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.

Amended by SR-FINRA-2015-030 eff. Sept. 21, 2015.

Amended by SR-NASD-99-60 eff. March 23, 2004.

Adopted by SR-NASD-85-28 eff. Nov. 12, 1985.

**Selected Notices:** 75-34, 80-62, 82-39, 85-21, 85-54, 85-84, 91-32, 94-44, 96-33, 01-79, 03-79.

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## INFORMATIONAL

### Selling Away And Outside Business Activities

NASD Reminds Members  
Of Their Responsibilities  
Regarding Private  
Securities Transactions  
Involving Notes And Other  
Securities And Outside  
Business Activities

## SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Executive Representatives
- Insurance
- Legal & Compliance
- Operations
- Registered Representatives
- Senior Management

## KEY TOPICS

- Outside Business Activities
- Private Securities Transactions
- Promissory Notes
- NASD Rule 3030
- NASD Rule 3040
- Supervision

## Executive Summary

NASD Regulation, Inc. (NASD Regulation) has brought a number of formal disciplinary actions against registered representatives for selling securities without prior notice to and approval from the representative's employer member firm and for engaging in outside business activities without prior notice to the employer member firm. 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.

Recently, NASD Regulation has seen an increase in selling away involving independent insurance agents registered solely as Series 6 Investment Company and Variable Contracts Products representatives. These Series 6 representatives are increasingly being targeted by issuers, promoters, and marketing agents to sell short-term promissory notes to their customers. Although in many instances these notes are securities, promoters of these products are marketing them to registered persons as non-securities products that do not have to be sold through a broker/dealer by a registered person. In a significant number of cases, associated persons have sold these notes to their customers away from their firms and without firm approval as required by Rule 3040.

Associated persons are required, either under Rule 3030 or Rule 3040, to report, in writing, any and all types of business that they plan to conduct away from their firms, whether or not it involves a security. Rule 3040 requires

associated persons to obtain written approval from their firms before they sell any security, including securities in the form of promissory notes, and Rule 3030 requires prompt written notice to a member of any outside business activity for which an associated person receives compensation, including the sale of a promissory note that is not a security. Since there has been some confusion among associated persons as to whether particular financial instruments are securities, this *Notice* advises associated persons to provide written notice to their firms **before** they engage in the sale of any financial instrument.

This *Notice* also reminds 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 Rules 3030 and 3040.

## Questions/Further Information

Questions concerning this *Notice* may be directed to Shirley H. Weiss, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8844.

## Private Securities Transactions Involving Promissory Notes Have Significantly Increased

There has been a significant increase in private securities transactions involving the sale of promissory notes. In 2000, NASD Regulation brought more than 100 formal disciplinary actions involving violations of NASD Rule

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3040, including cases against 39 individual representatives who sold more than \$12 million in notes to more than 300 investors. In 2000, the Securities and Exchange Commission (SEC), acting in conjunction with state securities regulators, also brought a series of disciplinary actions against hundreds of individuals and entities that had raised more than \$300 million from the sale of fraudulent promissory notes to thousands of investors.<sup>1</sup>

### Types Of Notes Being Marketed To The Public Through Associated Persons

Various types of schemes are being marketed to the public through associated persons, including promissory notes, payphone and ATM schemes, prime bank schemes, and Ponzi schemes.<sup>2</sup> Promoters also are actively marketing associated persons to sell "viatical settlements" away from their firms.<sup>3</sup> Members and associated persons should be aware that, depending on its structure, a viatical product may or may not be a security.<sup>4</sup>

Members and associated persons should be on the lookout for the various types of fraudulent statements that are used to market these notes to associated persons. Associated persons may be falsely told that the notes are low risk, with "guaranteed," high returns, or that they are collateralized. Associated persons also are being told that the notes are not securities, and therefore, persons selling them are not required either to be registered or to report the sales to their firms. Associated persons often are urged to invest themselves and, in some instances, are being offered

large commissions for selling to their customers. Associated persons can avoid the regulatory pitfalls associated with selling notes away from their firms by first obtaining written approval from their firms, as required by Rule 3040, before they sell any note.

### How Can An Associated Person Determine Whether A Note Is A Security

There appears to be some uncertainty among associated persons as to whether notes being sold to the public are securities, especially when issuers and marketing agents may insist that they are not. Except for some commercial loans,<sup>5</sup> most notes are securities. A promissory note is most likely a security if the seller is selling notes to the general public to raise money for the general use of a business enterprise and the buyer is lending money as an investment and is interested primarily in the profit that the note is expected to generate.<sup>6</sup>

Thus, it is likely that promissory notes that are marketed and sold to the general public are securities, and a registered person may not sell these notes without prior notice to and the express written permission of his or her firm. Further, it is not sufficient to have a Series 6 registration to sell promissory notes. An individual who sells promissory notes to public customers must be registered as a Series 7 registered representative.

Associated persons at times solely rely on information provided to them by issuers, issuers' counsel, or promoters, and they fail to confirm the facts. NASD Regulation strongly urges registered persons not to make

the assessment of whether a particular note is a security, but to give their firms the opportunity to determine whether sale of the note is merely an outside business activity or the sale of a security that requires written notice to the firm and firm permission. Associated persons are reminded that even if the product they wish to sell is a non-securities product, they may not accept compensation away from their firms unless and until they have provided prompt written notice to their firms.

