

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

Respondent.

Disciplinary Proceeding
No. CAF040056

Hearing Officer – DRP

**ORDER DENYING ENFORCEMENT'S MOTION TO MODIFY
PERMANENT CEASE AND DESIST ORDER**

I. Background¹

On January 14, 2005, an NASD Hearing Panel found that Respondent participated in public offerings and sales of unregistered securities issued by Respondent through a private placement offering in 2003, in violation of NASD Conduct Rule 2110 and Section 5 of the Securities Act of 1933. The Panel further found that, through its registered representatives, Respondent made material misrepresentations and omissions of material fact in connection with the offer, sale or purchase of securities issued by Respondent in private placement offerings in 2003 and 2004, in violation of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110.

For these violations, Respondent was expelled from NASD membership, fined \$500,000, and ordered to pay restitution in the amount of \$11,011,008, plus pre-judgment interest of at least \$450,113.87. The Panel also imposed a permanent cease and desist

¹ The procedural history of this case is rather involved and is included here for context, as well as to correct several factual misstatements made by Respondent in its opposition to this motion.

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 05-06 (CAF040056).

order (PCDO) to replace an August 30, 2004 temporary cease and desist order (TCDO) that expired upon issuance of the Panel's Decision, pursuant to NASD Rule 9840(c).

The final provision of the TCDO required Respondent to collect \$2 million due from its parent company (Holdings), and to deposit \$2 million in an escrow account (escrow provision).² During the disciplinary proceeding held on October 18-20, 2004, Respondent asserted that the amount due from Holdings was approximately \$1.6 million, and contended that the debt was properly "written off" as an uncollected receivable or allowance for doubtful account. Respondent also claimed that all funds raised in the firm's 2003 and 2004 private placement self-offerings had been disbursed for business-related purposes by Respondent and that no proceeds from the offerings were included in the receivable from Holdings.³

The Panel rejected Respondent's arguments and reaffirmed its conclusion that at least \$2 million of the \$11 million raised in the fraudulent offerings had been transferred

² In the Decision accompanying the TCDO, the Panel held that the firm's misconduct was likely to result in significant dissipation or conversion of assets or other significant harm to investors. The Panel found that as Respondent raised millions of dollars through two fraudulent private placement offerings, it paid no dividends and reported significant operating losses, while funds flowed from Respondent to Holdings. Furthermore, FM, who owned and controlled both entities, could not explain why \$2 million that appeared to have been raised in the offerings was diverted to, and due from, Holdings. The Panel voiced its concern that FM had moved investors' funds from the broker-dealer, which was subject to NASD's jurisdiction, to Holdings, a company beyond the reach of NASD. Thus, in this case of first impression, the Panel ordered the member firm to collect the amount due from the non-member entity and place the funds in escrow, in order to protect investors in the event the Panel ordered restitution upon completion of the underlying disciplinary proceeding. Under Rule 9870, the TCDO constituted final and immediately effective disciplinary sanctions imposed by NASD. The SEC denied Respondent's application to stay the escrow provision on October 1, 2004 and dismissed Respondent's application for review of the TCDO on February 28, 2005.

³ At a pre-hearing conference on September 15, 2004, the Hearing Officer ruled that evidence received during the TCDO hearing was part of the record and need not be repeated at the disciplinary proceeding. Contrary to Respondent's assertions, Respondent presented, and the Panel considered, additional evidence on issues related to liability and sanctions at the disciplinary hearing held in October.

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 05-06 (CAF040056).

to Holdings without explanation, and was due Respondent. Because Respondent had not deposited funds in escrow as required by the TCDO, on January 14, 2005, the Panel ordered Respondent to deposit \$2 million in an escrow account, to ensure that the firm would be able to pay at least some portion of the restitution ordered.⁴

On February 1, 2005, the National Adjudicatory Council held that the escrow provision of the TCDO was invalid as drafted.⁵ Specifically, the NAC found that under Rule 9840, a hearing panel may impose an escrow requirement in a TCDO.

Nevertheless, the NAC held the Panel erred in requiring Respondent to “unwind a prior transaction” and collect the debt from Holdings “before a full hearing is held on the underlying allegations” The NAC noted that NASD lacks jurisdiction over Holdings but added that transactions between a member and non-member may be relevant in some circumstances.

On February 4, 2005, the Department of Enforcement filed a motion to modify the PCDO. Enforcement concedes it is unclear whether the NAC's ruling regarding the TCDO has any impact on the validity of the PCDO. In order to accomplish the Panel's objective of preserving investor funds from dissipation, however, Enforcement asks the Panel to freeze sufficient funds to protect the amount of restitution and interest ordered (\$11,461,201.87), and to require Respondent to provide within 30 days, an accounting of all monies raised through its private placement offerings, with supporting documentation.

⁴ The relevant provision of the PCDO orders Respondent to “collect \$2 million due from holdings to Respondent and deposit \$2 million in an escrow account within 10 days of this Decision.”

⁵ After Respondent failed to comply with the escrow provision of the TCDO, Enforcement initiated a proceeding to cancel the firm's membership. In accordance with NASD Procedural Rules 9556 and 9559, a hearing was held on November 3, 2004, and the Panel's unissued decision was submitted to the National Adjudicatory Council Review Subcommittee, which called the decision for review on November 19, 2004. The NAC issued its decision on February 1, 2005. Respondent's description of this series of events is inaccurate.

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 05-06 (CAF040056).

