

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of

Department of Enforcement,

Complainant,

vs.

Franklyn Ross Michelin
Boca Raton, FL

and

L.H. Ross & Co., Inc.
Boca Raton, FL,

Respondents.

DECISION

Complaint No. C07000033

Dated: January 3, 2002

Respondents failed to implement supervisory tape-recording procedures. Held, Hearing Panel findings affirmed and sanctions modified.

L.H. Ross & Co., Inc. ("Ross" or "the Firm") and its president, Franklyn Ross Michelin ("Michelin"), appealed this matter pursuant to NASD Procedural Rule 9311, and we called this matter to review the Hearing Panel's findings and sanctions. Under review is a February 8, 2001 decision of an NASD Regulation, Inc. ("NASD Regulation") Hearing Panel. We find that L.H. Ross and Michelin violated NASD Rules by failing to implement tape-recording procedures as required by Conduct Rule 3010(b)(2) (hereafter "the Taping Rule"). We censure respondents and fine them \$10,000, jointly and severally. Based on the unique facts of this case, evidence that respondents presented during the course of this disciplinary proceeding, and our finding that respondents' violation is technical in nature, we prospectively order that Ross need not comply with the requirements under the Taping Rule, including the installation of a tape-recording system.

Factual and Legal Background

Ross is a registered broker-dealer with its principal place of business in Boca Raton, Florida. Ross has been an NASD member since September 1995.

Michelin has been registered as a general securities representative since March 1994 and has been associated with Ross since November 1994. During the period relevant to this complaint, July 30, 1999 to the present, Michelin has been registered with Ross as a general securities, options, and financial and operational principal and has been the Firm's president.

The Taping Rule requires a member to establish special supervisory procedures, including the tape recording of conversations, when it has hired more than a specified percentage of registered persons from certain disciplined firms.¹ The Taping Rule is a self-executing rule. Once a firm meets the criteria listed in the Rule (*i.e.*, a certain percentage of its work force is comprised of registered persons who have been employed by one or more disciplined firms) or is notified by NASD Regulation staff that the Rule applies to it, the firm must install a tape-recording system within 30 days and maintain the system for two years.²

The portion of the Taping Rule that is relevant to this case is subsection (b)(2)(viii) of Rule 3010, which states in pertinent part that a firm of at least 10 but fewer than 20 registered persons, in which four or more of its registered persons have been employed by one or more "disciplined firms"³ within the last three years, must adopt the

¹ The Taping Rule was intended to ensure that firms that hire a significant number of employees from previously disciplined firms properly supervise their sales forces to prevent fraudulent and improper sales practices.

² The Taping Rule currently does not provide an opportunity for relief to firms that become subject to the requirements of the Rule, although NASD Regulation staff has authority to grant exemptions in certain circumstances. See *infra* n. 10. NASD Regulation recently requested member comment on several proposed amendments to the Taping Rule, including an amendment that establishes a 30-day staff adjustment period whereby member firms are provided with a one-time only opportunity to adjust their rosters of registered persons (by reducing the number of registered representatives who formerly were employed by a disciplined firm) within 30 days of becoming subject to the Rule for the first time. See NASD Notice to Members 01-38 (June 2001) (NASD Regulation Requests Comment On Proposed Amendments to the Taping Rule).

³ For purposes of the Taping Rule, "disciplined firm" means a member firm that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking the firm's registration as a broker-dealer.

special supervisory procedures required by the Taping Rule. On the date at issue, July 30, 1999, Ross employed between 10 and 19 registered representatives, so Ross would have been required under the Taping Rule to install a tape-recording system if four or more of those registered representatives previously had been employed by disciplined firms.

Facts

The records of the Central Registration Depository ("CRD") indicated that, as of July 30, 1999, Ross employed 19 registered representatives, four of whom previously had been employed by a disciplined firm (Lizbeth Bloom ("Bloom"),⁴ Angel Sarmiento ("Sarmiento"),⁵ Marsha Selig ("Selig"),⁶ and Alan Siemens ("Siemens")). Respondents do not dispute that Bloom, Sarmiento, and Selig were associated with Ross on July 30, 1999 or that they had been employed by disciplined firms. The only factual dispute in this case is whether Siemens was engaged in the investment banking or securities business of Ross on July 30, 1999.