### Associated Persons' Reporting Responsibilities

Associated persons are required, either under Rule 3040 or Rule 3030, to report *any* kind of business activity engaged in away from their firms. Rule 3040 prohibits an associated person from selling any security "away" from the member firm unless the firm has authorized the associated person to make the sale. Rule 3040 applies to all sales of securities, including promissory notes that are securities. Rule 3040 ensures that, if a firm approves an associated person's participation in a securities transaction,<sup>7</sup> the firm assumes certain critical regulatory responsibilities that go with offering and selling securities to customers. In addition to requiring that the transactions be recorded on the firm's books and records, the firm must exercise appropriate supervision over the associated person in order to prevent violations of the securities laws. As recently stated by the SEC, Rule 3040 "protects investors from the hazards of unmonitored sales and protects the firm from loss and litigation."<sup>8</sup>

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Rule 3040 requires registered persons to provide notice of the proposed transaction, in writing, to his or her firm, before the sale is made. The notice must describe the proposed transaction(s) in detail and the associated person's proposed role and must also state whether the individual has received or may receive selling compensation (including any type of referral fee). Oral notice to the firm is not sufficient to meet the requirements of Rule 3040. If the associated person expects to receive compensation, the firm must advise the registered person, in writing, whether it approves or disapproves the person's participation in the proposed transaction. If the firm disapproves the person's participation, he or she may not participate in the transaction in any manner, directly or indirectly. If the member approves the person's participation in the proposed transaction, the firm must record the transaction on its books and records and supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.

If the note in question is not a security, the registered person is required under Rule 3030 to provide prompt written notice to his/her member firm that he or she has accepted compensation outside the scope of his relationship with the firm.

Because of the differences in the requirements of Rule 3030 and Rule 3040, it is important for registered persons to establish with their firms whether a particular note is a security and to follow the appropriate NASD rule requirements.

Associated persons are reminded that it is not sufficient to verify the non-securities status of a note solely by relying on the advice of the issuer or issuer's counsel. An associated person who attempts to conduct his or her own investigation of the issuer does so at his or her own regulatory risk, because an associated person's conclusions may be erroneous and because failure to report the proposed sales to the associated person's firm deprives the firm of the opportunity to challenge the issuer's analysis and conclusion. NASD Regulation strongly urges all associated persons to notify their firms in advance of any sales, so that the legal status of the note may be determined, and the proper notice given to the firm prior to any sales.

### **Members' Supervisory Obligations**

Given the significant number of fraudulent promissory note schemes that have been uncovered, members should review their supervisory and compliance procedures to make sure that their reporting requirements are clear and complete and that each associated person receives appropriate education and training regarding the sale of notes. Problems may arise, for example, when insurance sales persons, who also are registered as Series 6 representatives, are not required by their firms to report certain outside business activities, such as the sales of other insurance products. To avoid confusion, members are urged to adopt procedures that would require

registered persons to report any kind of income-producing activity.

NASD Regulation also suggests that firms review their supervisory and compliance programs to determine whether they are adequately educating their registered persons regarding the current proliferation of promissory note schemes and the importance of reporting all sales of notes under either Rule 3030 or Rule 3040. Firms should review their annual compliance checklists to make sure that their registered persons understand that all outside sales of notes, whether securities products or not, should be reported to their firms prior to any sales. Annual audits, compliance meetings, and continuing education programs also should include issues regarding the sale of notes. Firms also might consider conducting "preventive compliance conferences" that specifically address selling notes away from the firm.

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### Endnotes

- 1 See NASD Regulation Investor Alert, "Promissory Notes Can Be Less Than Promised," Jan. 11, 2001, which can be found on NASD Regulation Web Site ([www.nasdr.com](http://www.nasdr.com)).
- 2 For a description of some of these schemes, see "Top 10 Investment Scams List Released by State Securities Regulators" which can be found on the North American Securities Administrators Association (NASAA) Web Site ([www.nasaa.org](http://www.nasaa.org)).
- 3 Viatical settlements are interests in the death benefits of terminally ill patients. In a viatical settlement, investors acquire fractional interests in individual insurance policies. In general, the insured gets a percentage of the death benefit in cash, and the investors get a share of the death benefit when the insured dies.
- 4 See *SEC v. Life Partners, Inc.*, 87 F.3d 356 (D.C. Cir.), *reh'g denied*, 102 F.3d 587 (D.C. Cir. 1996); *Timothy James Fergus, et al.*, C10990025 (NAC May 5, 2001).
- 5 For example, consumer financing notes, notes secured by mortgages on homes, and short-term business notes secured by the assets of the business or an assignment of accounts receivable generally are not securities.
- 6 *Reves v. Ernst & Young*, 494 U.S. 56, 64 (1990).
- 7 Associated persons are reminded that "participation" in a securities transaction includes not only making the sale, but referring customers, introducing customers to the issuer, arranging and/or participating in meetings between customers and the issuer, or receiving a referral or finder's fee from the issuer.
- 8 *Robin Bruce McNabb*, Exchange Act Rel. No. 43411 (Oct. 4, 2000).

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# NASD NOTICE TO MEMBERS 96-33

## NASD Clarifies Rules Governing RR/IAs

### Suggested Routing

- Senior Management
- Advertising
- Corporate Finance
- Government Securities
- Institutional
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registration
- Research
- Syndicate
- Systems
- Trading
- Training

### Executive Summary

On May 15, 1994, the NASD® 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 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 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

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will or may receive selling compensation, the member must develop 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, 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 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. 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 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 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 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 invest-

ment 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 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 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 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 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 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 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, Section 35 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 securi-

ties 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 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.