

BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of

District Business Conduct Committee
For District No. 8,

Complainant,

vs.

James Allen Merten
Zionsville, IN

and

City Securities Corporation
Indianapolis, IN,

Respondents.

DECISION

Complaint No. C8A950030

District No. 8 (CHI)

Dated: October 31, 1997

This matter was called for review pursuant to NASD Procedural Rule 9310.¹ We affirm the findings of the District Business Conduct Committee for District No. 8 ("DBCC") that City Securities Corporation, Inc. ("City Securities" or "the Firm") and James Allen Merten ("Merten") violated Article III, Sections 1 and 27 of the NASD's Rules of Fair Practice ("Rules") (now and hereinafter referred to as Conduct Rules 2110 and 3010) by failing adequately to supervise a registered representative of City Securities. We also affirm the DBCC's finding that City Securities violated the Association's By-Laws, Schedule C (now and hereinafter referred to as "Membership and Registration Rule 1032(d)") by allowing a person to engage in selling option

¹ The NBCC called this case for review to determine whether the sanctions imposed by the District Business Conduct Committee are appropriate in light of the NASD Sanction Guidelines.

contracts without proper registration. We increase the sanctions imposed on City Securities and Merten to a censure and \$15,000 fine, assessed jointly and severally, and affirm the imposition of costs on City Securities for the DBCC hearing.

Background

City Securities has been a registered broker/dealer since 1936, and a member of the NASD since 1940, and its registration and membership remain effective. Merten entered the securities industry in July 1973 as a general securities representative and general securities principal of City Securities and his registrations remain in effect. In September 1992, Merten ascended to the position of President of City Securities.

Jerry Neal ("Neal") entered the securities industry in 1968 as a general securities representative of another member firm. In November 1979, Neal became registered as a general securities representative and general securities principal of City Securities, which registrations were terminated in May 1994.

Discussion

The complaint in this matter alleges that City Securities and Merten committed violations arising out of two activities: City Securities' method of closing a limited partnership offering and the supervision of a former City Securities registered representative, Neal. We will examine these activities in turn.

A. Cause One - The Riverpointe Offering

Facts. The purpose of the Riverpointe Partners, L.P. ("Riverpointe" or "the Partnership") offering was to raise funds to acquire, own, rehabilitate and operate a 282-unit apartment project housed in two high-rise buildings located near the White River in Indianapolis, Indiana. The offering was for 81 limited partnership interests, costing \$50,000 per unit, for a total offering amount of \$4,050,000. The Partnership was to purchase the apartment complex for approximately \$2,550,000, with no debt financing. The Partnership would use more than \$1,000,000 of the offering proceeds for interior and exterior rehabilitation of the complex, which had been foreclosed on.

City Securities entered into an underwriting agreement, on a firm commitment basis, with the general partner of Riverpointe on June 4, 1993, agreeing to purchase all unsold partnership units at the closing of the offering. City Securities' President, Merten, executed this underwriting agreement on behalf of City Securities. Neal, an Executive Vice President, initiated the Riverpointe deal and presented it to City Securities. The general partner of the Partnership was Metropolitan Housing, Inc. ("General Partner"), an Indiana corporation formed for the purpose of marketing student housing to colleges and trade and technical schools in and around metropolitan Indianapolis. The President of the General Partner was David Neal, age 33 at the time of the offering and Neal's son.

City Securities offered Riverpointe to potential investors pursuant to Rule 506 of Regulation D. 17 C.F.R. §230.506 (1996). The Private Placement Memorandum for Riverpointe ("PPM") was issued on April 29,

1993. The General Partner filed Form D, as required by Rule 506, with the SEC on April 30, 1993. The PPM provided that the offering would terminate on June 1, 1993, unless all of the units were sold prior to that date, or unless the termination of the offering was extended by the General Partner, in its sole discretion, until no later than August 31, 1993, defined as the termination date. The PPM also stated that "[i]f subscriptions for all the Units are not accepted by the General Partner on or before the [t]ermination [d]ate (defined below) [City Securities] has agreed to acquire all the remaining Units at the Offering price," less any commissions for these units.

