

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of	<u>DECISION</u>
Department of Enforcement,	Complaint No. C01000037
Complainant,	November 27, 2002
vs.	
Pacific On-Line Trading & Securities, Inc. San Jose, CA	
and	
Timothy Alan McAdams San Jose, CA,	
Respondents.	

**Respondents failed to file Pacific On-Line's Internet website with NASD as advertising material when Pacific On-Line became an NASD member, and the website omitted material information and contained misleading communications. Held, findings of violation affirmed, but sanctions modified.**

**Appearances**

For the Complainant Department of Enforcement: David A. Watson, Esq., NASD  
Department of Enforcement.

For the Respondents Pacific On-Line Trading & Securities, Inc. and Timothy Alan  
McAdams: M. Van Smith, Esq.

**Opinion**

Respondents Pacific On-Line Trading & Securities, Inc. ("Pacific On-Line" or "the Firm") and Timothy Alan McAdams ("McAdams") (collectively, the "Respondents") appeal a December 7, 2001 decision of an NASD Hearing Panel. The Hearing Panel held

that the Respondents violated NASD Rule 2210(c)(3)(A) (Communications With the Public),<sup>1</sup> and Rule 2110 by failing to file an Internet website with NASD's Advertising Regulation Department ("Advertising Department"). The Hearing Panel also found that the website used by the Respondents was misleading and violated NASD Rules 2210(d) and 2110.

We affirm the Hearing Panel's findings of violation, but modify the sanctions. We order that Pacific On-Line be censured and that the Respondents be jointly and severally fined \$2,500 for failing to file Pacific On-Line's website with NASD as advertising material. We also censure McAdams, order him to requalify as a general securities principal, and fine the Respondents \$20,000 jointly and severally for using a misleading website from January 7, 1999 through March 18, 1999 and on October 5, 1999. We also assess hearing costs and appeal costs on the Respondents.

## **I. Background**

McAdams became a registered general securities representative with Terra Nova Trading, L.L.C. ("Terra Nova") in May 1997. Prior to that time, he was not involved in the securities industry.<sup>2</sup> In April 1998, McAdams became a general securities principal with Terra Nova. In 1997, he incorporated two entities: (1) Electronic Day Trading Services Incorporated ("EDT"),<sup>3</sup> a corporation designed to teach people the basic fundamentals of on-line trading; and (2) Pacific On-Line, an on-line trading firm in San Jose, California<sup>4</sup> that became registered as a branch of Terra Nova in April 1998. McAdams submitted a broker-dealer application with NASD on behalf of Pacific On-Line in June 1998. Since January 7, 1999, when Pacific On-Line's registration as an NASD member became effective, McAdams has served as the Firm's President, Chief Executive Officer, Chief Financial Officer, Chief Operating Officer, Chief Compliance Officer, and general securities principal.

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<sup>1</sup> Rule 2210 has subsequently been amended and the applicable subsection has been renumbered as Rule 2210(c)(4)(A). For the purposes of this decision, we will refer to Rule 2210(c)(3)(A) as it applied at the time of the December 7, 2000 complaint.

<sup>2</sup> McAdams previously had owned a commercial printing company for 20 years.

<sup>3</sup> EDT is owned by McAdams and his wife, who serves as EDT's president.

<sup>4</sup> Until March 18, 1999, Pacific On-Line was known as Pacific Day Trading, Inc. For purposes of this decision, Pacific On-Line will also refer to Pacific Day Trading, Inc.

## **II. The Complaint**

On December 7, 2000, NASD's Department of Enforcement ("Enforcement") filed a three-cause complaint against four respondents, alleging advertising violations related to Pacific On-Line's website.<sup>5</sup> This decision involves only two of the four respondents, McAdams and Pacific On-Line, and two of the three causes of the complaint.<sup>6</sup>

McAdams created the website ("the Original Website") at issue in the complaint for Pacific On-Line in November 1997. The complaint alleged that the Original Website was used during three separate periods: (1) from November 1997 to January 7, 1999; (2) from January 7, 1999 through March 18, 1999; and (3) on October 5, 1999.<sup>7</sup>

Cause two of the complaint alleged that Pacific On-Line, acting through McAdams, failed to file the website with NASD's Advertising Department, but nonetheless used the Original Website as a website advertisement from January 7, 1999, when Pacific On-Line became a registered broker-dealer with NASD, until March 18, 1999. Cause two alleged that this conduct violated NASD Rules 2210(c)(3)(A) and 2110.

Cause three of the complaint alleged that the Original Website used by the Respondents from January 7 through March 18, 1999, and on October 5, 1999, violated Rules 2210(d) and 2110 and was false and misleading because it omitted material information concerning the risks of day-trading and contained six exaggerated, unwarranted, or false statements.

