

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT	:	
	:	
	:	
Complainant,	:	Disciplinary Proceeding
	:	
v.	:	
	:	
	:	
Respondent 1	:	Hearing Officer – DMF
	:	
	:	HEARING PANEL DECISION
	:	
	:	
Respondent 2	:	
	:	
	:	September 8, 2003
	:	
Respondents.	:	

The Department of Enforcement failed to prove, by a preponderance of the evidence, that respondents willfully misrepresented information on a Form U-5 Uniform Termination Notice for Securities Industry Registration, as charged. Therefore, the Complaint is dismissed.

Appearances

David Newman, Esq., Philadelphia, PA, (Rory C. Flynn, Esq., Washington, DC, Of Counsel) for Complainant.

_____, Pittsburgh, PA, for Respondents.

DECISION

1. Procedural History

The Department of Enforcement filed a Complaint on March 10, 2003, charging that respondents Respondent 1 and Respondent 2, its then-president, violated NASD Rule 2001 and IM-1001-1 by willfully misrepresenting information on a Form U-5 Uniform Termination Notice for Securities Industry Registration. Specifically, Enforcement

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alleged that in April 2001 respondents submitted a Form U-5 in connection with the termination of RP, who had been registered as a general securities representative with Respondent 1, indicating that RP's termination had been "voluntary." Instead, Enforcement charged, the Form U-5 should have indicated that RP had been "permitted to resign." Respondents filed an Answer contesting the charge and requested a hearing, which was held in Pittsburgh, PA, on July 15, 2003, before a Hearing Panel that included an NASD Hearing Officer and two members of the District 9 Committee.¹

2. Facts

Most of the relevant facts are not in dispute.² Respondent 1 has been a member of NASD since May 1981. Respondent 2 has been associated with Respondent 1 and registered with NASD as a general securities representative since 1984, except for a three month suspension beginning in February 2003. At the relevant time, he was also

¹ Prior to the hearing, the respondents filed a motion for summary disposition, pursuant to Rule 9264, in which they argued that in light of a prior SEC proceeding against them, this NASD disciplinary proceeding amounted to "double jeopardy." In that proceeding, the SEC charged RP with recommending and executing an unsuitable, aggressive trading strategy in the accounts of four customers while at Respondent 1, and with churning those accounts, and charged that Respondent 2 and Respondent 1 failed reasonably to supervise RP and failed to preserve certain firm records. Respondent 1 and Respondent 2 entered into a settlement with the SEC through which they accepted finds that they committed the supervision and records violations. Respondent 2 was suspended in all supervisory capacities for one year and in all capacities for three months and fined \$15,000, and Respondent 1 was censured, fined \$25,000 and required to retain an independent consultant to conduct a comprehensive review of its supervisory, compliance and other policies and procedures. (Tr. 107-08.)

The Hearing Officer denied respondents' motion. The Hearing Officer noted that SEC's order instituting the proceeding referred to the Form U-5, but did not charge Respondent 1 or Respondent 2 with any violations based on the Form U-5, and that the SEC's final order did not mention the Form U-5. In any event, the Hearing Officer held, the SEC's action would not preclude NASD from initiating charges against respondents to vindicate NASD's independent interest in requiring that NASD members and associated persons submit accurate U-5 Forms. Cf. Jones v. SEC, 115 F.3d 1173 (4th Cir. 1997), cert. denied, 523 U.S. 1072 (1998) (holding that neither the Double Jeopardy Clause of the Fifth Amendment, nor principles of res judicata precluded the SEC from imposing sanctions on Jones based on the same conduct for which he had been disciplined by NASD).

² The Panel heard testimony from Respondent 2 and CO, Respondent 1's compliance officer, and received nine Complainant's Exhibits (CX 1-8 and 11), and eight Respondents' Exhibits (RX 1-6, 14-15).

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registered as a general securities principal and served as president of Respondent 1.

(Compl. ¶¶ 1-2; Ans. ¶¶ 1-2; Tr. 27.)

In May 1999, RP became registered with Respondent 1 as a general securities representative. Prior to becoming associated with Respondent 1, RP was employed by another NASD member. According to the Form U-5 that the prior employer filed when RP left, he was “permitted to resign” because of “differences with management regarding investment philosophy.” Before hiring RP, Respondent 2 questioned the prior employer about RP and was told that, in fact, the employer had received three customer complaints about RP, two of which had resulted in financial settlements with the customers, with the other still pending resolution, as well as two other “insignificant complaints.” RP had already disclosed the complaints to Respondent 1 and the information that Respondent 2 received from the prior employer regarding those complaints was consistent with the explanations that RP had given Respondent 1. (CX 1, 2; RX 4; Tr. 28-29.)