The first sale of a Riverpointe unit to a customer occurred on May 19, 1993. By June 28, 1993, only 26 of the 81 units had been sold. The PPM was modified by Supplement No. 1 on June 28, 1993, and the termination date of the offering was extended to August 27, 1993, unless all units were sold before that time. By August 26, 1993, 49 units had been sold and 32 remained unsold. The Riverpointe PPM was again modified by Supplement No. 2 on August 26, 1993, which extended the termination date of the offering to October 29, 1993, unless all the units were sold before that time. Also on August 26, 1993, the General Partner and City Securities, acting through Neal, signed an "Extension of Termination Date and Indemnity Agreement," which extended the termination of the offering to no later than October 29, 1993. During this final extension of the termination date of the offering, one additional unit was sold to Neal. City Securities sold a total of 50 units. On October 29, 1993, City Securities purchased the remaining 31 units by completing a subscription agreement for the purchase of the units.

Although the General Partner and City Securities twice extended the termination date of the offering, the date to purchase the apartment complex from the previous owner remained June 28, 1993. City Securities preferred to complete the purchase of the property as scheduled in June, but continue selling Riverpointe units for an additional period of time. City Securities sought the advice of its outside attorneys as to how it should proceed. Pursuant to that advice, Merten, on behalf of City Securities, entered into an "Agreement for Advance" under which City Securities would transfer \$2,297,000 to the General Partner in order to close on the purchase of the apartment complex. The General Partner purchased the complex on June 28. The General Partner took over management of the apartment complex in June 1993 and arranged for the ongoing rehabilitation of the buildings. Also on June 28, 1993, Riverpointe held an interim closing of the offering, at which the existing purchasers of the units were admitted as limited partners. Supplement Nos. 1 and 2 to the PPM explained that purchasers of Riverpointe units after June 28, 1993 would later be admitted retroactively to the Partnership as of June 28, 1993.

Alleged Violation of Firm Commitment Underwriting Agreement. The complaint's first cause alleges that Merten and City Securities failed to abide by the firm commitment underwriting because City Securities did not purchase all 55 unsold units before June 30, 1993. Instead, the complaint alleges, City Securities continued to offer and sell the units to the public until at least September 30, 1993 and City Securities did not purchase the unsold units until it submitted a subscription document in October 1993. The DBCC hearing panel found that City Securities did not violate its firm commitment underwriting agreement. We agree.

The facts regarding City Securities' completion of the Riverpointe offering are not in dispute here; rather, the issue is the legal significance of extending the offering's termination date. The PPM stated that the offering

would terminate on June 1, 1993, unless extended by the General Partner, in its sole discretion, until August 31, 1993, defined as the Termination Date. The PPM also stated that City Securities "has agreed to purchase any Units for which subscriptions are not made and accepted by the General Partner by the Termination Date."² By these very terms, when the General Partner extended the termination date to August 27, 1993, City Securities was not obligated to purchase all unsold units by June 30, 1993. City Securities' obligation to purchase was likewise extended. The allegation in cause one that City Securities was required by the terms of the PPM to purchase all unsold Riverpointe units by June 30, 1993 is incorrect.

The fact that City Securities continued to offer Riverpointe units for sale until September 30, 1993 is also not a failure to abide by the firm commitment underwriting agreement. City Securities duly modified the PPM to reflect the new termination date. Supplement No. 1 to the PPM, dated June 28, 1993, explained that the purchase of the apartment complex closed on June 28, 1993, but that the termination date of the offering was extended by the General Partner to August 27, 1993. Supplement No. 1 further explained that City Securities advanced funds to the Partnership in an amount equal to the remaining unsold units, less underwriting fees, the proceeds of which were used together with the offering proceeds to close on the purchase of the apartment complex. Supplement No. 2 extended the termination date of August 27, 1993, for a final time to October 29, 1993. City Securities and the General Partner also modified their underwriting agreement to extend the termination date to October 29, 1993. On October 29, 1993, City Securities purchased the remaining 31 unsold units. Accordingly, City Securities abided by its firm commitment underwriting agreement.

We have found no statute, regulation, case law, or Conduct Rule that City Securities violated in conducting this offering and specifically in extending the termination date of the offering. We credit the testimony of City Securities' expert witness, Michael Wolensky, who testified that City Securities' advancement of funds, the supplement to the PPM, the extension of the offering and the closing of the transaction were all consistent with securities laws, regulations and case authority.³

We affirm the DBCC's dismissal of the first cause and dismiss this cause as to City Securities and Merten.

² The statements in the PPM are accurate descriptions of the terms of the underwriting agreement between City Securities and the General Partner.

