BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 8 Complainant, vs. Respondent 1, Respondent.	DECISION Complaint No. C8A960029 District No. 8 Dated: January 7, 1998

Introduction

Respondent 1 has appealed a July 29, 1997 decision of the District Business Conduct Committee for District No. 8 ("DBCC") pursuant to NASD Procedural Rule 9310. After a review of the entire record in this matter, we hold that Respondent 1, as alleged in the complaint, violated Conduct Rule 2110 (formerly Article III, Section 1 of the Rules of Fair Practice) by engaging in the securities business of Firm A without being registered with the NASD in any capacity, in contravention of Schedule C to the NASD By-Laws.[1] We order that Respondent 1 be censured and fined $7,500, jointly and severally with Firm A,[2] and that within 90 days from the issuance of this decision, Respondent 1 qualify by examination as a general securities principal. We also order that Respondent 1 be assessed $750 in costs for the NBCC proceeding.

[1] The provisions of Schedule C to the By-Laws are now contained in NASD Membership and Registration Rule 1021. The reorganization and renumbering did not result in any substantive changes.

[2] Firm A was named as a respondent below. The DBCC found that Firm A allowed Respondent 1 to act in a capacity requiring registration despite the fact that he was not qualified or registered in any capacity in violation of Conduct Rule 2110. Firm A was censured, fined $7,500 (jointly and severally with Respondent 1), and assessed costs of $786.75 for the DBCC hearing. Firm A did not appeal the DBCC's decision.

Background

Respondent 1 has never been qualified or registered with the NASD in any capacity. He owns 100 percent of the stock of Firm A, which became a member of the NASD in July 1992.[3] In May 1992, Respondent 1 signed a Uniform Application for Securities Registration or Transfer ("Form U-4") in which he identified himself as "Control Person Only."

Facts

During the entire period relevant to this action, Respondent 1 owned 100 percent of the stock of Firm A. Respondent 1 was also an officer and director of Firm A, and he maintained an office at the Firm's place of business. Firm A's board of directors during the relevant period consisted of only three members: Respondent 1; Employee 2, the financial and operations principal of the Firm;[4] and Employee 3, a registered general principal of the Firm.

During the DBCC hearing, an NASD examiner ("Examiner") testified that he had had several discussions with Respondent 1 relating to certain financial and operational aspects of Firm A. The Examiner stated that in late December 1994 or early January 1995, he was contacted by an unknown person at Firm A regarding the proper means by which capital could be infused into the Firm. Respondent 1 subsequently informed the Examiner that Firm A needed to show a net worth of $3 million on its books in order to persuade a prospective client to direct its third-market executions to the Firm. Respondent 1 requested the Examiner's assistance in structuring the infusion of funds into Firm A.

The Examiner described for Respondent 1 the alternatives available for infusing capital, including arranging a subordinated loan. On January 10, 1995, Respondent 1 and Employee 2 met with the Examiner at the NASD's Chicago district office to discuss the subordinated loan. At this meeting, Respondent 1 handed the Examiner a business card which identified him as Chairman and Chief Executive Officer ("CEO") of Firm A. The Examiner testified that during this meeting, he and Respondent 1 discussed the subordinated loan, including how it would affect Firm A's debt-to-equity ratio, what the appropriate "haircuts"[5] should be for certain of the securities pledged as collateral for the

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[3] Firm A engages in market-making activities via third-market execution of exchange-listed issues on a fully disclosed basis. Firm A maintains no retail customer accounts.

[4] Employee 2 is the son of Respondent 1. Employee 2 has been President of Firm A since June or July 1994.

