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## Handling Selling Away Cases

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### Introduction

Selling away cases are nightmares for Respondents, but not for Claimants. These cases generally present the most egregious examples of wrongful broker conduct. It is hard for a brokerage firm to justify why one of its employees has sold non-approved products. The focus of the cases is typically whether or not the firm had reasonable supervision controls in place and, more importantly, whether the firm actually implemented the policies and procedures.

### Prototypical Selling Away Case

An investor lost her retirement savings as a result of a selling away scheme perpetrated by her broker. The broker persuaded his client to invest her savings in numerous unsuitable, high-risk investments, including oil companies doing business with the Republic of Liberia and the broker's own private biotech firm, Ausam Biotechnologies, Inc. The scheme fell apart when Ausam filed for bankruptcy.

During the bankruptcy proceedings, it became clear that the broker was engaging in massive fraud. The broker owned almost 726,000 shares of Ausam himself and was a founder and eventual director of the company. The broker and some of his associates used cash from two hedge funds to make a \$3.6 million investment in Ausam. This was in addition to \$65 million which was invested in various other companies owned by the broker and his associates, as well as millions of dollars the broker solicited from individual investors.

The SEC commenced an enforcement action against the broker in the Southern District of New York, which is still pending. However, the broker died after the action commenced, of unexpected and suspicious causes. As a result of his death and the SEC action, the Claimant in this particular case had no chance to recover her stolen funds directly from the broker's estate. Instead, the investor pursued a selling away case against the brokerage firm, alleging that her losses would not have occurred but for the firm's failure to supervise. The case was settled for a confidential amount.

### Definition of Selling Away

The American Bar Association defines "selling away" as "[w]hen a registered representative of a broker-dealer sells financial products not authorized by the broker-dealer." M. Owen Donley III, A (Very Brief) Encyclopedia of Securities Fraud, [www.abanet.org/buslaw/blt/2007-03-04/donley.shtml](http://www.abanet.org/buslaw/blt/2007-03-04/donley.shtml). Often a registered representative will sell the same unauthorized products to multiple customers. As a result, selling away cases are attractive to arbitration attorneys because of the potential for multiple Claimants in one case, as well as the potential for large awards. Recently there has been an increase in the number of selling away cases brought to arbitration, as a result of brokerage firms allowing independent contractors to work as registered representatives from their homes or satellite offices, away from constant supervision. David E. Robbins, Securities Arbitration Procedure Manual § 5-6i (5th ed. 2005) at 5-93 (hereinafter, "Manual").

### How to Find Selling Away Cases

### Recurring Legal Issues in Selling Away Cases

A selling away case is usually pursued against the brokerage firm, not the individual broker. The individual broker is unlikely to have sufficient assets to satisfy an arbitration award, especially if the case involves multiple Claimants. Also, many brokers caught in this misconduct are either in

jail, on trial, or on the run by the time of the arbitration claim. Manual § 5-6i at 5-93. Furthermore, all parties involved (firm included) will generally concede that the customer lost money due to the broker's misrepresentations. As a result, the hearing will focus on why the brokerage firm should be vicariously liable for the acts of their independent broker.

The focus in these cases should be on the firm's conduct, not the individual profile and circumstances of the Claimant or Claimants. The hearing will be much more manageable if the Statement of Claim is drafted to highlight what the brokerage firm did or did not do, rather than the individual circumstances of the Claimants.

The following legal issues often arise in selling away arbitrations:

1. **Can a Firm be Liable to a Non-Customer (i.e., Someone Without an Account at the Firm)?**

NASD Rule 12200 states that a dispute must be arbitrated under the NASD Code if it is required by a written agreement or requested by the customer; the dispute is between a customer and a member or associated person; and the dispute arises in connection with the business activities of the member or associated person. In selling away cases, there is rarely an agreement to arbitrate between the firm and the Claimant. Manual § 5-6i at 5-94. As a result, the threshold issue becomes whether or not the Claimant was a customer of the brokerage firm, despite dealing extensively or exclusively with the independent broker. A number of court decisions have addressed this issue.

The United States District Court for the Middle District of Florida held that two investors were entitled to arbitration against their brokerage firm in Investors Capital Corp. v. Rimmler, 2001 U.S. Dist. LEXIS 5591 (M.D. Fla. Feb 5, 2001). In that case, there was no agreement to arbitrate between the investors and the firm. However, the investors argue, and the court agreed, that they knew and/or believed their broker worked for the firm, and that they relied on the broker's advice and recommendations. Id. at \*2-3. The court explained that its holding was analogous to a similar case, WMA Securities, Inc. v. Ruppert, 80 F. Supp. 2d 786 (S.D. Ohio 1999). In Ruppert, the court held that "[b]y conducting business with [the firm's] registered representatives, Defendants conducted business with [the firm] and became its customers." Id. at 789.