The following facts are undisputed. Ross hired Siemens on November 10, 1998. On April 7, 1999, the NASD approved Siemens' registration with Ross. On March 16, 2000, Ross filed a Form U-5 terminating Siemens' registration with the Firm. The Form U-5 indicated that Ross had terminated Siemens as of June 21, 1999.

Respondents contend that, although they did not file a Form U-5 to terminate Siemens until March 16, 2000, he actually resigned from the Firm on June 21, 1999.⁷

⁴ On July 8, 1999, the NASD approved Bloom's registration with Ross. Ross still employs Bloom.

⁵ On May 25, 1999, the NASD approved Sarmiento's registration with Ross. On September 9, 1999, Ross filed a Form U-5 Uniform Termination Notice for Securities Industry Registration ("Form U-5") terminating Sarmiento's registration with the Firm as of August 1999.

⁶ On December 10, 1998, the NASD approved Selig's registration with Ross. On January 7, 2000, Ross filed a Form U-5 terminating Selig's registration with the Firm as of January 2000.

⁷ Michelin testified that he knew Siemens from another member firm with which both he and Siemens had been associated and that Siemens was known as "a large producer." Siemens and Michelin testified that Ross hired Siemens for a seven-month term (November 15, 1998 through June 15, 1999) for a total salary of \$300,000 and that Siemens proffered his letter of resignation on June 21, 1999. Siemens' registration with Florida was not approved during Siemens' seven-month term with Ross, so Siemens never actually sold securities at Ross, which was located in Florida. Michelin contended

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Respondents argue that Siemens was not associated with the Firm on July 30, 1999, although they do not dispute that, as of July 30, 1999, CRD indicated that Siemens was actively registered with Ross. Respondents thus assert that, since Siemens was not engaged in the Firm's investment banking or securities business or associated with Ross in any way on July 30, the requirements of the Taping Rule should not have applied to the Firm.

The Department of Enforcement ("Enforcement") disputes that Siemens resigned from Ross on June 21, 1999 based on three facts. First, in a Taping Rule exemption request that the Firm filed on October 3, 1999, Michelin referred to Siemens as being "on leave of absence" and made no mention of Siemens' resignation. Second, in a January 3, 2000 appeal of the exemption denial, Michelin stated that the Firm "[would] most likely terminate [Siemens] in the near future," but the Firm still had not filed Siemens' Form U-5.⁸ Third, on December 24, 1999, Ross automatically renewed the 2000 registration of Siemens with the NASD and the State of California.⁹ Enforcement did not, however, produce affirmative evidence that Siemens was on Ross' premises or otherwise actively engaged in the investment banking or securities business of Ross subsequent to June 21, 1999.

To date, Ross has not installed a tape-recording system.

Procedural History

On August 5, 1999, the NASD Regulation Department of Member Regulation ("Member Regulation") notified Ross that, as of July 30, 1999, it was functioning in violation of the Taping Rule because a disciplined firm previously had employed four of Ross' 19 registered representatives. Ross requested an exemption from the requirements

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that Siemens assisted with office management and training during his seven-month term of employment.

Siemens testified that he left Ross on June 21, 1999 with no plans of returning and that he in fact never returned.

Michelin testified that he was responsible for failing timely to file Siemens' Form U-5 and that he filed it late because he had hoped that Siemens would return to Ross. Siemens, however, never returned.

⁸ Michelin characterized these references (and his continued failure to file Siemens' Form U-5) as illustrative of his wishful thinking that Siemens would return to Ross.

⁹ Michelin contended that, since the renewal was automatic, he never made a conscious decision to maintain Siemens' registration, which was never approved in Florida, and he had not even reviewed the renewal roster.

of the rule.¹⁰ Member Regulation denied the request, and Ross appealed the denial to us. We affirmed Member Regulation's denial of the exemption on the basis that Ross had not demonstrated that it had implemented enhanced supervisory procedures to ensure compliance with applicable securities laws and the NASD's Rules.¹¹ Respondents failed to install a tape-recording system, and Enforcement filed the complaint in this matter on May 1, 2000. Respondents thereafter requested that we reconsider our exemption decision. We declined and remanded the matter to the Hearing Panel for consideration of this action.

