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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	
Complainant,	Disciplinary Proceeding
v.	Hearing Officer - AWH
	Hearing Panel Decision
	December 22, 2003
Respondent.	

Registered principal found not liable for (1) violations of Penny Stock Rules, (2) failure to report customer complaints, (3) failure to make, keep current, and/or maintain books and records, and (4) failure to supervise. Complaint dismissed.

Appearances:

David F. Newman, Esq., and Thomas K. Kilkenny, Esq.,
for the Department of Enforcement

RL, Esq., for Respondent 2

DECISION

Introduction

On April 25, 2002, the Department of Enforcement ("Enforcement") issued a four-cause Complaint in this matter against Respondent 1 ("Respondent 1"), and Respondent 2 ("Respondent 2"), alleging (1) violations of the Penny Stock Rules (Section 15(g) of the Securities Exchange Act of 1934, SEC Rules 15g-2 – 15g-5 and 15g-9 thereunder, and NASD Conduct Rule 2110); (2) failure to report customer complaints, in violation of NASD Conduct

Rules 2110 and 3070; (3) failure to make, keep current, and/or maintain books and records, in violation of SEC Rules 17a-3 and 17a-4, and NASD Conduct Rules 2110 and 3110; and (4) failure to supervise, in violation of NASD Conduct Rules 2110 and 3010. The relevant time period of the alleged violations was from June 1997 to December 1999.

Respondent 2 filed an Answer to the Complaint, denying the alleged violations, and he requested a hearing. Respondent 1, whose registration, according to the Complaint, was cancelled on January 12, 2002, for failure to pay certain fees, did not file an Answer to the Complaint. Accordingly, Enforcement moved for a default decision against Respondent 1, and, as a result, the Hearing Officer will issue a separate Default Decision on the Complaint against Respondent 1. A hearing on the allegations against Respondent 2 was held in Philadelphia, Pennsylvania, on July 22 and 23, 2003. The parties filed post-hearing submissions on or before October 2, 2003.

Findings of Fact[1]

Growth of Respondent 1 and Respondent 2's Role as President

From 1995 until the end of 1999, Respondent 2 was the President of Respondent 1. Respondent 2 had been an examiner for NASD, responsible for compliance and financial examinations of member firms, had worked for the Philadelphia Stock Exchange, and held a license as a Certified Public Accountant. Tr. 373. After resigning as President of Respondent 1 in 1999, he remained at the firm until July 31, 2001. He currently owns and is associated with BV ("BV"), Ltd., a member firm, as a General Securities Principal, Compliance Officer, and Financial and Operations Principal, among other registrations. JX 1, at ¶¶ 8, 9. BV has been examined twice by NASD and once by the SEC since Respondent 2 has been associated with the

[1] References to Enforcement's exhibits are designated as CX_; Respondent's exhibits, as RX_; the joint Stipulations, as JX_; and the transcript of the hearing, as Tr._.

firm. BV has not been the subject of any regulatory action, arbitration proceeding, or customer complaints since Respondent 2 purchased the firm. Tr. 486, 490.

Respondent 1 became a member of NASD in 1958 under a predecessor name. In 1995, Respondent 1 had approximately 40 to 50 employees. In early 1997, it provided institutional services, and had from six to eight full service retail offices, a discount brokerage operation, and a corporate finance department in New York which employed a research analyst. Tr. 375. Until 1997, Respondent 2 had compliance responsibilities at the firm. Tr. 454-55. In 1997, Respondent 1 decided to expand its retail business. As a result, and as more fully discussed below, Respondent 1 opened three additional retail offices, which were owned and operated as independent offices, and designated as Offices of Supervisory Jurisdiction ("OSJs"): an office at Broad Street, New York, New York; an office at William Street, New York, New York; and an office in Boca Raton, Florida. Each office had a branch manager who was a Series 24 principal and the line supervisor at the office. The branch managers were to consult with the firm's compliance director if they had any questions or concerns about brokerage or compliance issues. Tr. 450-51. In 1998, Respondent 1 was comprised of its headquarters, which was in Philadelphia, 15 OSJs, and 5 branch offices in six states. It employed 144 representatives and 32 principals. JX 1, at ¶3.

The office at Broad Street was located next to Respondent 1's corporate finance department. MC was the Series 24 supervisory principal in the office in early 1997. Tr. 81. The beneficial owners of the office were PL and AS. Tr. 78. AS ran the day-to-day operations of the office. Tr. 378-79. In March 1997, the office had five or six brokers. Within 60 to 90 days, it had 20 to 25 brokers. Tr. 86.

