BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 3, Complainant, vs. Brian Prendergast Englewood, CO, Respondent.	DECISION Complaint No. C3A960033 Dated: July 8, 1999

Respondent was found to have acted as a broker/dealer without being registered as such; invested customer funds in a manner contrary to that set forth in certain offering materials; sold securities pursuant to offering materials that contained material misrepresentations and omissions; distributed misleading sales literature and advertisements; failed to provide notice to his employer that he had opened an account with another member firm; and refused to provide on-the-record testimony related to an investigation. Held, findings affirmed in part and reversed in part; sanctions upheld.

Brian Prendergast ("Prendergast") has appealed a November 19, 1997 decision of the District Business Conduct Committee for District No. 3 ("DBCC") of NASD Regulation, Inc. ("NASD Regulation"). For the reasons discussed below, we find that Prendergast failed to invest certain customer funds as set forth in a Private Placement Memorandum ("PPM"); sold securities pursuant to a PPM that contained material misrepresentations and omissions; distributed misleading sales literature; failed to provide the required notice to his employer that he had opened an account with another member firm; and failed to provide on-the-record testimony as requested by NASD Regulation district staff. We dismiss the cause of action alleging that Prendergast acted as a broker/dealer without being registered as such. We order that Prendergast be censured and barred from associating with any member firm in any capacity.

Background

Prendergast first became associated with a member of the NASD in August 1976 as a general securities representative. He joined former member firm AmeriNational Financial Services, Inc. ("AmeriNational") as a general securities representative in September 1993 and left the firm in November 1994. He is not presently associated with an NASD member.

Factual and Procedural History

The DBCC filed a six-cause complaint against Prendergast on August 2, 1996.[1] The period covered by the complaint is January 31, 1994 through November 30, 1994.

The first cause alleged that Prendergast effected securities transactions for the accounts of others without obtaining a broker/dealer registration, in violation of Conduct Rule 2110. Cause two of the complaint alleged that Prendergast invested funds from the sale of securities offered pursuant to a PPM in a manner that was inconsistent with representations in the PPM, in violation of Conduct Rules 2110 and 2120. The third cause alleged that Prendergast solicited certain securities transactions using a PPM that contained material misrepresentations and omissions, in violation of Conduct Rules 2110 and 2120. The fourth cause alleged that Prendergast distributed communications to purchasers that failed to conform to the general and specific standards of Conduct Rule 2210 for sales literature, in violation of Conduct Rules 2110 and 2210, and caused an advertisement to be placed in a newspaper that constituted a general solicitation prohibited by Rule 502(c) of the Securities and Exchange Commission ("SEC"), in violation of Conduct Rule 2210(e). The fifth cause alleged that Prendergast failed to provide proper notice to his employer, member firm AmeriNational, and to the executing member firm, Rocky Mountain Securities & Investments ("Rocky Mountain"), when he opened an account with Rocky Mountain, in violation of Conduct Rules 2110 and 3050. Finally, cause six alleged that Prendergast failed to provide information requested by NASD Regulation staff, in violation of Conduct Rule 2110 and Procedural Rule 8210.

According to evidence introduced at the DBCC hearing, the complaint resulted from a routine examination of member firm Rocky Mountain, during which an NASD Regulation staff examiner reviewed activity in an account under the name of Prism Financial Limited Liability Company ("Prism"). Further investigation disclosed that Prendergast, who was named on the Prism account documentation, was a registered representative of AmeriNational, then a member of the NASD. Staff asked AmeriNational whether it was aware of the Prism account and was

[1] The complaint actually contained seven causes of action, but only six allege that Prendergast engaged in misconduct. The seventh cause alleged violations of the NASD's supervisory rules by AmeriNational and its president with respect to Prendergast's conduct. These allegations were resolved by an Offer of Settlement accepted by the NASD before the hearing commenced. This decision does not concern those allegations.

advised by the firm's president that it was not. Staff then investigated the circumstances surrounding Prendergast's involvement in Prism, resulting in the current action.

The evidence also established that Prism was formed in January 1994. Prism offered securities in the form of "units" priced at $25,000 per unit pursuant to a PPM dated January 6, 1994. According to the PPM's Summary of the Offering, Prism was established "to continue the market research and product development originally begun by Prism Financial Corporation on state-of-the-art investment programs that incorporate the latest designs in technical forecasting and market analysis." The PPM further stated that Prism Financial Corporation had been created six months earlier to "promote investment concepts and products based upon proprietary computerized trading programs developed by . . . Brian Prendergast." The co-managers of Prism were Prendergast and Joel DeAngelis ("DeAngelis").

The Prism units were sold to 34 investors, raising approximately $920,000. According to staff, these purchases generated transaction-related compensation of approximately $92,000, in the aggregate. These fees were paid to AmeriNational for Prendergast's sales, to DeAngelis and to a number of other individuals and entities. Staff argued that Prendergast's payments to these other individuals and entities for soliciting sales of Prism securities required him to register as a securities broker and that his failure to do so violated Conduct Rule 2110. Prendergast countered that these payments constituted "advance management fees," not compensation for selling Prism securities, and that all Prism transactions were effected through member firm AmeriNational, which obviated any need for him to register separately as a broker.

Staff also introduced evidence regarding the application of investor funds. The PPM represented that approximately 60 percent of the funds raised would be placed in a "hedge fund," which was characterized by the PPM as a combination of "certain elements of traditional products" and Prendergast's "proprietary S&P 500 stock index trading program." The proprietary program was described as encompassing "elements of The Elliott Wave Theory as well as certain Fibonacci time/price relationships that measure, with simple mathematical ratios, the expected distance, either up or down, the S&P 500 index can be expected to travel within a certain time interval." The PPM also indicated that the hedge fund offered "diversification, safety of principal and automatic (IPD) internal profit dispersion," as well as "a great deal of asset allocation flexibility." In a discussion under the heading "The Asset Matrix™," the PPM stated as follows:

> I. The Asset Matrix depicted on the following page will comprise the Prism "Hedge Fund" in this offering.
>
> II. The allocation of the assets commited [sic] to this fund will be as follows:
>
> 1. 60% in the S&P 500 stock index futures
>
> 2. 40% into load and no-load mutual funds to be market timed.

Staff also prepared and introduced a schedule setting forth various categories of disbursements from the Prism bank account and the amounts therein. According to the staff

examiner who prepared it, the schedule was developed from a review of checks drawn on the account, bank statements, check registers and other information provided by Prendergast. According to this schedule, between March and October 1994, approximately $543,500 was deposited into three successive commodities accounts and another approximately $40,300 was used to acquire low-priced Canadian securities through several different brokerage accounts. Approximately 60 percent of the aggregate funds received from Prism investors was deposited into Prism's commodities account, which is approximately the percentage that the PPM indicated would be applied to the hedge fund.

In addition, account statements for Prism's commodities trading activity indicated that Prism engaged in a number of Standard and Poors ("S&P") 500 transactions during the first month of commodities trading, in March 1994. Approximately $262,000 was deposited into the account that month and the month-end total equity was $194,129.50, with a net realized loss from trading of $71,960.70. In the following month, April 1994, several Chicago Board of Trade ("CBT") Treasury Bond ("T-Bond") transactions were mixed in with the S&P 500 transactions. In the first 10 days of May 1994, less than half of the transactions involved S&P 500 index options. The balance of the transactions for the first 10 days in May were CBT T-bonds and foreign currency options. For the remainder of May and the month of June 1994, S&P 500 trades predominated, but foreign currency transactions accounted for approximately one-third of the transactions in July and August 1994. By the time Prendergast ceased to be associated with a member of the NASD in November 1994, his commodities trading activity had reduced aggregate deposits of approximately $540,000 to an account valued at approximately $64,000, for a loss of approximately $476,000.[2]

Staff argued that this evidence established that the investments Prendergast made with the Prism customer funds differed materially from what had been represented in the PPM. Prendergast acknowledged that the investments differed from the representations in the PPM. He argued, however, that the broad investment powers granted to the managers in the Prism operating agreement permitted him to deviate from the trading strategy discussed in the PPM in order to adjust to market conditions. He further explained how, in his view, the market conditions during the period in question had required him to alter his trading strategy early in the program.

In addition, staff introduced evidence regarding certain statements in the PPM that staff believed constituted impermissible misrepresentations, projections, exaggerations and omissions, discussed in detail below. Prendergast countered by arguing that the PPM was not misleading and did not omit material information, although he acknowledged that some of the discussions in the PPM may have been confusing.

---

[2] Prendergast was more successful with the low-priced securities, earning approximately $15,000 on the approximately $40,000 invested, primarily due to substantial gains in Rich Capital Corp.

Staff also introduced a series of letters sent to Prism investors and an advertisement placed in a California newspaper by Prism. Staff argued that these materials were all advertisements and that they contained misleading statements. Prendergast argued that the letters were not advertisements and that, in any event, they did not contain misleading information. Prendergast implicitly acknowledged that the newspaper advertisement may have been misleading.