The Hearing Panel issued its decision in this matter on February 8, 2001. The Hearing Panel determined that, as of July 30, 1999, the requirements of the Taping Rule applied to Ross and that respondents had violated the Taping Rule by failing to install a tape-recording system.¹²

On March 26, 2001, respondents requested that we stay Ross' obligation to install a tape-recording system pending appeal of this matter to the NAC. We stayed the Hearing Panel decision, as provided by Procedural Rule 9311,¹³ but we determined that the stay did not extend to the application of the Taping Rule to the respondents, and we declined to impose a stay for any other reason. Respondents requested that we reconsider and reverse our decision. We declined.

On June 15, 2001, Enforcement filed a second complaint against Michelin and Ross for their continued failure to install a tape-recording system. That complaint is not the subject of this appeal.

¹⁰ As currently drafted, subsection (b)(2)(xi) of the Taping Rule (Conduct Rule 3010(b)(2)(xi)) states that NASD Regulation may exempt any member unconditionally or on specified terms from the requirements of the Taping Rule upon a satisfactory showing that the member's supervisory procedures ensure regulatory compliance.

¹¹ When we considered Ross' appeal of an exemption denial, we based our review on the requirement for exemption in the Taping Rule, i.e., that NASD Regulation may exempt a member only upon a satisfactory showing that the member's supervisory procedures ensure regulatory compliance.

¹² The Hearing Panel censured respondents and imposed a \$24,000 joint and several fine.

¹³ Procedural Rule 9311(b) provides that the appeal to the NAC of a Hearing Panel decision shall operate as a stay of that decision.

Discussion

After a thorough review of the record, we affirm the Hearing Panel's findings of violation. We find that, as of July 30, 1999, CRD indicated that four of the 19 registered persons associated with Ross previously had been employed by a disciplined firm, thereby triggering the application of the Taping Rule. Although we uphold the Hearing Panel's findings of violation, we find, based on the unique facts and circumstances of this case and the evidence that respondents presented during the course of this proceeding, that respondents' violation is technical in nature and that implementation of the Taping Rule's requirements is not warranted going forward.

Neither party disputes that, according to CRD, on July 30, 1999, Siemens was registered as a general securities principal and representative. The parties do, however, disagree as to whether Siemens was physically present at Ross and engaged in the Firm's investment banking and securities business on that date. We find that he was not. Siemens tendered a letter of resignation to Ross on June 21, 1999, and he never returned to the Firm's premises after that date. The Hearing Panel credited Michelin's and Siemens' testimony in this regard. We affirm the Hearing Panel's determination. The credibility determinations of the initial fact-finder are entitled to considerable weight and deference particularly where, as here, the Hearing Panel had the opportunity to hear the testimony and observe the witnesses' demeanor. See Christopher J. Benz, 52 S.E.C. 1280 (1997) (credibility determinations of the initial decision maker are entitled to deference, since they are based on hearing the testimony and observing the witnesses' demeanor); Jonathan Garrett Ornstein, 51 S.E.C. 135 (1992) (same). Moreover, their testimony on this point is consistent with substantial evidence that respondents produced in this proceeding, including Siemens' letter of resignation, Siemens' agreed-upon term of employment, and the termination date indicated on the Form U-5 that Ross belatedly filed for Siemens. In addition, the evidence demonstrates that Siemens did not receive commissions after he left the Firm. Further, Enforcement did not provide any evidence to contradict Michelin's and Siemens' testimony or otherwise demonstrate that Siemens performed any functions at Ross subsequent to June 21, 1999. We therefore conclude that Siemens was not present on the premises of Ross and was not engaged in the investment banking or securities business for Ross on or after June 21, 1999. See Helene R. Schwartz, 51 S.E.C. 1207 (1995) (credibility determinations of the initial decision maker can be rejected only where the record contains substantial evidence to the contrary).¹⁴

¹⁴ We are mindful of the fact that, absent formal termination of Siemens' registration through Ross' submission of a Form U-5, Siemens remained eligible to perform (or resume performing) all the functions of a registered representative at any time, and we do not condone in any way Michelin's late filing of Siemens' Form U-5. Nonetheless, Enforcement presented no evidence of Siemens' activity in the capacity of a registered representative after June 21, 1999, and Ross and Michelin demonstrated that Siemens left the Firm on June 21, 1999 and never returned.