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<sup>5</sup> The complaint arose from NASD's initial examination of Pacific On-Line in March 1999.

<sup>6</sup> Cause one of the complaint, which contained allegations against Terra Nova and its former president, Gerald D. Putnam ("Putnam"), was settled by an offer of settlement accepted by the NAC on September 6, 2001.

<sup>7</sup> The parties have agreed that the only difference between the Original Website and the website available on October 5, 1999 was that the website in October contained a seminar calendar that had been updated for Fall of 1999. For the purpose of clarity, we will therefore refer to all of the Pacific On-Line websites at issue in the complaint as the Original Website.

### **III. Facts**

In November 1997, McAdams created the Original Website for EDT and Pacific On-Line. The Original Website was a portal and included two sub-sites – the EDT site and the Pacific On-Line site. Each of the pages on the EDT sub-site had a hyperlink to the Pacific On-Line sub-site, and each of the pages on the Pacific On-Line sub-site had a hyperlink to the EDT sub-site. McAdams submitted the Original Website to Terra Nova for its approval. The Original Website became operational after Terra Nova approved it.<sup>8</sup>

In April 1998, Pacific On-Line became a branch office of Terra Nova and McAdams amended the Original Website to reflect Pacific On-Line's designation as a branch office. McAdams made no other changes to the Original Website at that time. McAdams testified that from 1997 through 1998, he considered himself to be an employee of Terra Nova and he relied on Terra Nova to comply with NASD rules and regulations.

In June 1998, McAdams submitted a broker-dealer application for Pacific On-Line to NASD. On December 6, 1998, NASD notified the Respondents that Pacific On-Line would become a member of NASD in 30 days.

Pacific On-Line's registration as an NASD broker-dealer became effective on January 7, 1999. McAdams testified, however, that Pacific On-Line did not act as its own broker-dealer, but rather continued to operate as a branch office of Terra Nova from January through March 1999. During that time, Pacific On-Line maintained the Original Website.

In March 1999, NASD examiner LeVasseur ("LeVasseur") supervised the initial examination of Pacific On-Line, including a review of material that Pacific On-Line published on the Internet. In connection with the examination, LeVasseur used an Internet search engine to locate the website that appeared when he inserted Pacific On-Line's name. That search led LeVasseur to the Original Website, which he downloaded and sent to NASD's Advertising Department for review. LeVasseur also testified that he told McAdams that Pacific On-Line had to comply with NASD's advertising rules. The exit conference summary form from the initial examination stated that "[s]taff will be forwarding the firm's web-sites and sales literature for further review by . . . the Advertising Department regarding firm disclosures, representations, and pre-filing review submissions."

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<sup>8</sup> The record shows that Terra Nova's compliance officer approved the Original Website. Terra Nova's President admitted that Terra Nova had not filed the Original Website with NASD.

Shortly before the exit conference, on March 22, 1999, McAdams filed a new and improved website ("the Revised Website") with NASD's Advertising Department for approval.<sup>9</sup> The Revised Website was substantially different from the Original Website; it had much greater functionality, included risk disclosures concerning on-line trading, and did not contain any of the allegedly misleading statements that are at issue in the complaint. In a letter dated April 13, 1999, NASD's Advertising Department staff notified Pacific On-Line that the Revised Website was approved for use, with certain changes.

In August 1999, NASD's Advertising Department staff telephoned LeVasseur regarding Pacific On-Line's Original Website, which LeVasseur had submitted for review in March 1999. Following this call, LeVasseur used an Internet search engine, located Pacific On-Line's website, and found that the Original Website was still in operation. On October 5, 1999, LeVasseur again located Pacific On-Line's website, and again found that it was virtually identical to the Original Website.

On October 5, 1999, Advertising Department staff and staff from NASD's District 1 office telephoned McAdams, advised him that Pacific On-Line's website was unacceptable, and directed him to take the website down within 48 hours. NASD Advertising staff also sent a confirming letter to the Respondents on October 5, 1999, that specifically discussed why NASD staff believed that the Original Website failed to comply with the Communications With the Public Rule. McAdams immediately complied with this request and removed the website from the Internet.<sup>10</sup>

#### **IV. Discussion**

Based on our review of the record and the briefs on appeal, we uphold the findings of violation as to both causes. First, we find that the Respondents violated Rules 2210 and 2110 by failing to file the Original Website with NASD after Pacific On-Line

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<sup>9</sup> McAdams testified that this submission did not result from advice he received from LeVasseur about Pacific On-Line being required to comply with NASD advertising rules. Rather, he stated that at that time in March 1999, coincidentally, Pacific On-Line had received all of its outstanding state registrations, and he had determined that Pacific On-Line would cease operating as a branch office of Terra Nova and act solely as its own broker-dealer. He testified that he thus independently reached the conclusion that Pacific On-Line had to begin complying with NASD's advertising rules.

