



("California Financial"), located in Bakersfield, California.<sup>1</sup> On September 4, 1997, Barkate executed a registered representative agreement with Securities Service Network, Inc. ("SSN"), providing that he would operate his California Financial office as an office of supervisory jurisdiction ("OSJ") for SSN. From June 1997 to April 1999, Barkate was associated with SSN as a general securities principal and general securities representative. Barkate is not currently registered with any NASD member firm.

**B. Procedural History**

On August 9, 2001, NASD's Department of Enforcement ("Enforcement") filed a complaint alleging that Barkate violated NASD Conduct Rules 2110 and 3040 by participating in private securities transactions without giving prior written notice to SSN, the member firm with which he was then associated. On September 25, 2001, Barkate filed an answer to the complaint in which he denied the substantive allegations. On April 9, 10, and 11, 2002, a Hearing Panel held a hearing in Los Angeles, California. On September 5, 2002, the Hearing Panel issued its decision, finding that Barkate engaged in the misconduct alleged in the complaint and imposing a bar in all capacities. The Hearing Panel also imposed a \$400,144 fine to be reduced by any amounts paid in disgorgement of commissions within one month of the date of the decision and ordered Barkate to pay \$5,141.21 in costs. This appeal followed.

**C. Factual Background**

On September 4, 1997, Barkate executed a registered representative agreement with SSN, providing that he would operate California Financial as an SSN OSJ. The agreement expressly prohibited Barkate from offering or selling any security to any purchaser without the prior written approval of SSN. The registered representative agreement also required Barkate to disclose in writing all sources of outside income. On September 18, 1997, Barkate submitted his first outside business activity form to SSN, and he represented that he had outside income from advisory fees and insurance commissions.

In March 1998, Barkate's acquaintance introduced him to TLC instruments.<sup>2</sup> TLC instruments purportedly provided investors with a tax lien certificate that represented the right to collect delinquent taxes on real property. According to the TLC marketing materials, the investment process for TLC instruments was as follows: (1) the customer writes a check for the

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<sup>1</sup> California Financial became an NASD member in May 2000. NASD cancelled California Financial's membership in January 2003 for failure to pay membership fees. Barkate is not currently registered with any NASD member firm.

<sup>2</sup> TLC instruments were sold through and were for the benefit of one or a combination of the following entities: TLC Investments & Trade Co., TLC America, Inc., TLC Brokerage, Inc., TLC Development, Inc., and TLC Real Properties RLLP-1. For purposes of this decision, we collectively refer to these entities as "TLC."

investment, which is deposited with an escrow company,<sup>3</sup> and receives a one-year, fixed-rate TLC instrument;<sup>4</sup> (2) the escrow company clears and transfers the funds to a trust account at an FDIC insured bank; (3) TLC bids on a particular tax lien and has the bank issue a cashier's check to the municipality where the tax lien is purchased; (4) the municipality issues a tenant-in-common deed in the name of TLC and the investor;<sup>5</sup> (5) TLC issues a property letter to the investor listing the address of the property that is the subject of the investor's purchased lien; (6) TLC issues a warranty deed to the investor, verifying the purchase;<sup>6</sup> (7) the property is redeemed; and (8) the investor receives either his or her principal and interest in 365 days or rolls over his or her investment into another TLC instrument.

In July 1998, Barkate completed his first three sales of TLC instruments for a total of \$278,896, resulting in up-front commissions of \$13,388 and deferred commissions of \$3,693. In total from July 1998 through March 1999, while associated with SSN, Barkate solicited and sold \$6.8 million in TLC instruments. Barkate testified that his commissions ranged from four to six percent of the gross amount of each instrument. Barkate received a total of \$400,144 in commissions from TLC. Barkate admits that he did not provide SSN with prior written notice of his intent to sell the TLC instruments.

On March 31, 1999, Barkate submitted a proposed Web site to SSN for approval that advertised California Financial's sale of TLC instruments. The next day, April 1, 1999, SSN sent David Bellaire ("Bellaire"), legal counsel with SSN's compliance department, to Barkate's offices to conduct an unannounced audit. On April 1, 1999, SSN also directed Barkate to cease and desist from selling TLC instruments. SSN terminated Barkate's employment on April 12, 1999, and terminated his registration on April 16, 1999.

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<sup>3</sup> The TLC marketing materials stated that customer funds were deposited in an escrow account to be used solely to purchase tax lien certificates and tax lien deeds. In reality, the funds were used to pay prior investors and to pay the personal expenses of TLC officers, including the purchase of racehorses and the financing of a football stadium for the high school of the CEO's son.