In John Hancock Life Ins. Co. v. Wilson, 254 F. 3d 48 (2nd Cir. 2001), a group of investors bought fraudulent promissory notes from a registered representative of Hancock. Id. at 51. There was no express agreement to arbitrate between Hancock and the investors, and the investors presented no evidence showing they knew their broker was affiliated with Hancock. Id. Nevertheless, the Second Circuit found a valid agreement to arbitrate under NASD Rule 10301 (the predecessor to Rule 12200), because the investors were customers of Hancock. It noted that the NASD Code, in Rule 0120(g), defined customer broadly to exclude only brokers or dealers, neither of which applied to the investors. Id. at 59. Further, the court noted that any ambiguity in the Rule should be construed in favor of arbitration and, having done so, found that "the clause is not only susceptible of an interpretation covering the Investors' disputes, but requires one." Id.

These cases stand in contrast to Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc., 264 F. 3d 770 (8th Cir. 2001). In that case, the brokerage firm sued a corporate client to recover lost fees it was owed for providing financial advice during the course of a merger. Id. at 771. The corporate client moved to arbitrate and argued that, since it was not a broker or dealer, it should be considered a "customer" for purposes of the NASD rules. Id. The Eighth Circuit disagreed, holding that a customer (for the purposes of compelling arbitration) must be an individual or entity who receives investment or brokerage-related services from an NASD member. Id. at 773.

Thus, the definition of a "customer" for the purposes of compelling arbitration is interpreted broadly. It will usually cover investors in the selling away scenario. This issue is often decided by

principles of agency and *respondeat superior*. The Claimant should be prepared to present any applicable indicia of agency to link the broker with the firm.

## 2. Is the Firm Liable as a Controlling Person Under § 20(a) of the Securities Exchange Act of 1934?

After showing your client was a customer for the purposes of compelling arbitration, you will want to prove the brokerage firm was liable as a controlling person under the Securities Exchange Act of 1934 (hereinafter, "the '34 Act"). Section 20(a) of the '34 Act provides:

"Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

15 U.S.C.A. § 78t(a). As noted by the statute, this cause of action requires that the individual broker violated either a provision of the '34 Act or one of the SEC Rules promulgated thereby. As a result, you will want to either seek a concession from the firm or state a separate cause of action showing that the broker's misappropriation constituted a violation of, e.g., § 10(b) or Rule 10b-5.

The Claimant's task of proving that the firm is a controlling person was made much easier by the Ninth Circuit's decision in Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990), *cert. denied* 499 U.S. 976 (1991). In that case, investors sued a brokerage firm after its registered representative misappropriated the investors' funds for his personal use. The registered representative generated bogus receipts and account statements purported to be from the firm, while instead the money went into his personal checking account. *Id.* at 1567. The broker was eventually caught and convicted for criminal securities fraud and grand theft. *Id.* The district court granted summary judgment to the firm, but on appeal the Ninth Circuit reversed and held that a broker-dealer is a controlling person of its registered representatives for the purposes of § 20(a) liability. *Id.* at 1573. It also held that the investors were not required to allege that the firm was a "culpable participant" in the fraud, as the lower court had held. *Id.* at 1575. As a result of this case, to prove that a firm was a controlling person of a broker for the purposes of § 20(a), you will only have to prove that the broker was a registered representative of the firm.

After the Claimant has proven the firm was a controlling person of the broker, the burden is on the firm to present any good faith defenses. Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1120 (5th Cir. 1980). You can anticipate these defenses, and a showing that the firm "failed to establish, maintain or diligently enforce a proper system of supervision and control... would suffice to show its lack of good faith." *Id.* (citations omitted). Principles of *respondeat superior* also become a factor, and the Claimant should prepare a response to the defense that the broker was acting outside the scope of their employment with the firm. See Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2nd Cir. 1980), *cert. denied* 449 U.S. 1011 (1980).

## 3. Is the Firm Liable Under General Agency Principles?

In addition to causes of action for federal statutory securities violations, you will want to present causes of action for agency and *respondeat superior*. According to the Restatement (Second) of Agency, § 219 (1958), "[a] master is subject to liability for the torts of his servants committed while acting in the scope of their employment..." Conversely, § 219(2) provides that the master is not liable for torts committed outside the scope of employment, unless the master was reckless or the agent acted with apparent authority.

There will often be little evidence of express authority in selling away cases. This is true because the firm is generally unaware of the unauthorized trading perpetrated by the broker. Manual at 5-106. Therefore, the important question is whether or not there was apparent authority for the broker's conduct.

