

# SEC REJECTS FINRA'S 'SHOULD HAVE KNOWN' THEORY IN 'SELLING AWAY' CASE

By James G. Smith



The decision of the Securities and Exchange Commission in *In re James W. Browne and Kevin Calandro*, Exchange Act Release 58916, November 7, 2008, Admin. Proc. File No. 3-12926, reversing a decision by the Financial Industry Regulatory Authority (“FINRA”) (formerly NASD) against two brokers

for engaging in private securities transactions in violation of Rule 3040, serves as a good reminder for our securities industry clients and friends of the duties of both a broker and a FINRA member firm in “selling away” matters.

## FINRA Rule 3040

Rule 3040 generally provides that any person associated with a FINRA member firm who participates in any manner in a securities transaction outside of the regular course or scope of such person’s employment with such firm, otherwise known as “selling away,” must:

- provide prior written notice to the firm describing in detail the proposed transaction and stating whether such person may receive selling compensation; and
- obtain from the firm, in writing, confirmation that the firm has approved the proposed transaction.

If the firm approves the transaction, the member firm must record the transaction on its books and records, and supervise the transaction as though it were the firm’s own. A registered person who engages in “selling away” without first obtaining written approval from the firm violates Rule 3040. From FINRA’s view, Rule 3040 supports the general rule that a FINRA member firm has a duty to supervise its brokers.

The determination of whether an associated person is engaging in a securities transaction outside of the firm, referred to in Rule 3040 as a “private securities transaction,” is highly subjective, as demonstrated by the SEC’s decision in *In re Browne and Calandro*.

## In re Browne and Calandro

*Background.* James Browne and Kevin Calandro, while employed at PaineWebber, developed a joint client – a wealthy tech executive who, in 1997, founded, like many new businesses in the late 90s, an Internet-related software development company, which was named e2 Communications, Inc. Brokers, like lawyers, try to help new companies get established through introductions to, among others, potential customers and suppliers. Browne and Calandro, not being an exception, assisted e2 with introductions to, among others:

- IBM (which would eventually develop a marketing arrangement with e2);
- CompUSA (which would eventually become a customer of e2); and
- The largest reseller of HP products (which would eventually become a supplier and reseller of e2).

Several of these introductions eventually resulted in investments in e2 including investments in the company by Browne’s and Calandro’s relatives.

*Advisory board and finder’s fees.* Browne was appointed to e2’s advisory board and received e2 stock. The record indicated an unexecuted agreement where Browne received the stock in return for his networking activities, including “introductions to potential suppliers, customers, employees and investors.”

In late 1999, at the peak of the dot-com bubble, e2 conducted a Series B Preferred offering. Investors included Browne and Calandro’s wife, some of the original persons introduced by Browne and Calandro to e2, as well as several of Browne and Calandro’s co-workers, and other persons with whom Browne and Calandro had discussed e2.

The record also indicated an e2 Board of Directors unanimous written consent indicating that Browne and Calandro would receive 750,000 shares of Series B Preferred as “finders’ fees.”

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Browne and Calandro asserted they had no knowledge of the finders' fee. They claimed the only compensation they received was equity for Browne's services on the e2 advisory board.

*End of e2.* In 2002, after the demise of many Internet start-ups, e2 filed bankruptcy and, shortly thereafter, the disciplinary proceeding was brought against Browne and Calandro. FINRA ultimately determined that Browne and Calandro both violated Rule 3040 in connection with the Series B Preferred offering.

### **SEC's Review of Disciplinary Proceedings**

*"Participate in any manner."* In its review of the disciplinary proceeding, the SEC initially noted that Rule 3040's phrase, "participate in any manner," is to be read broadly, and noted decisions in the past upholding participation *where the broker took specific actions to affect the particular transaction or profited from specific involvement in a particular transaction.* Such decisions have included:

- a broker referring a customer to a specific investment instrument and receiving a commission;
- a broker informing the investor the issuer was seeking funds, providing the investor's contact information to the issuer, helping prepare the purchase agreements, receiving the investor's funds and receiving a referral fee;
- a broker signing the investment agreements, making arrangements to resell the investments, receiving investor checks made payable to the broker, and accepting funds from the sale of the proceeds; and
- a broker facilitating the mechanics of the transaction by assisting the customers with transferring funds and liquidating the firm accounts to purchase the investment.

*"Should have known" theory.* FINRA proposed a novel theory of liability arguing "[i]t is common knowledge that start-ups often seek funding from their advisors, suppliers, consultants and other individuals involved with the company, and under the facts and circumstances Calandro and Browne should have known that their introductions [in 1998] would lead to investments in e2 Communications [in 2000]." In its decision setting aside the sanctions against Browne and Calandro, the

SEC rejected the "should have known" theory since it was a new interpretation of Rule 3040 without providing prior notice to the applicants, stating "[t]his lack of notice alone raises concerns sufficient to warrant dismissal of the charges against Browne and Calandro."

It is also interesting to note that the SEC rejected FINRA's argument that the e2 Board of Directors unanimous written consent indicating that Browne and Calandro were issued Series B preferred stock as finder's fees demonstrates Browne and Calandro's participation in the securities offering. The SEC's view was that there was no link between the Series B preferred stock purportedly issued to Browne and Calandro and the particular purchase or sale of the Series B preferred stock by any of the investors.

### **Conclusion**

Over the past few years, we have seen extraordinary volatility in the securities and financial industries. Intelligent securities professionals should be creative and explore opportunities in response to these changes. However, securities professionals must be diligent in maintaining their regulatory compliance and ethical obligations.

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### ***About James G. Smith, Partner***

*James G. Smith practices in the areas of securities and corporate transactions, investment management and corporate law. His broad range of experience includes representing issuers, underwriters and investors in public and private offerings, PIPES, structured and asset-based financings, SEC reporting and compliance, and corporate governance matters.*