<sup>4</sup> The TLC instruments required a minimum investment of \$20,000, had a one-year term, and had a fixed interest rate. The selling broker determined the fixed-interest rate, ranging from nine to 12 percent, which a particular customer received. The lower the interest rate was for the customer, the higher the broker's commission rate was.

<sup>5</sup> TLC never sent investors the purported tenant-in-common deeds.

<sup>6</sup> The TLC property letter told investors that a warranty deed would be sent within 90 days of their investment in TLC and TLC's subsequent purchase of the distressed real estate. The property letter did not inform investors, however, that the TLC-issued warranty deeds were never recorded or intended to be recorded.

In October 2000, the Securities and Exchange Commission filed a complaint against TLC alleging that it had engaged in a fraudulent "Ponzi scheme."<sup>7</sup> On October 19, 2001, the United States District Court for the Central District of California entered a preliminary injunction against and appointed a receiver for TLC.<sup>8</sup>

## II. DISCUSSION

Neither Barkate nor Enforcement contests the Hearing Panel's findings of violation. Barkate's appeal instead focuses entirely on various aspects of the sanctions imposed below. Nonetheless, we will briefly review the findings of violation before discussing the issues germane to sanctions.

The complaint alleged, and the Hearing Panel below found, that Barkate participated in private securities transactions without giving his firm prior written notice of such activity, in violation of Conduct Rules 2110 and 3040. Registered representatives are required to adhere to just and equitable principles of trade pursuant to Conduct Rule 2110. Rule 3040 requires registered representatives who participate in any manner in a private securities transaction outside the regular course of their employment to provide prior written notice to the member firm at which they are employed and, if compensation is anticipated, to receive the firm's prior written approval prior to engaging in such activity.

There is no dispute that the TLC instruments at issue are securities.<sup>9</sup> Further, Barkate's admitted solicitation of investors while he was at SSN plainly constituted participating "in any manner" in the resulting sales of TLC instruments. Barkate's sale of the TLC instruments, moreover, was not within the course and the scope of his employment with SSN. In addition, Barkate received selling compensation for his sales of the TLC instruments, in the form of

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<sup>7</sup> In general, a "Ponzi scheme" is an investment system whereby returns are paid to earlier investors entirely out of money paid into the scheme by newer investors. TLC operated a Ponzi scheme by using new investor funds to pay prior investors, rather than paying the prior investors with purported returns from the real estate programs.

<sup>8</sup> *SEC v. TLC Investments*, 179 F. Supp. 2d 1149 (C.D. Cal. 2001) (granting the SEC a permanent injunction against the sales agent for TLC's offering, and imposing disgorgement of \$1,159,262.56 in profits and civil penalties of \$110,000 against the agent and \$550,000 against the agent's firm).

<sup>9</sup> In addition to the parties' and Hearing Panel's determinations that the TLC instruments are securities, we note that the United States District Court for the Central District of California held that the TLC instruments are securities under the test set forth in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) relating to investment contracts. See *SEC v. TLC Investments and Trade Co. et al.*, 179 F. Supp. 2d. 1149, 1156 (C.D. Cal. 2001) (citing *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)). Moreover, even if the TLC instruments were viewed as promissory notes, they still would be securities under the test enunciated by the United States Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). After reviewing the record and performing an independent analysis, we also find that the TLC instruments are securities.

\$400,144 in commissions. Finally, Barkate failed to provide prior written notification to and obtain written approval from SSN before engaging in such activities. In light of these facts, we uphold the Hearing Panel's findings that Barkate acted in contravention of Conduct Rules 2110 and 3040.

### III. SANCTIONS

The NASD Sanction Guideline for private securities transaction violations recommends that adjudicators impose a fine of \$5,000 to \$50,000 and a suspension of 10 days to one year or, in egregious cases, a longer suspension or a bar.<sup>10</sup> The Guideline also provides that "adjudicators may increase the recommended fine amount by adding the amount of a respondent's financial benefit."<sup>11</sup> The Guideline lists the following specific considerations in determining appropriate sanctions: (1) whether the respondent had a proprietary or beneficial interest in or was otherwise affiliated with the issuer; (2) whether the respondent attempted to create the impression that his employer sanctioned the activity; (3) whether the respondent sold away to customers of his employer; (4) whether the respondent gave his employer oral notice of his participation; (5) whether the respondent sold the investment after he had been told or warned by his employer not to do so; (6) whether the respondent properly was registered to sell the product at issue; and (7) whether the respondent sold the product directly to customers or participated in the sale by referring customers to an appropriately registered individual for purchase.<sup>12</sup>

