Secondary Liability and "Selling Away" in Securities Cases

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Introduction

Based on media accounts, there appears to be an increase in the number of Ponzi schemes and other fraudulent investments. The rise of these nefarious ventures may be explained, in part, by an investment public that is weary of the volatility of traditional markets and is susceptible to projects promising safety, stability, and reliable investment return.

Generally, for a registered securities brokerage firm to market investments for purchase directly from the issuer, the firm is obligated to conduct an investigation or due diligence of the investment opportunities.[1] Consequently, perpetrators of these ruses typically seek to avoid this scrutiny and do not sell their projects as approved investments through brokerage firms. These schemes instead are sold directly by the issuer to the investor and not through a market or an exchange. On other occasions, these counterfeit schemes appear as corporations that sell stock on the over-the-counter markets. These stocks normally are priced extremely low, are thinly traded, and are not approved for solicited sale by brokerage firms.

Nonetheless, individual securities brokers affiliated with a brokerage firm often will introduce their clients to such fraudulent investments even though the investment is not through the brokerage firm with whom they are associated. On those occasions, when the investment is solicited and/or sold without the approval of, and not through, a securities brokerage firm, the investment commonly is known as being "sold away." Various securities industry rules prohibit brokers from "selling away" regardless of whether the broker receives any compensation for the transaction.[2] Moreover, brokerage firms virtually always have their own policies that prohibit "selling away" activities and procedures for preventing the activity.

Brokerage firms, however, cannot simply rely on these rules and internal procedures to avoid potential liability in the event their brokers violate the rules and "sell away." Brokerage firms can be liable for the "selling away" actions of their brokers under certain theories of secondary liability. Under Michigan law, when an investment is truly "sold away" from the brokerage firm, the firm potentially can be held liable pursuant to claims of vicarious liability, apparent authority, negligence couched as a failure to supervise, and "control person" liability under the Michigan Uniform Securities Act. Moreover, liability may arise in more uncommon circumstances. For example, a brokerage firm can be liable for the broker's conduct even after the broker leaves a firm. This article discusses each of these theories and when, under Michigan law, a brokerage firm can be liable for such claims.[3]

Vicarious Liability and Apparent Authority

The initial question in "selling away" cases is the scope of the securities brokerage firm's liability for the actions of its broker under theories of vicarious liability and apparent authority. The brokerage firm, obviously, cannot be vicariously liable unless its broker is found to be primarily liable.[4] The broker probably cannot be found primarily liable based solely on the fact that he or she violated industry rules or the brokerage firm's policies prohibiting selling away activities.[5] Consequently, an investor seeking to hold a brokerage firm liable must first establish that the broker is liable under some actionable claim, such as misrepresentation or malfeasance.[6]

Further, the brokerage firm may not be vicariously liable for the selling away activities of its broker where the firm was unaware of the activity, and the broker acted outside the scope of his or her association with the brokerage firm and for the broker's own purpose. For example, in *Smith v Merrill Lynch Pierce Fenner & Smith*,[7] a customer brought a claim under a theory of respondeat superior against a brokerage firm for the employee stockbroker's failure to repay a personal loan from the customer to the stockbroker. The Michigan Court of Appeals held that the brokerage firm was not liable as a matter of law where the stockbroker was "acting

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to accomplish a purpose of his own" because the firm "could not be held vicariously liable for [the stockbroker's] independent action."[8] Additionally, courts have recognized that vicarious liability is inappropriate where the broker's conduct violates industry rules and the brokerage firm's own policies.[9] Logically, in such circumstances, the broker could not be deemed to be acting on behalf of the brokerage firm, so the brokerage firm could not be vicariously liable.