[5] The term "haircut" refers to the formulas used in the valuation of securities for the purpose of calculating a broker/dealer's net capital. The haircut varies according to the class of a security, its market risk, and its time to maturity.

loan, and how the securities accounts were to be set up to hold the securities being loaned. The Examiner did not recall Employee 2's being very involved in the meeting.[6]

The Examiner testified that he received a letter from Respondent 1, dated January 11, 1995, thanking him for his assistance in arranging the subordinated loan and stating that the subordinated loan of $2.6 million would be reflected on Firm A's January "FOCUS Report" with a footnote showing that the loan would need to be approved by the NASD. Respondent 1 wrote this correspondence on Firm A's letterhead and signed it "Respondent 1, Chairman." The Examiner stated that the subordinated loan was in fact reported on Firm A's FOCUS Report as described by Respondent 1. The Examiner also testified that he was told by the Firm's accountant that Respondent 1 had instructed her how to reflect the loans on the FOCUS Report.

The Examiner stated that he sent a letter to Employee 2, dated February 17, 1995, concerning the registration status of Respondent 1. This letter cited Schedule C to the NASD By-Laws, which requires associated persons who meet the definition of "Principal" and are actively engaged in the management of a member's securities business to be registered as principals. The letter stated that officers and directors of corporations are included in the definition of "Principal" and that Respondent 1, "as the Chairman, Chief Executive Officer and sole shareholder of Firm A, is required to qualify and register with the [NASD] as a General Securities Principal." Respondent 1 was allowed 90 days from the date of the letter to qualify by examination and to register as a general securities principal.

On February 23, 1995, Employee 2 responded to the Examiner's letter, expressing confusion over whether Respondent 1 was required to register in any capacity. This letter asserted that " Respondent 1 is not an active member in the day to day operations of the business, for he clearly does not supervise any of the traders and does not solicit any new or existing customers." The letter also stated that there appeared to be no reason why the NASD would require Respondent 1 to qualify by examination as a principal.

By letter dated March 1, 1995, the Examiner's supervisor ("Supervisor") responded to Employee 2's February 23, 1995 correspondence and stated that Respondent 1 was required to register as a general securities principal for a number of reasons: Respondent 1 was the Chairman, sole shareholder and CEO of Firm A; he had regular contacts with NASD district staff concerning Firm A's business; and he maintained an office at Firm A. The letter acknowledged the difference of opinion between the NASD district staff and Firm A over whether Respondent 1 needed to be registered, and it invited Firm A to contact the NASD's Qualifications and Membership department to seek a waiver of the requirement. The letter requested a response by March 15, 1995, as to how Firm A intended to proceed.

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[6] During the DBCC hearing, Employee 2 acknowledged that Respondent 1 primarily dealt with the Examiner at the January 10, 1995 meeting.

Employee 2 responded to the Supervisor's letter in writing on March 13, 1995, stating that Firm A's board of directors determined that Respondent 1 should take the Series 62 (Corporate Securities Representative) examination. The letter indicated that Respondent 1 would take the examination within the year. In addition, the letter stated that Respondent 1 would no longer have any contact with the NASD and that he would discontinue using the title CEO. The letter also stated that Employee 2 had directed Respondent 1 to contact NASD district staff concerning the subordinated loan arrangement. The letter then requested a copy of the statute and by-laws that supported the NASD's position so that Firm A could include them as part of the board minutes.

Neither Firm A nor Respondent 1 offered the board minutes as exhibits in advance of the hearing before the DBCC. During the hearing, however, Firm A and Respondent 1 offered copies of three handwritten documents, all on Firm A's letterhead, which Firm A and Respondent 1 argued related to the facts in dispute in this matter. The first document purports to be a letter from Respondent 1, dated December 17, 1994, to Firm A's board of directors. This letter relates to the request to infuse $2.5 to $3 million in capital into the Firm. The second document is a letter from Respondent 1, dated February 18, 1995, to Firm A's board of directors, which provides that Respondent 1 was resigning his positions as Chairman and CEO of Firm A. The third document is a letter from Respondent 1, dated May 5, 1995, to Employee 2 wherein Respondent 1 deems the request that he take the Series 62 examination to be unacceptable. This letter further conveys Respondent 1's belief that he is not required to register as a principal simply because he is the majority stockholder of Firm A.