On February 14, 2005, Respondent filed its opposition to the motion to modify the PCDO. Respondent argues that the Panel lacks authority to grant Enforcement's motion, because the Panel's Decision has been stayed pending appeal to the NAC,⁶ and in any event, the Panel may not drastically increase the severity of the PCDO's terms by imposing a sanction without necessary due process.⁷

For the reasons stated below, Enforcement's motion to modify the PCDO is denied.

II. Validity of the Escrow Provision

Enforcement's motion was prompted by concern that the NAC's February 1, 2005 decision invalidating the TCDO's escrow provision may nullify the escrow provision of the PCDO. If true, Respondent would be free to convert for its benefit, or otherwise dissipate, \$2 million and thwart the Panel's goal of safeguarding at least a portion of the restitution ordered. For this reason, Enforcement requests a modification of the PCDO in the form of an asset freeze equal to the amount of restitution and pre-judgment interest ordered (approximately \$11.5 million).

The recent decision may not invalidate the escrow provision of the PCDO, however. The NAC's holding was premised in large part on its interpretation of Rule 9840, "which establishes the limitations and requirements of TCDOs." There is no similar rule limiting a hearing panel's authority regarding the terms of a PCDO. In fact,

⁶ On February 8, 2005, Respondent filed a notice of appeal of the Panel's January 14, 2005 Decision.

⁷ On February 15 and 16, 2005, Enforcement sought leave to file a reply to Respondent's opposition in order to address "the recent sale by Respondent of its remaining inventory to its customers – in many instances through unauthorized trades – and the draining of cash from its accounts," including a demand that its clearing firm wire-transfer \$150,000 out of an Respondent account containing approximately \$160,000. The Hearing Officer did not permit Enforcement to file a reply.

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 05-06 (CAF040056).

under Rule 8310(a)(7), a hearing panel may impose “any ... fitting sanction” after an adjudication on the merits, language that is much broader than Rule 9840.

Furthermore, the NAC found that the primary purpose behind a TCDO is to stop ongoing misconduct and maintain the status quo pending completion of the underlying proceeding. For this reason, it found that requiring Respondent to collect \$2 million from Holdings and “unwind a prior transaction ... *before a full hearing is held on the underlying allegations ... goes too far in a temporary proceeding.*” (emphasis added) Though the rationale for imposing a PCDO may be similar in some instances (i.e., to maintain the status quo until a decision becomes final disciplinary action of NASD), it may only be imposed after a full hearing. Any benefit of the doubt to which a respondent may be entitled at the TCDO stage no longer exists after an adjudication on the merits. The NAC's decision does not dictate otherwise.

Respondent had a full and fair opportunity to present evidence at the disciplinary proceeding regarding the requirement that Respondent unwind a prior transaction (i.e., collect \$2 million due from Holdings). The Panel did not credit FM's hearing testimony and reaffirmed its previous conclusion that at least \$2 million raised in the fraudulent offerings had been inexplicably transferred to, and was due from, Holdings. Accordingly, we ordered Respondent to collect the debt from Holdings and place the funds in escrow, which we believe are fair and fitting sanctions.

The NAC had one further objection to the provision regarding Holdings. It found that requiring Holdings, a non-member, to pay its debt to Respondent went beyond NASD's jurisdiction. The escrow provision, however, orders Respondent, the member firm,

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 05-06 (CAF040056).

to collect the debt from Holdings. This specific phrasing was intended to overcome any jurisdictional limitations. In support of the view that this is more than mere semantics, it is noted that NASD has authority to require a member experiencing financial or operational difficulty “to collect all [unsecured] loans, advances or [other similar] receivables where practicable.” *See* IM-3130(e)(6). In any event, ordering Respondent to collect a loan from Holdings is essentially a legal fiction, as FM owns and controls both entities.

For all these reasons, it is unclear whether the NAC's decision nullifies the escrow provision of the PCDO, which is currently in effect.⁸

III. Authority to Modify the PCDO

Pursuant to Rule 9311(b), Respondent's timely appeal to the NAC operates as a stay of the Panel's Decision and confers jurisdiction on the NAC.⁹ The appeal does not, however, stay that portion of the Decision imposing the PCDO, and for that reason, it is unclear whether the Panel has been divested of jurisdiction over the PCDO.

Even if the Panel has jurisdiction, Enforcement cites no statutory or regulatory authority that would permit the Panel to modify the PCDO as requested. While Enforcement seeks to enforce the intent of the escrow provision, altering the terms of the PCDO to impose a more significant sanction (freezing \$11.5 million, as opposed to \$2 million) would be patently unfair to Respondent.¹⁰

⁸ Respondent filed requests with the NAC, the SEC and the U. S. Court of Appeals for the D.C. Circuit to issue an emergency stay of the escrow requirement of the PCDO. All three requests for a stay were denied.

⁹ Enforcement argues that its motion to modify the PCDO was filed before Respondent filed its appeal, rendering “ineffectual” Respondent's attempt “to rob” the Panel of jurisdiction by appealing the Decision. Though Enforcement is correct that its motion preceded Respondent's appeal, under Rule 9311(a), Respondent was required to file a notice of appeal within 25 days after service of the Decision. There is no evidence that Respondent acted in bad faith.

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 05-06 (CAF040056).

IV. Conclusion

For the foregoing reasons, Enforcement's motion to modify the permanent cease and desist order is hereby denied.

SO ORDERED.

Dana R. Pisanelli
Hearing Officer
For the Hearing Panel

Dated: March 2, 2005
Washington, DC

¹⁰ A more interesting question is whether the Panel could modify the PCDO merely to conform to the NAC's February 1, 2005 decision (e.g., by eliminating the collection requirement and ordering Respondent to deposit immediately \$2 million in an escrow account).