

BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of

District Business Conduct Committee  
for District No. 3,

Complainant,

vs.

Respondent Firm 1,

Respondent 2,

and

Respondent 3,

Respondents.

DECISION

Complaint No. C3A950073

District No. 3

Dated: December 29, 1997

This matter was appealed pursuant to Procedural Rule 9310. We find that while there was a violation of certain books and records rules and of Article III, Sections 1 and 21 of the Rules of Fair Practice (now known as and hereinafter referred to as "Conduct Rule 2110" and "Conduct Rule 3110"), and that the DBCC's findings of violations should be affirmed, the sanctions should be reduced to a Letter of Caution, for the reasons discussed below.

Background

Respondent Firm 1 became a member of the NASD in April 1988. Respondent 2 first entered the securities industry in May 1987 and worked for five NASD member Firms before becoming associated as a general securities principal with Respondent Firm 1 in April 1991. Respondent 2 is also the president of Respondent Firm 1. Respondent 2 entered the securities industry in June 1992, when she became associated as a financial and operations principal ("FINOP") with Respondent Firm 1.

## Factual Background

The complaint was issued on December 28, 1995, alleging failure to maintain required books and records; effecting transactions with customers at unfair and excessive prices; and inadequate written supervisory procedures. On February 12, 1996, an amended complaint (First Amended Complaint) was issued, which eliminated allegations pertaining to unfair and excessive prices. The First Amended Complaint also alleged that the Firm's written supervisory procedures did not designate a principal as responsible for the supervision of the preparation and maintenance of the Firm's books and records. A second amended complaint ("Second Amended Complaint") was issued on August 19, 1996, which eliminated allegations relating to inadequate written supervisory procedures.

The Second (and final) Amended Complaint contained one cause, which alleged that the Firm, acting through Respondent 2, purchased shares of Company A from Company B, a non-broker/dealer, and shares of Company C from Individual 1, a non-broker/dealer, without preparing and maintaining new account documents for Company B and Individual 1, or order tickets or confirmations for the transactions, and without otherwise causing the details of the transactions to be reflected on the Firm's purchase and sale blotter, all as required by Exchange Act Rules 17a-3 and 17a-4 and Conduct Rules 2110 and 3110. The complaint further alleged Respondent 3, as the FINOP, was responsible for the supervision of individuals who were involved in the preparation and maintenance of the Firm's books and records, as set forth in Part II, paragraph (2)(c)(ii) of Schedule C to the Association's By-Laws (now Conduct Rule 1022(b)(2)), and that Respondent Firm 1, acting through Respondent 2 and Respondent 3, violated Conduct Rules 2110 and 3110 by failing to prepare and maintain the books and records of the above-described transactions.

Description of Company A Transaction. Examiner 1, an NASD Regulation, Inc. ("NASD Regulation") staff examiner, testified that her examination disclosed that the Firm had acquired shares of Company A and Company C stock but did not record the transactions in its purchase and sale blotter. Examiner 1 also did not find any order tickets, confirmations or account information in the Firm's records as to those two transactions. In addition, Examiner 1 testified that she did not find any documentation concerning the two transactions maintained together and identified as a Rule 17a-3 record.

In the course of investigating the Company A and Company C transactions, Examiner 1 requested information from Respondent Firm 1's office manager, about the acquisition of the Company A and Company C stock. In a letter dated June 16, 1995, the Office Manager advised Examiner 1 that he had contacted an individual with Company A about obtaining Company A stock in a block purchase at a discount to the current market price. The Office Manager stated that he had been referred to Company B; that he had negotiated a price for 500,000 shares of Company A securities; and that, within a few days, the monies had been transferred from Respondent Firm 1's account to the account of Company B at its clearing firm, Firm A. The Office Manager's letter also indicated that after the transfer of the monies had been completed, the 500,000 shares were transferred to Respondent Firm 1's account at its clearing firm, Firm B.

Examiner 1 testified that Firm A provided to staff a letter (that was on Company B's letterhead and addressed to Firm B) in response to an NASD request for information, that advised Firm A of the arrangement made between Company B and Respondent Firm 1 for Respondent Firm 1 to acquire 500,000 shares of Company A "in a private sale." (emphasis in original). Other documents in connection with the transaction that Examiner 1 acquired included: a letter dated October 6, 1994 from Firm A to the Office Manager in which Firm A advised Respondent Firm 1 that at the direction of its customer, the 500,000 shares would be delivered upon receipt of payment; (2) wire instructions from Respondent Firm 1 to Firm B to wire \$93,750 to Bank 1 for ultimate delivery to Company B; and (3) Depository Trust Company ("DTC") instructions from Respondent Firm 1 to Firm A or the Company A shares.

