BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of The Department of Enforcement, Complainant, vs. Respondent.	DECISION Complaint No. C8A010020 Dated: October 17, 2002

Respondent, who was associated with a member firm, purchased "hot issues," failed to inform member firm in writing that he maintained a trading account at another firm, and failed to inform second firm in writing that he was associated with a member firm. Held, findings of violation and sanctions affirmed.

Opinion

Respondent appeals a February 2002 Hearing Panel decision pursuant to Procedural Rule 9311. We find that Respondent purchased securities in five initial public offerings ("IPOs") that rose to an immediate premium at the opening of secondary trading, in violation of NASD Conduct Rule 2110 and IM-2110-1, the Free-Riding and Withholding Interpretation ("Free-Riding Interpretation"). We also find that Respondent failed to notify in writing the firm that maintained his personal brokerage account that he had become registered with a member firm and failed to notify in writing his employing member firm that he maintained a securities account at another firm, in violation of Conduct Rules 2110 and 3050(c). We order that Respondent be fined $9,546 ($5,000 plus disgorgement of $4,546) and assessed hearing costs.

I. Background

In 1984, Respondent and his partner founded Firm A or ("the Firm"), a commodities futures clearing firm. Firm A became an NASD member in February 1997. In 1997, Respondent became registered as a general securities principal, general securities representative, and government securities principal with Firm A. Respondent is currently employed by Firm A in these same capacities.

II. Facts

During the course of a routine examination of Firm B in August 1999, NASD's Department of Enforcement ("Enforcement") staff discovered that Respondent, while associated with member Firm A, had purchased shares in five public offerings that immediately traded at a premium in the secondary market ("hot issues"). An Enforcement staff examiner testified that, during his review of Respondent 's account activity, he determined that Respondent had realized a profit of $4,546 on the purchases. The purchases occurred between April 24, 1998 and May 19, 1999, during which time Respondent was registered in the capacities of securities principal and general securities representative with NASD member Firm A.

Respondent opened a personal brokerage account at Firm B in 1993, and granted discretionary trading authority to Employee B, who handled Respondent 's Individual Retirement Account at Firm B, to buy, sell, and trade in stocks, bonds, and other securities of all kinds in Respondent 's accounts. At the time that Respondent opened his brokerage account, he was not registered with an NASD member firm.

Respondent entered the securities business in February 1997 when Firm A, the commodities firm that he co-owned, became registered as a member of NASD and Respondent registered as a general securities principal, general securities representative, and government securities principal. Respondent never advised anyone at Firm B that he had become associated with a member firm.

From April 1998 to May 1999, Employee B purchased for Respondent's account securities in the following IPOs: Company 1; Company 2; Company 3; Company 4; and Company 5. Each of these securities traded at an immediate premium in the aftermarket as follows:

Date of Purchase	Security	Amount	IPO price	First Trade Price
4/24/98	Company 1	200 shares	$14.50	$18.50
5/20/98	Company 2	100 shares	$16.00	$18.375
12/4/98	Company 3	100 shares	$15.00	$40.00
3/19/99	Company 4	100 shares	$15.00	$30.00
5/19/99	Company 5	100 shares	$12.00	$15.50

Respondent testified that he was unaware of the hot issue purchases in his brokerage account because he had given Employee B discretionary authority over the accounts and thus did not discuss with Employee B the purchases that Employee B made for those accounts. Respondent admitted that, although he had received preliminary prospectuses related to the hot issue purchases, he did not routinely review or retain them because Employee B had discretionary authority to make investment decisions in the accounts. Respondent also testified that he did not carefully review the trade confirmations for the hot issue purchases, except to note that his account consistently showed substantial profits. Employee B confirmed that the purchases that he made on behalf of Respondent 's account were executed without Respondent 's prior knowledge.

III. Discussion

A. Cause One

We find under cause one of the complaint that Respondent, while an associated person, purchased stock in five IPOs that were hot issues, in violation of Conduct Rule 2110 and the Free-Riding Interpretation.

The purpose of the Free-Riding Interpretation is to ensure that NASD members and their associated persons make bona-fide distributions to the public of securities that are part of a public offering and to prevent restrictions on the supply of public offerings that trade at a premium in the immediate aftermarket. See John M. W. Crute, 53 S.E.C. 870, 877 (1998), aff'd, 208 F.3d 1006 (5th Cir. 2000). Generally, the Free-Riding Interpretation prohibits broker-dealers and associated persons from purchasing hot issues. See Charles Martin Powell, 51 S.E.C. 601, 602 (1993).