In addition, staff introduced evidence showing that certain Canadian stocks purchased by the Prism "hedge fund" were purchased and sold through a succession of securities accounts established at various broker/dealers other than the firm with which Prendergast was registered. There is no dispute that Prendergast controlled and benefited from the activity in those accounts. Staff argued that, although Prendergast's broker/dealer, AmeriNational, was aware of one such account, at Yorkton Securities ("Yorkton") in Canada, Prendergast failed to disclose to AmeriNational the domestic account that he opened with Rocky Mountain after closing the Yorkton account and failed to disclose to Rocky Mountain that he was associated with AmeriNational, an NASD member at that time. Prendergast did not directly contest staff's argument, stating instead that this failure was merely an oversight on his part and that AmeriNational was aware of the trading activity.

Finally, staff introduced evidence that Prendergast refused to appear and provide on-the-record testimony concerning the staff's investigation into Prism's activities. Prendergast countered by arguing that he had been cooperative and provided the staff with all records, checks, ledgers, memoranda and internal documents of Prism. He stated further that he had volunteered to meet with the staff for an off-the-record interview but that he did not want to make an on-the-record statement because he was concerned that such information might be used by aggrieved customers.

On November 19, 1997, the DBCC issued its decision, finding that Prendergast had engaged in the misconduct alleged in the complaint. As a result, the DBCC ordered that Prendergast be censured and barred from associating with any member firm in any capacity. This appeal followed.

Discussion

As indicated above, the complaint in this matter contains six causes of action related to Prendergast. We will discuss each cause separately, but we begin with causes two through six and end with our analysis of cause one.

Cause Two - Inconsistent Use of Offering Proceeds. The second cause of action relates to Prendergast's alleged failure to apply investor funds in a manner consistent with certain representations made in the PPM. The DBCC found, and we agree, that the PPM contained several representations concerning the intended application of the funds received from unit purchasers. The "Use of Funds" chart located in the PPM also represented that 60 percent of the investment amount would be allocated to the hedge fund. The evidence indicates, however, that approximately this amount was employed to fund the commodities trading and the equities

accounts, rather than the hedge fund account. With respect to the application of funds within the hedge fund, as noted above, the PPM includes a section with the heading "Asset Matrix™," which stated that the allocations set forth on those pages would "comprise the Prism 'Hedge Fund' in this offering." That illustration allocated 60 percent of the assets to the S&P 500 stock index futures trading program and 40 percent to mutual funds that were to be market-timed. This, however, was not how the funds were actually allocated. Instead, approximately 59 percent of the proceeds was deposited in the commodities accounts and approximately 4 percent was invested in low-priced Canadian securities. None of the funds were invested in mutual funds. Furthermore, the activity in the commodities accounts extended beyond the S&P 500 stock index futures trading program into foreign currency options, CBT T-Bonds and several precious metals transactions. Finally, it does not appear that whatever stop-loss mechanisms were intended to be used were actually employed.

During the DBCC hearing, Prendergast explained that a number of factors, including adverse market movement shortly after the commodities account was opened, caused him to modify the intended hedge fund strategy. He stated that he did not purchase any mutual funds because mutual funds were losing value at the time and did not appear to be an appropriate investment. He also claimed that the statement in the "Asset Matrix™" section of the PPM that the fund has a "great deal of asset allocation flexibility in that 80% of the asset categories can be changed at any time to match changing market conditions" permitted him to engage in any kind of transaction he believed to be appropriate with the hedge fund's capital. In addition, Prendergast referred to the broad investment powers set forth in the Prism "Operating Agreement" as authorizing him to allocate the hedge fund's assets in a manner other than that set forth in the PPM.[3]

We agree with the DBCC that neither the statements made in the "Asset Matrix™" portion of the PPM nor the provisions of the Operating Agreement supersede the specific

---

[3] Section 12.2(g)(iv) of the Prism "Operating Agreement" permits the Prism managers, with respect to Prism's assets, to:

> purchase, take, receive, subscribe for or otherwise acquire, own, hold, vote, use, employ, sell, mortgage, lend, pledge or otherwise dispose of, and otherwise use and deal in and with, shares or other interests in or obligations of other limited liability companies, domestic or foreign corporations, associations, general or limited partnerships, or individuals or direct or indirect obligations of the United States or of any government, state, territory, governmental district, or municipality or of any instrumentality of any of them.

The foregoing is one of a number of general and specific powers granted to the managers of Prism in the Operating Agreement. These powers are not unlike the corporate governance provisions of the by-laws of a corporation or the partnership agreement of a limited partnership.

representations made in the PPM regarding allocation of the funds raised in the offering. In In re DWS Secs. Corp., 51 S.E.C. 814 (1993), respondents argued that the PPMs in question described the proposed use of proceeds in general enough terms to encompass the manner in which the offering proceeds were actually disbursed. Id. at 817. The SEC disagreed and held that the PPMs, at the very least, led investors to believe that their funds would be used in a manner different than they actually were. Id. The SEC concluded that respondents misrepresented and omitted material facts with respect to the manner in which the offering proceeds would be used, and the SEC upheld the NASD's finding that respondents violated Conduct Rules 2110 and 2120.

Similarly, in In re Wilshire Discount Secs., Inc., 51 S.E.C. 547 (1993), a respondent was alleged to have made fraudulent use of the proceeds of a securities offering. The PPM used in the offering provided that the issuer was to engage in the business of effecting discount brokerage transactions for customers, effecting customers' futures transactions and providing clearing services. None of the proceeds were used for these purposes. In fact, the issuer, at the direction of the respondent (who, in addition to being a registered representative, was an official of the issuer), used more than one-third of the gross proceeds to purchase stock in two airlines. Id. at 549. The SEC noted that the PPM provided both that the issuer had "broad discretion" regarding application of proceeds and that working capital could be used for general corporate purposes. Id. at 549-50. Nevertheless, the SEC held that the purchase of the stock in the two airlines changed the entire structure of the issuer's stated business strategy. Id. at 550. The SEC concluded that the respondent had acted fraudulently. Id. at 550-51.

We find that the PPM in the current case led investors to believe that their funds would be applied in a manner different from the way in which they were actually disbursed. The PPM represented that a certain percentage of the funds raised would be allocated to the hedge fund and that the hedge fund would in turn be allocated as set forth in the "Asset Matrix™." Prendergast was obligated to use investor funds in that manner. Any other result would render the "use of proceeds" disclosure meaningless and, as the DBCC stated, convert the offering into essentially a "blank check."

We also find that Prendergast's conduct with respect to investor funds was sufficiently reckless to prove, by a preponderance of the evidence, that he acted with scienter. Prendergast knew what the PPM had represented to investors concerning the disposition of their funds. His decisions to invest in low-priced Canadian securities and to eliminate the mutual fund component of the hedge fund were made with complete disregard of those representations. In essence, he operated as if those funds had been invested with the expectation that the money would be pooled in a large discretionary account. That was in stark contrast to the representations made in the PPM.

By making use of investor funds received in an offering in a manner inconsistent with the representations in the PPM, Prendergast induced and effected securities transactions by means of a deceptive and fraudulent device or contrivance, in violation of Conduct Rule 2120, the NASD's anti-fraud provision. See, e.g., DWS Secs., supra, at 820 (finding that respondents acted with scienter and violated Conduct Rule 2120 where they "participated in the preparation and use of the PPMs that described uses of proceeds that did not occur."); In re Gene Lester Roach,

Complaint No. LA-4332, at 8 (NBCC Nov. 27, 1991) ("[W]e believe that Roach's deviations from the uses of the proceeds outlined in the offering memorandum were fraudulent since they were made knowingly or with reckless disregard for their misleading effect."). Prendergast also acted in a manner inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of Conduct Rule 2110. Accordingly, we find that Prendergast violated Conduct Rules 2110 and 2120, as alleged in cause two of the complaint.

Cause Three - Misleading Projections and Material Misstatements and Omissions. The third cause of action alleged that the PPM contained misleading projections and assumptions, exaggerations and material misrepresentations and omissions. We will discuss each separately below.

Projections and Assumptions. The complaint alleged, and the DBCC found, that the Prism PPM made projections of expected return without a reasonable basis. We agree. Certain language used in the PPM is especially illustrative. For instance, at one point the PPM provides:

> Although the components of [Prism's products] are not newly designed financial instruments, the manner in which Prism has combined certain elements of traditional investment products inside of a separate "hedge fund" which contains its proprietary S&P 500 stock index trading programs enhances historical yields by as much as 100% per year. (Emphasis added)

This statement suggests that the Prism program created some kind of synergy that would double the return historically realized on the unidentified individual investment products that were to make up the Prism product. Because the Prism product had no real experience, having only been computer tested, the lack of a disclosure in the same section[4] informing investors that the product had no actual yield history was misleading. Furthermore, the failure to provide the "historical yields" to which Prism was being compared makes the statement impossible to verify. Finally, as the DBCC noted, the projections of substantially above-market returns are inherently suspect. We find that this statement is materially misleading.