Claimants frequently confuse vicarious liability with apparent authority by arguing that vicarious liability applies because the broker was selling a security and the brokerage firm authorized the broker to sell securities. But in typical situations, the brokerage firm did not actually authorize the broker to sell the investment away from the firm, instead the broker was acting beyond the scope of his or her authority, which negates a claim of vicarious liability.[10]

Moreover, just because a brokerage firm authorizes the broker to sell securities does not mean the broker has the apparent authority to sell all securities, such as unapproved securities. "[A]pparent authority must be traceable to the principal and cannot be established by the acts and conduct of the agent."[11] Consequently, courts must analyze the surrounding facts and circumstances of the sale to determine if liability for apparent authority may exist.[12] Those facts and circumstances include the supervision activities of the brokerage firm and the objective reasonableness of the investor's belief that the sale was through and approved by the brokerage firm.[13] Thus, courts look to more than just the relationship between the brokerage firm and the broker when considering claims under an "apparent authority" theory. Courts also look to the details of the transaction between the claimant and the broker.[14]

While Michigan courts have clearly set forth the requirements to show apparent authority, few Michigan courts have applied the requirements in the securities context. In one such case, *Carsten v North Bridge Holdings, Inc*,[15] the investor did not know the broker had left the brokerage firm. The court found that the broker was not acting with the apparent authority of the brokerage firm in part because the broker had left the firm, the broker was not authorized to sell unapproved securities, and the investor did not rely on the brokerage firm when she signed a blank piece of paper authorizing any unexplained transaction.

Similarly, in *Kohn v Optik*, a non-Michigan case,[16] the court made it clear that "where the irregularity on the actions of the employee provide notice to the third party that the employee is acting outside the scope of the employee's employment, the employer is not bound by the employee's action as no apparent authority exits."[17] In dismissing the investor's agency law claim, the court noted that:

> it is uncontested that Plaintiff did not open a regular account with [the brokerage firm], that Plaintiff did not send her checks to the brokerage, and that Plaintiff never received a single receipt, statement, or other communication bearing [the brokerage firm's] name. Thus, the irregularity of the transaction at issue provided notice to Plaintiff that [the registered representative] was acting outside the copy of his employment.[18]

In *Harrison I*, the court delineated additional factors important in analyzing a claim under an apparent authority theory:

> Here the undisputed facts show Harrison did not open an account with Dean Witter but, instead, transferred money to Kenning and Carpenter for them to place in Carpenter's employee account at Dean Witter for subsequent investment. In so doing, Harrison expected to enhance his return by paying the lower commission charged Dean Witter employees, although he was not an employee entitled to the benefit. It is clear neither Kenning nor Carpenter had the authority, actual or apparent, to use the account thusly; Dean Witter's rules expressly forbade it, as would ordinary prudence.[19]

The *Harrison I* court concluded that no "reasonably prudent person" could conclude that the employees had the authority because the investment transactions "were not regular on their face and could not appear to be within the ordinary course of business."[20]

Thus, a claimant asserting a claim against a brokerage firm for vicarious liability and apparent authority based on the actions of a broker must allege more than simply that there was an employment relationship between the brokerage firm and the broker. The claimant must allege facts, and come forward with evidence, that the brokerage firm was aware of, was involved in, or benefited from the transactions at issue.

Failure to Supervise and Control Person Liability

Michigan courts recognize a claim against a brokerage firm based on the firm's supervision, or failure to supervise, a broker. The claim is couched either as a negligence claim for the failure to supervise[21] or as a claim for "control person" liability under the Michigan Uniform Securities Act.[22]

Michigan courts recognize a failure to supervise claim arising from a duty to supervise based on the special relationship between an individual (such as an investor) and another entity or person (such as a brokerage firm).[23] This duty comes from the securities regulations, such as NASD Rule 3010(a), which provides that broker dealers "shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is *reasonably* designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules."[24] Thus, a failure to supervise claim coincidentally embodies a similar standard for supervision as the criterion set forth in the rules of the securities regulators.

In analyzing the duty imposed on brokerage firms, the standard is reasonable, not perfect, supervision. As stated by one regulatory body:

> The standard of 'reasonableness' is determined based upon the circumstances of each case…. The burden is on the staff to show that respondent's procedures and conduct were not reasonable….*It is not enough to demonstrate that an individual is less than a model supervisor or that the supervision could have been better*.[25]

From the regulators' point of view, as well as a court's, a reasonableness standard is desirable for at least two reasons. First, the reasonableness standard provides flexibility in evaluating different circumstances and factual situations. Second, the required level of supervision must consider the cost to consumers for access to the capital markets. Supervisory costs necessarily are reflected in brokerage firms' commissions and fees. Perfect or near perfect supervision will require the expenditure of such significant resources that it will result in a significant increase in the cost to invest.