³ We note that securities offerings that do not have a firm commitment underwriting are subject to several regulations that did not apply to the Riverpointe offering. See, e.g., Rule 15c2-4 (establishing liability unless, among other conditions, underwriter holds all subscription proceeds from an all-or-none or minimum-maximum offering in an escrow account or a separate, trustee account maintained at a financial institution); Rule 10b-9 (establishing liability if any person represents that a security is being offered on an all-or-none or maximum-minimum basis, unless the offering meets enumerated conditions); SEC Release No. 33-6455, question and answer No. 80 (March 3, 1983) (investors in all-or-none offerings must either: 1) affirmatively elect to recommit to the offering when the issuer notifies them that the termination date of the offering is being extended; or 2) if they do not respond, or choose not to recommit, have their funds promptly returned).

B. Cause 10 - Options Trading⁴

Cause 10 alleges that City Securities, acting through Merten, allowed Neal to effect options transactions with a public customer and receive commissions when Neal was not registered in the appropriate capacity. The evidence established that Neal became registered as a general securities representative in 1968 and subsequently became registered as a general securities principal. Neal did not, however, take any qualifying examination to enable him to conduct options trading. Neal's investigative testimony and City Securities' year-end commission run demonstrate that Neal conducted options transactions at City Securities. Accordingly, we find that City Securities violated Membership and Registration Rule 1032(d) and Conduct Rule 2110 by allowing a person to engage in selling option contracts without proper registration.

As to Merten, we affirm the DBCC's dismissal of this cause. The complaint alleges that Merten allowed Neal to trade options. Merten, however, was not City Securities' senior registered options principal, nor was he its compliance registered options principal, nor was he charged with responsibility for the Firm's registration requirements. Consequently, Merten should not be held responsible for Neal's improper options trading.

C. Cause 11 - Inadequate Supervision

1. Factual Background

Merten began working at City Securities in 1973 as a registered representative. In 1978 or 1979, City Securities purchased the firm at which Neal was working. After joining City Securities, Neal served in the role of a senior salesman in charge of bank coverage. For five years, ending in 1984, Merten and Neal worked together daily because Merten was managing the bond department and Neal was very active in selling bonds. After 1984, Merten moved to the public finance department of City Securities and no longer worked closely with Neal.

Merten became President of City Securities at the beginning of September 1992. Before and during the Riverpointe offering, Merten was the supervisor of underwriting activities. Merten's appointment as President represented a change in the management structure of City Securities. Prior to this time, the Firm had both a President and an executive committee, with the committee discussing the general direction of the Firm. After Merten became President, the executive committee was disbanded and Merten reported only to the Board of Directors. During the time period from 1992 to 1994, the Chairman of the Board of Directors was John Peterson ("Peterson"). The Chief Operating Officer, Jack Jenney ("Jenney"), reported to Merten. Jenney was responsible for the day-to-day operations of City Securities and oversaw equity trading, the special products division and the back office. By the Spring of 1993, City Securities had two sales managers that reported to Jenney. Mike Perry was sales manager for Indianapolis and Bob Griffiths was sales manager for all the branch offices, which included Lafayette, Anderson and South Bend.

⁴ The complaint as issued named three respondents: Neal, Merten and City Securities. Neal entered into a settlement as to all causes. City Securities and Merten were named only in causes one, 10 and 11.

From September 1992 to 1994, Julie McMorrow ("McMorrow") was the head of City Securities' special products division. This division handled annuities, mutual funds, investment trusts, direct participation programs and taxable fixed income products. During the relevant time period, McMorrow reported to Jenney.

In 1992, Beth Schmidt ("Schmidt") was a Vice President of City Securities in charge of the Firm's compliance functions. Schmidt reported to several different managers, including Jenney and Merten, depending on the issue.

Events Relevant to City Securities' and Merten's Supervision of Neal. In January 1993, City Securities began considering underwriting the Riverpointe project. On January 18, 1993, Jenney wrote a memo to Merten criticizing the marketability and fairness of Riverpointe as it was then structured. Jenney concluded his one-page memo by saying "[t]here is no way this deal with this structure could or should be sold to the public by City Securities Corporation." Before being offered to investors, many of Jenney's concerns were addressed by changing the structure of the Riverpointe offering.

The Riverpointe PPM was dated April 29, 1993. On the same day, Schmidt wrote a memo to Merten charging that Neal had violated a number of securities regulations.⁵ The memo asserted that Neal had violated the quiet period, distributed unapproved prospectuses, violated the Firm's Chinese Wall policy, and -- in the near future -- may violate state registration requirements by selling Riverpointe in states where Neal is not registered and may falsify customer addresses.