<sup>10</sup> McAdams testified that he later received permission from NASD staff to place the Revised Website back up on the Internet and that he confirmed this in an October 8, 1999 letter to NASD staff. The record indicates, however, that the person from whom McAdams claimed to have received such permission denied giving permission.

became an NASD member. Second, we find that the Original Website failed to disclose the risks of on-line trading and contained misleading statements.

A. The Respondents Violated Rules 2210 and 2110 by Failing to File the Pacific On-Line Website With NASD After Pacific On-Line Became an NASD Member Firm

Rule 2210(c)(3)(A) requires any member that has not previously filed advertisements with NASD to file its initial advertisement at least 10 days prior to use and to continue to file its advertisements at least 10 days prior to use for one year. Article I(q) of NASD's By-Laws defines a member as any "broker or dealer admitted to membership in the NASD."

There is no dispute here that Pacific On-Line became a member of NASD on January 7, 1999. There is also no dispute that the Respondents did not comply with the pre-use filing requirements of Rule 2210(c)(3)(A) for the Original Website from January through March 1999. The Respondents argue, however, that they did not commit any violations because the Original Website was not under their control during that time and was not their "initial" website. The Respondents maintain that Pacific On-Line did not hold itself out as its own broker-dealer from January through March 1999 because it had not yet received all of its state registrations. Accordingly, the Respondents contend that, from January through March 1999, Pacific On-Line should not be treated as a member of NASD for the purposes of Rule 2210 because the Firm continued to function as a branch office of Terra Nova during that time and Terra Nova was responsible for filing websites with NASD.

We find that the record does not support the Respondents' arguments. Pacific On-Line became a registered member of NASD on January 7, 1999. In addition, McAdams' statements and conduct show that Pacific On-Line ceased to act as a Terra Nova branch office at that time. In January 1999, McAdams executed an NASD membership agreement on behalf of Pacific On-Line, established \$5,000 of net capital in the Firm's account, and started filing FOCUS reports for Pacific On-Line. Further, in a September 13, 1999 letter to NASD staff, McAdams stated: "In January 1999, [Pacific On-Line] became its own broker/dealer entity and [McAdams] stopped forwarding documents to Terra Nova for their [sic] approval." McAdams also represented in a November 1, 1999 letter to NASD staff that "[f]rom January 1999 to the present, [Pacific On-Line] has been using the website and all other sales literature referenced as a separate broker/dealer and not as a branch office of Terra Nova." We find that McAdams' signing of the membership agreement, his filing of FOCUS reports, and his later letters contradict the Respondents' contention that the Firm remained a branch office of Terra Nova.

We also note that even if McAdams had believed that Pacific On-Line was dually registered by continuing to act as a branch office of Terra Nova while being admitted to membership on its own behalf, McAdams should have known that Pacific On-Line was

obligated to comply with NASD rules. McAdams was President of Pacific On-Line and its sole principal and therefore he was responsible for ensuring that the Firm was in compliance with all of NASD's rules. See Gary E. Bryant, 51 S.E.C. 463, 470-471 (1993).<sup>11</sup>

Accordingly, we find that Respondents violated Rules 2210 and 2110 by failing to file the Original Website with NASD after the Firm became a member of NASD on January 7, 1999. As of that date, the Original Website was an "initial advertisement" for Pacific On-Line that the Firm was required to file with the Advertising Department. The Respondents were not free to select which NASD rules they would follow, such as deciding to file FOCUS reports but ignoring advertising rules. Instead, Pacific On-Line was subject to all of the rules and requirements that accompany NASD membership.

**B. The Respondents Were Responsible for Maintaining the Original Website From January 7 Through March 18, 1999 and on October 5, 1999**

The complaint alleged that the Respondents maintained a misleading website from January 7 through March 18, 1999, and on October 5, 1999. As set forth above, we already have found that Pacific On-Line became responsible for the Original Website when Pacific On-Line became a member of NASD on January 7, 1999. That responsibility continued through March 18, 1999, when NASD examiners downloaded Pacific On-Line's website and discovered that the Original Website was still in operation.