We turn now to the pivotal issue in this case -- the significance, for purposes of interpreting the Taping Rule, of these facts: (1) that Siemens was not engaged in the investment banking or securities business of Ross and was not physically present at Ross on or after June 21, 1999; and (2) that Siemens' securities industry registration, as indicated on CRD, showed that he was employed by Ross until Ross' March 2000 filing of a Form U-5.

We start with a review of the language of the Taping Rule. The Rule states, in pertinent part:

Rule 3010. Supervision

(b) Written Procedures

(viii) The following members shall be required to adopt special supervisory procedures over the telemarketing activities of their registered persons:

A firm with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been employed by one or more [d]isciplined [f]irms within the last three years;

(ix) For purposes of this Rule, the term "**registered person**" means any person registered with the Association as a representative . . . pursuant to the **Rule 1030 Series. . . .**

Rule 1031 states, in pertinent part:

Rule 1031. Registration Requirements

(a) All Representatives Must Be Registered

All persons engaged or to be engaged in the investment banking or securities business of a member who are to function as representatives shall be registered as such with the Association in the category of registration appropriate to the function to be performed A member shall not maintain a representative registration with the Association for any person (1) who is no longer active in the member's investment banking or securities business, (2) who is no longer functioning as a representative, or (3) where the sole purpose is to avoid the examination requirement prescribed in paragraph (c)

(b) Definition of Representative

Persons associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member . . . are designated as representatives.

Respondents argue that the Taping Rule, by referring to the Rule 1030 Series in conjunction with its definition of "registered person," requires that an individual be engaged in the investment banking or securities business of a member in order to be a "registered person" for purposes of the Rule. We do not agree. The plain language of the Rule defines "registered person" as a person registered in any capacity pursuant to various rule series, including the series applicable here, the Rule 1030 Series. According to CRD, Siemens was, without question, registered pursuant to Rule 1031 on July 30, 1999. Siemens' status as a "registered person" on July 30, 1999 is unaffected by his employment status or by whether he was actively engaged in the Firm's investment banking or securities business on that date.

Subparagraph (b)(2)(viii) of the Taping Rule establishes tape-recording requirements based on member firms' rosters of registered persons. The Rule does not require that, in order to trigger the Rule, the pertinent individuals (registered persons who previously had been employed by disciplined firms) also must be actively employed by and engaged in the investment banking or securities business of the member firm. The Taping Rule simply refers to the status of the individuals at issue as "registered." Our interpretation of the Taping Rule is consistent with the language of the Rule.¹⁵ On July 30, 1999, CRD listed Siemens as a registered person at Ross. Regardless of whether Siemens had resigned from Ross as of that date, as indicated on CRD, Siemens was registered with Ross on July 30.

Our interpretation of the Taping Rule also is consistent with NASD Regulation's policy of holding member firms responsible for notifying the NASD promptly of changes in their rosters of registered persons. Article V, Section 3 of the NASD By-Laws provides that member firms must give notice to the NASD of the termination of the association of a registered person within 30 days of the termination. Furthermore, Rule 1031(a) prohibits member firms from maintaining the registration of individuals who are

¹⁵ See Thomas Jefferson University v. Shalala, 512 U.S. 504, 129 L.Ed. 2d 405, 114 S. Ct. 2381 (1994) (an agency's interpretation of its own regulations must be given controlling weight if not inconsistent with the regulation or plainly erroneous); City of Aurora v. Hunt, 749 F.2d 1457 (10th Cir. 1984) (courts must respect an agency's reasonable interpretation of its own rules, even if the interpretation is not the only interpretation permitted by the rule's language); National Labor Relations Board v. U.S. Postal Service, 827 F.2d 548 (9th Cir. 1987) (the construction of a statute by those charged with its execution should be followed unless there are compelling indications that it is wrong).