The William Street office was beneficially owned by AR and JC. On March 24, 1997, MW began as the Series 24 supervisory principal at the William Street office. MW had been associated with Shearson Lehman for 24 years. Tr. 330. He was to be the registered principal in the William Street OSJ, responsible for all operations and compliance. Tr. 310. The office had five to eight brokers in early 1997, but shortly grew to 30 or 40 brokers Tr. 87.

The Boca Raton office was owned by CE and SD. Both had previously invested capital in Respondent 1. Tr. 74-75. CE was interested in starting a market-making operation in Florida. Tr. 376. After the office was opened, Respondent 1's trades in over-the-counter and nonlisted securities were called into the Florida office, while transactions in listed securities continued to be called into the Philadelphia office. Tr. 314. In the summer of 1997, SD became registered with Respondent 1, and functioned as the liaison between the New York and Philadelphia offices of Respondent 1, overseeing commission runs and the accuracy of trading records. Tr. 85-86; CX 9.

<u>CD Becomes Compliance Director</u>

In 1997, with the growth of the firm to 135-140 employees, and with his increased activity in developing Respondent 1's institutional business, Respondent 2 decided to relinquish day-to-day responsibility for compliance, and hire a Compliance Director. Because the New York offices concentrated on equities and retail customers, Respondent 2 decided to place the Compliance Director in New York rather than in Philadelphia, where the concentration was in nonsolicited business with a lower exposure of risk for clients. Tr. 419-21. CD was referred to Respondent 2 by the same person who had referred CE and SD to Respondent 2. Tr. 72-73, 81. CD had been a branch manager at another firm and had a background in compliance. Tr. 132. Although he did not have a background in corporate finance, CD wanted to develop a contact he

had in India for a corporate financing deal, and he wanted the title of Corporate Finance Officer to work on the deal.[2] Tr. 433. In May 1997, Respondent 2 offered CD the position of Compliance Director and Corporate Finance Officer, with responsibility for the overall compliance activities of the firm, and supervision of the Corporate Finance Office in New York. The offer letter stated that he would have responsibility for continuing professional education, written supervisory procedures, and all customer related compliance issues. RX 20.

Prior to CD joining Respondent 1, the firm had a copy of its written supervisory procedures ("WSPs") on a computer disk. When he joined the firm, CD was given a copy of the disk so that he could update the WSPs in light of the recent growth of the firm. Tr. 134, 437-38. He later forwarded to Respondent 2 a draft of a proposed updated compliance manual. Tr. 139. In addition to scheduling inspections for all branch offices, as part of his duties and responsibilities, CD (1) reviewed and approved new accounts, (2) approved correction notices for trades, (3) issued a new policy on transactions in non-rated bonds, (4) issued a policy for extensions on IPO trades, (5) approved commission rates and advertisements, (6) required his approval before a representative could solicit purchases of Bulletin Board stocks, (7) required branch managers to fill out quarterly report forms on customer complaints, and reported to Respondent 2 on open customer complaints, (8) distributed continuing education requirements, (9) issued a variety of compliance and operations guidelines, (10) approved Form U-4s, Form U-5s, and newsletters, (11) monitored trades for concentration and suitability, (12) investigated and reported to Respondent 2 on customer complaints that were brought to Respondent 2's attention, (13) reported when an IPO offering was "all sold," and (14) approved trade blotters. RX 21-33,

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[2] CD never brought in an underwriting to Respondent 1. Tr. 433. Respondent 2 estimated that CD spent five percent of his time on corporate finance activities. *Id.* CD testified that he spent 75 percent of his time on corporate finance deals. Tr. 138. It is clear from CD's testimony that he was uninterested in his job as Compliance Director, and his testimony provided no details of any efforts he might have made in the corporate finance area. As discussed later, he was not viewed positively in either job.

37, 41-49. CD also instituted a procedure for penny stock disclosure agreements that were to be signed by customers, and he formulated a nonsolicitation letter, also to be signed by customers. Tr. 153-54. MW, the principal at the William Street office, spoke to CD twice a week about compliance issues. CD told MW that he was going to audit the office, and that he would put together a compliance manual. Tr. 328.

Respondent 2 testified that in November 1997, CD became directly responsible for supervising the office at Broad Street, that he agreed to take on that position, and that he was additionally compensated by PL for doing so. Tr. 386, 390-91. Respondent 2 also testified that CD was designated in writing, and was in fact, the registered general securities principal having supervisory responsibility for sales practices in the New York offices. Tr. 430-31. CD, on the other hand, testified that he did not supervise the sales practices in that office, that he was not interested in that job, and that the reference in the compliance manual that states that he was such a supervisor is incorrect. Tr. 144, 158.