Also, under the Michigan Uniform Securities Act, a brokerage firm can be held liable for the sale of unregistered securities by one of its brokers, the sale of securities by a broker who is not properly registered, or for the misrepresentation of its broker, if the brokerage firm is a "control person."[26] A brokerage firm typically, but not always, is considered a "control person" for a broker it licenses and supervises as it typically "directly or indirectly controls" its brokers.[27] The brokerage firm, however, can avoid liability if it "sustains the burden of proving that the controlling person did not know, and in the exercise of reasonable care could not have known, of the existence of the conduct by reason of which the liability is alleged to exist."[28] In the brokerage firm context, the reasonable care or "good faith" defense essentially concerns a brokerage firm's "failure to supervise" a registered representative, and thus overlapping with the failure to supervise claim.[29] Accordingly, a brokerage firm generally is not liable for the underlying violation if it establishes that it maintained "a reasonable system of supervision, enforced that system with reasonable diligence, and that the [brokerage firm] did not directly or indirectly induce the violations by its [registered] representative."[30]

Courts consider many factors to determine whether the good faith defense bars "control person" liability, such as: to whom and where the investor sent checks, whether the investment procedures were typical, and whether the investment procedures were part of the broker's efforts to circumvent compliance efforts by the brokerage firm.[31] Courts also consider the rules and procedures in place to prevent the underlying violation, the brokerage firm's implementation of those rules, and whether the brokerage firm had actual notice or should have known of the underlying violation—meaning whether "red flags" were present and investigated.[32]

Again, the decision in *Kohn*[33] is instructive. In *Kohn*, the court ruled, as a matter of law, that no "control person" liability existed against the brokerage firm.[34] In reaching that conclusion, the *Kohn* court considered numerous factors, such as: whether the fraudulent investments were even available through the brokerage firm; whether the broker disclosed his affiliation with the brokerage firm to the investors; whether the brokerage firm authorized the broker to solicit for the investments;

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where the investor sent investment checks; whether the investor received receipts, account documents, account numbers, correspondence, confirmation slips, or monthly statements from the brokerage firm; and whether any documents even mentioned the brokerage firm. The *Kohn* court concluded that:

> Plaintiff was not reasonably relying on [the broker] as a [broker] of [the brokerage firm], but was placing her money with him for purposes other than investment in markets to which he had access only by reason of his relationship with [the brokerage firm]; it is uncontested that [the investment] was not traded on any market to which [the broker] had access solely because of his relationship with [the brokerage firm] and that [the brokerage firm] did not manage the purchase transaction.[35]

Thus, courts have ruled against claimants asserting failure to supervise and control person claims in "selling away" cases when the broker controls the transaction and the brokerage firm receives no benefits from the transaction.[36]

It is evident from the above discussion that whether a brokerage firm may be liable as a "control person" and whether the "good faith" defense applies is a fact-intensive inquiry. As a result, even in "selling away" cases where a brokerage firm was completely mislead by its broker, it can be difficult to convince a court to dismiss an investor's claim on the pleadings and some discovery likely will be warranted.

Liability For Foreseeable Harm After Termination

Beyond being liable for the actions of a current broker, some courts have recognized that, under certain circumstances, a brokerage firm can be liable for the actions of a former broker even after the broker is no longer associated with the brokerage firm. For example, imagine a situation where a brokerage firm discovers its broker is violating the rules or is engaged in some other activity that could potentially harm investors (such as engaging in unreported outside business activities or selling away) and then fails to take steps to remedy the harm or to notify other brokerage firms that may be looking to hire the broker engaged in the wrongful conduct. In this circumstance, a brokerage firm can be liable to another brokerage firm if it stays silent even though it knows that there is a reasonable possibility that the broker has engaged in, and may continue to engage in, the unlawful activity at a subsequent brokerage firm. While, no Michigan court has addressed this issue directly, courts applying statutes and regulations substantially similar to those enacted in Michigan have done so, and brokerage firms must be cautious not to run afoul of these requirements.