[4] On the succeeding page, separated from the projection by other text discussing other elements of the offering, is the following statement:

> At the heart of all of Prism's investment products and the primary yield enhancement mechanism, is the proprietary S&P 500 trading program. Although Prism has spent the last two years developing and testing this proprietary computerized investment program, it has not been tested within the parameters of either the hedge fund or the institutional Asset Enrichment Program.

The PPM also included certain illustrations of the S&P trading program that contained misleading information. One illustration used in the PPM allegedly charts "actual program performance" and indicates returns on 39 trades of 6.92 S&P points per month. The same illustration also provides a hypothetical $5 million account with the same transactions listed in the "actual program performance" and represents that the account would have had a gross value of $19 million and would have been worth $13 million after expenses for a 278 percent return. We agree with the DBCC that the representation of an "actual program performance" was materially misleading and inconsistent with the statements in other parts of the PPM that the S&P trading program had only been simulated, not employed in the market. Moreover, the limited information provided in the PPM does not allow an investor to verify the accuracy of these representations. Specifically, we find that it would have been virtually impossible for a prospective investor reasonably to evaluate the accuracy of the 278 percent return based on the information provided in the PPM.

The DBCC also found certain misleading assumptions and projections contained in the following excerpt taken from the "Asset Matrix™" listed in the PPM:

> 1. The S&P 500 projected performance is based upon the assumption that the S&P 500 trading program will average at least 3 S&P points per month profit. Prism's past four year, back tested program has averaged over 5 S&P points per month although this is no guarantee of future success.
>
> 2. The mutual fund timing segment is projecting an annual return of at least 16%. Prism's past seven-year track record has averaged over 16.5% per year on a compound return basis.
>
> DISCLAIMER: *Prism cannot guarantee that the projections illustrated in this spreadsheet [sic]*[13] *and cannot guarantee the final ending balances will be achieved. Prism has taken a conservative approach to projecting a compound rate of return that is below its*

---

[13] The page that follows these representations is a spreadsheet that projects the 10-year return on an aggregate $745,000 investment in the hedge fund, allocated 64.4 percent to the futures program and 35.5 percent to mutual funds. The spreadsheet shows monthly returns, management fees, debt service (which did not occur because no investors elected to finance their investment), monthly net to the fund, annual distributions to investors and anticipated returns. At the end of 10 years, the fund was projected to have realized $216 million in returns, paid management fees of $51 million, distributed $81 million to investors and have an "ending balance" of $150 million.

> *historical trading record but cannot guarantee future results. There are many factors beyond the control of Prism that could affect the Company's trading results.*

We agree with the DBCC that the PPM provided insufficient information to permit an investor to evaluate the reasonableness of the assumptions and projections made in this portion of the PPM and that the assumptions and projections were materially misleading. For instance, the absence of an explanation of the "back tested" program prevents an investor from evaluating the accuracy of the claimed five-point profit average or the applicability of the back-tested program to the hedge fund described in the PPM. The statements in the PPM also constitute material misrepresentations because they fail to clarify that Prism had not actually traded pursuant to the computer model.

Similarly, the PPM lacks sufficient information for an investor to evaluate the reasonableness of the mutual fund segment projected return. The PPM does not, for example, specifically define the types of mutual funds in which the hedge fund intends to invest. Thus, there was no way for an investor to compare returns on such investments outside of the hedge fund. Moreover, the basis of the projected 16 percent annual return for the mutual fund timing segment is unclear. The PPM's claim that Prism's seven-year track record has averaged an annual rate of return of 16.5 percent is also unsubstantiated and inconsistent with other representations that Prism was a new entity without a track record. We find that the statements made in this portion of the PPM were materially misleading.

The disclaimer paragraph, moreover, does not remedy these shortcomings. While the disclaimer indicates that the spreadsheet results are not guaranteed, it then states that Prism's projections result from a conservative approach that indicates a return below its historical trading record. As discussed above, the reference to a historical trading record is misleading and without a reasonable basis because the Prism hedge fund had no actual historical record, only a computer simulation, the substance of which is not discussed. Additionally, the statement that Prism has taken a conservative approach to projecting a rate of return minimizes the importance of the disclosure.

Prendergast testified at the DBCC hearing that he had "tried in a general sense to describe the computer trading program so that a layman could read this and get some sense of how the program operated. It was a proprietary program. We were not going to disclose every detail of the program." He also discussed the "back testing" of his computerized trading program, stating that "a $6,000 audit was completed by my CPA. This audit went back from June 1, 1990 to December 2, 1993. And this audit audited every trade the computer program made, every trade. It audited both the price of the trade and it audited the profit or losses. . . . The audit that was performed verified that the program did do 5.9 points per month for an average return of 354 percent." He did not further explain the projections of return that are set forth above.

In sum, we agree with the DBCC that the Prism PPM contained projections of return without a reasonable basis. The projections appear to have been based upon the "back testing" that was done by Prendergast's CPA, but the PPM offers little information about the program that

was tested or the back-testing process. The disclosures contained in the PPM do not permit an investor to determine whether the claims made about the program are true, whether the back-testing process replicated market conditions, whether the projections are reasonable in the current market, whether all components of the hedge fund were included in the test, or whether there are any assumptions or other factors that are unreasonable and could affect returns. The claim that the S&P 500 program had been "publically [sic] tested and audited over a four year period of time" is misleading in light of Prendergast's testimony that the audit in fact spanned a shorter period and, as noted above, the statement made in another portion of the PPM that the test period lasted for only two years. We also find troubling the PPM's reference to "actual program performance." Statements made in the PPM and Prendergast's testimony during the DBCC hearing both indicate that there had been no "actual" performance prior to the investment of the first $95,000 received in the private placement.

We note as well that several of the projections, such as the claim that the Prism hedge fund "enhances historical yields by as much as 100%," are stated as fact, although no basis for the factual assertion appears anywhere in the PPM. Projections of future return are, by their nature, somewhat speculative. Nonetheless, a registered representative may not cause an issuer to make predictions that lack a reasonable basis. See, e.g., In re C. James Padgett, Exchange Act Rel. No. 38423 (Mar. 20, 1997) (holding that predictions of substantial increases in the price of any security made without a reasonable basis are fraudulent); In re Lester Kuznetz, 48 S.E.C. 551, 553 (1986) (same). Moreover, a person or entity may not, in connection with the offer or sale of securities, make projections of return without a reasonable basis and avoid liability by simply inserting generic disclaimers that the projected returns may not be achieved due to factors beyond the issuer's control. See, e.g., In re Donald J. Trump Casino Secs. Lit., 7 F. 3d 357, 371 (3d Cir. 1993) ("[A] vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation."), cert. denied sub nom, Gollomp v. Trump, 510 U.S. 1178 (1994); Picard Chemical Inc. Profit Sharing Plan v. Perrigo Co., 940 F. Supp. 1101, 1122 (W.D. Mich. 1996) (boilerplate disclaimers are inadequate to prevent misinformation); cf. In re Jay Michael Fertman, 51 S.E.C. 943, 950 & n.32 (1994) (advertising that contained unwarranted claims not cured by general disclaimers of risk).

Exaggerated Claims. The DBCC found that certain language in the PPM constituted exaggerated claims for which Prism lacked a reasonable basis. Specifically, the DBCC focused on the following characterizations and statements made in the PPM:

- The PPM characterizes the Prism product as "unusual and high-yielding . . . when compared to other mutual fund products."

- The PPM states that "[t]he current investment environment has seen over $30 billion dollars [sic] a month pour into the mutual fund and insurance annuity marketplace because of low interest rates. Over 95% of all mutual funds are designed and look the same. Yet out of this very large market, there are few mutual funds that provide the diversification and earnings potential of the Prism hedge fund."

- The PPM states that Prism provides a "short term Asset Enrichment Program to corporations in need of short term money management . . . ," offers a

"participating yield enhancement program to pension plans seeking to add yield to their high grade, fixed income portfolios" and "offers proprietary market timing services to banks who desire to provide a semi-advisory service to their customers seeking higher yields through mutual funds."

- The PPM states that "[t]his is a system of managing client money within a calculated framework of a risk/reward relationship that limits downside losses and maximizes upside potential."

- The PPM states that the hedge fund "incorporates elements of diversification, safety of principal, and automatic (IPD) internal profit dispersion."