Respondent 1 decided to hire RP. When RP joined the firm, Respondent 1 and Respondent 2 understood that he had a program for trading his customers’ accounts based on the “Dorsey Wright analysis,” which involved active trading of the accounts. (Tr. 45, 124; RX 14; CX 4.) This was a departure from the long-term “buy and hold” approach that Respondent 1 had traditionally recommended to its customers. (Tr. 45-46; CX 4.) According to Respondent 2, Respondent 1 hoped that RP would “bring[] his technical strategy to the buy and hold philosophy, because I felt it had value in a buy and hold strategy as well.” In fact, however, “[s]ometime through the course of this period of time [from May 1999 to March 2001, there came] the realization that [RP] wasn’t going to move towards us as originally intended” (Tr. 48, 55.)

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As a result, over time, friction developed between Respondent 2 and RP that boiled over in March 2001. According to notes that Respondent 2 prepared shortly after a meeting with RP on March 6, 2001, RP was upset because, in February, Respondent 1 had sent “happiness letters” – questionnaires asking customers about their financial circumstances, investment goals and satisfaction with the handling of their accounts – to its customers whose accounts were actively traded, including RP’s customers, without RP’s prior review. In addition, according to Respondent 2’s notes, RP indicated that he “[e]xpects to be treated with favoritism due to his high level of production”; [b]elieves that we should pick up more of his expense ...”; “[o]bjects to not having received a piece of [a departing representative’s] book” and “[o]bjects to our handling of leads” As a result, Respondent 2’s notes indicate, RP “expressed his loss of confidence” in Respondent 1. Respondent 2, on the other hand, believed Respondent 1 had “provided [RP] with the tools, personnel and amenities to grow his business,” and was “offended” by RP’s lack of appreciation for the firm’s efforts. (CX 4; Tr. 57.)

On March 21, Respondent 2 presented RP with a letter telling him that his employment with Respondent 1 was terminated, effective March 31, 2001. The letter was unsigned, and after showing the letter to RP, Respondent 2 withdrew it. Respondent 2 explained that he showed the letter to RP because he “felt it was necessary to shock him into understanding that we did not believe it was working, and we didn’t believe it would work, and a termination letter was the choice.” He testified that the letter did, in fact, shock RP, and thus accomplished his goal. RP began looking for other employment

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“almost immediately,” leaving his assistants to handle his customers’ accounts.³ (CX 5; Tr. 62-64, 70-71, 132.)

On March 26, RP sent Respondent 1 and Respondent 2 a draft letter proposing a “separation ‘phase-out’ process.” In the letter, he indicated that he had already interviewed with 13 possible employers, “three of which are good prospects,” and that he expected to receive an offer from a new employer “within the next two weeks.” He urged, however, that he and the firm “work together through a transition period that needs to be extended to April 30, 2001.” Respondent 2 testified that he “dismissed” RP’s proposals out of hand, believing that “when something quits working it should stop, or in this case never did work and it should stop. So carrying it on for ... weeks if not a month or more ... would have been counter-productive.” On March 30, RP delivered a letter to Respondent 2 at Respondent 1 resigning from Respondent 1 effective March 31, 2001. He became associated with a new firm the following week. (CX 1, 6, 7; Tr. 71-72.)

Respondent 2 testified that, from his perspective: “Once we shocked [RP] into understanding that the arrangement was not working and we needed – he needed to get on with his life ... in a more flexible environment [RP] then resigned.” If RP had not resigned Respondent 2 was prepared to fire him, “but fortunately I didn’t have to do it.” (Tr. 75, 95-96.)

Respondent 2 and CO, Respondent 1’s compliance director, testified that after RP resigned, they prepared a Form U-5, and carefully considered how to classify RP’s termination. (Tr. 75-77, 97-98.) The Form U-5 requires that one of five boxes be checked to describe the termination of a registered representative: (1) “voluntary”; (2)

³ RP “had another registered representative with him and another young fellow with him that was not registered and a secretary.” (Tr. 45.)