Account statements for two Respondent Firm 1 accounts with its clearing firm, Firm B, show that Respondent Firm 1 wired \$93,750 from a proprietary account at Firm B on October 19, 1994, and that another Respondent Firm 1 proprietary account at Firm B received 500,000 shares of Company A on October 20, 1994. On the same day that the 500,000 shares were received into Respondent Firm 1's proprietary account, they were sold to Respondent Firm 1's inventory account. These transactions were reported in the account statements and inventory report as received, sold and purchased at zero. The inventory report also shows the sale of approximately 400,000 shares on October 20 at .46875 per share, primarily to customer accounts. The account statement for Company B shows the receipt of \$93,750 into the account on October 19, 1994 and the delivery out of 500,000 shares of Company A on October 20, 1994.

Description of Company B Transaction. Respondent B testified that she had been advised by Respondent 2 about the possibility of the Company C transaction and had contacted Individual 1 to work out the details. She testified that when she contacted Individual 1, he advised her that he did not wish to become a customer because he wanted to do only one transaction with the Firm. On that basis, Respondent 3 did not cause Individual 1 to fill out a new account form. According to Respondent 3, the Firm's correspondence with Individual 1 set forth all of the terms and conditions of the Company C transaction; however, she had been unable to locate the documents since December 1994, when she had brought them to the NASD's Denver office for a post-exit interview meeting.<sup>1</sup>

Respondent Firm 1 directed Firm B to wire \$60,000 from the Respondent Firm 1 "house account" to Bank 2 for the account of Individual 1. The "house account" statement shows a \$60,000 wire to Bank 2 on February 16, 1994, as well as the receipt of 200,000 shares of Company C stock on February 17 and the sale of those shares to the Firm's inventory account on the same day. Respondent Firm 1's inventory account showed the purchase of 200,000 shares from the "house account" on February 17, 1994, at a price of zero. Respondent 3 testified that both the Company A and Company C transactions were booked by Firm B at a price of zero because Respondent Firm 1 had paid for the transactions out of its non-customer account.

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<sup>1</sup> Respondent 3 testified that she thought that she had left the letters with some other documents at the NASD's Denver office on December 21, 1994, which was the date of the post-exit interview.

Testimonial Evidence -- Company A and Company C Transactions. Examiner 1 testified that during her examination she had requested customer account documentation for Company B and Individual 1, but had been advised that no such documents had been prepared. Respondent 3 testified that she had "probably" talked about the Conduct Rule 3110 requirement that an account be opened for each customer with the Firm's counsel and had understood that the Firm would not be required to open a new account through Firm B for Individual 1. Firm B advised her that she did not have to open an account with respect to either transaction. The record, however, does not contain any testimony from the respondents' attorney or from representatives of Firm B about the issue.

During her examination of Respondent Firm 1, Examiner 1 observed that Respondent Firm 1 maintained a purchase and sale blotter of the type customary in the securities business (i.e., separated by agency vs. principal trades and by day). The record shows that although Examiner 1 had requested that the Firm provide her with a copy of the Firm's purchase and sale blotters specific to the relevant period, the Firm did not produce the requested documents. Examiner 1 testified that during her routine exam of the Firm, she did not find copies of DTC instructions, wire instructions, account statements, and other documents relevant to Company A and Company C with Respondent Firm 1's purchase and sale blotters. Examiner 1 also testified that the documents in the record relevant to the Company A and Company B transactions were not kept in a single place as a record of the transactions.

Examiner 1 testified that she reviewed the Firm's order tickets for the relevant period and found none for the Company A or Company C transactions. Respondent 3 testified that the information in the correspondence to and from the Firm satisfied the requirement for an order ticket for each transaction with the Firm's account, with the exception of time of execution requirement. Respondent 3 also testified that while the Firm had order tickets for its purchases and sales, order tickets were not prepared for the transactions at issue. She maintained, however, that the lack of order tickets was not a problem because, in her opinion, the documents and the memoranda in the record satisfied the requirement in the rule.

As to the requirement that there be a confirmation for each transaction, Respondent 3 testified that, in her opinion, the purpose of a confirmation is to advise the other party to a trade as to the details of the transaction. She claimed that the correspondence between the parties as to the two transactions at issue communicated those details in a manner that satisfied the rule.