We agree with the DBCC that these characterizations and statements were exaggerated and materially misleading. Specifically, we find that it was misleading to characterize a new and unproven product as "high yielding," to state or imply that an investment is a mutual fund when it is not registered as an investment company and subject to the regulations imposed upon the registered investment companies with which it is being compared,[5] to suggest that a product's earnings potential exceeds 95 percent of the mutual funds available when that product has no earnings experience, to state or imply that the issuer is presently providing certain products or services when no such products and services are being provided, to state or imply attributes that have not yet been established, to make projected rates of return without a reasonable basis and to, in general, fail accurately to describe an investment. See, e.g., In re Larry Ira Klein, Exchange Act Rel. No. 37835, at 7-8 (Oct. 17, 1996) (finding statement that "interest and face value at maturity are guaranteed" by the issuer without disclosing any credit ratings for various debt securities was materially misleading); In re Gold Properties Restoration Co., 50 S.E.C. 1236, 1242 (1992) (finding materially misleading statements in a PPM concerning the value of certain gold reserves where inadequate sampling and testing had been performed to support such representations); In re Thomas J. Fittin, 50 S.E.C. 544, 546 (1991) (finding the characterization

---

[5] With respect to the comparison with a mutual fund, we note that, once it began operations, the Prism hedge fund differed significantly from a mutual fund in that Prism's investors did not purchase an undivided interest in the assets of the fund. The fund commenced operations as soon as a little more than $100,000 had been invested, with $95,000 going into the S&P 500 index options trading program and approximately $8,000 applied to the purchase of low-priced Canadian stocks. Additional investments were made as additional funds were received. It appears from the manner in which profits and losses were credited and deducted from each investor’s "account," as confirmed by Prendergast at the hearing, that the investments were "assigned" to investors based upon the transactions that were effected using those investors’ funds as they were received. As the investments realized profits or suffered losses, those profits and losses were allocated to different investors in different amounts. According to a schedule prepared by the staff from the "statements" sent to investors by Prendergast, some investors lost considerably more than others, despite investing the same amounts at or about the same time, and some were “credited” with considerably more of the expenses of the fund than others. Prendergast stated that his accountant had determined that it was necessary to handle the accounting in this fashion.

of certain drilling programs as involving developmental wells, when they were actually exploratory, to be materially misleading). As the DBCC aptly noted, a PPM is not a marketing tool, it is a disclosure document.

Omissions to Disclose Material Information and Misstatements. The DBCC found that the PPM failed to disclose certain material information, and made additional misstatements. In part, this finding was based on the following passage in the PPM (and related attachments):

> Since 1987, principals of Prism have researched and developed sophisticated computerized programs to track various stock, bond and gold indexes as well as individual mutual funds. These programs, although utilized to only manage mutual funds, have earned the principals of Prism consistent rankings in the top 20 money managers of the Professional Money Managers' Championship conducted by Dr. Norm Zadeh out of Beverly Hills, Ca. since 1989 (see attachments). Prism earned these rankings through two of its predecessor corporations, Investment Resource & Design, Inc. (IRD) and Managed Asset Programs, Inc. (MAPS).

The attachments consist of excerpts from magazine articles discussing the Zadeh ranking program and reporting the money manager ratings. The time period covered is from July 1989 to July 1992, but there are some gaps and overlaps in the coverage. Prendergast's performance is as follows:

Period Covered	% Return	Ranking
July - Oct. 1989	6.2%	9 out of 10
July - Dec. 1989	14.5%	3 out of 18
Jan. - Apr. 1990	.5%	8 out of 8
Jan. - Dec. 1990	3.0%	21 out of 24
Jan. - Apr. 1991	2.8%	21 out of 22
Jan. - July 1991	6.9%	28 out of 30
Jan. - Oct. 1991	4.1%	36 out of 36
Jan. - July 1992	.9%	24 out of 24

Prendergast's results were listed in the Conservative Growth segment of the rankings. According to the articles attached to the PPM, money managers who wished to have their performance evaluated by Zadeh were required to designate an account worth at least $1 million, send all confirmations of transactions to Zadeh and pay a fee ($400 in 1991, $500 in 1992) to be evaluated and ranked. The March 19, 1990, issue of Wall Street Letter reported that 74 managers had participated in 1989 and a 1991 Barron's article indicates that 97 managers were enrolled in 1991. The Barron's article also quotes Zadeh as claiming that, of about 4,000 money managers, only some 400 "add enough value to warrant their compensation." A 1992 Barron's article represented that Zadeh "derives most of his income from commissions paid by those money managers to whom he refers customers and with whom he has a contract."

The DBCC noted that investors had to parse through the small print of magazine articles attached to the offering memorandum in order to evaluate the accuracy of Prendergast's claims in the PPM, and as such the PPM failed to comply with the requirement to disclose in the offering memorandum all information necessary for the disclosures made not to be misleading. In addition, the DBCC found that the PPM inaccurately represented that Prendergast had "consistently" been in the top 20 money managers when he was below the top 20 in five of the eight periods listed. Moreover, the DBCC found that the failure of the PPM to provide information concerning the required payment for participation was a material omission, as was the failure to compare Prendergast's performance to traditional market measures such as the Dow and bank rates, which would have put the performance claim in the proper perspective.

The DBCC also found that the failure to describe the disposition of certain funds constituted a material omission. The PPM represents in the "Use of Funds" discussion that approximately 11 percent of the proceeds will be applied to a "bank reserve" that was required for financing the purchase of units and to the "bank discount," which represented the difference between the face value of the investor notes and the price Prism expected to receive on the sale of those notes where investors elected to finance their purchase. The PPM does not account for those funds in the event that investors do not elect to finance their purchases, which is what in fact occurred. The PPM's failure to address the intended disposition of those funds in the "no financing" scenario, the DBCC concluded, was a material omission.

In addition, the DBCC found that the PPM contained other material omissions, such as information necessary for an investor to determine whether the assumptions upon which the S&P 500 index option strategy was built or the execution parameters established for the program were reasonable, as well as information about the risk to investor funds if the market did not perform in a manner consistent with the expectations built into the program.

We conclude that the PPM omitted material information and failed to provide an accurate and balanced picture of the risks and benefits of the investment offered. With regard to the Zadeh rankings, we agree with the DBCC that the rankings included in the attachment do not support the representation that Prendergast was consistently ranked in the top 20 managers. The rankings disclose that he was below number 20 more often than above it. Furthermore, the representations in the PPM did not accurately and completely set forth the circumstances and significance of the rankings. If Zadeh is correct (and correctly quoted) concerning the "universe" of money managers, then less than 5 percent of them participated in the Zadeh program. It would have been material for an investor reading the performance and ranking claims to know that some 95 percent of money managers were not part of the evaluation and ranking and, further, that those who were involved had paid to be rated. We are also concerned that the PPM did not include Prendergast's actual percentage returns and compare them to other market indicators. Such information should have been provided because it affects the investor's ability to evaluate the claim that Prendergast is a top money manager.[6]

---

[6] For example, although Prendergast's performance ranked ninth in the third quarter of 1989, his return of 6.2 percent was less than the 10.6 percent gain in the Standard & Poor's 500 Index during the same period.

We also find that the PPM should have provided information about the disposition of those proceeds earmarked to support the unit purchase financing plan in the event that no unit purchases were financed. We agree with the DBCC that reasonable investors would have found material how the issuer planned to use 11 percent of their funds in the "no financing" scenario. When the disposition of the funds that passed through the Prism bank account is compared to the "use of funds" representations, it appears that a substantial amount of this money was allocated to management and incentive management fees.

Finally, we find that the PPM failed adequately to disclose the risks to investor capital that this investment represented. The cover page of the PPM states in bold face, capital letters that the securities are speculative and subject to high risk, referring the reader to the "Risk Factors" disclosures. Only two of the 14 factors discussed, however, actually relate to the speculative nature of the hedge fund and the market in which it trades. The first risk factor reads as follows:

> 1. PROPRIETARY PROGRAMS UNTESTED. At the heart of all of Prism's investment products and the primary yield enhancement mechanism, is the proprietary S&P 500 trading program. Although Prism has spent the last two years developing and testing this proprietary computerized investment program, it has not been tested within the parameters of either the hedge fund or the institutional Asset Enrichment Program.

The last factor states:

> 14. OTHER FACTORS. The financial markets are totally unpredictable although Prism and the founder, Mr. Prendergast do not subscribe to the "random walk theory." As such, outside factors unknown to have occurred or may be about to occur, such as political events, wars, severe weather, economic or social upheaval could have an adverse affect [sic] on the trading programs that the management of Prism will employ to manage the Company assets.