The Hearing Panel found that three of these considerations applied to this case. Barkate created the impression that SSN sanctioned the sales and he sold the TLC instruments to SSN customers. For instance, he offered and sold the TLC instruments from his SSN office, primarily to his existing customers in his capacity as their SSN advisor. Barkate also did not disclose his involvement with TLC to SSN, despite numerous opportunities to do so.<sup>13</sup>

The Hearing Panel found a number of additional aggravating factors. In applying the Sanction Guideline's "Principal Considerations,"<sup>14</sup> which are applicable to all violations, the Hearing Panel found that Barkate's violations continued over an extended period of time (nine months), involved numerous acts of misconduct (more than 100 transactions), involved

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<sup>10</sup> See NASD Sanction Guidelines: Selling Away (Private Securities Transactions) (2001 ed.) at 19-20.

<sup>11</sup> *Id.* at 19 n.2.

<sup>12</sup> *Id.* at 19-20.

<sup>13</sup> Although we agree with the Hearing Panel that Barkate attempted to conceal his activity from SSN, we make no finding regarding whether Barkate disregarded SSN's specific warning to him to stop selling the TLC securities once it learned of his activities.

<sup>14</sup> See NASD Sanction Guidelines: Principal Considerations in Determining Sanctions (2001 ed.) at 9.

substantial sums of money (\$6.8 million), and cost investors millions in losses. The Hearing Panel also determined that Barkate's violations were deliberate, and that he lacked candor, gave false testimony during the hearing, and failed to acknowledge responsibility or show any remorse for his misconduct.

The Hearing Panel concluded that Barkate's misconduct was egregious, and ordered that he be barred. The Hearing Panel also fined him \$400,144, to be reduced by any amounts that had been paid in disgorgement of commissions to his customers or the TLC receiver within one month of the issuance of the decision. In imposing these sanctions, the Hearing Panel rejected Barkate's argument that his sanction should be minimal because he reasonably believed that the TLC instruments were not securities when he sold them and because he submitted an outside business activity disclosure form with information concerning TLC to SSN in August 1998.

On appeal, Barkate makes three arguments for reducing the bar to a suspension:<sup>15</sup> (1) that he provided SSN with an outside business activity report that disclosed his involvement with TLC; (2) that he did not attempt to conceal his involvement with TLC; and (3) that, at the time of the sales, he reasonably believed that the TLC instruments were not securities. We will address each contention in turn.

Barkate first asserts that he sent outside business activity disclosure forms to SSN regarding TLC on August 21, 1998, shortly after he began selling TLC instruments.<sup>16</sup> In support of his testimony, two of Barkate's employees, Dianna Jones ("Jones") and Cassandra Woodward ("Woodward"), testified that Jones sent, on Barkate's behalf, the TLC material to Securities Network on August 21, 1998. However, two former and one current SSN compliance employees—Bellaire, Darla Goodrich ("Goodrich") and Jeffrey Currey ("Currey")—testified that they did not receive any such disclosure forms from Barkate regarding TLC.<sup>17</sup> For instance, Bellaire testified below that he reviewed Barkate's files at SSN before leaving to conduct an unannounced audit of Barkate's OSJ site on April 1, 1999, and that Barkate's files contained no information pertaining to TLC. Bellaire also testified that Barkate did not mention or produce any outside business activity forms submitted to SSN during the April 1999 audit. Indeed, Bellaire testified that, during the audit, Barkate acknowledged that he had not disclosed his TLC activities to SSN.

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<sup>15</sup> Barkate does not contest the fine or imposition of costs.

<sup>16</sup> In support of his argument, Barkate submitted several exhibits before the Hearing Panel, consisting of TLC sales material and outside business activity forms reflecting his transactions in TLC. During the hearing, however, Enforcement questioned the authenticity of the documents, many of which appeared to have been created after the conduct at issue took place. Barkate now admits that the exhibits are not the actual documents that he allegedly sent to SSN. He claims that the exhibits were only intended to be "exemplars," designed to replicate the forms that he claims he submitted to SSN on August 21, 1998.

<sup>17</sup> Bellaire, Goodrich, and Currey testified that if the TLC material had been received by SSN's mailroom, the material would have been sent to the compliance department.