On June 22, 1993, the head of the special products division, McMorrow, wrote a memo to Jenney in which she expressed concerns about the suitability of three investors in Riverpointe. The memo states that: "the purchase of Riverpointe seems to represent a significant change in the investment objectives and investment history of these investors." Jenney forwarded the McMorrow memo to Merten with a cover memo that said: "I most wholeheartedly agree. We all know that suitability is our big exposure. We would welcome another opinion." (emphasis in original). Merten testified that after he received this memo, he spoke with Neal about the three investors in question. Merten was satisfied with the explanation given by Neal, made no independent inquiry, and took no further action on the matter.

On August 1, 1993, Schmidt wrote a memo to Merten concerning possible use of discretion by City Securities registered representatives, in violation of the Firm's policy prohibiting discretion. The memo first described an incident in which a sales assistant was speaking on the telephone with a customer and the conversation, as reported, sounded like discretion may have been used in the customer's account. The memo also described a letter addressed to Neal that Schmidt said could be interpreted as saying a customer had previously given discretionary powers to Neal. The memo concluded that City Securities should review its discretionary policy in light of the possible use of discretion.

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As discussed below, the memo is in error in asserting several supposed violations.

In October, November or December of 1993, the SEC conducted a review of the suitability of Riverpointe for several investors at City Securities. In January 1994, Merten decided to withhold commissions from Neal for two Riverpointe customers who lived in states where Neal was not registered. The two customers were JS and RM. In response to the SEC's inquiries, Neal drafted a letter that discussed why Riverpointe was suitable for the five customers in question. On March 18, 1994, Schmidt wrote a memo to Neal regarding his proposed responses to the SEC. Schmidt's memo told Neal that he needed to expand on his responses to address the areas that the SEC saw as problems.

The NASD began a regularly scheduled examination of City Securities on March 28, 1994. On March 30, 1994, City Securities placed Neal on special supervision status. During this time, Merten hired an investigator to review Neal's accounts independently and report back to City Securities. On April 21, 1994, Merten suspended Neal from employment with City Securities. Thereafter, City Securities' investigator made his report, and Merten called a meeting of the Board of Directors, at which the Board voted to terminate Neal. On May 26, 1994, Merten terminated Neal.

The complaint alleges that City Securities and Merten failed adequately to supervise Neal in four areas: failing to disclose loans in the Riverpointe PPM; making unsuitable investment recommendations; distributing misleading sales literature; and engaging in unauthorized trades. Our analysis will follow the same sequence as set forth in the complaint.

2. Failure To Disclose Loans Between Neal and the General Partner of Riverpointe

The complaint alleges that City Securities and Merten failed to supervise Neal in that Neal distributed offering materials for Riverpointe that failed to disclose that Neal held outstanding personal notes for \$35,000 from Riverpointe's General Partner. The evidence established that Neal held in his rollover IRA account, which was maintained at City Securities, a \$10,000 note from the Secretary of the General Partner and a \$25,000 note from his son, David Neal, the President of the General Partner.

Conduct Rule 3010 requires NASD member firms to establish, maintain and enforce written procedures that are reasonably designed to achieve compliance with all applicable laws and regulations, to supervise the types of business in which they engage, and to supervise registered representatives.

Focusing first on Merten, we find no failure to supervise resulting from the omission of the loan disclosures in the Riverpointe PPM. Merten was the contact person at City Securities for the Riverpointe offering. The circumstances surrounding the undisclosed loans, however, did not raise a red flag to Merten. Merten, Neal and the attorneys working on the Riverpointe offering discussed whether there were any business transactions between the parties, and Neal did not disclose the loans. Although the PPM discloses that "David D. Neal, President of the General Partner is the son of Jerry Neal, one of the key personnel of the Underwriter," there is no disclosure of the loans. Because Merten exercised reasonable diligence in attempting to uncover inter-party transactions and because Merten had no reason to believe that Neal was failing to disclose the loans, we find that Merten's supervision was not inadequate as to the omission.

As to City Securities, we disagree with the DBCC and decline to find inadequate supervision as to the loan disclosure omission. The evidence did not show a weakness in City Securities's supervisory procedures that could have been changed in order to prevent the omission in the Riverpointe PPM. The evidence also did not show that City Securities's procedures were not reasonably designed to supervise its underwriting activities. Accordingly, our finding of inadequate supervision by City Securities and Merten is not based on the failure to disclose loans in the Riverpointe PPM.