The disclosure that the proprietary trading program was untested, while accurate, is confused and diluted by the repeated claims elsewhere in the PPM concerning the audited back-testing and the profitability it demonstrated, the "actual performance" figures used by Prism, the references to Prism's past performance and the promises of future results. We do not believe the disclosures adequately communicate the possibility that the program simply would not succeed in the real world. Although the PPM does articulate some of the assumptions upon which the program is based and cautions that certain transaction costs will increase as the size of the fund increases, it does not address such issues as whether the viability of the program is affected by the amount of money in the fund and the extent to which the program is capable of dealing with volatility beyond that which it assumes. The broad disclosures in paragraph 14 that the market is unpredictable and that unforeseen events in the world can impact the performance of an investment are not an adequate substitute for a discussion of the effect that movements within the specific market targeted by the hedge fund could have on the value of this investment. <u>See</u>, <u>e.g.</u>,

Blatt v. Merrill Lynch, Pierce, Fenner & Smith Inc., 916 F. Supp. 1343, 1356 (D.N.J. 1996) (noting that vague disclaimers that an investment has risks are usually inadequate and holding that the disclosed warnings in the prospectus in question did not adequately alert potential investors to the Fund's alleged speculative nature).

In fact, as Prendergast testified, the program was not equipped to handle the market movements that occurred from the time it was instituted. As he stated at the DBCC hearing:

> The fund, we tried to keep this fund going. Although we had lost, most of our losses occurred the first three months. . . . I put 15,000 of my own money in this account to keep it going. And we tried to continue it so long as we could. But it came to a point where we didn't have enough capital to even trade -- to even try to do any trading, so we had to -- we just had to bail out.
>
> . . .
>
> I have the computer program here. I have all the algorithms that were designed by the programmer and all the trading rules. . . . We [did] get to trade it on certain occasions when the market was not as volatile as it was. But it was designed for 5-point stops. And we did not have enough capital with a market that was moving. When we first started trading the S&P market the average range -- daily range was 14 to 16 basis points. This program was designed to trade on a 5-point stop reversing each time. So effectively if we had traded it, we could have gotten whipsawed four or five times in a single day, and we would have lost all our capital within a very short period of time.

These potential problems of using the computerized trading program -- market volatility and the lack of adequate capital -- were not unforeseeable and should have been explained to potential investors. The positive and promissory representations in the PPM when compared to the cursory and banal risk disclosures painted an inaccurate picture of the true limitations of and risks associated with Prism's computerized trading program. The PPM lacked the information necessary to prevent the disclosures in the PPM from misleading potential investors.

Similarly, the information in the PPM does not permit an investor to evaluate the reasonability of the assumptions upon which the S&P 500 strategy was based (from the ability to predict movement in the index with mathematical ratios to the five-point profit objective and stop-loss barrier) and the assumptions upon which the projected returns depended, such as the three-point per month profit prediction. We note that, in a later communication to investors, Prendergast points out several actual market conditions that were not anticipated by the program and caused Prism basically to abandon the intended strategy early on.

In light of the foregoing, we conclude that the Prism PPM pursuant to which Prendergast sold Prism securities projected returns without a reasonable basis, contained exaggerated claims and material misstatements, and omitted to disclose material information necessary to prevent the

disclosures made from misleading investors. Moreover, the offer and sale of such securities by Prendergast pursuant to the PPM involved reckless conduct sufficient to constitute scienter and was inconsistent with high standards of commercial honor and just and equitable principles of trade. We, therefore, find that Prendergast violated Conduct Rules 2110 and 2120 as alleged in cause three of the complaint.[7]

Cause Four - Misleading Sales Literature and Advertisements. The fourth cause of action alleged, and the DBCC found, that Prendergast distributed misleading sales literature and advertisements. For the reasons set forth below, we agree.

Sales Literature. During the period that the hedge fund was operational, Prendergast sent a number of letters to Prism investors reporting on the progress of the offering, the status of the hedge fund and other pertinent matters. These communications were addressed to "Prism Financial LLC Member" and were sent in the same form to each investor. As a threshold matter, we determine that these letters were properly characterized by the DBCC as being "sales literature" that had to comply with the requirements of Conduct Rules 2210. That rule defines "sales literature" as follows:

> any written or electronic communication distributed or made generally available to customers or the public, which communication does not meet the foregoing definition of 'advertisement.' Sales literature includes, but is not limited to, circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing scripts, seminar texts and reprints or excerpts of any other advertisement, sales literature or published article. (Emphasis added).

---

[7] In so finding, we reject Prendergast's claimed "advice of counsel" defense. The "advice of counsel" defense requires a showing that the party claiming it made a complete disclosure to counsel, sought advice as to the legality of his or her conduct, and relied on that advice in good faith. Markowski v. SEC, 34 F.3d 99, 104-05 (2d Cir. 1994). Even if these elements are proven, however, "such reliance is not a complete defense, but only one factor for consideration." Id. at 105. Here, Prendergast merely asserts, in conclusory fashion, that an attorney assisted in preparing various materials related to the offering at issue. Prendergast did not provide any information regarding what specific advice he affirmatively sought or what advice was affirmatively provided. Thus, there is no way to determine whether his alleged reliance was reasonable. In addition, it is not clear from the record exactly who the attorney was representing and in what capacity. In this regard, we note that a broker normally may not rely on counsel's advice when the attorney is representing the issuer, i.e., to be considered a relevant factor, the advice must come from an independent and wholly disinterested party. See, e.g., Sorrell v. SEC, 679 F.2d 1323, 1327 (9th Cir. 1982); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 182 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978); In re Michael Ben Lavigne, 51 S.E.C. 1068, 1071 n.18 (1994), aff'd, 78 F.3d 593 (9th Cir. 1996) (table format). Accordingly, Prendergast's assertion of the "advice of counsel" defense is unavailing as to this cause of action (and the others).

Here, the letters were both form letters and performance reports or summaries.

Having found that the letters come under the purview of Conduct Rule 2210, we now turn to the requirements of that rule. Subsection (d)(1) sets forth certain general standards for communications with the public, including the requirements that such communications provide a sound basis for the reader to evaluate the facts of the security discussed and that no material information be omitted. This subsection also prohibits the use of "[e]xaggerated, unwarranted or misleading statements or claims" in all public communications of members. Subsection (d)(2) contains specific standards applicable to particular types of communications with the public, including the requirement that advertisements contain the name of the member broker/dealer, the prohibition against promises of specific results, exaggerated or unwarranted claims or unwarranted superlatives, opinions for which there is no reasonable basis or forecasts of future events which are unwarranted or which are not clearly labeled as forecasts and the requirement that comparisons be clear, fair and balanced. We believe that the communications at issue here fell far short of those standards for the reasons discussed below.

The first communication that the DBCC identified as violating Rule 2210 is a letter dated April 16, 1994. In that letter, Prendergast stated that "Prism has a very successful track record for recovering from losses caused by bumpy markets and then exceeding market performance (witness 1993 mutual fund performance)." We agree with the DBCC that this communication is misleading because the Prism hedge fund, which is the subject of the letter, had no track record at all.

In that same letter, Prendergast also stated, "We specialize in one sector of the market (S&P 500) with a proven computer program that, over time, will produce profitable results." We concur with the DBCC's finding that this statement is misleading because the Prism computer program had not been "proven" at that time. There is, moreover, no reasonable basis for predicting profitable results.

Prendergast's April 16 letter also provided that "[w]e have the offsetting mutual fund category to buffet inconsistent or erratic stock index futures trading." This is misleading because it implies that mutual funds had been purchased, when none had at that time.

By letter dated June 6, 1994, Prendergast wrote that "[t]he majority of dollars to be collected to close out the program will be invested in mutual funds. This approximately $350,000 that will be committed to mutual funds will insure that all members will receive their original capital back within a period of 7.4 years regardless of how the S&P 500 trading program performs. This factor is an important distinction and aspect of the Prism hedge fund." This statement is misleading for a number of reasons. First, the statement assumes that the maximum offering proceeds will be received and does not provide the reader with information regarding what will occur if less than the maximum is raised (which is what actually occurred). Second, the assurance that investors will receive their original capital back within 7.4 years regardless of the performance of the S&P trading program lacks a reasonable basis. Third, the record indicates that Prism never purchased any mutual funds.

The June 6 letter also made the following representation:

> CURRENT PICTURE: Although we are down over 60% in the trading account including commission costs associated with the hundreds of trades we made, I am confident that with a calmer bond market, we can begin to recover and surpass the past eight weeks of losses. As you know, we originally projected a monthly return of 13% with the program. With the experience we have gained over the past eight weeks and the fact that we still have capital to trade with, we should now be able to surpass this monthly performance target.

We agree with the DBCC that the representations that Prism will not only recover from its losses but surpass the original optimistic projection of return is promissory, exaggerated and without a reasonable basis.

The June 6 letter stated further that "[w]e initially purchased three Canadian mining stocks in lieu of placing our excess cash in a money market account because of high upside potential on these stocks with a contained risk factor that was evaluated based upon extensive knowledge of the buying and selling volume within these stocks. . . . We have begun liquidating our position with the expectation that any losses on this stock will be recovered through the purchase of a new IPO stock at a steeply discounted basis." As the DBCC noted, this item fails to provide a balanced presentation of the risks associated with investments in low-priced, speculative securities. Moreover, the term "contained risk factor" is not explained and implies that the risk of investing in these securities is somehow limited. The rational of "contained risk" based on only one factor -- trading volume -- appears fundamentally incomplete and flawed. Furthermore, the statement that the Canadian mining stocks were purchased in lieu of placing excess cash in a money market account could be viewed as implying that the two investments are comparable. Finally, the prediction that losses on the Canadian mining stocks would be recovered through the purchase of a new issue at a discount is a forecast of future results which has no reasonable basis.