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“permitted to resign”; (3) “discharged”; (4) “deceased” or (5) “other.” The form also requires an explanation if the reason for discharge is other than “voluntary” or “deceased.” The Form U-5 does not include any definitions or instructions regarding these categories. Moreover, Enforcement was unable to cite, and the Hearing Panel, after substantial research, was unable to find any Notice to Members or other NASD publication, or even any prior litigated disciplinary proceeding, clarifying the circumstances under which a resignation must be classified as “permitted to resign,” rather than as “voluntary.”⁴

In completing the Form U-5, Respondent 2 and CO were not aware of “any instructions or guidelines or bulletins or other information that was in existence by the NASD or [any] other organization telling [them] under these circumstances [they] should use the permitted to resign [designation] or the voluntary [designation].” Therefore, they looked to industry understanding and practice regarding the significance of a “permitted to resign” designation, and the possible consequences if they described RP’s departure in that manner. Respondent 2 believed that the “permitted to resign designation means there are potential problems” or “issues that need to be addressed,” which could include “a rules violation [or] a concern over customer complaints.” Similarly, CO, who has been in the securities industry for 34 years and in the compliance field for more than 20 years with several NASD members, viewed a “permitted to resign” designation on a Form U-5 as “a warning [device] to a prospective employer that there may be some questions to ask regarding customer complaints or administrative problems, possible regulatory problems.” He explained: “Something that would bring into question the conduct of the

⁴ The Form U-5, including the “voluntary” and “permitted to resign” designations, has been in effect since January 1, 1977. See Notice to Members 76-43, 1976 NASD LEXIS 11 (Dec. 27, 1976).

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individual. That is where I would say that a permitted to resign would be applicable.” Enforcement “could not agree more with their testimony. [‘Permitted to resign’] is a red flag and a warning mechanism.” (Tr. 59, 98, 122-23, 130, 149.)

Under these standards, Respondent 2 and CO did not believe that Respondent 1 had adequate cause to describe RP’s termination as “permitted to resign.” CO explained, “[T]here was nothing to hang a hat on. There were no customer complaints at all. ... There were no regulatory actions at that time. There was nothing to suspect.” They believed Respondent 1’s obligations differed from those of RP’s prior firm, which had indicated on the Form U-5 it filed that RP was “permitted to resign,” because that firm “had customer complaints. They had evidence and reasons to potentially pass along. They had things to talk about.”

Respondent 2 and CO were also concerned that if Respondent 1 submitted a Form U-5 indicating that RP had once again been “permitted to resign,” RP might not be able to find employment in the industry, which would affect not only RP, but his customers. As CO explained: “[T]he majority of [RP’s] active clients were participating in a Dorsey Wright system. To stop them in the middle of a system would have caused confusion, not only to them, but to the trading approach they were taking for their accounts. We did not have anyone at Respondent 1 who had the time or the actual knowledge to follow that system.”

Finally, because they believed Respondent 1 had no cause for designating RP’s termination as “permitted to resign” under industry standards, Respondent 2 and CO were concerned that, if they did so, the firm might be subject to an arbitration claim by RP. In the absence of any clear guidance to the contrary, they believed (and still believe) that

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“there was no reason to make it anything other than voluntary, because that [was] the best choice available.” Therefore, at Respondent 2’s direction, on April 6, 2001, CO signed and submitted on behalf of Respondent 1 a Form U-5 describing RP’s termination as “voluntary.” (CX 8; Tr. 75, 90, 100, 113, 124, 126-29.)

Respondents did not, however, attempt to conceal the reasons for RP’s departure from Respondent 1. Several prospective employers contacted Respondent 2 about RP, and Respondent 2 “tried to explain [RP’s] strategy and how he dealt with his clients, and that it was a difference in investment philosophy from what we did at Respondent 1.” The firm that hired RP asked Respondent 2 to provide information in writing concerning the circumstances under which RP had left Respondent 1, and whether RP had any customer complaints or regulatory issues. Respondent 2 sent a candid reply in which he indicated that RP had left Respondent 1 because of “differences in investment philosophy”; that Respondent 1 was aware of some customer complaints against RP at his prior firm; and that RP had been denied registration by the state of Ohio. (RX 15; Tr. 80-81, 99.)

3. Discussion

Enforcement charges that by submitting a Form U-5 describing RP’s termination as “voluntary,” respondents breached their duty under Rule 2110 to “observe high standards of commercial honor and just and equitable principles of trade.” Enforcement argues that, under the circumstances, respondents were obliged to classify RP’s termination as “permitted to resign,” and to include an explanation such as “differences in investment philosophy” on the form.