3. Unsuitability

The complaint alleges that Neal recommended to five customers that they purchase Riverpointe units when Neal did not have a reasonable basis for believing that the recommendations were suitable for the customers in light of their investment objectives, financial situation and needs. The complaint further alleges that City Securities and Merten inadequately supervised Neal when they allowed the customers to purchase Riverpointe units. We agree with the DBCC and find that City Securities and Merten did inadequately supervise Neal's selling of Riverpointe units.

We find that Merten had a duty to supervise Neal because Merten was working on the Riverpointe offering with Neal, had the power to supervise Neal, and was faced with "red flags" that signified a potential problem as to Riverpointe's suitability for several customers. See In re John H. Gutfreund, 51 S.E.C. 93, 108 (1992). On this suitability issue, we do not hold Merten responsible based on the rule that a firm president is ultimately responsible for all compliance requirements unless he clearly delegates that responsibility. Here, Merten committed a violation because he failed to investigate when his employees raised red flags regarding suitability.

A broker/dealer must adequately follow-up and review a matter when the firm's own procedures detect irregularities. See In re Rita H. Malm, Exchange Act Rel. No. 35000 (Nov. 23, 1994). Once a situation raises red flags, supervisors cannot discharge their supervisory obligations simply by relying on the unverified representations of employees. See In re Shearson Lehman Hutton Inc., 49 S.E.C. 1119, 1123 (1989); In re Prudential-Bache Securities, Inc., 48 S.E.C. 372, 396 (1986). When a supervisor is faced with red flags, especially when the employee in question has no effective line supervisor, the supervisor's duty to follow-up and investigate is heightened. In re Bradford John Titus, Exchange Act Rel. No. 38027 (Dec. 9, 1996).

We now turn to the various communications that Merten received concerning Neal to determine if those communications were red flags signifying potential misconduct by Neal. The first potential red flag was Schmidt's April 29, 1993 memo to Merten regarding securities regulation violations by Neal. Even though this memo contained several errors, it also contained a warning that Neal was willing to disregard securities regulations. Schmidt testified that several of her assertions in her memo were incorrect, including the claims of Neal's distribution of unapproved prospectuses, Neal's discussions with potential investors about Riverpointe, and the Chinese Wall violation. Schmidt explained that she was incorrect because at the time she did not know any of the details of this exempt offering. Schmidt's memo discussed additional claims, however. She also raised general concerns about Neal's attitude toward compliance with securities regulations as follows:

[Neal] stated he knew he was in violation of securities regulations more than once. Yet, he proudly proceeded to discuss in detail the prospectus distributions, the lack of proper state registrations and falsifying of addresses with me. . . .

As an individual, I am appalled that any individual feels he or she is so far above the law. As a Compliance Officer, I feel I have been placed in a position whereby my securities licenses and career, as well as those of the firm and other individuals, could be compromised had I abetted such actions by my silence.

Merten's response to this memo was to discuss the issues with Neal. Merten testified that Neal was cautioned to follow the procedures that were discussed with City Securities' lawyers as to how the offering should be conducted, including suitability, keeping a record of who received the PPM and keeping the subscription agreements. We find, however, that this memo should have put Merten on notice that Neal's Riverpointe sales efforts should have been more closely supervised.

Moreover, the June 22, 1993 McMorrow memo, forwarded by Jenney to Merten, raised a red flag as to suitability. McMorrow's memo identifies three investors for whom she had suitability concerns, RN, LT and JS. McMorrow attached to her memo the confidential purchase questionnaire and printouts of the three customers' accounts. McMorrow explained the following: the three non-accredited investors were selling AAA-rated bonds to purchase Riverpointe units. The Riverpointe purchases seemed to represent a significant change in the investment objectives and investment history of these investors. McMorrow was bringing this issue to Jenney's attention so that someone of higher authority could decide on the suitability of Riverpointe for these investors. The seriousness of the suitability concerns was reinforced by Jenney, who wrote to Merten that suitability was the Firm's "big exposure."

Merten's response to these suitability concerns was to discuss, in detail, the three customers with Neal. Merten did not examine the customers' account statements and did not review the customers' investment objectives, annual income, or net worth. Merten also did not direct anyone else to take these steps.