Respondent 3 testified at the DBCC hearing that the Firm made manual trading records for the Company A and Company C transactions. The record shows that the DBCC did not permit respondents to introduce evidence of the manual trading records because it was not filed in a timely manner. We have allowed these documents to be introduced into the record.<sup>2</sup>

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<sup>2</sup> The NBCC subcommittee ("Subcommittee") that considered this case on appeal decided to permit the introduction of the evidence into the record after respondents filed a timely motion to adduce additional evidence. While the motion also asked for leave to adduce inventory reports into the record, the

Examiner 1 testified that she discussed her concerns about the Company A and Company C transactions with the respondents during an exit conference. She stated that Respondent 2 advised her that while the transactions were with Company B and Individual A (both non-broker/dealers), it was his belief that clearing the Company A and Company C transactions on a delivery versus payment ("DVP") basis<sup>3</sup> was adequate. According to Examiner 1, Respondent 2 advised her that it was his understanding that because the transactions were done on a DVP basis, the records that normally would be made to comply with Rule 17a-3, were not required. With respect to the Company A transaction, Respondent 3 testified that it was her position that Respondent Firm 1 was dealing with Firm A (which is a broker/dealer) on the other side of the transaction, not Company B.

Examiner 1 testified that the staff sent the respondents a letter dated December 14, 1994, that asked for documents in connection with each private securities transaction the Firm had conducted since January 1, 1993. The letter also requested that Respondent 2 and Respondent 3 appear at a meeting on December 21 in the NASD's Denver office because the staff had additional questions regarding the items it had discussed with the respondents during an exit conference that was held after Examiner 1 had completed her examination of the Firm.<sup>4</sup> Examiner 1, the Supervisor, and Respondent 3 all testified that when Respondent 2 and Respondent 3 appeared at the meeting on December 21, the Respondents declined to discuss the books and records issue pertaining to the Company A and Company C transactions because they observed that a court reporter was there to record the meeting.

The supervisor of examiners who was responsible for the examination that led to the complaint in this matter, testified that the Respondents were not called in for a subsequent interview because an Assistant U.S. Attorney had called her about five minutes after the Respondents left the NASD's Denver office and had stated that the Respondents were cooperating in an investigation. The Assistant U.S. Attorney stated that he was concerned that if the Respondents were allowed to testify on the record in this matter, that record would be subject to discovery. According to the Supervisor's testimony, the attorney sent staff a follow-up letter asking staff not to meet with the Respondents for some time because of the investigation he had referenced in his earlier phone call to the Supervisor. The Supervisor testified that staff acquiesced to the attorney's request and did not ask for another meeting with the Respondents.

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Subcommittee noted that those reports were already in the record as Exhibits 10 and 16 and denied the motion. We ratify and affirm the Subcommittee's determinations.

<sup>3</sup> "DVP" is a term commonly used with institutional accounts, whereby delivery of securities sold is made to the buying customer's bank in exchange for payment. Such transaction can also be referred to as "delivery against payment."

<sup>4</sup> Examiner 1 testified that staff had raised its concerns about the Firm's books and records with respect to the Company A and Company C transactions with the respondents during the exit conference.

The Supervisor testified that under Rule 17a-3(a)(1), firms typically maintain either: (1) a purchase and sale blotter or a trade blotter that lists chronologically the transactions, the purchases and sales of the stock involved in the transactions, the parties on the other side, the amount of shares, and the price; or (2) a "unit system" that is comprised of order tickets or confirmations that reflect the relevant information.

### Discussion

Rule 17a-3(a)(1). Rule 17a-3(a)(1) requires every broker or dealer to make and keep current blotters (or other records of original entry) containing an itemized daily record of all purchases and sales of securities.<sup>5</sup> The Securities and Exchange Commission ("SEC") has stated that maintenance of records by a Firm's clearing bank does not meet the requirement in the rule that a "broker or dealer make and keep current" the required records pertaining to its business. In re Voss Co., Inc., 47 S.E.C. 626 (1981). The record shows that a number of the documents that the respondents argued were original documents of entry, were made by Firm B or Firm A, not by Respondent Firm 1. Accordingly, since Respondent Firm 1 did not make those documents, we find such documents do not meet the requirements of the rule.<sup>6</sup>

The SEC has stated that daily purchase and sale blotters should reflect all transactions as of the trade date and should be prepared no later than the following business day. See SEC Release No. 34-10756, April 26, 1974 ("1974 Interpretive Release"). The Supervisor testified that the Firm B account statements (which respondents argued were original records of entry) presented transactions on a settlement date, rather than on a trade date, basis. Some of the other records cited by the respondents as being evidence of original records of entry preceded the dates of the transactions, and thus do not meet the requirement of the rule. Moreover, Respondent Firm 1's blotter did not include an "itemized" daily record of all purchases and sales" as required by the rule because it did not include any information about the Company A and Company C transactions. The 1974 Interpretive Release states that, as used in Rule 17a-3, the term, "other records" should be construed to include copies of "vouchers, confirmations, or similar documents which reflect the information required by the applicable subparagraph arranged in appropriate

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<sup>5</sup> We find that there is no merit to Respondent 2's contention that the Company A and Company C transactions need not comply with the requirements of Rule 17a-3 because they were transacted on a DVP basis. We note that there is no exemption from the requirements of Rule 17a-3 when a transaction is effected on a DVP basis.