no longer functioning as representatives or active in the member's business. As a registered person, Michelin was chargeable with knowledge of these NASD Rules. Jay Frederick Kutor, 50 S.E.C. 1128 (1992). Michelin chose to ignore these rule requirements. By postponing the filing of Siemens' Form U-5 in the hope that Siemens would return to the Firm, Michelin exposed Ross to the potential implications of maintaining Siemens' registration, *i.e.*, that Siemens would be counted as one of Ross' registered representatives on July 30, 1999.¹⁶

Moreover, although not part of the complaint in this case, a firm's failure to file a Form U-5 in a timely manner is a violation of NASD rules. Depending on the seriousness of the offense, untimely filings of Forms U-5 can result in substantial fines and suspensions. See NASD Sanction Guidelines at 75-76 (2001 ed.) (in egregious cases of late filings, consider suspending the firm from all solicited retail business for up to 20 business days).

Our interpretation also is consistent with NASD Regulation's undertakings in connection with adopting the Taping Rule. When NASD Regulation announced the adoption of the Taping Rule, it advised the membership that staff intended to provide member firms with all the information that they would need to determine whether they were subject to the requirements of the Rule. NASD Regulation advised the membership that staff would determine monthly which firms were subject to the Rule and notify those firms. See NASD Notice to Members 98-52 (SEC Approves Taping Rule); Exchange Act Rel. No. 39883 (April 17, 1998) (Order Granting Approval of Proposed Rule Change). Our interpretation is consistent with this undertaking. Because NASD Regulation does not have sufficient resources to investigate each member firm every month to determine if it has triggered the application of the Taping Rule, NASD Regulation must be able to rely solely on the information contained in CRD.

Furthermore, NASD Rule 0113 provides that the Association's rules shall be interpreted so as to "aid in effectuating the purposes and business of the Association . . ." Our interpretation of the Taping Rule, which enables NASD Regulation staff routinely and efficiently to determine which firms have triggered the application of the Rule and to notify those firms, aids in effectuating the regulatory purposes of the Association.

In sum, we find, for purposes of the Taping Rule, that Siemens was a registered person at Ross on July 30, 1999. Therefore, as of that date, Ross was subject to the Taping Rule's heightened supervisory procedures. By failing to install a tape-recording

¹⁶ As a registered person, Michelin also should have been familiar with NASD Regulation's long-standing policy of determining the date of termination of an individual's registration for jurisdictional purposes by the date of the NASD's receipt of a Form U-5, not the date of termination of the individual's employment. E.g., Donald M. Bickerstaff, 52 S.E.C. 232 (1995); Richard Greulich, 50 S.E.C. 216 (1990). Our interpretation here is consistent with this policy.

system, Ross violated the Taping Rule (Conduct Rule 3010(b)(2)) and Conduct Rule 2110. See Stephen J. Gluckman, Exchange Act Rel. No. 41628 (July 20, 1999) (violation of another NASD or SEC rule or regulation constitutes a violation of Rule 2110).¹⁷

Sanctions

In light of our finding that respondents violated the Taping Rule, we censure respondents and fine them \$10,000, jointly and severally.¹⁸

Michelin's actions caused respondents to violate the Taping Rule, and we hold respondents responsible for the violation of the Taping Rule. Moreover, although we conclude that respondents' violation is technical in nature, we also find that certain aggravating factors exist that make the imposition of these sanctions appropriate. Michelin intentionally waited to file Siemens' Form U-5 because he hoped that Siemens would decide to return to Ross. When Ross requested an exemption from the requirements of the Taping Rule, Michelin misrepresented Siemens' status by claiming that Siemens was on leave of absence, and he did not seek to mitigate the situation by filing Siemens' Form U-5 at that time. When Michelin appealed the exemption denial, he stated that he intended to file a Form U-5, but as of that date (January 3, 2000), he still had not filed Siemens' Form U-5. Indeed, Michelin did not actually file the Form U-5

¹⁷ Respondents argue that, by pursuing this action, NASD Regulation staff has demonstrated bias against the Firm. We find no evidence in the record that NASD Regulation staff acted improperly. In any event, the Hearing Panel, not NASD Regulation staff, made the findings of violation, and we, not NASD Regulation staff, have reviewed those findings. See Frank J. Custable, Jr., 51 S.E.C. 855 (1993) (bias on the part of NASD staff does not mean that disciplinary decision is biased, since staff does not make decision).