We find that Merten's response was inadequate. Customer LT purchased one \$50,000 Riverpointe unit. McMorrow's memo described her as 75 years old and a non-accredited investor. Had Merten investigated, he would have found that her account card was filled out in 1982 and did not show investment objectives, annual income, or net worth information. Customer LT's City Securities monthly account statements for the previous three months showed that her portfolio net worth was between \$131,000 and \$149,000. More than nine months after LT's purchase, when City Securities further investigated her suitability, a new customer account form was completed, showing LT's annual income as \$12,000, her approximate net worth as \$136,000 and her investment objective as income. These facts conclusively show that Riverpointe was an unsuitable investment for LT. After City Securities conducted its investigation in 1994, it voluntarily offered to rescind LT's Riverpointe purchase, with interest.

The second customer in question was customer RN, who was 72 years old and purchased one unit. Had Merten examined RN's account statements for the preceding months, he would have found a portfolio net worth of \$210,000 to \$214,000 at City Securities. This information should have prompted further investigation as to whether Riverpointe, an illiquid and risky investment, should make up close to one-quarter of RN's portfolio, if indeed all of her investments were held at City Securities. Based on the documentary information about customer RN that was available, Merten inadequately supervised Neal by failing to object to RN's purchase without any further investigation.

The final investor identified in McMorrow's memo was customer JS, age 65, who purchased one Riverpointe unit in her IRA rollover account. Had Merten examined JS' customer account form, it would have shown that in 1989 JS was retired, had an annual income of \$50,000, an approximate net worth of \$500,000 and an investment objective of safety of principal. Customer JS' IRA rollover account had a portfolio net worth of between \$105,000 and \$107,000 in the months before she purchased Riverpointe. Based on the investment objective of JS, Merten should have disapproved of JS' purchase.⁶ Merten's failure to inquire was inadequate supervision.

Under the circumstances of this case, Merten failed to supervise Neal regarding the suitability of Riverpointe for investors. Not only did McMorrow's memo raise a red flag regarding suitability, but Jenney's note to Merten highlighted that suitability was an area of particular concern. Merten, therefore, should have been fully aware of the suitability concerns regarding an illiquid, risky investment such as Riverpointe. Considering all of these facts, Merten's reliance on Neal's unverified oral responses about suitability constitutes inadequate supervision. For similar reasons, we also find that City Securities' supervision of Neal was inadequate.

4. Misleading Sales Literature

The fourth cause alleges that Neal distributed sales literature in the form of correspondence that contained exaggerated, unwarranted or misleading statements. Because Neal's conduct is not directly at issue here, the DBCC limited its review to the period of time after which Merten became President of City Securities. After September 1992, Neal sent three letters to customers regarding the Indiana Growth and Treasury Trust and three letters to customers regarding Riverpointe.

Basis for Neal's Letters Violating Conduct Rules. Initially, we note that cause four refers to the letters that Neal sent as "sales literature," a term that is defined under Conduct Rule 2210 as including written communications distributed or generally made available to the public, exclusive of those communications deemed "advertisements." Subsection (a)(2) of the rule cites as examples of sales literature the following:

⁶ Merten also should have further investigated the suitability of an illiquid asset in an IRA account that was intended to distribute assets in approximately six years. An IRA account must begin distributing some minimum amount from the account to the individual by April 1 of the calendar year following the calendar year in which the individual attains the age of 70 ½ or be subject to an excess accumulation penalty. See I.R.C. §§ 408(a)(6) & 4974(a); Treas. Reg. § 1.408-2(b)(6).

circulars, research reports, market letters, performance reports and summaries, form letters, seminar texts, and the like.

The definition of sales literature, therefore, contemplates materials that are generally distributed, not written materials prepared for use with individual prospective customers. NBCC precedents do not support the concept of applying all of the requirements of Conduct Rule 2210 to single pieces of correspondence. Neal's letters in the record are not form letters, but rather are individualized correspondence. We frame our review of Neal's correspondence with potential investors under Conduct Rule 2110, which was also alleged in cause four as the basis for a violation. Consequently, Neal's letters must comply with the broader requirement that members observe high standards of commercial honor.

Applying this standard, we find that Neal's letter to customer JE contains a misrepresentation in violation of Conduct Rule 2110.⁷ Neal's letter to JS states:

I believe I sent you a prospectus on this perhaps a month ago, and I attempted to call but you were busy at the time. [JE], I think this is very [un]usual from a number of standpoints, producing yields in excess of 11% a year with very little if any risk. The prospectus does not explain some of the things that are happening, and [i]f it generates any interest please give me a call

