BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. James S. Davenport Glasgow, Kentucky, Respondent.	AMENDED DECISION Complaint No. C05010017 Dated: May 7, 2003

Respondent made false representations to his firm. Held, Hearing Panel's findings are affirmed and sanctions are affirmed in part and modified in part.

Appearances

For the Complainant Department of Enforcement: Mark Dauer, Esq., NASD Department of Enforcement.

For the Respondent: James S. Davenport, *pro se*.

Opinion

We called this decision for review pursuant to NASD Procedural Rule 9312 to examine various aspects of the sanctions. After a review of the record in this matter, we affirm the Hearing Panel's findings that Davenport violated Conduct Rule 2110 by falsely representing to his firm that he had not borrowed money from any of his firm's customers. We affirm the Hearing Panel's sanctions in part and modify them in part. We affirm the imposition of a $10,000 fine and $1,110.42 in costs and a nine-month suspension from association with any NASD member in any capacity. We vacate the Hearing Panel's imposition of a restriction on Davenport's trading activities, should he re-enter the industry. We also reject the Hearing Panel's holding that Davenport be given credit against his nine-month suspension for the time he has been out of the industry

since Dean Witter Reynolds, Inc. ("Dean Witter")[1] fired him. Instead, we order that Davenport's nine-month suspension run from the date of the Hearing Panel decision.

Background

Davenport became an associated person in 1987. From September 1987 until July 1999, Davenport was registered as a general securities representative with J.J.B. Hilliard, W.L. Lyons, Inc. ("Hilliard"). Davenport worked at Hilliard until he joined Dean Witter in July 1999. He remained at Dean Witter until February 1, 2000, when Dean Witter fired him because of misrepresentations he had made to Hilliard about loans that he had received from customers. Davenport has not been registered with NASD since March 1, 2000.[2] He remains subject to the jurisdiction of NASD for purposes of this proceeding pursuant to Article V, Section 4 of the NASD By-Laws.

The complaint alleged that in June 1997, May 1998, and July 1999, Davenport completed and signed three "Prohibited Activities Listing" forms, in which he falsely represented to Hilliard that he had not borrowed money from customers.

Facts

None of the facts are disputed. On or about January 11, 2000, an anonymous person sent a letter to Dean Witter, with copies to NASD and the Securities and Exchange Commission ("SEC") Division of Enforcement, stating that Davenport had borrowed money from the anonymous person's mother and other Dean Witter customers. The anonymous person requested that Dean Witter repay these outstanding loans immediately.[3]

After receiving the anonymous letter, a Dean Witter supervisor met with Davenport to discuss the allegations. Davenport immediately admitted that while at Hilliard he had borrowed money from and maintained loans with a number of his customers. Dean Witter fired Davenport and filed a Uniform Termination Notice For Securities Industry Registration (Form U-5) on March 1, 2000, stating that Dean Witter had terminated Davenport for "admitt[ing] that he had received loans while employed by his prior firm."

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[1] In 1997, Dean Witter merged with Morgan Stanley. The Central Registration Depository nonetheless listed the firm in 2000 as "Dean Witter Reynolds, Inc." The combined company is now called Morgan Stanley.

[2] Davenport was registered as a general securities representative at Dean Witter from August 16, 1999 until March 1, 2000.

[3] Dean Witter was unable to identify the source of the letter, which had neither a postmark nor a return address.

NASD then launched an investigation to examine the cause of Davenport's termination. Davenport responded to NASD's request for information and cooperated fully with NASD examiners investigating the matter. He provided NASD with a detailed list of all of the customer loans, which amounted to over $1.5 million borrowed from 26 customers.[4] Davenport gave each of the lenders a promissory note bearing interest at a fair market rate.

Hilliard had a written policy prohibiting employees from borrowing money from the firm's customers. In order to enforce its policies, Hilliard required employees to complete and sign an annual "Prohibited Activities Listing" form, which asked, among other things, whether employees had borrowed money from customers. Davenport completed and signed three false Prohibited Activities Listing forms (June 1997, May 1998 and July 1999) in which he misrepresented to Hilliard that he had not borrowed money from any customer.