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“Disciplinary hearings under Rule 2110 are ethical proceedings, and one may find a violation of the ethical requirements where no legally cognizable wrong occurred. ... The NASD has authority to impose sanctions for violations of ‘moral standards’ even if there was no ‘unlawful’ conduct.” Further:

In the caselaw developed under the rule, some types of misconduct, such as violations of federal securities laws and NASD Conduct Rules, are viewed as violations of Conduct Rule 2110 without attention to the surrounding circumstances because members of the securities industry are expected and required to abide by the applicable rules and regulations. ... Other types of violations, such as failures to honor obligations imposed by private contracts, are viewed as violations of Conduct Rule 2110 only if the surrounding facts and circumstances indicate that the conduct was unethical. The concepts of excuse, justification, and “bad faith” may be employed to determine whether conduct is unethical in these cases.

Department of Enforcement v. Shvarts, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *12-13 (June 2, 2000) (citations omitted).

As a general matter, providing false information to the NASD on a Form U-5 is a violation of Rule 2110 “without attention to the surrounding details.” Indeed, IM-1001-1 specifically provides:

The filing with the Association of information with respect to membership or registration as a Registered Representative which is incomplete or inaccurate so as to be misleading, or which could in any way tend to mislead, or the failure to correct such filing after notice thereof, may be deemed to be conduct inconsistent with just and equitable principles of trade and when discovered may be sufficient cause for appropriate disciplinary action.

“The NASD, which cannot investigate the veracity of every detail in each document filed with it, must depend on its members to report to it accurately and clearly in a manner that is not misleading.” Robert E. Kaufman, 51 S.E.C. 838, 839 (1993). It is particularly important that U-5 Forms be accurate, because “[t]he Form U-5 serves as a warning mechanism to firms of the potential risks and accompanying supervisory responsibilities

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they must assume if they decide to employ an individual with a suspect history.” Henry Irvin Judy, 52 S.E.C. 1252, 1256 (1997).

There is no dispute that if a registered representative who would otherwise be discharged for proven or suspected wrongdoing resigns, the firm must designate the termination as “permitted to resign,” with an appropriate explanation. Any attempt to “conceal from potential employers, members of the investing public, and the NASD the fact that [a registered representative] had engaged in misconduct ... in violation of the NASD’s rules” would violate the ethical standards imposed by Rule 2110. See DBCC No. 1 v. Nichols, No. C01950004, 1996 NASD Discip. LEXIS 30, at *29-30 (Nov. 13, 1996).⁵

In this case, however, Respondent 2 and CO testified, with support from contemporaneous records, that Respondent 1 and RP parted company not because Respondent 1 suspected RP of wrongdoing, but because of differences in investment philosophy and, to some degree, a clash of personalities. Indeed, Enforcement agreed that “differences in investment philosophy” would have been an acceptable explanation, if the Form U-5 had indicated that RP was “permitted to resign.” (Tr. 13-14.) Importantly, Enforcement did not argue, and did not attempt to prove, that RP’s departure

⁵ Cf. Department of Enforcement v. Foran, No. C8A990017, 2000 NASD Discip. LEXIS 8, at *9-12 n.12 (NAC Sept. 1, 2000) (After a registered representative’s employer firm discovered that he had posted house commissions to his own personal commission account, the firm agreed to file a Form U-5 indicating that his termination had been voluntary, in exchange for the representative’s agreement that he would repay the commissions and would not divulge the names and addresses of the firm’s clients and employees to his subsequent employers; the firm later filed an amended Form U-5 disclosing the representative’s suspected wrongdoing, after he hired away several of the firm’s other representatives. The NAC’s decision, which only addressed charges against the representative, noted that the firm and its president had resolved allegations that the initial Form U-5 was false through a Letter of Acceptance, Waiver and Consent “whereby they were censured and fined \$5,000, jointly and severally.”)

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from Respondent 1 was attributable to any suspicion that RP had engaged in the misconduct that eventually led to the SEC proceedings.

Enforcement did, however, urge the Hearing Panel to infer that RP's departure was due, at least in part, to negative comments on one customer's response to the "happiness letters" that Respondent 1 sent out in February 2001. Customer CF's response indicated that she was "unhappy with all the commission I pay while watching my portfolio go down." (CX 3.) Respondent 2 and CO testified, however, that, although CF's response initially raised concerns that she "did not understand what [RP] was doing," after Respondent 2 spoke to her they did not view the response as a "customer complaint." (Tr. 51, 90, 93-94, 134.) Moreover, there is no evidence that CF's response had any impact on RP's termination. Respondent 2 testified that it did not, and his contemporaneous notes do not mention it. (Tr. 94; CX 4.) In addition, Enforcement's argument is inconsistent with its concession that "differences in investment philosophy" would have been an adequate, non-misleading explanation for RP's termination. The Hearing Panel, therefore, declines to infer, on the basis of pure speculation, that RP's termination was influenced by CF's response to the "happiness letters," or, indeed, by any suspicion that RP might have been guilty of wrongdoing.