The June 6 letter also stated:

> METHOD OF ACCOUNTING. Please recognize that the accounting that is represented on your statements reflects the staggered returns as additional investors and money was [sic] added to the trading account. The figures you see operate much like the Net Asset Value of a mutual fund. As more money is added to the fund and additional investors come into the fund, expenses are reallocated proportionately and profits and losses incremented each month.

Contrary to the above statement, the evidence in the record indicates that the Prism accounting was not at all like the accounting of a mutual fund. For instance, instead of calculating a net asset value by dividing the total asset value by the number of outstanding units, the value of each Prism investor varied based upon when he or she invested and whether that investment was allocated to the S&P 500 trading program or the Canadian stocks. Thus, contrary to the accounting representation made in the June 6 letter, profits, losses and expenses were not

redistributed in order to even out the allocations among earlier and later investors. In addition, Prendergast's use of the accounting method of a mutual fund as a basis for comparing Prism's accounting could be viewed as attaching the same level of financial stability to the Prism product that mutual funds possess. Not only is this comparison misleading based on the differences between the accounting methods, but it could also be taken as suggesting that Prism is subject to the same type of regulation as that of a mutual fund, namely the Investment Company Act of 1940. Prendergast's use of this comparison, especially in light of his failure to disclose the differences between Prism's fund and mutual funds, was materially misleading. See, e.g., SEC v. C. R. Richmond & Co., 565 F.2d 1101, 1106 (9th Cir. 1977) (finding advertisement that compared the performance of a model portfolio to the Dow Jones Industrial Average to be misleading because each was based on different factors which were not disclosed).

By letter dated July 20, 1994, Prendergast provided investors with a general discussion of Prism's sale of all of the fund's previously owned Canadian mining stocks, the purchase of approximately $30,000 of Rich Capital at an average cost of $0.22 per share and the intention to purchase another Canadian security, Big Valley. As with the June letter, the discussion in the July 20 letter fails to disclose the risks of investing in low-priced speculative securities. Additionally, the July letter stated that "[w]e expect ultimately that Rich Capital will go as high as $2.50 Canadian and Big Valley will reach $4.50 Canadian by mid-September." These price predictions, which led investors to believe that they could expect extraordinarily high returns over a very short period of time, lacked a reasonable basis. Moreover, we agree with the DBCC that predicting future prices of speculative securities is inherently misleading, particularly in the absence of strong cautionary language. See, e.g., In re Donald A. Roche, Exchange Act Rel. No. 38742 (June 17, 1997) ("We long have held that predictions of specific and substantial increases in the price of a speculative security within a relatively short period of time are fraudulent.").

Prendergast wrote to investors again by letter dated September 21, 1994, stating:

> Some investors have expressed concern about the apparently declining value of their account while others have seen an increase in their account value because of the appreciation in our stock portfolio. As I have explained to several members, even though it appears that your individual account may have dropped, because of the system of accounting that is employed in our fund, the larger fund picture itself is not obvious from your individual statements. In other words, things are not as bad as they might appear on your statement.

As the DBCC noted, Prendergast's September 21 letter suggested that investor statements did not accurately depict the status of an individual's investment in the Prism securities and implied that profits and losses would eventually be equalized. There is no basis for this implication. Indeed, the record indicates that such an equalization was not intended and did not occur. Furthermore, Prendergast's statement that "things are not as bad as they seem" is incredible in light of the significant losses that Prism's S&P trading program had experienced as of August 30, 1994. Prendergast's September 21 letter also stated that "[w]e have not and will not run out of money to invest or trade with." This statement is misleading because there is simply no way to guarantee that the fund will not lose everything, especially in light of the fund's track record at the point

when the statement was made. Taken as a whole, this letter was clearly meant to cloak the true state of affairs of the Prism fund and was materially misleading. See, e.g., In re Donald T. Sheldon, 51 S.E.C. 59, 70 (1992) (finding that respondent violated anti-fraud provisions of the securities laws by causing materials to be published that "minimized the increasingly significant risks" of certain bonds), aff'd, 45 F.3d 1515 (11th Cir. 1995).

By letter dated November 1, 1994, Prendergast wrote to investors stating that "[t]he fund has begun to purchase mutual funds with the new monies that have been added." This statement was patently false as there is no evidence that mutual funds were ever purchased by the Prism hedge fund.

In brief, we find that the communications discussed above violated the requirements of Conduct Rule 2210. These communications did not contain a balanced statement of the benefits of the investment and its risks. Indeed, the letters minimized the losses incurred and emphasized the positive occurrences. They also omitted material facts (such as the basis for various claims and adequate disclosure of the risks of such investments); included statements that were exaggerated, unwarranted and misleading; made promises of specific results; made exaggerated or unwarranted claims; and provided forecasts that were unwarranted. Accordingly, we find that Prendergast violated Conduct Rule 2210 by sending these communications. See In re Sheen Financial Resources, Inc., Exchange Act Rel. No. 35477 (Mar. 13, 1995) (stating that failure to discuss risks specifically associated with investment is material fact, omission of which contributed to finding advertisement misleading); In re 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.").[8]

Advertisement. On or about September 25, 1994, an advertisement for Prism appeared in the San Jose, California Mercury-News. The advertisement was in the form of an invitation to the public to attend a seminar sponsored by Prism. The advertisement contained the following information:

"Today's Hottest Investment"

---

[8] We also reject, as unsubstantiated by the record, Prendergast's defense that he provided more detailed disclosures of the risks involved and of the basis for certain statements orally to investors. Moreover, even if we assume, for purposes of argument, that he had made such oral disclosures, such action would not act as a defense to this cause of action. In Sheen Financial, supra, the SEC stated:

> [W]e do not agree that any defects in the advertisements could be cured through detailed explanations -- allegedly made at seminars also advertised in the communications -- of the risks of the offered investments. Advertisements must stand on their own when judged against the standards [of Conduct Rule 2210].

Id. at 9

The advertisement did not include the name of Prendergast's broker/dealer, AmeriNational. In addition, the evidence indicates that Prism's private offering was still underway at the time the advertisement was published.

The DBCC held that, because the Regulation D private offering was ongoing at the time, the advertisement constituted a general solicitation of investments in the private placement, which is not permitted under SEC Rule 502(c), and therefore violated Conduct Rule 2210(e).[9] We agree.

SEC Rule 502(c) of Regulation D, promulgated pursuant to the Securities Act of 1933 ("1933 Act"), prohibits an issuer or person acting on its behalf from offering or selling securities by any form of general solicitation or general advertising, including but not limited to "[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising." When determining whether the placement of an advertisement violates this rule, three issues must be analyzed.

The first issue that must be addressed is whether the advertisement was placed by an issuer or person affiliated with an issuer. Here, there is no question that Prendergast directed that the advertisement be placed and that he was acting as the issuer's agent, in light of his role as co-manager of Prism.

The second issue that must be analyzed is whether the advertisement was used to "offer or sell the securities" of the issuer. The term "offer" used in the 1933 Act and the rules promulgated thereunder, including SEC Rule 502, has been construed broadly and encompasses a much wider range of conduct than is encompassed by the common law contract connotation of the term. See, e.g., SEC v. Cavanagh, 155 F.3d 129, 135 (2d Cir. 1998); SEC v. Starmong, 31 F. Supp. 264, 266 (E.D. Wash. 1940); In re G.J. Mitchell, 40 S.E.C. 409, 414 (1960). Section 2(3) of the 1933 Act provides, in relevant part, that the terms "offer to sell," "offer for sale," and "offer" include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."

In In re Gearhart & Otis, Inc., 42 S.E.C. 1 (1964), aff'd, 348 F.2d 798 (D.C. Cir. 1965), a respondent was held to have violated Section 5 of the 1933 Act for his role in the sale of

---

[9] Conduct Rule 2210(e) provides, "In addition to the provisions of paragraph (d) of this Rule, members' public communications shall conform to all applicable rules of the Commission, as in effect at the time the material is used."

unregistered securities of an issuer, National Lithium Corp., which was organized for the principal purpose of acquiring and developing certain mining claims containing lithium deposits. One issue in the case -- related to the respondent's claim that the securities at issue were entitled to a private offering exemption -- was whether certain news articles that respondent had distributed to a number of securities dealers constituted offers to sell the securities in question. The articles respondent distributed contained enthusiastic descriptions of the uses of lithium, the subject of the issuer's business, and indicated that investments in lithium could be the next market sensation. Although the articles did not expressly offer any securities for sale or even specifically reference the issuer, the SEC, noting that the definition of the term "offer" had been construed broadly, held that "the distribution of the literature concerning lithium was the first step in a campaign to sell National Lithium stock and as such constituted an offer to sell such stock." Id. at 26. The SEC stated further that, "[w]hile . . . the literature in question made no specific reference to National Lithium or to the prospective offering of its securities, it was designed to awaken an interest in lithium securities which could shortly afterwards be focused on the National Lithium stock." Id. The SEC rejected the respondent's assertion that the securities were entitled to a private offering exemption and held that he violated Section 5(c) of the 1933 Act by selling unregistered securities.