We find this letter untrue because investing in Riverpointe involved substantial risks, not little or no risk. The risk factors section of the Riverpointe PPM begins by stating: "The purchase of Units offered hereby involves various substantial risks in addition to the general risks inherent in any investment." The PPM goes on to discuss several specific risks of Riverpointe including: the risk of the project not maintaining adequate occupancy levels to generate adequate revenue to meet operating obligations; the risk of cost overruns for the construction and rehabilitation of the project; and the risk that the General Partner will not successfully manage the project. The General Partner had never owned or operated an apartment project similar to Riverpointe. Taking into consideration that Riverpointe units were illiquid and involved substantial risks, we find Neal's assurance of low risk, if any, to be untrue.⁸

⁷ To the extent the DBCC decision relied on the other five Neal letters to support its conclusion that City Securities and Merten failed adequately to supervise Neal's distribution of sales literature, we decline to adopt this rationale because the other five letters are individualized and, therefore, should not be analyzed under the sales literature rules.

⁸ Neal's unqualified use of the 11 percent yield figure further distances this statement from the truth. The support for this figure comes from the accountants' projections of Riverpointe's pre-tax cash flow to investors, assuming one ignores the year 1993 and computes the mean of the percent returns for years 1994 to 2001. To achieve the projected returns, Riverpointe occupancy must be 92.5 percent through the end of 1994 and 95 percent in all years thereafter. Starting in 1995, the base rental rates must increase three percent each year and the operating costs must rise at the same rate. Achieving these results relies on the management skill of the General Partner and other, additional risk factors discussed in the PPM such as competing residential housing developments in the vicinity of Riverpointe, reduced enrollment of the colleges and other schools in the

Merten's Responsibility To Supervise Neal. Turning to the question of whether City Securities and Merten failed adequately to supervise Neal regarding his sending out correspondence, we find such a failure. On this issue, we do premise Merten's responsibility on the fact that he was President of City Securities, as did the DBCC. Although we find Merten responsible, we discuss below in the sanctions section several important mitigating circumstances that lessen the severity of his violation.

Merten testified that, after he became President, generally the Firm's salesmen reported to a sales manager who reviewed the salesmen's correspondence, and approved transactions. Neal, however, did not report to a sales manager as did all the other salesmen. Neal would "discuss" things with Chairman Peterson, but Neal did not report to Peterson, and his correspondence and trades were not reviewed by Peterson. Merten explained that Neal was more senior than the sales manager and therefore did not report to him. While Neal in fact discussed issues with Peterson, the written supervisory procedures for City Securities did not record this arrangement. Merten testified that Neal was supervised on routine matters by Schmidt in that she conducted an annual compliance review and distributed compliance memos to all of City Securities' sales force. We noted earlier, however, Schmidt's commentary about Neal's attitude toward compliance. (See p. 9.)

The Conduct Rule on supervision sets specific endorsement requirements for certain correspondence:

Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

Conduct Rule 3010(d).

City Securities had no such procedure for Neal's correspondence soliciting securities transactions. Therefore, we agree with the DBCC and find that City Securities failed adequately to supervise Neal. As to Merten, he knew or should have known that City Securities' procedures for Neal did not involve having Neal's correspondence endorsed by a registered principal in writing. As President, Merten was responsible for City Securities' system of reviewing correspondence unless and until he reasonably delegated that function to another person. See In re Michael Ben Lavigne, Exchange Act Rel. No. 33951 (April 21, 1994).⁹ Although Merten delegated some supervisory responsibility for Neal to Peterson, the responsibility for review of correspondence was not given to Peterson. If Merten delegated this responsibility to Schmidt, he should have known that Neal

vicinity of Riverpointe, adverse use of adjacent or neighboring real estate and changes in general local economic conditions. To describe Riverpointe as yielding over 11 percent with little if any risk is patently untrue because reaching an 11 percent return would require overcoming all of the risk factors described in the PPM.

⁹ The Lavigne case further explains that if a president delegates the responsibility for compliance to another person, the president is still responsible for all compliance requirements if he knew or had reason to know that such person's performance was deficient. See id.

was disregarding Schmidt's supervision when Merten received Schmidt's April 29, 1993 memo indicating that Neal admitted violating securities laws.

Merten's counsel argued on appeal that Merten's conduct in this matter was reasonable and that some broker/dealers have branch managers who are designated principals and review all correspondence for the branch, including their own. This point does not apply to our review of this case; however, such procedures would be in violation of Conduct Rule 3010. Cf. In re Royal Alliance Assocs., Inc., Exchange Act Rel. No. 38174 (Jan. 15, 1997). Nevertheless, such a system was not in place for Neal. Although Neal was qualified as a principal of the Firm, City Securities' procedures manual did not state that Neal would review and approve his own correspondence. Moreover, no evidence in the record establishes that Neal was authorized to approve his own correspondence.