Regional Counsel objected to the introduction of the documents as untimely. Regional Counsel also noted that the documents offered at the hearing appeared to be on the style of letterhead which the firm used in 1996 -- as evidenced by Firm A's answer to the complaint, dated May 29, 1996 -- but which differed from the letterhead used by the Firm during the period in which the documents were purportedly created, as indicated by Firm A's earlier correspondence to the NASD district office. In response, Respondent 1 stated that he wrote each document on the date signified therein and that the documents had been copied from the "plain paper" on which they were originally written onto the Firm's current letterhead immediately prior to the hearing. Employee 3, who testified at the DBCC hearing, claimed that the Firm had revised its letterhead around the time when the documents were purportedly created and that both styles of letterhead were being used during that period.

The DBCC hearing panel determined to accept the documents as exhibits, but requested that the original documents be produced within 24 hours of the hearing so that they could be compared to the photocopies. The original documents were produced to the hearing panel in a timely manner. The DBCC observed, however, that the original documents appeared to be written on the more-recent letterhead used by the firm -- i.e., the style used for Firm A's May 1996 answer to the complaint -- and not on plain paper as suggested by Respondent 1 during the hearing.[7]

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[7] Neither party presented a formal motion to include or exclude these documents during

A second NASD examiner ("Second Examiner") testified that he was one of two examiners who conducted a routine examination of Firm A in July 1995. The Second Examiner stated that during the course of the examination, Respondent 1 was present at Firm A's office on three of the four days that the Second Examiner was at Firm A. The Second Examiner personally observed Respondent 1 occasionally walking along the Firm's trading desk, looking over the shoulders of the traders at their computer terminals and having discussions on unknown topics with the traders. The Second Examiner also observed Respondent 1 call Employee 3 and Employee 2 into his office at Firm A for meetings on several occasions. The Second Examiner specified that these meetings took place during the day. In addition, the Second Examiner testified that he and another NASD examiner made copies of approximately 100 checks drawn on Firm A's account that were signed by Respondent 1. These checks were issued for payment for order flow or rebates to Firm A's broker/dealer customers, payments to the Nasdaq Stock Market, Inc. ("Nasdaq") and various exchanges, as well as for payment of routine expenses of rent and utilities.

A former NASD examiner ("Former Examiner") testified that she also was involved in conducting the July 1995 examination of Firm A and that she was physically present at its office for 10 to 12 days. She stated that Respondent 1 was present at Firm A's office on most of the days that she was there. The Former Examiner testified that she observed Respondent 1 walking around the trading desk and having various unknown discussions with the traders. She observed Respondent 1 call Employee 2, Employee 3, and another trader into his office for meetings. The Former Examiner also heard Respondent 1, on one occasion, tell Employee 2 to "get out of" certain unknown securities positions. She testified further that at the time Respondent 1 made that statement, an unidentified person reminded Respondent 1 that "the NASD is here," to which he responded "I don't give a [blank] about the NASD being here."

Respondent 1 testified that he attended the January 10, 1995 meeting at the NASD's Chicago district office because he was the one who was putting a substantial amount of money into the Firm and he wanted to make sure that a subordinated loan was the appropriate means of infusing the funds.[8] He explained further that because the collateral securities were held in several different accounts in which he had an interest or which he controlled, he had to be involved in arranging the accounts so that they properly reflected the fact that they were to be held in a subordinated loan account for the benefit of Firm A. Respondent 1 also arranged to have current account statements created and delivered so that the appropriate "haircuts" on the securities could be calculated.

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the NBCC proceeding. Nonetheless, we have reviewed and considered them in connection with this appeal.

[8] Respondent 1 testified that he also wanted to make sure that the method of infusing the funds protected the funds from ongoing litigation in an unrelated matter.