Similarly, in In re Econative Corp., SEC No-Action Letter (Feb 27, 1978), a broker/dealer specializing in direct participation programs wanted to publish an advertisement headlined "Tax Shelters Wanted." The firm asserted that it was "not advertising to the general public to sell [securities] but, rather, to the real estate community for [securities to sell]." Notwithstanding this alleged purpose, the SEC replied that the advertisement would be "the first step in a public offering" and would thus violate SEC Rule 146(c), the predecessor to SEC Rule 502(c).

In the current case, we hold that the Prism advertisement constituted an "offer" for purposes of SEC Rule 502(c). We find that Prism's use of the bolded phrase "Today's Hottest Investment," right above the phrases "Hedge Funds[,] What They Are[,]" How To Invest," was calculated to "awaken an interest" in Prism's securities. The proximity in time between the advertising and the offering, moreover, further supports this conclusion. In general, the closer in time that the advertising is to the offering, the stronger the possibility of a link. Cf. In re Gerald F. Gerstenfeld, SEC No-Action Letter (Dec. 3, 1985). As the DBCC noted, Prism's advertisement was published while its Regulation D private placement was still underway.

The third and final element that must be reviewed in determining if a violation of SEC Rule 502(c) has occurred is whether there has been a "general solicitation." The SEC has stated that, in determining what constitutes a general solicitation, it "has underscored the existence and substance of pre-existing relationships between the issuer and those being solicited." In re Kenman Corp., Exchange Act Rel. No. 21962 (April 19, 1985) (Order Instituting Proceedings and Making Findings). Here, the advertisement invited the general public to attend Prism's seminar to learn how to invest in hedge funds. There is no evidence that the advertisement was intended to or did reach only potential investors who had a pre-existing relationship with Prism. Accordingly, we find that Prism's advertisement constitutes a "general solicitation."

In light of the foregoing, we find that Prendergast violated Conduct Rule 2210(e), which requires members' public communications to conform to all applicable rules of the SEC, by directing Prism to publish an advertisement that contravened SEC Rule 502(c).

The complaint also alleged, and the DBCC found, that Prendergast violated Subsection (d)(2)(A) of Conduct Rule 2210 because the advertisement did not include the name of the broker/dealer with whom he was registered, AmeriNational. We agree. Rule 2210(d)(2)(A) states flatly that "[a]dvertisements and sales literature shall contain the name of the member. . . ." There is no dispute that Prendergast did not list AmeriNational's name on the advertisement. As the person responsible for the publication of the advertisement, Prendergast thus violated the rule. See, e.g., In re Sheen Financial Resources, Inc., Exchange Act Rel. No. 35477, at 9 (Mar. 13, 1995).

Finally, the DBCC found that the characterization of the investment opportunity as "today's hottest product" was exaggerated, unwarranted and misleading, in violation of subsection (d)(1)(B) of Conduct Rule 2210. We agree.[10]

In summary, we find, as did the DBCC, that the sales literature prepared and distributed by Prendergast and the advertisement placed by him failed to conform to the general and specific standards of Conduct Rule 2210 as alleged in cause four of the complaint. We also find that Prendergast's conduct was inconsistent with high standards of commercial honor and just and equitable principles of trade and a violation of Conduct Rule 2110, as alleged in cause four.

Cause Five - Failure to Disclose Association with Broker/Dealer in Connection with Account at Non-Employer Member. The DBCC also found, and we agree, that Prendergast violated Conduct Rules 2110 and 3050 by failing to disclose his association with member firm AmeriNational when he opened securities accounts in the name of Prism at member firm Rocky Mountain. Prendergast admits that he failed to advise AmeriNational that he had opened an account with Rocky Mountain and failed to inform Rocky Mountain that he was associated with AmeriNational, claiming that such omissions were merely oversights. We find that his failure to make the required disclosures constituted a violation of Conduct Rule 3050, as alleged in the fifth cause of action. In addition, we find that such failures constituted conduct inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of Conduct Rule 2110.

Cause Six - Failure to Provide Information. The DBCC found that Prendergast violated Procedural Rule 8210 and Conduct Rule 2110 by refusing to provide on-the-record testimony. The record indicates that NASD Regulation staff provided notice to Prendergast requesting that he provide on-the-record testimony on at least two occasions. Prendergast refused to provide on-the-record testimony. Prendergast responded to staff's first request by stating that all relevant information had already been provided, that he would not attend the scheduled interview and that further inquiries should be directed either to the attorney who prepared the Prism PPM, the accountant who handled Prism's books or AmeriNational. Staff responded to Prendergast's

---

[10] We note, as well, that Conduct Rule 2210 does not require that a communication name a specific security in order for it to violate the rules provisions. See, e.g., Sheen Financial, supra, at 8-9 n.22 (finding that an advertisement violated NASD's advertisement rule even though it promoted certain types of securities -- e.g., annuities, money market funds, etc. -- rather than identifying specific securities by name).

remarks by letter stating that the purpose of the on-the-record interview was not only to obtain information but also to provide Prendergast with an opportunity to explain his activities with Prism. Staff further notified Prendergast that the interview had been rescheduled. Prendergast then advised staff that he would only meet off-the-record. Staff, according to testimony at the hearing, determined that an off-the-record meeting was not an acceptable alternative because of concerns about the reliability of certain information that Prendergast had previously provided during the investigation.[11] Prendergast never provided on-the-record testimony prior to the DBCC hearing.

At the DBCC hearing, Prendergast testified that "[t]here was considerable concern on [his] part that if [he] went on the record, where that record would go. And if it went back into the hands of the investors because their attorneys had requested a copy of the record -- at this time this was a very sensitive thing with the investors." Similarly, at the NAC appeal hearing, Prendergast stated that he refused to provide on-the-record testimony because he did not "feel that was appropriate at the time because of the feedback [he was] getting from some of [Prism's] investors who were unhappy with the performance of the fund, and [he] didn't want that information at least on record to pass on to those investors at that time." Prendergast commented later during the appeal hearing that he did not want to answer questions on the record because he was "trying to protect [his] own position."

Procedural Rule 8210 authorizes NASD Regulation, in the course of its investigations, to require persons associated with an NASD member -- and persons who are not presently associated but remain subject to the NASD's jurisdiction -- to "provide information orally [or] in writing . . . and to testify, under oath or affirmation administered by a court reporter[,] . . . with respect to any matter involved in the investigation. . . ." As the SEC has emphasized, because NASD Regulation lacks subpoena power over its members, a "failure to provide information fully and promptly undermines the NASD's ability to carry out its regulatory mandate." In re Brian L. Gibbons, Exchange Act Rel. No. 37170, at 5 (May 8, 1996), aff'd, 1997 U.S. App. LEXIS 8875 (9th Cir. April 25, 1997).

Here, there is no question that Prendergast steadfastly refused to provide on-the-record testimony. Moreover, Prendergast's claim that he had already submitted all relevant information to staff provides him with no defense, as members and associated persons may not second guess NASD Regulation's requests for information. In re Robert A. Quiel, Exchange Act Rel. No. 39056 at 5 (Sept. 11, 1997); In re Mark Allen Elliott, 51 S.E.C. 1148, 1151 (1994). Prendergast's assertion that he was willing to provide off-the-record testimony is likewise unavailing. It is axiomatic that members and associated persons are not permitted to impose conditions under which they will provide information to NASD Regulation. In re Richard J. Rouse, 51 S.E.C. 581, 585-86 (1993); In re Michael David Borth, 51 S.E.C. 178, 181 (1992). Furthermore, a respondent cannot, consistent with the NASD's rules, refuse to provide requested information simply because he or she has determined that it might be detrimental to his or her own interests to cooperate with an NASD Regulation investigation. See, e.g., In re Darrell Jay Williams, 50 S.E.C. 1070, 1072 (1992) ("[Respondent] was clearly obligated to supply the information that the

---

[11] See, e.g., infra, note 12.

NASD requested, and the possibility of litigation in connection with the underlying transaction provided no excuse for his failure to do so.").

We find that Prendergast's failure to provide on-the-record testimony, as requested by staff, violated Procedural Rule 8210, as alleged in cause six of the complaint. We also find that such action was inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of Conduct Rule 2110.