In their pre-hearing brief and at the hearing before the Hearing Panel, the Respondents contended that Pacific On-Line had designed the Revised Website, which it had submitted for NASD's approval on March 22, 1999. The Respondents maintained that they had received comments about the Revised Website from NASD's Advertising Department staff on April 13, had made all of the suggested revisions, and had been continuously running the Revised Website for Pacific On-Line since April 1999.<sup>12</sup>

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<sup>11</sup> McAdams testified that his outside compliance consultant told him that Pacific On-Line did not have to follow the advertising rules while it was acting as a branch office of Terra Nova. We have taken this alleged reliance into consideration in our discussion of sanctions below. As to the violation alleged in cause two, however, we find that as President of the Firm, McAdams was responsible for knowing the applicable NASD rules.

<sup>12</sup> The NAC Subcommittee denied Respondents' pre-hearing motion to adduce evidence on appeal in the form of a live demonstration of the functioning of the Revised Website. We affirm the Subcommittee's determination that such evidence is not material to the consideration of this matter. The record contains a downloaded and printed copy

According to the Respondents, the Original Website's appearance on the Internet on October 5, 1999 was inadvertent and was caused by a web host server crash and Pacific On-Line's web host's subsequent erroneous posting on the Internet of the Original Website, rather than the Revised Website.

We conclude that the record shows that the Respondents, and not the web host, were responsible for the Original Website being operational on October 5, 1999. Other than his own testimony, McAdams did not adduce any documentary or testimonial evidence to support his argument that the web host had inadvertently used an obsolete back-up tape of the Original Website in October 1999.<sup>13</sup> McAdams also did not offer any evidence, beyond his own testimony, to show that the Revised Website was available on the Internet starting in April 1999.

Moreover, McAdams did not assert, in writing,<sup>14</sup> his claim that the web host server crashed until he filed his pre-hearing brief in June 2001, only three weeks in advance of the hearing before the Hearing Panel. The record shows that McAdams had numerous opportunities prior to that time to explain the alleged web host crash. McAdams participated in a conference call with NASD staff on October 5, 1999, during which NASD staff informed him that the Original Website was unacceptable and had to be taken down immediately. McAdams never suggested during that call that the web host server had crashed. Before the Hearing Panel, McAdams testified that he was confused during that call and was not sure which website NASD staff was critiquing – the Original Website or the Revised Website. McAdams also testified, however, that after the telephone call he looked on the Internet, found that the Original Website was displayed for Pacific On-Line, and discovered later in the day on October 5, 1999 that the web host server crash had occurred. Yet he did not contact NASD staff and tell them about the alleged web host server crash.

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of the Revised Website, as well as the Original Website. A live demonstration of the website therefore would have been cumbersome and cumulative, but not material.

<sup>13</sup> The record includes a letter dated October 8, 1999 from EDT to the web host that terminates the service and references a "hosting problem." This letter does not, however, specifically mention a web host server crash or the inadvertent use of an obsolete back-up website.

<sup>14</sup> McAdams testified that he did mention the alleged problem with the web host to an NASD Enforcement staff attorney during a meeting in June 2000. Yet as discussed in more detail above, he did not mention the alleged web host problem again, or set forth that argument in any written response, until the Respondents filed their pre-hearing brief on June 22, 2001.

NASD staff also sent McAdams a letter dated October 5, 1999, that specifically quoted language from the Original Website that staff found to be promissory, exaggerated, and misleading. Those quoted sections appeared only in the Original Website, and not in the Revised Website. McAdams responded to NASD staff in a letter dated October 8, 1999, stating that he had "revised the Website in accordance with [NASD staff's] letter dated October 5, 1999," and had deleted the language at issue. McAdams did not state in that letter that he was confused about which website NASD found to be offensive, and again McAdams did not mention the alleged web host server crash, or the alleged posting of the wrong website on the Internet.

McAdams also responded in writing to further inquiries from NASD staff on November 1, 1999 and November 8, 1999. Neither of those letters referred to a web host problem on October 5, 1999. On June 14, 2000, McAdams responded to NASD staff's letter of June 5, 2000 ("the Wells Letter").<sup>15</sup> In his response letter, McAdams set forth a very detailed "chronology of events" to establish "the salient facts why a formal complaint is not justified." Again, McAdams made no mention of a web host problem in that chronology. The complaint was issued on December 7, 2000. McAdams filed his answer to the complaint on January 3, 2001 and again he did not reference any difficulties with a web host or an incorrect posting of the Original Website.