Respondent 1 claimed that he signed checks drawn on Firm A's account because only he and Employee 2 were authorized to do so. He stated that Employee 3 would prepare the checks and present them to him for his signature. Respondent 1 acknowledged, however, that he would review the checks and the corresponding bills when they were presented to him.

Respondent 1 stated that he was present at the Firm in July 1995, when the NASD examination occurred, more than he normally would have been because he was preparing for the trial of an unrelated lawsuit. (The lawsuit was unrelated to the current matter, but it involved a former Firm A employee's claim against Respondent 1.) Respondent 1 testified that his lawyers required him to gather and organize documents to defend the lawsuit. He stated that any contact he might have had with the Firm's traders or principals during this period, other than the exchange of greetings and casual pleasantries, was related to the lawsuit, not to trading securities.

Respondent 1 testified that he periodically would review the computer monitors used by Firm A's traders to check on the price of certain of his personal securities holdings, but he denied ever discussing any client-related trading positions with the Firm's traders. He also asserted that he did not supervise anyone at the Firm because he did not have a good understanding of exactly how the traders did their jobs. He stated that he did not even know how information was entered into the Firm's trading system. He further insisted that he did not solicit any clients. Respondent 1 admitted, however, that he did have some contact with Firm A's clients. He stated that he would occasionally take a client to the country club to play golf, out to dinner, or to a Chicago Bulls basketball game.

Employee 2 testified that Respondent 1 did not solicit clients, supervise traders or execute trading orders. According to Employee 2, Respondent 1 was not involved in the securities business of Firm A. Employee 2 also maintained that he directed Respondent 1 to contact the NASD concerning the subordinated loan negotiations because Respondent 1 was investing the funds.

Discussion

The complaint alleged, and the DBCC found, that Respondent 1 violated Conduct Rule 2110 by engaging in the securities business of Firm A without being registered with the NASD in any capacity, in contravention of Schedule C to the NASD By-Laws. Schedule C, Part II provides that "[a]ll persons engaged or to be engaged in the . . . securities business of a member who are to function as principals shall be registered as such. . . ." Schedule C, Part II states further that "[p]ersons associated with a member, enumerated in items (i) -- (v) hereafter, who are actively engaged in the management of the member's . . . securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions are designated as principals." The enumerated persons referred to above include (i) sole proprietors, (ii) officers, (iii) partners, (iv) managers of offices of supervisory jurisdiction, and (v) directors of corporations. In addition, Schedule C, Part VI provides that certain persons are exempt from the registration requirements, including (1) persons associated with a member who are not actively engaged in the

investment banking or securities business; and (2) persons associated with a member whose functions are related solely and exclusively to the member's need for nominal corporate officers or for capital participation.

Respondent 1 disputed whether his involvement in the affairs of the Firm was such that he was "actively engaged" in the management of Firm A's securities business. He claimed to be a nominal corporate officer and passive investor. According to Respondent 1, he was thus exempt from any registration requirements.[9]

The evidence, however, supports the finding that Respondent 1 was actively engaged in the affairs of Firm A and that the NASD's rules required him to register as a principal. Respondent 1 was a director, an officer and the sole shareholder of Firm A. As the SEC has stated, it is unlikely that a director could be considered a nominal officer. See In re Samuel A. Sardinia, 46 S.E.C. 337, 342 (1976) (holding that the exemption for "nominal officers" did not apply to respondent, who was an officer and a director, and stating that it is unlikely that a director could be considered a "nominal officer").[10] Moreover, the record here shows that, far from serving as a nominal corporate officer and passive investor, Respondent 1 used these various positions to control and direct Firm A's affairs.[11]