The seminal case for imposing liability on a brokerage firm for the conduct of a former broker is *Twiss v Kury*.[37] In *Twiss*, defendant E.F. Hutton ("Hutton") learned that its sales representative, Kury, was involved with outside business activities in violation of securities laws and regulations. In response, Hutton requested and received Kury's resignation. Hutton then filed with the regulators a Form U-5[38] incorrectly stating that the termination was voluntary and failing to disclose its investigation and the probable violations committed by Kury. Kury remained in the securities industry and, four years later, was found to have sold interests in what turned out to be a $2.4 million Ponzi scheme.

The plaintiffs in *Twiss* were all persons who became Kury's clients after his resignation from Hutton. The plaintiffs asserted negligence claims, alleging that Hutton breached a duty to Kury's then and future customers when it misrepresented the reasons for Kury's termination and failed to submit a proper and accurate Form U-5 to the regulatory authorities. On appeal, the court found that Florida law imposed a duty "to report the fact of [Kury's] termination to the [state agency], to accurately state the reason for such termination, and to specify any illegal or unprofessional activity committed…then known by Hutton. The rule required Hutton to make the report to the Department by filing a form U-5."[39] Thus, Hutton was liable to the plaintiffs even though they had never been Hutton's customers.

Like Florida, the NASD bylaws impose the same duties to file and later correct Form U-5 disclosures.[40] In a Notice to Members issued in 1988, the NASD explained that one purpose of the obligation to provide accurate information on the Form U-5 is that the "[f]ailure to provide this information may [] subject members of the investing public to repeated misconduct and may deprive member firms of the ability to make informed hiring decisions."[41] Subsequently, in 2004, the

NASD reinforced the importance of filing timely and accurate Form U-5's, and corrections when necessary, by increasing the NASD's enforcement options for the failure to timely submit amendments to the U-5.[42]

The *Twiss* claim, however, is not an effort to imply a cause of action under the Florida securities act or the NASD/FINRA rules. Rather, the reporting requirements of the Florida act, as well as the NASD and FINRA rules, inform the common law malfeasance claim in defining the class of individuals to whom the brokerage firm is liable for the subsequent misconduct of its broker. For example, *Twiss* relied upon *Palmer v Shearson Lehman Hutton, Inc*,[43] where the court stated:

> The violation of a duty created by statute is recognized at common law as satisfying the duty of care requirement in a negligence action, provided the injured party is in the class the statute seeks to protect and the injury suffered is the type the statute was enacted to prevent.
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> ….
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> …A statute creates a duty of care upon one whose behavior is the subject of the statute to a person who is in the class designed to be protected by the statute, and that such duty will support a finding of liability for negligence when the injury suffered by a person in the protected class is that which the statute was designed to prevent.[44]

Thus, the enactments and rules that require a brokerage firm to file a properly completed Form U-5 inform the common law malfeasance claim of the parties who can bring a *Twiss* claim against the brokerage firm. Those parties are clearly investors who are harmed by the broker's subsequent conduct. But other brokerage firms that hire the broker with no knowledge of the broker's prior wrongful activity may be as well because one purpose of Form U-5 is to permit subsequent employers to make informed hiring decisions.[45] Thus, brokerage firms also may be able to bring and prevail on claims pursuant to *Twiss*.[46] In other words, a brokerage firm can be liable to another brokerage firm that hires the broker in question for negligence for violating its duties.

Michigan law imposes the same duties found in the Florida act and the NASD rules. For example, MCL 451.2408(1) states:

> If an agent registered under this act terminates employment by or association with a broker-dealer or issuer,…the broker-dealer, investment adviser, or federal covered investment adviser shall promptly file a notice of termination. If the registrant learns that the broker-dealer, issuer, investment adviser, or federal covered investment adviser has not filed the notice, the registrant may file the notice.