Enforcement offered a witness in response to McAdams' assertions that the web host was responsible for the inadvertent one day appearance of the Original Website on October 5, 1999. NASD examiner LeVasseur testified that the Original Website was also available on Pacific On-Line's website when he viewed it in August 1999. The Hearing Panel specifically stated that it found LeVasseur's testimony to be credible. The Hearing Panel also assessed the testimony of McAdams on this issue and concluded that the weight of the credible evidence showed that the Respondents, and not the web host, were responsible for the availability of the Original Website on October 5, 1999.<sup>16</sup> The

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<sup>15</sup> A Wells Letter refers to a letter sent by NASD staff notifying a respondent "that a recommendation of formal disciplinary charges is being considered" and it usually provides the respondent with an opportunity to "submit a written statement explaining why such charges should not be brought." NASD Notice to Members 97-55, 1997 NASD LEXIS 77, at \*13 (Aug. 1997).

<sup>16</sup> The Respondents argue that the complaint did not charge them with a violation for the availability of the Original Website in August 1999, and that therefore the Hearing Panel erred in crediting LeVasseur's testimony. We note, however, that Enforcement offered LeVasseur's testimony to impeach McAdams' late-asserted defense and testimony that the Original Website appeared only on one day in October 1999 because the web host had experienced a problem. We find that the Hearing Panel properly considered LeVasseur's testimony in reaching its credibility determination on this issue.

Hearing Panel's assessment of the witnesses' credibility is entitled to considerable weight and can be overcome only where the record contains "substantial evidence" for doing so. Anthony Tricarico, 51 S.E.C. 457, 460 (1993). The Respondents have not identified any such evidence and we affirm this finding.<sup>17</sup> We also find that McAdams' statements to NASD staff and the timing of his raising this argument further support the Hearing Panel's finding.

Accordingly, we find that Pacific On-Line and McAdams were responsible for the availability of the Original Website on October 5, 1999.

C. The Original Website was Misleading

We consider first whether the Original Website was misleading because it created an unbalanced presentation of on-line trading. Second, we examine six specific statements that the complaint alleged were misleading.

1) *There Was No Disclosure of the Risks Inherent in On-Line Trading*

Conduct Rule 2210 prohibits members and associated persons from making exaggerated, unwarranted or misleading statements in their public communications. All public communications must be based upon the principles of fair dealing and good faith, provide a sound basis for evaluating the facts discussed, and not omit material facts or qualifications that would cause the communication to be misleading in light of its context. Conduct Rule 2210(d)(1).

The content of the communication must be accurate and must provide sufficient information to evaluate the facts with respect to the securities products or services discussed. See Brian Prendergast, Complaint No. C3A960033, 1999 NASD Discip. LEXIS 19, at \*14-18 (July 8, 1999) (finding that respondent violated NASD Conduct

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<sup>17</sup> The Respondents argue that other evidence rebutted the finding that the Original Website was available in August 1999. They refer to audits conducted by the Commission and the California Department of Corporations in August 1999, during which the examiners allegedly scrutinized Pacific On-Line's website and commented that the disclosures were adequate. We note that the NAC Subcommittee granted the Respondents' pre-hearing motion to adduce evidence in the form of correspondence from these two regulators to show the dates of their audits and the areas they examined. Yet again, McAdams produced no evidence in this regard other than his own testimony. We have considered McAdams' testimony and, in light of the Hearing Panel's credibility finding and the other evidence in the record, we find that the weight of the evidence is against McAdams.

Rule 2210 by sending customers sales literature that failed to present a balanced statement of the benefits and risks of the investment).

Here, the Original Website contained statements that touted the benefits of on-line trading, including: "Now the individual investor . . . can get into the action . . .;" "Now you have the power to get in or out of the markets in seconds, thereby taking big advantages of short-swing moves in the market." Yet the Original Website contained no risk disclosures about on-line trading, or about investing in general. There was no disclosure of: 1) the risk of loss of funds used in on-line trading; 2) risks that trades would not be executed, or risks associated with volatile stocks; 3) risks that customers would pay high total commissions due to the large volume of trades; or 4) the risk that customers might not have sufficient market knowledge or understanding of how Pacific On-Line's systems worked.

The Respondents acknowledged that the Original Website did not contain any disclosure of the risks of on-line trading. They argued, however, that potential investors received subsequent and separate disclosures of the risks of on-line trading when they either attended the EDT seminars or opened an account. The Respondents contend that at that time, the potential investors received disclaimers and other information pertaining to the risks of on-line trading.

We find that the subsequent dissemination of disclosure information does not cure the misleading nature of the Original Website. Advertisements must be evaluated in the context of the material provided in the advertisement itself. See Sheen Financial Resources, Inc., 52 S.E.C. 185, 190-191(1995). There, the Commission stated that defects in advertisements could not be cured through detailed explanations of risks allegedly made at subsequent seminars. Id. "Advertisements stand on their own when judged against the standards of [advertising sections] of the NASD Rules". Id. (emphasis added).