5. Unauthorized Trading

The fifth cause alleges that Neal exercised discretionary trading authority in customers' accounts prior to obtaining written authorization from the customers and without obtaining prior written approval from City Securities.

City Securities' policy was not to allow its representatives to engage in discretionary transactions. Consequently, City Securities did not require representatives to document the agreement of customers to allow discretionary trading in their accounts.

Unknown to Merten or Schmidt, on January 6, 1993, Neal wrote to one of his customers that he had exercised the authority to sell the customer's stock. Neal explained that he was selling a large block of the stock and did not want to leave the customer's stock in the account.

Schmidt's August 1, 1993 memo to Merten discusses Neal's possible use of discretion in a customer's account and the possibility of Neal using discretion in other accounts. Schmidt testified that she discussed the possible use of discretion in the customer's account with Merten, and Merten said Neal denied any use of discretion.

Merten's response was merely to accept unverified assurances from Neal. In light of Neal's supervisory situation, Merten's response was inadequate. Neal was not being closely supervised. No one was reviewing Neal's correspondence and City Securities' compliance officer had warned Merten that Neal acted as if he were above the law. Once Schmidt raised the issue of unauthorized use of discretion, Merten should have conducted some level of independent investigation. Had Merten overseen such an investigation he could have discovered, as he did in July 1994, that Neal was using unauthorized discretion.

We find that Merten failed to supervise Neal, in that Neal was allowed to exercise unauthorized discretion in at least customer JS' account. Merten's response to Schmidt's memo of simply discussing the issue with Neal was insufficient investigation and follow-up to achieve compliance with securities laws and regulations. We agree with the DBCC and find that City Securities failed adequately to supervise Neal so as to prevent his

unauthorized use of discretion.

Sanctions

We impose a \$15,000 fine on City Securities and Merten, jointly and severally. We affirm the DBCC's assessment of \$2,841.50 of costs on and censure of City Securities. Additionally, we censure Merten. We have increased the fine imposed on City Securities because we find the weaknesses in City Securities' supervisory system to have been potentially serious. We have increased the sanctions imposed on Merten because his initial failure to investigate in response to red flags regarding suitability exposed City Securities' customers to unnecessary risk and deserves more of a sanction than only a Letter of Caution.

We have also considered the NASD Sanction Guidelines' ("Guidelines") comment that, in a typical case, the responsible individual should be suspended for 10 to 30 business days and should requalify by examination.

In light of all the circumstances of this case, we do not order that Merten be suspended or that Merten requalify. Several mitigating factors support this result. First, Merten has no disciplinary history. Second, Neal had no disciplinary history, had been in the industry for 25 years, and was one of the most senior registered representatives at City Securities. In addition, when Merten and Neal had been working together several years before, Merten saw Neal as a mentor.

Third, Merten eventually took action to investigate fully Neal's activities, albeit after the SEC had questioned the suitability of Riverpointe for several customers. Merten hired an outside investigator to examine Neal's dealings with Riverpointe customers, retained a law firm for advice on what actions to take, and ultimately demanded of City Securities' Board of Directors that Neal be terminated or Merten would resign from the Firm. The Board approved Merten's recommendation, and Merten terminated Neal shortly after the Association began investigating this matter.

Fourth, City Securities voluntarily offered rescission, with interest, to Riverpointe purchasers for whom the investment was of questionable suitability. Therefore, City Securities prevented customer losses.

Fifth, at Merten's direction, City Securities instituted a new organizational structure that strengthens its compliance system and aims to prevent the recurrence of the kind of violations that took place in this case.

In summary, we find that Merten's actions were inadequate in responding to reports regarding Neal's possibly improper activities. Once Merten began to suspect that he could not trust Neal's explanations, however, Merten's actions forcefully and thoroughly corrected the problem. Given these mitigating factors and the circumstances of this case, the Guidelines' recommendation of a suspension and requalification is not warranted.¹⁰

¹⁰ We have considered all of the arguments of the parties. They are rejected or sustained to the extent inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, any member who fails to pay any fine, costs, or

Accordingly, we order that City Securities and Merten be censured and fined \$15,000, joint and several. We further order that City Securities pay \$2,841.50 in costs for the DBCC hearing.

On Behalf of the National Business Conduct Committee,

Joan C. Conley, Corporate Secretary

other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails promptly to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.