The prior version of the Michigan Uniform Securities Act contained a similar provision.[47]

Pursuant to MCL 451.2408(1), the state administrator has adopted Form U-5, the Uniform Termination Notice for Securities Industry Registration, as the appropriate form to satisfy the requirements that the brokerage firm file a notice of termination.[48] Thus, a brokerage firm has a duty to file a U-5 with the State of Michigan on the termination of its broker's connection with the brokerage firm. A brokerage firm also is under a continuing obligation to correct a U-5 to include matters that occur or become known after the initial submission of the form.[49]

Further, in another context, Michigan courts have followed the reasoning in *Palmer* that statutory obligations can inform and identify the class of individuals who can bring a common law malfeasance claim. For example, in *Transportation Dep't v Christiansen*,[50] the defendant was driving a flatbed truck loaded with machinery. The height of the machinery was above the legal limit and struck a highway overpass. The machinery was knocked off the truck and onto the highway where it struck plaintiff's vehicle. The court noted that the "legal effect of [the defendant's] violation of the statutory duty of care, standing alone, would be enough to establish a prima facie case of negligence." The court further explained, however, that this "presumption of negligence" could be rebutted by applying the "statutory purpose doctrine." Under this doctrine, the court considered whether the statute was intended to protect against the result of the violation, whether the plaintiff was within the class intended to be protected by the statute, and whether the violation was the proximate contributing cause of the plaintiff's injuries.[51]

These principles also would apply to a brokerage firm accused of failing to complete an accurate Form U-5. The claimant's com-

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mon law negligence claim would be informed by the statutory violations, and the success or failure of such a claim would depend, in part, on an analysis of whether the claimant is within the class of individuals protected by the statute. Other courts have either followed *Twiss*, reached a similar result, or endorsed its reasoning.[52]

To be clear, a *Twiss* claim properly understood is not simply the failure to report suspected or actual wrongdoing. Liability also can arise from the failure to take corrective action. A *Twiss* claim is grounded in a common law malfeasance claim for failure to supervise. The malfeasance can be evinced in two different ways, each of which may be actionable. First, the brokerage firm may have had actual knowledge of a violation and took no corrective action, thereby permitting the violation to continue after the broker left the brokerage firm. Second, the brokerage firm may have knowingly failed to disclose the activity on broker's Form U-5 or otherwise as required by the NASD/FINRA rules and state regulation.

Consequently, the first and fundamental element is that the brokerage firm knowingly permitted the broker to engage in improper conduct without taking steps to gain compliance. If the brokerage firm is guilty of such conduct, then the brokerage firm may be liable for malfeasance. Further, while terminating a broker may be a proper remedial action for selling away activities, termination alone is not sufficient. The focus is on the disclosure (or lack of disclosure) of the broker's improper conduct on his Form U-5. A brokerage firm's failure to disclose the real reason for the termination on the Form U-5 (instead, giving the broker a clean bill of health), can be the basis of liability. But it must be remembered that liability is not limited simply to improper disclosure on the Form U-5. It is first predicated upon the knowing failure to take corrective action when the brokerage firm learns of the improper conduct.

Conclusion

In most cases, brokerage firms already take great care to prevent their brokers from selling away, and for good reason. Not only does selling away expose brokerage firms to possible secondary liability, but any customer funds that are invested in unapproved investments necessarily are not invested in approved investments, which generate commissions for the brokerage firm. Supervision and prevention of selling away activities is particularly challenging because the activity is necessarily done outside the brokerage firm and typically done clandestinely. Ultimately, the incentives are clear, but no system of supervision is bullet-proof—and the law does not require such a system, only a reasonable one.

NOTES

1. *See, e.g.,* NASD Notice to Members 03-71. Due diligence obligations likely developed after the adoption of Section 11 of the Securities Act of 1933. A brokerage firm may not be liable under Section 11 of the Securities Act of 1933 for misstatements or omissions of material fact in a securities offering registration statement if it can prove that it had "after reasonable investigation, reasonable grounds to believe and did believe" there were no misstatements or omissions of material fact.