During the hearing in this matter, Davenport testified that he had borrowed the money from high-net-worth customers to cover losses he had sustained from trading options while at Hilliard. Davenport began trading options in 1994 and continued trading for several years. As Davenport lost money, he increased the size of his trades. His trading losses continued to grow, and by 1999, he was in debt more than $700,000. He testified that at this point he realized that he had a "gambling problem." Davenport explained to his customers that he needed to borrow the money to cover his losses from options trading. He did not tell the customers, however, the extent of his losses or that he was borrowing from other customers.

Davenport testified that his branch manager at Hilliard had confronted him about one of the loans four or five years before he left Hilliard. The compliance department at Hilliard had also contacted Davenport several times about the size of his options losses to ask him whether he could afford to lose that much money and whether he was "OK."

In early 1999, Dean Witter offered Davenport a job at Dean Witter's new office in Glasgow, Kentucky. Several brokers, who had left Hilliard to join Dean Witter's office in Bowling Green, Kentucky, recommended that Dean Witter recruit Davenport. Davenport initially declined Dean Witter's offer. He changed his mind and accepted the offer, however, after Dean Witter increased Davenport's signing bonus to $278,000.

Davenport testified that he viewed the Dean Witter job as an opportunity to stop trading options and to repay his loans. He did not open a margin account at Dean Witter, and he used $263,000 of his signing bonus, and $105,000 from his IRA, to repay part of his outstanding loans. Davenport made all of the installment payments, including interest, on the outstanding loans until Dean Witter fired him in February 2000. After Dean Witter fired him, Davenport renegotiated the payment terms of his loans. He has

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[4] The customers' loans to Davenport ranged from $15,000 to $200,000, with the bulk of the loans ranging from $25,000 to $85,000.

continued to make payments according to the revised terms of the loan agreements, and none of his customers has complained about the loans. Several of his customers testified at the hearing before the Hearing Panel that they were glad they had loaned Davenport money and they were satisfied with his repayment of the loans.

Currently, Davenport sells veterinary supplies for a company owned by one of his former brokerage customers. He earns $60,000 per year. At the time of the Hearing Panel decision, the aggregate balance of the outstanding loans was approximately $400,000.

Enforcement initiated these proceedings on June 6, 2001. On March 4, 2002, the Hearing Panel issued its decision, finding that Davenport had made false representations to his firm in violation of NASD Rule 2110. The Hearing Panel fined Davenport $10,000, suspended him from associating with any member firm in any capacity for nine months, and prohibited Davenport from opening and maintaining a leveraged account upon rejoining a member firm. The Hearing Panel gave Davenport credit against his nine-month suspension for the time he had been out of the industry since Dean Witter terminated him in February 2000. On April 16, 2002, we called the matter for review to examine the sanctions imposed by the Hearing Panel. Both parties filed briefs and, on September 24, 2002, both parties participated in a telephonic hearing.

Analysis of Violation

We called this matter for review to examine both the sanctions and the rationale for imposing them. Although neither Davenport nor Enforcement contests the Hearing Panel's findings of violation, we will briefly review them before discussing the sanctions.

The complaint charged Davenport with violating Conduct Rule 2110 by representing falsely to his firm on three occasions that he had not borrowed money from any customers. Conduct Rule 2110 provides that "every member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." Conduct Rule 2110 thus allows NASD to regulate broker/dealers under ethical standards, as well as legal standards.[5]

The SEC has construed Conduct Rule 2110 broadly to apply to all business-related misconduct, regardless of whether the misconduct involved securities. See, e.g., DWS Securities Corp., 51 S.E.C. 814, 822 (1993) ("We have repeatedly held that a self-

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[5] The 1938 Maloney Act Amendments to the Securities Exchange Act of 1934, which authorized the creation of self-regulatory organizations, allow NASD "to regulate itself by prohibiting and preventing fraud and unethical conduct by its members and by promoting in them professionalism and technical proficiency . . . ." Jones v. SEC, 115 F.3d 1173, 1182 (4th Cir. 1997) (emphasis added). See also First Jersey Sec., Inc. v. Bergen, 605 F.2d 690, 698 (3d Cir. 1979) (noting that the Maloney Act sought to promote self-regulation of the securities industry to guard against both unethical and illegal practices).