Cause One - Unregistered Broker/Dealer. The first cause of action alleged that Prendergast's activities required him to be separately registered as a broker. In support of this cause of action, NASD Regulation staff introduced copies of five "Solicitation Agreements" between Prism and several individuals and entities who solicited members of the public to purchase Prism units. These Agreements provided for compensation to the "solicitors" in the unit offering as follows:

- For each unit sold in the offering, the solicitor would receive a portion of the management fee to which the managers (Prendergast and DeAngelis) would be entitled if the "company" (Prism) was profitable;

- The solicitor would receive a portion of the "ending equity" of the [hedge] fund equal to the number of units sold times .005 upon termination of the fund; and

- In three of the five agreements, the solicitor would receive a stated amount for each unit sold at the time of sale as an "advance" on the management fee described above.

Staff also introduced a number of checks issued by Prism that had notations that appeared to indicate transaction-related compensation to third parties. For instance, many of these checks had notations on the memo line characterizing the payment as a management fee advance and listed the purchaser's name. Twenty-three of the 43 payments were made to DeAngelis.[12]

The staff examiner testified that, because the PPM and the Solicitation Agreements indicated that there would be no entitlement to any management fees unless and until Prism was profitable, he reviewed the agreements and other information received during the investigation to determine if the solicitors undertook to repay the "advances." He stated that he was unable to

---

[12] An NASD Regulation staff examiner testified that, late in the investigation, he learned that DeAngelis was not the recipient of most of these funds. Another individual, Don Maier, was the original payee on most of the checks, but when Prendergast provided photocopies of the checks, Maier's name was whited out and DeAngelis' name was inserted. This apparently occurred because Maier, who was registered with an NASD member broker/dealer (unlike DeAngelis, who was not), did not wish to become involved in the investigation. Prendergast confirmed the alterations during his testimony at the hearing, stating that Maier was ill and deserved to be protected from the investigation.

find any indication of any repayment obligation for these advances. He also testified that the amount paid to DeAngelis, AmeriNational and the third-party solicitors approximated 10 percent of the offering proceeds, which was the amount allocated to commissions in the PPM. For these reasons, the staff formed the belief that Prendergast functioned as an unregistered broker/dealer in connection with the sale of Prism units.

Prendergast claimed that DeAngelis could not have received commissions because of his manager position with Prism and that advances on management fees were the only way to compensate DeAngelis for investors he brought to the program. Prendergast did not discuss the remaining payments, nor did he contest the staff's assertion that they were transaction-based compensation.

Section 15(a)(1) of the Securities and Exchange Act of 1934 ("Exchange Act") requires the registration of any broker who is a natural person not associated with a broker/dealer and who effects transactions in, or induces or attempts to induce the purchase or sale of, any security. Section 3(a)(4) of the Exchange Act, in turn, defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others. . . ."

In the current case, Prendergast was associated with member firm AmeriNational as a registered representative. Both Prendergast and AmeriNational stated that all Prism transactions by Prendergast were done through AmeriNational and that AmeriNational was provided with subscription agreements for all Prism investors. Staff presented no clear evidence contradicting these claims, although staff did present evidence that, in his role as co-manager of Prism, Prendergast directed Prism to make payments to certain third parties in connection with the solicitation of purchasers of the Prism securities.

The first issue we confront is whether, as a matter of law, a person registered with a broker/dealer may be required, under certain circumstances, to register separately as an independent broker/dealer. The answer to this query is in the affirmative. In In re Charles A. Roth, 50 S.E.C. 1147 (1992), aff'd, 22 F.3d 1108 (D.C. Cir.), cert. denied, 513 U.S. 1015 (1994), an individual who was associated with a member firm was alleged to have acted as a broker/dealer without being registered as such. The bases for the allegations in Roth were that the respondent billed clients in his own name and received their direct payments; used personalized stationery that carried only his own name when corresponding with clients; engaged in and received compensation for certain securities activities without disclosing such information to the member firm with whom he was associated; and permitted an issuer to characterize him in a tender offer circular as being an "independent securities broker" and to represent that he (not the member firm with whom he was associated) was providing "brokerage services." Id. at 1151-53. The SEC upheld the NASD's determination that, under the circumstances of that case, the respondent was required to obtain independent registration as a broker/dealer. Id. at 1152.

Next we must consider whether, under the facts of this case, Prendergast was required to register separately as a broker/dealer. Unlike in Roth, the uncontradicted evidence in this case indicates that all of the transactions effected by Prendergast related to the Prism private offering went through and were known to AmeriNational. This case is thus distinguishable from Roth, where the respondent concealed certain security activities from his firm, received direct payments from purchasers and otherwise acted completely independently from the broker/dealer with

whom he was associated. We cannot say, under the present record, that Section 15(a) required Prendergast to register independently as a broker/dealer. Staff's argument that Prendergast directed Prism to pay third-parties in relation to their solicitation of purchasers of Prism securities does not, without more, suggest otherwise. Such conduct may very well have violated the prohibition against paying commissions to unregistered persons in connection with the purchase or sale of securities,[13] a charge not alleged in the complaint,[14] but it does not alone require an associated person to register separately as a broker/dealer.

In brief, we find that the record does not show, by a preponderance of the evidence, that Prendergast violated Conduct Rule 2110 by acting as a securities broker without complying with the registration provisions of the federal securities laws. Accordingly, we reverse and dismiss the findings of the DBCC with regard to cause one.

Sanctions

The DBCC determined that Prendergast should be censured and barred from associating with any member firm in any capacity. For the reasons discussed below, we agree. As a threshold matter, we note that, in arriving at the appropriate sanctions, we have considered the entire record in this matter, the nature and seriousness of the misconduct, and the relevant NASD Sanction Guidelines.[15]

We find that Prendergast engaged in significant, pervasive misconduct and exhibited a fundamental lack of understanding of his obligations as a registered representative. He accepted nearly $1 million from the public pursuant to offering materials that were materially defective in numerous respects, applied much of those funds in a manner different from that represented in the offering materials, lost nearly the entire amount of the invested funds, distributed misleading sales literature and published a misleading advertisement, failed to provide proper disclosure to his employer that he had opened an account with another member firm and refused to give on-the-record testimony in order to protect his own position vis-a-vis complaints by investors. This

---

[13] See, e.g., In re Michael Brian Kormos, Exchange Act Rel. No. 35823 (June 8, 1995) (finding respondent in violation of Conduct Rule 2110 where he allowed an unregistered person to solicit securities business); In re Gary D. Cohee, 48 S.E.C. 917 (1987) (holding that respondent violated the NASD's rules by permitting unregistered person to effect securities transactions and paying certain consulting fees to the unregistered person in relation to such activities). See also Conduct Rule 2420. We note as well that a person not associated or registered with a member broker/dealer who receives fees for soliciting the purchase of securities likely would have to be registered as a broker/dealer. See, e.g., In re Birchtree Financial Services, Inc., SEC No-Action Letter, 1998 WL 652137 (Sept. 22, 1998) ("[T]he receipt of securities commissions or other transaction related compensation is a key factor in determining whether a person or an entity is acting as a broker-dealer.").

[14] Because the complaint did not allege that Prendergast engaged in misconduct on this basis, we make no determination as to whether such a claim would have merit.

[15] See NASD Sanction Guidelines (1996 ed.) at 5, 22, 34.

conduct deviates grossly from the standards to which persons in the securities industry must adhere.[16]

In light of our duty to protect the investing public and to ensure the integrity of the market, we would be remiss in not acting decisively in cases, like the present matter, where the evidence indicates that a registered representative has engaged in a calculated and wide-ranging course of misconduct. As the SEC has noted, the securities industry "presents a great many opportunities for abuse and overreaching, and depends very heavily on the integrity of its participants." In re Bernard D. Gorniak, Exchange Act Rel. No. 35996, at 5 (July 20, 1995); see also In re Mayer A. Amsel, Exchange Act Rel. No. 37092, at 11 (April 10, 1996) (noting that the securities industry is "rife with opportunities for abuse."). Because we find that Prendergast's continued participation in the securities industry presents a risk to the public, we hold that his exclusion from association with any member firm in any capacity is necessary, notwithstanding that we have dismissed one of the six causes of action against him.

Accordingly, we impose a censure and a bar from associating with any NASD member firm in any capacity.[17] The bar is effective immediately upon the issuance of this decision.[18]

On Behalf of the National Adjudicatory Council,

____

Joan C. Conley
Senior Vice President and Corporate Secretary

---

[16] We are concerned, moreover, by Prendergast's complete lack of remorse and failure to accept responsibility for his actions. We also note that Prendergast was previously sanctioned for participating in private securities transactions without providing prior written notice to his member firm and for establishing securities accounts for two customers and purchasing securities in those accounts based on instructions he received from a third party without verifying whether the third party had authority to act for the customers.

[17] We note that the DBCC did not impose any monetary sanctions as a result of Prendergast's bankruptcy filing. We decline to impose monetary sanctions as well.

[18] 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.