Bellaire further testified that he had never seen any disclosure of outside business activity concerning TLC until Barkate brought it to his attention approximately one week after the April 1999 audit. Bellaire stated that the first time that SSN became aware of TLC was when Barkate submitted the multi-page printed version of a Web site on March 31, 1999 that contained information about TLC. That submission caused SSN to conduct the unannounced audit the very next day, on April 1, 1999. Goodrich and Currey corroborated Bellaire's testimony that Barkate had not disclosed any information to SSN regarding TLC until he submitted the Web site materials on March 31, 1999. A memorandum that Bellaire prepared shortly after the April 1999 audit also supported Bellaire's testimony.<sup>18</sup>

The Hearing Panel credited the testimony of Bellaire, Goodrich and Currey over that of Barkate, Jones, and Woodward. It is axiomatic that "[a]n initial factfinder's assessment of credibility deserves special weight." *Alderman v. SEC*, 104 F.3d 285, 288 n.4 (9th Cir. 1997).<sup>19</sup> There is nothing in the record, moreover, to call into question this initial credibility determination. We uphold the Hearing Panel's finding that Barkate did not provide SSN with notice of outside business activity regarding the TLC instruments.

Moreover, we do not find Barkate's claim, even if true, to be mitigating for the purpose of sanctions. Barkate claims that he sent SSN the disclosure materials on August 21, 1998. Barkate thus would have violated Conduct Rules 2110 and 3040 in any event because the alleged disclosure would have been sent 40 days *after* he had effected his first sales transactions in TLC instruments. Moreover, according to Barkate, the disclosure he claims to have sent to SSN regarded an outside business activity, not the selling away of securities to SSN customers. Finally, it is undisputed that SSN did not provide Barkate with written approval to engage in the TLC sales.

Barkate next argues that he did not attempt to conceal his TLC activities from his firm. The Hearing Panel did not find Barkate's claim in this regard to be credible. We agree with the Hearing Panel's assessment. Barkate testified that SSN's compliance department was openly available to him. He acknowledged that he could call the compliance department by telephone whenever he had a question. Barkate, however, admitted that he never made any such call to SSN about TLC.

In addition to the general availability of SSN's compliance personnel, Barkate had specific opportunities to disclose his TLC activities to SSN. On September 23, 1998, for

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<sup>18</sup> The memorandum, dated April 5, 1999, affirms that Barkate told Bellaire that he did not bring TLC or the TLC certificates to the attention of SSN as he should have done. The memorandum also confirms that Barkate admitted that he failed to discuss the matter with SSN compliance personnel because he was concerned that SSN would not approve the activity.

<sup>19</sup> The Hearing Panel's assessment of credibility is entitled to considerable weight and deference because it is based on hearing the witnesses' testimony and observing their behavior. *See Jonathan Garrett Ornstein*, 51 S.E.C. 135, 137 (1992).

example, Brad Keeter, an SSN compliance examiner, sent an audit report to Barkate, which summarized the results of a June 1998 audit, including a specific discussion of outside business activities. The audit report made no mention of TLC. Barkate responded to the report on November 23, 1998, and assured Keeter that he understood the disclosure requirements for outside business activities that were discussed during the audit. Barkate, however, did not mention his involvement with TLC. In light of the foregoing, we find, as did the Hearing Panel below, that Barkate actively concealed his activity from SSN.

Barkate also argues that the bar should be reduced to a suspension because, at the time of the sales, he reasonably believed that the TLC instruments were not securities. Barkate acknowledges now that the TLC instruments are securities, but contends that he previously believed that the TLC instruments were "ordinary real estate transactions" because the structure of the TLC instruments did not resemble a security and because he relied on the legal opinion of counsel for TLC America that the instrument was not a security. As an initial matter, we note that the Hearing Panel found that Barkate's claim was not credible and we find nothing in the record to warrant any different finding. The TLC instruments give every appearance of being a security. Furthermore, Barkate, who is not a licensed real estate agent, admitted that, prior to the sales in question, he had called the Real Estate Commission of the State of California and was informed that he did not need a real estate license to sell the TLC instruments because such sales would not be considered real estate transactions. At that point, he knew that the TLC instruments were not "ordinary real estate transactions." Notwithstanding this obvious red flag, Barkate still failed to call SSN's compliance department to discuss (or otherwise alert SSN about) his TLC activities. We agree with the Hearing Panel that his version of events is not plausible.

Barkate further claims that he reasonably believed that the TLC instruments were not securities based on the legal opinion of Paul Turner, counsel for TLC America. The evidence that Barkate offers, however, does not meet our requirements for mitigating sanctions based on reliance on advice of counsel. Under the NASD Sanction Guidelines, when considering a respondent's claim of reliance on the advice of counsel, we must examine "whether the respondent demonstrated reasonable reliance on competent legal . . . advice."<sup>20</sup> Here, Barkate claims that he relied on a legal opinion prepared by Turner and that he (Barkate) verified that Turner was a member in good standing with the California Bar.