regulatory organization's disciplinary authority is broad enough to encompass business-related conduct that is inconsistent with just and equitable principles of trade, even if that activity does not involve a security."); George R. Beall, 50 S.E.C. 230, 231-32 (1990) (finding that respondent's passing of bad checks to his firm in connection with options trading in his personal account was a violation of Article III, Section 1 of the Rules of Fair Practice, now Conduct Rule 2110); Thomas E. Jackson, 45 S.E.C. 771, 772 (1975) ("Although Jackson's wrongdoing in this instance did not involve securities, the NASD could justifiably conclude that on another occasion it might."). The principal consideration is whether the misconduct reflects on an associated person's ability to comply with regulatory requirements necessary to the proper functioning of the securities industry and protection of the public. See James A. Goetz, 53 S.E.C. 472, 477 (1998) (finding that respondent's false representation that he would not personally benefit from his firm's matching gifts program violated Conduct Rule 2110 because it reflected "directly on [his] ability to comply with regulatory requirements fundamental to the securities business and to fulfill his fiduciary responsibilities in handling other people's money").

Davenport does not contest the factual basis of the complaint. Indeed, he freely admits that he violated his firm's policy against borrowing from customers and that he tried to conceal his violation. Applying the foregoing principles to this case, we find that Davenport's misconduct – misrepresenting to his firm that he had not borrowed from customers in violation of the firm's policy – occurred in the context of his business-relationship with his employer. We also find that Davenport's dishonesty to his firm reflects directly on his ability to abide by his firm's policies, many of which are designed to protect the public and the firm, and to deal responsibly with the public. We therefore affirm the Hearing Panel's finding that Davenport 's misrepresentations to his firm that he had not violated his firm's policy violated Conduct Rule 2110.

Sanctions

Having reviewed the finding of violation, we now turn to the sanctions that the Hearing Panel imposed. In the absence of a Sanction Guideline for this type of misconduct and the lack of an NASD or SEC decision directly on point, the Hearing Panel properly looked for guidance to other Sanction Guidelines involving the false reporting of information.[6] The Sanction Guideline recommends a fine of $10,000 to $50,000 for filing false Focus Reports[7] and a fine of $2,500 to $50,000 for filing false

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[6] We agree with the Hearing Panel that the proper focus is on the nature of Davenport's misconduct – namely, his misrepresentations to his firm – and not the loans themselves, which in this instance did not violate any NASD rule.

[7] See Guidelines (2001 ed.) at 76 (FOCUS Reports – Filing False or Misleading Reports).

Forms U-4 and U-5.[8] The Sanction Guideline for filing misleading FOCUS reports recommends suspending the responsible principal for up to two years. The Sanction Guideline for filing misleading or inaccurate Forms U-4/U-5 recommends suspending a responsible individual for up to 30 business days. In egregious cases involving false, inaccurate or misleading filings, the Sanction Guideline recommends a suspension of up to two years or a bar.

We find that Davenport's misrepresentations to his firm on three occasions were sufficiently serious to warrant a substantial sanction. We disagree with the Hearing Panel, however, that Hilliard's knowledge of one loan and ability to discover the other loans was mitigating. Hilliard did not obtain its information about the loan from Davenport, who lied to his firm about the loans. We therefore do not find that Hilliard's awareness of, or ability to discover, the loans mitigated the seriousness of Davenport's misconduct. Similarly, we do not find mitigating the facts that Davenport was "a valued employee at both his firms," "president of the local Rotary Club" and "a member of the local industrial development board." None of these facts mitigate his dishonesty and deception in this case.

However, we do find that Davenport's cooperation and admission of and contrition for his wrongdoing are mitigating factors, and we take these into account as we determine the proper sanctions. The record makes clear, and the NASD attorney representing Enforcement on appeal testified that Davenport has acknowledged his violation, accepted responsibility for it, and cooperated willingly and completely with NASD investigators.