Respondent argues that he is "legally exempt" from the Free-Riding Interpretation under IM-2110-1(a)(4), which states that the Interpretation "[does] not apply to government securities as defined in Section 3(a)(42)" of the Securities Exchange Act of 1934. Respondent contends that, since Firm A's business is restricted solely to government securities, the Free-Riding Interpretation does not apply to him.[1]

Respondent misconstrues the plain meaning of the exemption. Section (a)(4) of the Interpretation exempts purchases of government securities by restricted parties, not purchases of equity securities by restricted parties associated with government securities dealers. The notice of proposed rule change explained this point.[2] The Commission stated that NASD proposed "to amend the Interpretation to clarify that it does not apply to transactions in government securities in order to ensure that normal distribution practices in government securities are not adversely affected by this rule."[3] (Emphasis added). If NASD had intended to exempt from the Interpretation any person associated with a government securities dealer, it could have done so, as it did in subsection (c) of the Free-Riding Interpretation, which exempts persons associated with a "member engaged solely in the purchase or sale of either investment company/variable contracts securities or direct participation program securities." NASD opted not to create a similar exemption for persons associated with government securities dealers. We therefore find that there is no basis for Respondent's argument that IM-2110-1(a)(4) exempted his hot issue purchases.

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[1] We do not reach the issue of whether Firm A's business was restricted to government securities because it is not relevant to our resolution of this issue.

[2] Notice of Filing of Proposed Rule Change by the NASD Relating to Application of the Rules of Fair Practice to Transactions in Exempt Securities and an Interpretation of its Suitability Rule, Exchange Act Rel. No. 36383, 1995 SEC LEXIS 2834, *69-70 (Oct. 17, 1995).

[3] Id.

Respondent also argues that he should not be held liable for the allegations in cause one because he was unaware that Employee B had purchased hot issues for his securities account. Knowledge and intent, however, are not elements of a Free-Riding Interpretation violation. The Free-Riding Interpretation "is a 'prophylactic' rule 'and does not require scienter to support a finding of violation.'" Crute, supra, at 877 (quoting First Philadelphia Corp., 50 S.E.C. 360, 361 (1990)). Thus, Respondent's ignorance of Employee B's purchases does not excuse his misconduct. See Rothschild Sec. Corp., 45 S.E.C. 444, 446 (1974) (noting that it is "immaterial, except in connection with fixing the nature of the sanctions to be imposed in the public interest, whether [the respondent] was aware [that he] was violating [an] NASD rule"); Dist. Bus. Conduct Comm. v. Velasco, Complaint No. C07950057, 1996 NASD Discip. LEXIS 50, *11-12 (NBCC, Oct. 14, 1996) (finding "it is not necessary for NASD staff to demonstrate bad faith, willfulness, intent, or any other mental state . . . as an element of [a Free-Riding Interpretation] violation"). Indeed, Respondent could have monitored his account more closely but chose, instead, to take no notice of the trades executed in his own account. He cannot relieve himself of responsibility for his own inaction.

There is also no basis for Respondent's argument that he cannot be held liable for violating the Free-Riding Interpretation because he was not the "legal cause" of any violation. Respondent claims that Employee B caused the violations because he failed to follow the procedures at Firm B that required him to obtain the client's consent before buying IPO securities for a discretionary account. We reject Respondent's attempt to shift the blame to Employee B. First, we note that Respondent, by failing to advise Employee B of his registration status, neglected his own obligations under NASD rules. Furthermore, Respondent cannot escape liability by attempting to shift his compliance obligation to another individual. See Jay Michael Fertman, 51 S.E.C. 943 (1994) (respondent is obligated to comply with requirement to notify executing member in writing of his association with a member firm and cannot delegate that responsibility to another); see also Thomas C. Kocherhans, 52 S.E.C. 528 (1995) (respondent cannot shift responsibility for compliance to others).

Given Respondent's association with a member firm at the time of the five stock transactions at issue and the evidence in the record that the transactions were hot issues, we find that Respondent violated Conduct Rule 2110 and IM-2110-1. We therefore affirm the Hearing Panel's findings.

B. Cause Two

We find under cause two that Respondent: (1) failed to provide written notice to Firm A of his Firm B personal brokerage account; and (2) failed to provide written notice of his registration to Firm B when he became registered with NASD through Firm A, in violation of Conduct Rules 2110 and 3050(c).

Conduct Rule 3050(c) requires an associated person to give notice to two firms:

> A person associated with a member, prior to opening an account or placing an initial order for the purchase or sale of securities with another member, shall notify both the employer member and the executing member, in writing, of his or

> her association with the other member; provided, however, that if the account was established prior to the association of the person with the employer member, the associated person shall notify both members in writing promptly after becoming so associated.

Respondent therefore was required immediately after he had become associated with a member firm to notify Firm B in writing of his association with member firm Firm A and to notify Firm A in writing of the securities account he maintained at Firm B. We find that he did neither.

It is undisputed that Respondent failed to notify Firm B, either orally or in writing, that he was registered with a member firm. Respondent testified that his failure to notify Firm B of his change in registration status was an oversight. Since intent is not an element of the violation, however, it is not relevant whether Respondent's failure was intentional or negligent. We affirm the Hearing Panel's findings that Respondent failed to notify Firm B in writing that he was registered.