Enforcement, however, contends that, even if respondents did not suspect wrongdoing, they were required to classify RP's termination as "permitted to resign" because his departure was initiated by Respondent 2. Enforcement points out that Respondent 2 presented RP with a termination letter, and that, although Respondent 2 took the letter back, he clearly wanted RP to leave Respondent 1 and was prepared to discharge RP if he had not resigned. Enforcement argues that industry understanding and

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practice is irrelevant – “you’re talking about the English language; voluntary versus permitted.” Indeed, Enforcement agreed with the suggestion that, under its interpretation, a “permitted to resign” designation would be required “any time that a boss says, ‘I don’t think this is working out. You need to look for something else’” (Tr. 146-47.)

NASD members and associated persons have an obligation to complete U-5 Forms and other NASD forms accurately, but the Hearing Panel credits the testimony of Respondent 2 and CO that, in completing the Form U-5 for RP, they attempted to fulfill that obligation. In doing so, they had no definitions, instructions or guidance from NASD regarding the intended scope of the Form U-5 categories designated as “voluntary” and “permitted to resign,” beyond the words themselves. The Hearing Panel does not agree with Enforcement that those words clearly convey to members and associated persons that any resignation prompted by the employer, even one attributable to philosophical differences between the employee and the employer, must be classified as “permitted to resign.” Therefore, the Panel concludes that it is permissible to consider “the surrounding circumstances,” and “the concepts of excuse, justification and ‘bad faith’” in determining whether respondents willfully submitted an inaccurate or misleading Form U-5, as charged.⁶

Having observed and questioned Respondent 2 and CO, the Hearing Panel credits their testimony that they designated RP’s termination as “voluntary” in good faith, after carefully considering the available options. They selected “voluntary” as “the best choice

⁶ The result would be different, of course, if NASD, by adding definitions or instructions to the Form U-5, issuing a Notice to Members, or in some other manner, were to make it clear to members and associated persons that the “permitted to resign” designation on the Form U-5 applies whenever the member, rather than the registered representative, initiates the departure. In the absence of such clear guidance from NASD, however, the Panel is unwilling to impose such a broad requirement through this disciplinary proceeding, particularly since it might tend to undermine the important value of the “permitted to resign” designation as a red flag for members.

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available,” based upon their understanding that the “permitted to resign” designation was intended to serve as “a warning [device] to a prospective employer that there may be some questions to ask regarding customer complaints or administrative problems, possible regulatory problems,” and their belief that they did not have “any reason even to put suspicion that [RP] was doing something that was considered to be wrong.” (Tr. 113, 123, 129.) They were also very concerned about the potentially serious adverse consequences of an erroneous “permitted to resign” characterization on RP and Respondent 1, but especially on RP’s customers. The Hearing Panel finds that their understanding of the purposes of the designation and their concerns about the possible effects of an erroneous characterization were reasonable. Further, the Hearing Panel credits the witnesses’ testimony that, at the time, they were unaware of any misconduct or suspicious circumstances that would have required them to raise a red flag for RP’s prospective employers, and the Panel notes that Respondent 2 was candid in responding to inquiries from prospective employers.

The Hearing Panel finds that, taking into consideration all these circumstances, respondents’ description of RP’s termination as “voluntary,” rather than as “permitted to resign” because of “differences in investment philosophy,” was not unethical, and did not amount to a failure to “observe high standards of commercial honor,” in violation of Rule 2110, or make the Form U-5 “inaccurate so as to be misleading” in violation of IM-1001-1. Accordingly, the charges against respondents will be dismissed.⁷

⁷ If the Hearing Panel had found a violation of Rule 2110 and IM-1001-1 in this case, based on Enforcement’s argument that they were required to designate RP’s termination as “permitted to resign” because Respondent 2 initiated the actions that led to RP’s departure, considering all the circumstances the Panel would have held that the violation was not willful, and that the appropriate sanction would be a letter of caution.

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4. Conclusion

Enforcement failed to prove by a preponderance of the evidence that respondents willfully misrepresented information on a Form U-5 in violation of Rule 2110 and IM-1001-1, as charged. Therefore, the Complaint is dismissed.⁸

HEARING PANEL

By: David M. FitzGerald
Hearing Officer

⁸ The Hearing Panel has considered all of the arguments of the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.