We agree with the Hearing Panel that Davenport's misconduct warrants a $10,000 fine, which is at the low end of the fines recommended for false reporting of information. The Hearing Panel determined, and we agree, that a fine of $10,000 is sufficiently remedial and will not unreasonably interfere with Davenport's ability to continue repaying the loans. We also find that the imposition of a lengthy suspension is warranted in this case. Notwithstanding the mitigating factors discussed above, Davenport engaged in a sustained campaign of deception for three years while at Hilliard. We thus find that a nine-month suspension is sufficiently remedial under the circumstances. See James A. Goetz, 53, S.E.C. at 478-79 (imposing a bar with a right to reapply after one year for respondent's misrepresentations, in violation of Conduct Rule 2110, that he would not benefit from his firm's matching gifts program).

We find, however, that the Hearing Panel was wrong to give Davenport credit against his nine-month suspension for the time he has been out of the industry since Dean Witter terminated him. As a general matter, NASD, in determining the appropriate sanction, does not give weight to the fact that a firm terminated a respondent. See Department of Enforcement v. Prout, Complaint No. C01990014, 2000 NASD Discip.

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[8] See Guidelines (2001 ed.) at 77 (Forms U-4/U-5 – Filing False or Misleading Forms or Amendments).

LEXIS 18 at *11 (Dec. 18, 2000) ("We [do not] credit a respondent who was terminated by a firm" in determining the length of a suspension.); Department of Enforcement v. Greer, Complaint No. C05990035, 2001 NASD Discip. LEXIS 34 at *13-14 (Aug. 6, 2001) (stating that it is "neither appropriate nor consistent with the Sanction Guidelines" when determining the length of the suspension to give Greer credit for time out of the industry since Greer's firm terminated him).

This case is unusual because had the Hearing Panel ordered the appropriate starting date for Davenport's suspension – April 22, 2002, the date on which the Hearing Panel decision would have become final had we not called it for review[9] – Davenport would have served his suspension by now. Therefore, on the facts of this particular case, having called the matter for review to correct this error and neither party having appealed, we order that the nine-month suspension run retroactively from April 22, 2002, the date on which the Hearing Panel decision would have become final.

Finally, we eliminate the requirement that Davenport be prohibited from engaging in leveraged trading in a personal account that he might open at a firm with which he becomes associated in the future. We are opposed to mandating specific requirements on a potential employer when Davenport is the party that committed the violation. As with any other registered person with a disciplinary history, any firm that hires Davenport must consider whether special supervisory procedures tailored to Davenport are necessary. See Notice to Members 97-19 (April 1997). We conclude that mandating a single restriction on leveraged trading is potentially too narrow an approach and should not be mandated by us.

Accordingly, we order that Davenport be fined $10,000;[10] ordered to pay costs of $1,110.42; and suspended for nine months, with credit for the suspension beginning on April 22, 2002.[11]

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[9] Under NASD Procedural Rule 9268(e), a Hearing Panel decision constitutes final disciplinary action of NASD for purposes of SEC Rule 19d-1(c)(1) if it is not appealed within 25 days, or called for review within 45 days, of the date that the Hearing Panel issues the decision.

[10] The Hearing Panel made Davenport's fine payable according to the terms of an installment plan to be agreed upon by Enforcement and Davenport, if he re-enters the securities industry. Unless Enforcement extends the time, Enforcement and Davenport are to arrive at an installment plan once Davenport becomes associated with a member firm. The installment plan will take into account Davenport's payment obligations on the customer loans and will require Davenport to report periodically to Enforcement regarding the status of the loans. Enforcement may accelerate the balance due on the fine in the event that Davenport defaults on his loan payments.

[11] The recommended sanctions are consistent with the applicable NASD Sanction Guidelines ("Guidelines"). See Guidelines (2001 ed.) at 76 (Filing False or Misleading FOCUS Reports) and 77 (Filing False or Misleading Forms or Amendments).

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

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 that 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.