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[9] Respondent 1 also asserted that the NASD failed to object to the titles he held and the role he played at Firm A until late 1994 or early 1995, despite knowledge of these facts since 1992. Even assuming, arguendo, that this assertion is accurate, the Securities and Exchange Commission ("SEC") has emphasized that "a securities dealer cannot shift its compliance responsibility to the NASD. A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation." In re W.N. Whelen & Co., 50 S.E.C. 282, 284 (1990). See also In re Thomas C. Kocherhans, Exchange Act Rel. No. 36556, at 6 (Dec. 6, 1995) ("[W]e have repeatedly held that a respondent cannot shift his or her responsibility for compliance with applicable requirements to . . . the NASD."); In re Lowell H. Listrom & Co., 48 S.E.C. 360, 366 (1985) (same), aff'd, 803 F.2d 938 (8th Cir. 1986); In re Melvin Y. Zucker, 46 S.E.C. 731, 733-34 (1976) (same).

[10] As noted above, Respondent 1 was not only a director of Firm A, he was also the CEO and sole shareholder of the Firm. Respondent 1 himself conceded that the CEO and majority shareholder of a company would normally have considerable control over the company's operations.

[11] While Schedule C of the NASD By-Laws requires a showing that the associated person was "actively engaged in the management of the member's . . . securities business[,]" it does not require a showing that the individual was responsible for the day-to-day management of the member. See, e.g., In re American Nat'l Equities, No. LA-4323, National Business Conduct Committee, at 8, 1991 NASD Discip. LEXIS 86, at *20 (NBCC Nov. 25, 1991) ("We note that Schedule C does not limit the 'principal' definition to those who are involved in day-to-day management of broker/dealers.").

As one of only two authorized signatories on the Firm's bank account, Respondent 1 signed over 100 checks issued by Firm A from March through May 1995.[12] These checks were issued by the Firm in payment not only of routine expenses of rent and utilities, but also in payment for order flow or rebates to its broker/dealer customers, in payments to Nasdaq, and in payments to various exchanges. Many of these payments were thus directly related to the Firm's securities business. Respondent 1 also reviewed portions of the Firm's FOCUS Report, in part, to determine potential areas to reduce expenses, which responsibilities he would then delegate to the Firm's other directors.

Respondent 1 's active involvement in Firm A's operations is further demonstrated by the role he played in arranging the subordinated loan to the Firm. Respondent 1 informed the Examiner that Firm A needed to demonstrate a net worth of $3 million in order to secure a prospective client's third-market execution business. On January 10, 1995, Respondent 1 met with the Examiner to discuss the subordinated loan. At this meeting, Respondent 1 handed the Examiner a business card which identified him as Chairman and CEO of Firm A. The Examiner testified that he and Respondent 1 discussed the subordinated loan, including how it would affect Firm A's debt-to-equity ratio, what the appropriate "haircuts" should be for certain of the securities pledged as collateral for the loan, and how the securities accounts were to be set up to hold the securities being loaned.

In addition to meeting with the Examiner, Respondent 1's extensive involvement in arranging the subordinated loan is evidenced by his advising the Examiner -- in a letter dated January 11, 1995, and written on the Firm's letterhead -- how the capital infusion would be identified on the Firm's FOCUS Report. The non-approved loan[13] was in fact shown on the Firm's January 1995 FOCUS Report as Respondent 1 had described. The Examiner also testified that the Firm's accountant stated that Respondent 1 had instructed her as to how the loans should be reflected on the FOCUS Report. The level of Respondent 1's involvement in the subordinated loan goes far beyond that of a nominal officer and passive investor.

Respondent 1's physical presence at office and his interaction with the Firm's principals and traders further supports the finding that he actively was involved in the operations of the Firm. During a routine NASD examination of the Firm, Respondent 1 was observed taking part in meetings with Employee 2, Employee 3, and another trader. Respondent 1 also was observed frequently walking behind various traders and having unknown discussions with them. Although Respondent 1 asserted that he was either discussing an unrelated lawsuit or exchanging pleasantries with the traders on these occasions, the fact that these conversations were frequent and that they took place at the trading terminals seems to belie this assertion. This claim is also called into question by Employee 2's admission

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[12] Employee 3, who was a director and a general principal of Firm A, testified that he was not made a signatory on the Firm's account at his request because he did not want the responsibility that went along with having to sign checks.