2. For example, Financial Industry Regulatory Agency ("FINRA") Rule 3040 prohibits associated persons from "participat[ing] in any manner in a private securities transaction" unless the associated person discloses to, and obtains approval from, the licensing brokerage firm. This Rule distinguishes participation with or without compensation to the associated person. If the associated person is to receive compensation, then he or she must have prior written approval of the licensing brokerage firm. If the associated person is not to receive any compensation, then he or she needs to provide written disclosure of their contemplated participation to his or her licensing brokerage firm prior to involvement in the transaction. The purpose of prior notification is to allow the brokerage firm to prohibit or regulate the activity.

3. Where appropriate, this article will cite federal case law in addition to Michigan law because in many contexts, such as the Michigan Uniform Securities Act, Michigan law is the same as or similar to federal law. *Kirkland v EF Hutton & Co,* 564 F Supp 427, 446 (ED Mich 1983); *Pukke v Hyman Lippitt, PC,* No 265477, 2006 Mich App LEXIS 1801 (June 6, 2006).

4. The pre-condition for such secondary theories of liability as vicarious liability is that there first is a finding of primary violation. *PR Diamonds, Inc v Chandler,* 364 F3d 671, 696-97 (6th Cir 2004); *Southland Secs v Inspire Ins Solutions, Inc,* 365 F3d 353, 383 (5th Cir 2004) ("Control person liability is secondary only and cannot exist in the absence of a primary violation."); *Heliotrope Gen, Inc v Ford Motor Co,* 189 F3d 971, 978 (9th Cir 1999) (secondary liability as a controlling person cannot exist without a primary violation); *SEC v First Jersey Secs, Inc,* 101 F3d 1450, 1472 (2d Cir 1996) (In order to find secondary liability, plaintiffs must show a primary violation by the controlled person whom the controlling persons control.); *Behrens v Wometco Enters, Inc,* 118 FRD 534, 539 (SD Fla 1988) ("As with all secondary liability under the securities laws, a primary violation of those laws must first be found.").

5. There can be no primary liability for any violation of regulatory rules because the courts generally have held that there is no private right of action for violations of such rules. See, e.g., *Vennittilli v Primerica, Inc,* 943 F Supp 793, 798 (ED Mich 1996) (the "Sixth Circuit has held that there is no private cause of action for violation of National Association of Securities Dealers rules.") (citing *Craighead v EF Hutton & Co,* 899 F2d 485, 493 (6th Cir 1990)); *Lantz v Private Satellite Television,* 813 F Supp 554, 556 (ED Mich 1993) ("the Sixth Circuit has held that these rules [NYSE and NASD] do not provide a private right of action.").

6. For examples of causes of actions against brokers under Michigan law, see R. Henney & M. Hindelang, *Investor Claims Against Securities Brokers Under Michigan Law*, 28 Mich Bus L J 50 (Fall 2008).

7. 155 Mich App 230 (1986).

8. *Id.* at 236. See also *Cocke v Trecorp Enters, Inc,* No 198201, 1998 Mich App LEXIS 2311, *14 (Feb 20, 1998) ("summary disposition is appropriate 'where it is apparent that the employee is acting to accomplish a purpose of his own.'").

9. *Harrison v Dean Witter Reynolds, Inc,* 974 F2d 873, 891 (7th Cir 1992) (*Harrison I*) (dismissing investor's vicarious liability claim because "[the brokerage firm's] rules expressly forbade" the acts in question).

10. *Grewe v Mt Clemens Gen Hosp*, 404 Mich 240, 253, 273 NW2d 429 (1978).

11. *Meretta v Peach*, 195 Mich App 695, 698-699, 491 NW2d 278 (1992).

12. *Id.*, at 699.

13. *Sanders v Clark Oil Refining Corp*, 57 Mich App 687, 691, 226 NW2d 695 (1975) ("plaintiff's belief in the agent's authority 'must be a reasonable one'").