The Respondents also argued that NASD did not require specific disclosure of the risks of on-line trading until it adopted Day Trading Rules 2360 and 2361, effective October 16, 2000, which was after the date of their alleged violation.<sup>18</sup>

We reject this argument and find that even prior to the adoption of the Day Trading Rules, Rule 2210 required advertisements to present a balanced statement of risks and benefits of any products and services being advertised. See, e.g., Sheen Financial Resources, Inc., 52 S.E.C. 185, 190 (1995) (stating that advertisement's failure

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<sup>18</sup> Notice to Members 00-62 sets forth NASD's adoption of Day Trading Rules 2360 and 2361, which require broker-dealers that promote a day trading strategy to furnish a risk disclosure statement to customers prior to their opening of an account.

to discuss risks specifically associated with investment was misleading); Jay Michael Fertman, 51 S.E.C. 943, 950 (1994) (stating that advertisements must "disclose in a balanced way the risks and rewards of the touted investments."); Donald T. Sheldon, 51 S.E.C. 59, 70 (1992) (finding that published materials that "minimized the increasingly significant risks" of certain bonds was misleading), aff'd, 45 F.3d 1515 (11th Cir. 1995).

Accordingly, we find that the Original Website violated Rules 2210 and 2110 because it was misleading in that it described purported benefits of on-line trading, but failed to provide risk disclosures regarding on-line trading.

2) *The Six Specific Statements From the Original Website That Were Cited in Cause Three of the Complaint Were Misleading*

We have carefully reviewed the Original Website, the statements that were alleged to be misleading, and the testimony of the witnesses with regard to each statement. The standard that we used is what a "reasonable investor" would understand. We find each of the six statements to be misleading for the reasons set forth below.

a) **Statement One**

The first statement that the complaint identified as misleading was: "With [Pacific On-Line] there is less risk because you control your own buy and sell by the second." ("Statement One"). Enforcement's witness on this issue was Thomas Pappas ("Pappas"), the Director of NASD's Advertising Department. Pappas testified that Statement One wrongly implied that investors would have less risk with their investments because they had the opportunity to put in their own orders and make their own decisions about when they wanted to buy and sell. Pappas stated that this was a misleading statement because the risk of the investor sustaining losses remained the same, even if the investors could decide when they wanted to buy and sell.

McAdams testified that Statement One referred only to the risk of a customer being unable to achieve a timely execution of a transaction because he or she could not contact a broker in a timely manner to conduct a trade. The Respondents asserted that they reasonably believed that Pacific On-Line's system was less risky because customers would not have to use a broker. The Respondents' expert, Robert Lowry ("Lowry"), also testified that Statement One referred only to the risk of failure of timely execution. He stated that because there was less risk of failure of execution with Pacific On-Line's system, Statement One was not exaggerated, unwarranted, or misleading.

We affirm the Hearing Panel's finding that Statement One is misleading. It appears in the same section of the Original Website that discusses how much money market makers have been making for years, and how now the individual investor "can get into the action." Given this context, we find that a reasonable investor's understanding of this statement would be that he or she would have less market risk, or less risk of

volatility, neither of which was true. Therefore Statement One is misleading and violates Rules 2210 and 2110.

b) Statement Two

The second statement at issue in the Original Website is:

"Do the math  
1 Point on 1000 shares=\$1000.00  
1 Point average per day=240,000 Annually" ("Statement Two").

Pappas testified that Statement Two contained a promise of specific results for which there was no reasonable basis, which violates Conduct Rule 2210(d)(2)(C). He stated that Statement Two implied that an investor needed to make just one point per day on a 1,000-share trade to net \$240,000 annually. Pappas also stated that Statement Two did not discuss commission fees, or any other fees that might affect the amount that the investor could earn.

McAdams and Lowry both testified that Statement Two referred to the costs of trading, and not to possible trading profits. Lowry stated that because Pacific On-Line's system included real time information, an investor could execute a trade closer to the quoted price and thereby reduce the costs of execution. The Respondents therefore asserted that the "[d]o the math" language in Statement Two was meant to show the increased costs incurred by investors who did not have real time information.

We find that it is more likely that potential investors would reasonably interpret Statement Two to refer to trading profits, and not to costs of transactions. This is particularly true because on the Original Website, Statement Two immediately follows the statement that stockbrokers "have made money doing this for years." Accordingly, we conclude that a customer reasonably would view Statement Two as promising profits for those engaging in on-line trading through Pacific On-Line. Thus, Statement Two is promissory and violates Rules 2210 and 2110.

c) Statement Three

The third statement at issue in the Original Website read as follows: "8 Hours of Professional Instruction, Supervised by NASD Series 24 Registered Principal." ("Statement Three").