[13] The subordinated loan was never submitted for final approval.

that Respondent 1 would talk to the traders "about all different types of stuff[,]" including occasionally asking them questions about how certain trades were accomplished. Moreover, on one occasion, an NASD examiner heard Respondent 1 tell Employee 2 to get out of certain securities positions.

In regard to interaction with clients, Respondent 1 asserted that he did not solicit any business. Nonetheless, his admitted entertaining of clients seems to at least cross into maintaining, if not expanding, business clientele. Such interaction gives an appearance of being involved in developing and maintaining the Firm's client base.

Respondent 1 's use of the Firm's letterhead and of business cards identifying him as Chairman and CEO of Firm A casts further doubt on Respondent 1's claim that he acted only as a nominal officer and passive investor. Through this practice, Respondent 1 held himself out in a manner that would lead an objective observer to infer that he was intimately involved in Firm A's securities business.[14]

Finally, Respondent 1's disregard for the specific instructions of Firm A's board of directors indicates that he was not simply a nominal officer and passive investor. In a letter dated March 13, 1995, Employee 2 informed the NASD district staff that "the board of directors has advised me that [Respondent 1] should take the Series 62 exam. The board has asked [Respondent 1] to resolve this problem within the year." Despite the fact that he was directed by the Firm's board to take the Series 62 examination, and despite the fact that the president of the Firm (Employee 2) affirmatively represented to the NASD that Respondent 1 would take the exam, Respondent 1 openly defied the board in this instance. Yet, Firm A allowed Respondent 1 to continue as a director of the Firm.[15]

The cumulative effect of Respondent 1's activities supports the finding that he was actively engaged in Firm A's securities business and that he acted in contravention of Schedule C by failing to register as a principal. The requirement that a person, like Respondent 1 here, must register as a principal when actively engaged in a firm's securities business is an important one. This requirement assists in the policing of the securities markets. It also ensures that a person in a position to exercise some degree of control over a firm has a comprehensive knowledge of the securities industry and its related rules and regulations. This, in turn, enhances investor protection. We deem it essential to the well-being of the investing public that persons engaged in a firm's securities business strictly adhere to

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[14] As previously mentioned, Respondent 1 himself acknowledged that the Chairman and CEO of a company would normally be perceived as having a certain amount of control over the company's operations. Taking the evidence as a whole, we find that such a notion is not unjustified in the current case.

[15] During the DBCC hearing, Respondent 1 claimed to have relinquished the titles CEO and Chairman of Firm A in February 1995. He acknowledged, however, that he remained the sole shareholder and a director of the Firm. In addition, Respondent 1 was still a signatory on Firm A's bank account, and he continued to make use of his office at the Firm at the time of the hearing.

the proper registration requirements. Cf. In re Ashvin R. Shah, Exchange Act Rel. No. 37954, at 8 (Nov. 15, 1996) ("The requirement that an associated person be registered before engaging in any securities business provides an important safeguard in protecting public investors. Consequently, strict adherence to the registration requirement is essential."); In re Patricia H. Smith, Exchange Act Rel. No. 35898, at 4 (June 27, 1995) (same). In light of the above discussion, we affirm the DBCC's decision.

Sanctions

We order that Respondent 1 be censured and fined $7,500, jointly and severally with Firm A, and that within 90 days from the issuance of this decision, Respondent 1 qualify by examination as a general securities principal. We also order that Respondent 1 be assessed $750 in costs for the NBCC proceeding. In reaching these sanctions, we have considered the applicable NASD Sanction Guideline for registration violations ("Guideline"). We find that the sanctions are remedial and consistent with the range recommended in the Guideline.[16]

On Behalf of the National Business Conduct Committee,

Joan C. Conley, Corporate Secretary

[16] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.