14. See *Harrison I,* 974 F2d at 881 (dismissing investor's vicarious liability claim because "[the brokerage firm's] rules expressly forbade" the acts in question and because no "reasonably prudent person [could] naturally suppose that [registered representative] possessed the authority" for the acts in question). See also *Sanders,* 57 Mich App at 691-92.

15. 2006 Mich App LEXIS 230 (Jan 24, 2006)

16. 1993 US Dist LEXIS 7298 (CD Cal, Mar 30, 1993).

17. *Kohn,* 1993 US Dist LEXIS 7298 at *17.

18. *Id*.

19. 974 F2d at 884.

20. *Id.*

21. While there is no case in Michigan based on a failure to supervise in the securities broker context, there are cases in the employer/employee context generally (see generally *Millross v Plum Hollow Golf Club,* 429 Mich 178, 192, 413 NW2d 17 (1987)), and other states have applied the doctrine to brokerage firms in the securities context. *Burns v Rudolph*, 2005 Ohio App LEXIS 6222 (Ohio App 9 Dist, Dec 28, 2005).

22. MCL 451.2509(7) ("The following persons are liable jointly and severally with and to the same extent as persons liable under subsections (2) to (6): (a) A person that directly or indirectly controls a person liable under subsections (2) to (6), unless the controlling person sustains the burden of proving that the controlling person did not know, and in the exercise of reasonable care could not have known, of the existence of the conduct by reason of which the liability is alleged to exist"). Significant amendments to the Michigan Uniform Securities Act went into effect in 2009. See Public Act 551. The previous "control person" liability statutes was MCL 451.810.

23. *Mason v Royal Dequindre, Inc,* 455 Mich 391, 397, 566 NW2d 199 (1997) (stating that a special relationship gives rise to an exception to the general rule that there is no duty to protect someone from third parties).

24. NASD Rule 3010(a) (emphasis supplied).

25. *In re William Lobb*, NASD Compl. No 07960105, p 5 (4/6/00) (emphasis supplied).

26. MCL 451.2509(7).

27. *Id*. Compare *Martin v Shearson Lehman Hutton, Inc,* 986 F2d 242, 244 (8th Cir 1993) (status as employer of broker was sufficient to establish it as control person); *Hollinger v Titan Capital Corp*, 914 F2d 1564, 1573-76 (9th Cir 1990) (same) with *Hauser v Farrell,* 14 F3d 1338 (9th Cir 1994) (recognizing that a broker's conduct is not always within the brokerage firm's control) and with *Mosley v American Express Financial Advisors, Inc*, 256 Mont 27, 38, 230 P3d 479 (2010) (weighing *Martin, Hollinger, and Hauser* and concluding that "as a general rule a broker-dealer controls its registered representatives, whether directly or indirectly").

28. *Id*. It may be questioned whether the disagreement noted in footnote 24 regarding whether a brokerage firm is a "control person" of its brokers is really an application of the "good faith" defense. The cases do not always make it clear.

29. See, e.g., *Hunt v Miller*, 908 F2d 1210, 1214 (4th Cir 1990). The analysis for "control person" liability is similar under both federal securities laws and under Michigan securities law. *Kirkland v EF Hutton & Co,* 564 F Supp 427, 446-47 (ED Mich 1983); *Pukke v Hyman Lippitt, PC*, No 265477, 2006 Mich App LEXIS 1801, *13 (June 6, 2007).

30. *Harrison v Dean Witter Reynolds, Inc,* 79 F3d 609, 615 (7th Cir. 1996) (*Harrison II*) (requiring a showing that the fraudulent activity was so obvious that the control person must have been aware of it).

31. *Harrison I*, 974 F2d at 881.

32. *Id*. See also *Mosley,* 356 Mont at 39 (ruling after trial that no "control person liability existed and considering whether the broker acted in his role as a representative of the brokerage firm when he sold the investment, whether the investment had any relationship to the brokerage firm or was an authorized product, whether the purchase of the investment required access to a market through the firm, and whether the investment was "the kind of investment for which a customer typically relies on a broker with access through his firm to a stock exchange," whether the investor received a statement from the brokerage firm, whether the investor ever invested money through the brokerage firm, whether the investor was told it was an authorized product, and whether the brokerage firm had knowledge of or a financial interest in the investment).