Pappas testified that Statement Three violates Rule 2210(d)(2)(J) which prohibits members from using NASD's name or the name of any other regulatory body to imply approval or endorsement. Pappas stated that Statement Three was misleading because NASD was identified in a manner that gave credibility to the service offered.

The Respondents argued that Statement Three only meant that the person supervising the class had a Series 24 registration, and did not imply that NASD endorsed the service provided by EDT. McAdams testified that he wanted potential EDT customers to know that the course was "being taught by somebody who basically understands something of the stock market."

We find that a reasonable investor would read Statement Three to mean that because McAdams is registered as an NASD Series 24, NASD includes topics on the examination that address an applicant's knowledge of on-line trading. Even if we accept McAdams' characterization of the purpose of Statement Three, it is at best ambiguous. It is likely that a reasonable investor, especially one not familiar with NASD's registration system, could read Statement Three as implying NASD endorsement. In addition, we note that the successful completion of a Series 24 examination does not necessarily qualify anyone to teach a course about on-line trading. We therefore conclude that Statement Three violated Rule 2210(d)(2)(J) because it implied that passing an NASD Series 24 principal examination qualifies a principal to instruct others in on-line trading.

d) Statement Four

The fourth statement at issue is: "The fastest Access to the Market today." ("Statement Four"). Subsection (d)(1)(A) of Rule 2210 requires firms to provide readers with a sound basis for evaluating advertising statements. Pappas testified that Statement Four was misleading because the Original Website did not contain any information to allow an investor to evaluate whether this statement was accurate. Pappas therefore stated that the Original Website provided no sound basis for such a statement.

McAdams testified that he made Statement Four based on information he obtained from the software developer and on the configuration of the hardware that McAdams provided to his customers. Lowry testified that Pacific On-Line's program's access to the market compared favorably with his prior experience with a NASDAQ Level II system and that therefore Statement Four was not exaggerated.

We find that Statement Four is misleading because the reader has no basis for evaluating the statement. The Respondents' rationale for making the statement is irrelevant; the focus of the rule is to give the reader a basis for the statement. This provision was designed to ensure that members of the public have sufficient independent information to evaluate claims made in an advertisement. See Dist. Bus. Conduct Comm. v. Daniel C. Montano, Complaint No. C02950050, 1997 NASD Discip. LEXIS 8 (NBCC, Jan. 23, 1997).

e) Statement Five

The fifth statement at issue reads: "Stock Brokers and Market Makers have made money doing this for years, many times at your expense." ("Statement Five"). Pappas

testified that Statement Five was misleading because it implied that customers had been abused by stockbrokers and market makers who used electronic systems. Pappas stated that Statement Five was an exaggeration because it failed to disclose that some stockbrokers and market makers had been losing money using electronic systems and it failed to disclose that customers also could lose money using electronic systems.

McAdams testified that he intended only for Statement Five to make customers understand that Pacific On-Line had a system that was similar to the one that market makers had used for years to make money.

We find that Statement Five is misleading because it fails to discuss the fact that regular customers and stockbrokers can lose money using electronic systems and because it implies that customers will have the same access to the market as stockbrokers and market makers. In this regard, we note that McAdams admitted before the Hearing Panel that Pacific On-Line's on-line trading customers would not have the same capability as that of market makers and stockbrokers.

f) Statement Six

The sixth and final statement at issue is: "Pacific Day Trading, Inc. is a branch of Terra Nova Trading, LLC." ("Statement Six"). Pappas testified that Statement Six was misleading because Pacific On-Line was a broker-dealer as of January 7, 1999, and not a branch office of Terra Nova.

The Respondents again argued that they believed Statement Six was true from January 7 through March 18, 1999 because Pacific On-Line was operating as a branch office of Terra Nova. The Respondents admitted, however, that on October 5, 1999, Statement Six was false.

We find that Statement Six was misleading from January 7 through March 18, 1999 and on October 5, 1999. As noted, the Respondents admit that Statement Six was false on October 5, 1999. As to the earlier period, the Original Website only identified Pacific On-Line as a branch office of Terra Nova. We have previously found that Pacific On-Line was an NASD broker-dealer, subject to all rules of NASD, as of January 7, 1999. Thus, regardless of the Respondents' purported belief as to the Firm's status, Pacific On-Line was a broker-dealer, and the language of Statement Six could be read by a reasonable investor to say that Pacific On-Line was not a broker-dealer.