<sup>6</sup> Although the Firm's manual trading records were introduced into the record on appeal, we find that those records, taken together with the other documents in the record, do not meet the requirements of Rule 17a-3(a)(1). The respondents never introduced any evidence that could authenticate the manual trading records as being those of Respondent Firm 1. We note that those records had no authenticating characteristics, such as the name of Respondent Firm 1 or the name of the Firm employee who had manually entered the information. Moreover, respondents introduced no evidence that could confirm that the information was made as of the trade dates contained in the records.

sequence and in appropriate form . . . ." We conclude that the documents at issue are not in the appropriate form or sequence, in violation of Rule 17a-3(a)(1) and Conduct Rule 2110.

Rule 17a-3(a)(7). Rule 17a-3(a)(7) requires that each broker or dealer make and keep current a memorandum of each purchase and sale for its account showing specified information. We agree with the DBCC that the reference to a "memorandum" in the rule implies that the information concerning the purchase or sale be set forth in a single document and that this information be contained in an order ticket. Respondent 3's own admission, Respondent Firm 1 did not maintain the required information concerning each of the Company A and Company C transactions in a single document, and Respondent Firm 1's records did not contain information about the times of execution with respect to the Company A and Company C transactions. Thus, we conclude that the Firm violated Rule 17a-3(a)(7) and Conduct Rule 2110.

Rule 17a-3(a)(8) and Conduct Rule 3110. In order to assess whether the Firm failed to make and maintain a confirmation of each transaction as required by Rule 17a-3(8)<sup>7</sup> and to prepare and maintain the customer account information required by Conduct Rule 3110, we must first determine the status of Company B and Individual 1. Company A's letter to Firm A describes the Company A transaction as a "private sale" arranged by the principals of Company B and Respondent Firm 1; the sale was therefore between those two entities. Although Firm A facilitated the transaction by receiving funds and delivering out securities, it did not sell those securities as principal or as agent for the customer and took no compensation for the trade. The transaction was specifically characterized by Firm A in a letter as a delivery out, not a sale. The evidence also shows that Firm A advised Respondent Firm 1 by letter that if the transaction was completed satisfactorily, "Company B" would sell to Respondent Firm 1 an additional 500,000 shares. On the basis of the foregoing, we conclude that Respondent Firm 1 purchased shares of Company A stock from Company B, rather than from Firm A. It was not, therefore, a dealer-to-dealer transaction as respondents contend. It is undisputed that the purchase of Company C stock from Individual 1 was not a dealer-to-dealer transaction.

We next turn to the question of how properly to characterize Company B and Individual 1. NASD General Provisions Rule 0120(g) ("Rule 1020(g)") states that the term customer "shall not include a broker or dealer." Although this definition does not specifically provide that the term "customer" encompasses all parties to a transaction with a broker/dealer other than another broker/dealer, the purpose and intent of the securities regulatory system requires that construction. Therefore, we conclude that Company B and Individual 1 were "customers" within the meaning of Rule 1020(g), thereby requiring respondents to prepare and maintain confirmations and new account information with respect to the Company A and Company C transactions. We find that respondents' failure to do so violates Rule 17a-3(8) and Conduct Rules 3110 and 2110.

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<sup>7</sup> Rule 17a-3(a)(8) requires that every broker or dealer make and keep current copies of confirmations of all purchases and sales of securities for the accounts of "customers" of such broker or dealer.

### Sanctions

While we affirm the DBCC's findings of violation, we have concluded that the sanctions imposed by the DBCC should be set aside, and that this decision should serve as a Letter of Caution as to the Respondents and the Firm.<sup>8</sup> In making this determination, we considered that: the complaint pertained to only two violative transactions; Respondent 3 represented that because of the unusual nature of the transactions, she had made inquiries about how they should be handled; there was no effort to conceal the transactions; and allegations of the type contained in the complaint are frequently handled with a Letter of Caution, a compliance conference, or a minor rule violation, and often do not result in a formal disciplinary proceeding.

### Conclusion

In summary, we affirm the DBCC's findings of violation and reduce the sanctions imposed by the DBCC to a Letter of Caution as to the Respondents and the Firm. We order that the respondents pay \$1,733.00 in costs for the DBCC hearing.

On Behalf of the National Business Conduct Committee,

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Joan Conley, Corporate Secretary

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<sup>8</sup> We thus eliminate the censure and the \$2,000 fine (joint and several) as to the Firm and Respondents. As to the Firm, we eliminate the requirement that it retain the services of an independent consultant to conduct an examination of the Firm's books and records practices and to certify to NASD Regulation staff that the Firm's books and records are being maintained in compliance with all applicable rules and regulations.