Turner, however, was counsel for TLC, an interested party. *See Department of Enforcement v. Flannigan*, Complaint No. C8A980097, 2001 NASD Discip. LEXIS 36, at \*20 (June 4, 2001) (holding, in part, that respondent had failed to show how reliance on advice of issuer's counsel was reasonable). There is no evidence, moreover, that Turner and Barkate had an attorney-client relationship or that Turner provided Barkate with any specific advice in response to Barkate's questions about whether the TLC instruments were securities. The legal opinion also was not created for Barkate or for public dissemination and explicitly stated that it was "not intended nor should it be used as an inducement or marketing tool to solicit investors."

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<sup>20</sup> *See* NASD Sanction Guidelines: Principal Considerations in Determining Sanctions (2001 ed.) at 9.

*Department of Enforcement v. Fergus*, Complaint No. C8A990025, 2001 NASD Discip. LEXIS 3, at \*51-52 (NAC May 17, 2001) (holding, in part, that the fact that the purported legal advice in question was sent from the issuer to a former marketing firm and was not supposed to be publicly distributed weighed against viewing the respondent's reliance as being reasonable).

Barkate's claim that he allegedly verified that Turner was a member in good standing with the California Bar adds little to the equation in light of the other relevant facts. In addition, such an inquiry, even if true, does not assist in determining whether Turner was qualified to make a determination regarding whether the TLC instruments were securities. *See id.* at\*49 (noting that reliance was unreasonable, in part, because there was no evidence that the attorney was a securities lawyer who had the expertise or competency to render judgment on matter at issue); *Department of Enforcement v. Luther Hanson*, Complaint No. C9A000027, 2001 NASD Discip. LEXIS 41, at \*21 (Dec. 13, 2001) (holding that relevant inquiry is whether attorney had the experience or expertise to render particular legal advice). Under these circumstances, we reject Barkate's claim of reasonable reliance on advice of counsel.

In summary, we agree with the Hearing Panel's finding that Barkate's misconduct was egregious. At the time of the misconduct, Barkate had been a registered securities principal for nearly 10 years and had been a registered representative for 15 years. Barkate also knew that his firm had a strict policy regarding private securities transactions because he owned and operated California Financial as an OSJ for SSN. Pursuant to his agreement with SSN, Barkate agreed to notify SSN in writing prior to engaging in the offer or sale of securities.<sup>21</sup> The agreement also provided that SSN would maintain a list identifying the products that were approved for sale by SSN representatives. The TLC instruments were not on the approved list of products. Moreover, SSN's Compliance and Operations Manual ("Manual") expressly prohibited the sale of any product that had not been approved by SSN, and prohibited representatives from accepting or receiving compensation in connection with any investment without the prior written consent of SSN. Yet, Barkate intentionally sold securities away from his firm to 93 investors, most of whom were SSN's customers. Barkate's misconduct occurred over nine months and involved over 100 transactions worth millions of dollars.

Moreover, Barkate's misconduct is egregious because it prevented his firm from performing due diligence on TLC. A due diligence inquiry may have revealed that TLC was engaged in a fraudulent Ponzi scheme, and may have prevented Barkate's customers from suffering substantial losses. As the SEC has stated on numerous occasions, "Rule 3040 is designed not only to protect investors from unmonitored sales, but also to protect securities firms from exposure to loss and litigation in connection with sales made by persons associated with them." *Jim Newcomb*, Exchange Act Rel. No. 44945, 2001 SEC LEXIS 2172 (Oct. 18, 2001).

In light of the numerous aggravating factors and the absence of mitigating factors, we affirm the Hearing Panel's imposition of a bar in all capacities. The Hearing Panel also imposed a fine of \$400,144, to be reduced by any amounts paid in disgorgement of commissions to

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<sup>21</sup> The agreement states in relevant part: "Representative agrees that he shall neither offer nor sell any security to any purchaser without the written approval of SSN."

customers. We disagree with the Hearing Panel's decision to impose the fine, and eliminate it accordingly. We uphold the Hearing Panel's imposition of costs in the amount of \$5,141.21.

## V. CONCLUSION

We uphold the Hearing Panel's findings, which the parties do not dispute, that Barkate violated NASD Conduct Rules 2110 and 3040 as alleged in the complaint. We uphold the sanction of a bar, and eliminate the monetary sanctions imposed by the Hearing Panel. Accordingly, Barkate is barred from association with any member firm in any capacity.<sup>22</sup> In addition, we order Barkate to pay appeal transcript fees of \$616.93, appeal costs of \$1,000, and the hearing costs for the proceeding below in the amount of \$5,141.21.

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President

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<sup>22</sup> We note that we have considered and reject without discussion all other arguments advanced by Barkate.