Publishing an advertisement that does not conform to the requirements of Rule 2210 is inconsistent with high standards of commercial honor and just and equitable principles of trade. See Steven B. Theys, 51 S.E.C. 473, 480 (1993) ("the NASD may properly find . . . violations of these, or any other sections of the [NASD] Rules, to be inconsistent with just and equitable principles of trade, in contravention of [Rule 2110] thereof"). Accordingly, we find that the Respondents violated Rules 2210 and 2110.

E. Sanctions

NASD's Sanction Guidelines ("Guidelines") governing communications with the public recommend that failure to file an advertisement warrants a fine ranging from \$1,000 to \$15,000. The particular considerations applicable to establishing a fine for violations of this rule are: (1) whether the failure to file was inadvertent; (2) whether the communication with the public was widely circulated; and (3) whether an individual respondent failed to notify a supervisor of the communication with the public.

In reaching an appropriate sanction, we have considered certain mitigating circumstances with regard to this cause of complaint. Terra Nova was responsible for filing the Original Website when it was first developed in November 1997. The record shows that McAdams submitted the Original Website to Terra Nova and received approval from Terra Nova personnel. McAdams also testified that he reasonably believed that Terra Nova had filed the Original Website with NASD and had received approval. Further, McAdams testified that he believed that Pacific On-Line was operating only as a branch office of Terra Nova from January 7 through March 18, 1999 and that he consulted with his outside compliance consultant, and she advised him that Pacific On-Line did not have to file advertising with NASD while the Firm continued as a branch office of Terra Nova.

In light of these factors, we conclude that a fine at the low end of the Guidelines for cause two is appropriate. Accordingly, for failing to file their advertisement before it was published, the Respondents are jointly and severally fined \$2,500, and Pacific On-Line is censured.

The Guidelines governing cause three's allegations of misleading communications with the public recommend a fine ranging from \$1,000 to \$20,000 for inadvertent use of misleading communications, or a fine ranging from \$10,000 to \$100,000 for intentional or reckless use of misleading communications. The Guidelines list the principal consideration for establishing the amount of the fine as whether the violative communications with the public were circulated widely.

The Guidelines provide that a determination of appropriate sanctions is based on whether the violation was inadvertent, or intentional or reckless. Here, we conclude that McAdams' dissemination of misleading communications was inadvertent, rather than intentional. The record suggests that McAdams did not understand the implications of the language he included in the Original Website. He also did not seem to fully appreciate his responsibility as the President of Pacific On-Line to ensure that communications with the public were balanced, and not misleading. Moreover, McAdams also demonstrated that he provided fuller and more balanced information to potential customers at seminars, and prior to the opening of any new customer on-line account. We find that McAdams' subsequent distribution of risk disclosure material to

potential Pacific On-Line customers indicates that his violations were inadvertent, and were mitigating for the purposes of sanctions. See Thomas S. Foti, 51 S.E.C. 217, 222 (1992). We also considered that there was no showing of demonstrable harm or injury to the investing public from the Respondents' misconduct. See Daniel C. Montano, 53 S.E.C. 681, 690 (1998).

We balance these mitigating factors, however, against the aggravating factors present here, namely that the omissions and the misleading statements included in the Original Website were serious and had the potential to be widely viewed by the public over the Internet. We also consider McAdams' continued refusal to appreciate that the Original Website he drafted was misleading. We find that this refusal, along with the serious errors McAdams made in drafting the Original Website, support the affirmance of the Hearing Panel's requirement for McAdams to requalify as a general securities principal. For these reasons, we increase the sanctions imposed by the Hearing Panel and impose sanctions in the higher range of the applicable guideline for inadvertent use of misleading communications. Thus, for cause three we hereby fine the Respondents \$20,000, jointly and severally, censure McAdams, and require McAdams to requalify as a general securities principal.

Accordingly, for cause two, Pacific On-Line is censured and the Respondents are jointly and severally fined \$2,500. For cause three, McAdams is censured and required to requalify as a general securities principal, and the Respondents are jointly and severally fined \$20,000, jointly and severally.<sup>19</sup> The Respondents are also ordered to pay appeal transcript fees of \$389.50, \$1,000 in appeal costs, and the costs for the Hearing Panel proceeding below.<sup>20</sup>

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President  
and Corporate Secretary

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<sup>19</sup> The recommended sanctions are consistent with the applicable NASD Sanction Guidelines. See Guidelines (2001 ed.) at 87 (Communications With the Public – Late Filing; Failing to File; Failing to Comply With Rule Standards or Use of Misleading Communications).

<sup>20</sup> 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 imposed in this decision, after seven days' notice in writing, will summarily be revoked for non-payment.

We also have considered and rejected without discussion all other arguments advanced by the Respondents.