¹⁸ Effective April 2001, NASD Regulation revised the NASD Sanction Guidelines. The revised Guidelines include a guideline for violations of the Taping Rule. See NASD Sanction Guidelines at 105 (2001 ed.). The Hearing Panel rendered its decision in this matter in February 2001. The version of the Guidelines that existed as of February 2001 did not include a sanction guideline for violations of the Taping Rule. As such, the Hearing Panel relied on the guidelines for supervision failures. See NASD Sanction Guidelines at 89 (1998 ed.). Since the Hearing Panel relied on the 1998 edition of the Guidelines, we too consulted the 1998 edition. In that we find respondents' violation to be technical and not egregious, the sanctions are within the range suggested in the applicable guidelines. See NASD Sanction Guidelines (1998 ed.) at 89 (Supervision -- Failure to Supervise); 90 (Supervisory Procedures -- Deficient Written Supervisory Procedures).

until March 16, 2000, because he had hoped to convince Siemens to return to the Firm. Ross violated the Taping Rule because of Michelin's purposeful inaction.¹⁹

We turn now to the issue of whether we should relieve Ross of the requirements under the Taping Rule, including that it tape record all telephone conversations between its registered persons and both existing and potential customers, and comply with all related record-keeping and retention requirements. First, while we find that Michelin intentionally waited to file Siemens' Form U-5, we also find that Michelin did not seek to circumvent the Taping Rule. We credit his contention that he failed timely to file Siemens' Form U-5 because he had hoped that Siemens would reconsider his resignation, and we find that Michelin had not considered the ramifications of his untimely filing. Second, although we find that Ross fell within the parameters of the Taping Rule on July 30, 1999, we do not find that the application of the Rule to these respondents at this time furthers the purpose of the Rule, which is to prevent sales practice abuses at firms that have hired significant numbers of individuals from disciplined firms.

Accordingly, based on the unique facts of this case, the technical nature of respondents' violation of the Taping Rule, and that the application of the requirements under the Rule to the Firm at this time would not further the purposes of the Rule, we order that respondents do not need to comply with the requirements of the Taping Rule prospectively.²⁰ We emphasize that we do not in any way condone Michelin's late filing of Siemens' Form U-5. As noted earlier, a firm's failure to file a Form U-5 in a timely manner is a violation of NASD rules and can result in substantial sanctions. Michelin's late filing of a Form U-5, however, was not alleged in this case. Because we are not fining Ross for the late filing of a Form U-5, we have modified the sanctions imposed by the Hearing Panel by reducing the fine to \$10,000 from \$25,000. We also reduce the fine in light of our conclusion that respondents' violation is technical in nature and that the Rule was not designed to address this fact pattern.

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¹⁹ The case before us today is substantially different from Ross' appeal of an exemption denial. Our focus during our consideration of Ross' exemption appeal was on Ross' supervisory procedures rather than on Siemens' activities (or lack thereof) at the Firm, since Ross had not yet filed Siemens' Form U-5 and did not present evidence of Siemens' resignation. We now know, however, that Siemens effectively resigned from Ross on June 21, 1999 and that Michelin did not timely file Siemens' Form U-5.

²⁰ Our order that Ross need not comply with the requirements of the Taping Rule is strictly limited to the facts presented and the allegations made in this case. Our order does not apply to any triggering of the requirements of the Taping Rule by Ross after the events at issue in this complaint or in the future.

In sum, given the extraordinary circumstances present in this case and the nature of respondents' violation, we conclude that it would not be beneficial, going forward, to require Ross to incur the expense of installing a tape-recording system. Accordingly, Ross and Michelin each are censured and fined \$10,000, jointly and severally.²¹

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary

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²¹ 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.