We also find that Respondent failed to notify Firm A in writing that he maintained a securities account at Firm B. The Hearing Panel concluded that Firm A was aware of the existence of the Firm B account. The record, however, is devoid of evidence to support this conclusion, other than Respondent's statement to that effect. The Enforcement staff examiner who investigated this matter testified that Respondent never provided NASD with evidence, as requested, that he had given Firm A written notification of the securities account that he maintained at Firm B. The Interpretation requires written notice. In the absence of evidence of written notice we find that Respondent failed to notify Firm A in writing of his securities account at Firm B. Thus, we find that Respondent violated Conduct Rules 2110 and 3050 as alleged in the complaint.

IV. Sanctions

In determining sanctions, we have considered carefully all of Respondent's arguments in mitigation. We affirm the Hearing Panel's sanctions of a fine of $9,546, consisting of disgorgement of $4,546 in realized profits and a $5,000 fine. Although the Hearing Panel treated Respondent's misconduct as one course of conduct, we have decided to sanction Respondent separately for his violations under causes one and two of the complaint. Therefore, we apportion the $5,000 fine between cause one ($4,000) and cause two ($1,000), and order disgorgement under cause one. We agree with the Hearing Panel's conclusion that a censure is not necessary under the facts of this case.

We concur with the Hearing Panel's decision to depart from the Sanction Guidelines ("Guidelines"),[4] which recommend a fine that includes transaction profit. Transaction profit is

[4] The Guideline for Free-Riding and Withholding Violations recommends a fine of $1,000 to $15,000, plus the transaction profit if the respondent is the restricted buyer, and a suspension in any or all capacities for up to 30 business days or, in egregious cases, a longer suspension (of

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defined in the Guidelines as the greater of the immediate aftermarket unrealized profit (the price determined to be the immediate aftermarket price times the number of shares minus the public offering price) or the actual profit realized.[5] Although the immediate aftermarket unrealized profit exceeds the actual profit realized, we base the fine on Respondent's actual profit because Respondent did not deliberately attempt to circumvent NASD rules. Rather, his violations were primarily the result of negligence and inattention.[6] In deciding to base Respondent's fine on his actual profit instead of the immediate aftermarket unrealized profit, we also considered the applicable Principal Considerations listed in the Guidelines. There is no evidence that Respondent was attempting to conceal the relevant information from Firm B or Firm A, which is Principal Consideration No. 10 under the Guidelines.[7] Further, we find no evidence that Respondent violated the Free-Riding Interpretation for the purpose of improperly conferring financial benefit on himself or another person, which is a Principal Consideration under the Guideline for Free-Riding and Withholding.[8] For these reasons, we also agree with the Hearing Panel's decision not to impose a suspension in this matter.

We disagree with the Hearing Panel's decision to cite as a factor that contributed to Respondent's purchase of five hot issues the fact that Employee B failed to follow Firm A's procedures that called for him to obtain an acknowledgement of IPO trades from discretionary clients. Employee B's failure to follow his firm's rules has no relevance to our determination of the appropriate sanctions in this matter. We also do not consider to be mitigating factors, as the Hearing Panel did, that Respondent "is generally not a negligent person" and that he served on a number of regulatory committees. Finally, the Hearing Panel cites the fact that Respondent's

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up to two years) or a bar. See Guidelines (2001 ed.) at 29 (Free-Riding and Withholding Violations).

The Guidelines applicable to violations of NASD Conduct Rules 3050 and 2110 recommend a fine from $1,000 to $25,000 and, in egregious cases, a suspension for up to two years or a bar. See Guidelines (2001 ed.) at 21 (Transactions For or By Associated Persons).

5 See Guidelines (2001) at 29, n.1 (Free-Riding and Withholding Violations).

6 The Hearing Panel credited Respondent's testimony that he neglected to disclose his registration status to Firm B. The Commission has held that the credibility determinations of the initial fact-finder are entitled to considerable weight and deference, and we find nothing in the record to call the Hearing Panel's credibility determination into question. Joseph S. Barbera, Exchange Act Rel. No. 43528, 2000 SEC LEXIS 2396 (Nov. 7, 2000).

7 See Guidelines (2001 ed.) at 9 (Principal Considerations in Determining Sanctions No. 10).

8 See Guidelines (2001 ed.) at 29 (Free-Riding and Withholding Violations, Principal Consideration No. 4).

misconduct did not affect the market as a mitigating factor. Although evidence that Respondent's misconduct had a market impact would be evidence of an aggravating circumstance, the lack of such evidence is not a mitigating factor. We therefore have not considered these factors in deciding to affirm the Hearing Panel's sanctions.

Accordingly, Respondent is fined $9,546 ($5,000 plus disgorgement of $4,546 in actual profits). In addition, Respondent is ordered to pay $4,612 in hearing costs ($3,612 in costs for the proceedings below and $1,000 in appeal costs) and $575.90 in transcript costs on appeal.[9]

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

[9] We have also considered and reject without discussion all other arguments advanced by Respondent.

Pursuant to NASD Procedural Rule 8320, any member that fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.