33. *Kohn*.

34. *Id.* at *7-8

35. *Id.* at *8.

36. See *Harrison I; Harrison II; Kohn; Bradshaw v Van Houten*, 601 F Supp 983, 906 (D Ariz 1985).

37. 25 F3d 1551 (11th Cir 1994).

38. A form U-5 is a disclosure required of brokerage firms on the termination or departure of a broker. The form requires the brokerage firm to disclose (a) if the termination was for cause and why, (b) if the brokerage firm was aware of any wrongful conduct of the broker at the time of the broker's termination, or (c) if the brokerage firm was conducting an investigation of the broker at the time of his termination.

39. *Id.* at 1556.

40. NASD Bylaws, Art. V, sec. 3(a) & (b) (note that this rule remains applicable to brokerage firms after the FINRA merger); see also *Andrews v Prudential Secs, Inc,* 160 F3d 304, 305-06 (6th Cir 1998).

41. NASD Notice to Members 88-67 (emphasis supplied).

42. NASD Notice to Members 04-77.

43. 622 So2d 1085, 1090 & n. 8 (Fla App Dist 1, 1993).

44. *Palmer,* 622 So2d at 1090; see also *Twiss,* 25 F3d 1556 (examining whether plaintiffs "were within the class of persons these provisions were designed to protect").

45. See NASD Notice to Members 88-67.

46. See also *Prudential Securities, Inc v Am Capital Corp,* 1996 US Dist LEXIS 7196 (NDNY May 15, 1996) (holding that a brokerage firm's claim against another brokerage firm for having "violated its duty to inform defendant of" factors leading to its employee's termination on the Form U-5, and that "it would not

have registered [the employee] as its representative, and hence would not have incurred liability…," is arbitrable).

47. MCL 451.601(b) of the previous version of the securities act stated: "When an agent begins or terminates a connection with a broker-dealer or issuer, or begins or terminates those activities that make him or her an agent, the agent as well as the broker-dealer or issuer shall immediately notify the administrator in writing on a form prescribed by the administrator."

48. MCL 451.2605 delegates to power to issue form to the administrator. the Department of Energy, Labor & Economic Growth's website contains the Form U-5. Under the former securities act, § 451.601(b), the administrator had adopted Rule 451.602.2(2), which stated that: "A notice of agent termination shall contain the information specified in U-5." This Rule is still in effect while the state agency adopts new rules implementing the updated securities act.

49. See the Instructions to the Form U-5. Also, MCL 451.603 of the former securities act stated that "If the information contained in any document filed with the administrator is or becomes inaccurate or incomplete in any material respect, the registrant shall promptly file a correcting amendment unless notification of the correction has been given under section 201(b)." While this language appears to have been removed from the updated securities act, brokerage firms are still under an obligation to disclosure new information and file an amended U-5.

50. 229 Mich App 417, 420 (1998).

51. *Id.*

52. *See, e.g., Prymak v Contemporary Fin Solutions*, 2007 US Dist LEXIS 87734 (D Colo Nov 29, 2007) (recognizing a negligence claim against a securities dealer based on its failure to fulfill its statutory duty of filing a truthful Form U-5, but rejecting a private right of action for a violation of the requirement); *SII Investments, Inc v Jenks*, 2006 US Dist LEXIS 51753 (MD Fla July 27, 2006) (affirming arbitration award where SII failed to make numerous required disclosures on a Form U-5 relating to its employee who later sold unregistered securities to claimant); *Palmer v Shearson Lehman Hutton, Inc*, 622 So2d 1085 (Fla App Dist 1, 1993). One state court has rejected *Twiss* where a state statute existed that expressly "prohibits the recognition of an private-party state law statutory civil tort liability." *Ugarte v Atlas Sec, Inc*, 2004 Cal App LEXIS 1721 *18 (Cal App 3 Dist, Apr 1, 2004).

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