**4. Did the Broker Have Apparent Authority to Recommend the Investments?**

The issue is whether the broker was acting with apparent authority to recommend the investments. The doctrine of apparent authority was explained in FSC Securities Corp. v. McCormack, 630 So. 2d 979 (Miss. 1994) as follows:

"An act is considered to be within the agent's apparent authority when a third party is justified in concluding that the agent is authorized to perform it from the nature of the duties which are entrusted to him. McPherson v. McLendon, 221 So. 2d 75, 78 (Miss. 1969). Apparent authority is to be determined from the acts of the principal and requires reliance and good faith on the part of the third party. Tarver v. J.W. Sanders Cotton Mill, 192 So. 17 (Miss. 1939)."

Id. at 985. More recently, the doctrine was clarified by the court in Blanchard v. MBNA America Bank, N.A., 2005 U.S. Dist. LEXIS 18450 (W.D.N.C. 2005):

"The general rule is that a principal is responsible to third parties for injuries resulting from the fraud of his agent committed during the existence of the agency and within the scope of the agent's actual or apparent authority from the principal, even though the principal did not know or authorize the commission of the fraudulent acts."

Id. at \* 10-11 (citing Northwestern Bank v. Roseman, 344 S.E. 2d 120 (N.C. App. 1986)).

In the context of a selling away case, a Claimant will have to show he acted reasonably in believing the broker was authorized by the firm to sell the financial products at issue, based upon the various indicia of agency provided by the firm. All indicia of agency should be investigated and researched. Questions to be asked include:

- a. What did the broker's business card say?
- b. Does the business card identify the broker as a representative of the firm?
- c. What address is used on the card?
- d. Did the broker's office have a sign out front containing the name of the firm?
- e. What did the sign on the broker's door say?
- f. Did the broker use firm letterhead or stationary?
- g. Was there a telephone listing for the broker with the name of the firm?
- h. Was there a link to information about the broker on the firm's website?
- i. Did the selling away of the product occur at the firm's office?
- j. Where were the customer files kept?

All of these questions are designed to show that the broker was acting within the scope of their employment when recommending the investments to the Claimant. If the broker was acting within the scope of their employment, vicarious liability should exist for the firm.

### **Damages**

As mentioned previously, successful selling away cases traditionally produce large damage awards. In a majority of cases, it is undisputed that the Claimant lost large amounts of money and that these losses were directly attributable to the acts of the broker. Additionally, the broker's actions in taking advantage of unsophisticated investors may contribute to a large damage award.

There is generally no set formula for calculating damages. The '34 Act says that damages are to be limited to "actual damages", but does not provide an explanation as to what that means. See 15 U.S.C.A. § 78bb(a). However, arbitrators are given wide latitude in awarding damages and are able to award equitable relief and/or punitive damages, so long as the arbitration agreement can be interpreted as contemplating such awards. This is so because the Federal Arbitration Act, by favoring arbitration, mandates that agreements to arbitrate be construed broadly. Bonar v. Dean Witter Reynolds, Inc., 835 F.2d 1378, 1387 (11th Cir. 1988).

A couple of cases illustrate that Panels will enter substantial damage calculations once persuaded that there was a failure to supervise. In Battle, et al. v. Northeast Securities, Inc., FINRA No. 06-04110 (March 18, 2008)(copy of Award attached), a number of Claimants brought a selling away case against a brokerage firm. The firm's registered representative sold investors fraudulent promissory notes as part of a Ponzi scheme. These notes often claimed to generate a 10% quarterly return and were purportedly "tax-free". The broker started this fraud before joining the firm, and only one of the ten Claimants was ever a customer of the firm. Nevertheless, the Panel awarded the Claimants \$329,242 with interest. The Panel found that although the firm had reasonable supervisory procedures, it failed to implement them in a reasonable and timely fashion. When calculating the award for each individual investor, it limited damages to their out-of-pocket losses. In other words, the Panel began with each investor's investment in the scheme, then subtracted any so-called "interest payments" (but which were actually returns of capital) received on the contracts they bought from the broker during the time he was with the firm. By calculating damages in this fashion, the Panel said it was trying to avoid creating a double recovery for the investors. On the other hand, the panel also added to the award any new monies invested by the Claimants during the same period, in order to ensure they were not under-compensated.

Similarly, in Chandler, et al. v. FSC Securities Corporation, FINRA No. 05-04443 (July 2, 2007), six investors brought a selling away case against their brokerage firm. The Panel found the firm to be reckless in failing to investigate numerous red flags, such as the fact that the broker had been fired previously for selling away and that he forged account documents on at least two occasions. As a result, the Panel held the firm liable for compensatory damages, attorneys' fees, and costs to the tune of \$687,313 plus interest. Additionally, the Panel noted that it would have awarded punitive damages as well, were it not for the fact that at least some of the firm's supervisory procedures were adequate under existing NASD regulations.

### **Conclusion**

Selling away arbitration cases are becoming more common and offer attorneys substantial economic incentives. Recognizing how to frame the issues and pursuing theories of agency and federal securities violations is important to the success of these cases. The key to a successful case is discovering all facts tending to show a relationship of control and supervision between the brokerage firm and the individual broker.