The Hearing Panel credits Respondent 2's testimony and not CD's. CD's testimony that he was not responsible for reviewing commission statements, and that he was not aware of the firm trading or making a market in International Mercantile Corporation ("IMTL") stock, is contradicted by documentary evidence that he signed off on commission statements and IPO retention/pricing wires, and that he was directly involved with compliance concerns involving penny stock issues. Tr. 161-62; RX 37, 39. His testimony and demeanor suggested that he downplayed his compliance responsibilities, while he exaggerated his efforts in corporate finance. There is no evidence that he had any success in the latter area, and the fact that he was replaced as Compliance Director only 17 months after assuming the position, indicates that he

was less than fully successful in the former.[3] Respondent 2 and other witnesses credibly testified to that effect.

The documentary evidence, noted above,[4] demonstrates that CD had extensive involvement in compliance matters at the firm; and that he had full authority to perform his compliance responsibilities. Whenever a compliance issue was brought to Respondent 2's attention by anyone, Respondent 2 followed up by discussing the matter with CD. For example, when CD mentioned to Respondent 2 that some prospective brokers had three or four complaints on their records, Respondent 2 told him not to sign their U-4s if he felt that was the appropriate course. Tr. 157-58. When Respondent 2 learned from his operations manager and his head trader that there were a large number of trade cancellations involving the 800 Travel Systems ("IFLY") issue, he wrote to CD asking for an explanation.[5] Tr. 424-25. When he received three customer complaints in a one or two week period, Respondent 2 wrote to CD, requesting an investigation and a written report of his findings, his actions against any brokers, and his determination whether there was "any patterns of compliance problems." Tr. 464; RX 42. CD replied with a report, in which he concluded:

> I will [sic] believe that the complaints are increasing because of some losses were [sic] created because Of [sic] GIRC and IFLY. The complaints are from two branches. I am tracking the brokers involved and if there is a pattern with any one broker, I will make a recommendation for termination of the broker.

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[3] CD testified that he stopped doing compliance work because his position was being eliminated. Tr. 180. However, as noted later, his job was not eliminated; rather, he was replaced by the branch compliance officer in the Florida office. Tr. 258.

[4] RX 21-33, 37, 41-49.

[5] Respondent 2 received daily trading reports from Respondent 1's clearing firm. Tr. 282.

RX 43. Finally, the Hearing Panel finds that Respondent 2 was candid and forthright in his testimony, and that his testimony was consistent with the documentary evidence and the testimony of witnesses other than CD.

Addition of a Chief Operating Officer at Respondent 1

In June 1998, Respondent 2 hired HS as the firm's Chief Operating Officer. HS, who earned an MBA at New York University, had been the Director of Compliance and Chief Financial Officer at a full service investment banking and securities brokerage firm. Tr. 222; RX 50. CD, as the Chief Compliance Officer, was to report to HS. Tr. 226. CD told HS that he [CD] was performing the compliance function because "that's where he wound up, but it wasn't exactly where he thought he should be." Tr. 228.

HS immediately faced a number of problems at the firm that took up a great deal of his time. Shortly after HS began his employment with Respondent 1, he found the accounting system to be outdated, and replaced it with one that he prepared for use. Tr. 224-25. He found that the Operations Manager and his staff were not very productive, and that operational records were not maintained in an orderly fashion. Tr. 230. HS recommended to Respondent 2 that certain employees be terminated and replaced. Two of the four employees in Operations left, and one new person was hired. Tr. 262. Eventually, the firm hired temporary help to clean up the backlog of paperwork that needed to be filed. Tr. 294. The Financial and Operations Principal ("FINOP") had left the firm, but was coming in on weekends to help a support person whom she had trained before she left Respondent 1. Tr. 233-34. Finally, during HS's first year at the firm, Respondent 1 changed clearing firms, disrupting the processing of paperwork for a period of time. Tr. 299.

HS visited the office at Broad Street which, at that time, was going through substantial construction in order to merge the two offices located in that building. HS found that records were not well organized. Tr. 238. He found that CD maintained the vast majority of customer complaints in the New York location, and that the complaints maintained in Philadelphia were only a portion of total customer complaints. CD reiterated to HS that he was more interested in being involved in corporate finance than in the compliance function. Tr. 239. Respondent 2 told HS that he did not hold CD in high esteem. As HS testified:

> Mr. Respondent 2 made it clear to me that my background in compliance and my experience in those areas would be very helpful in helping Mr. CD aid the firm to be as compliant as possible both at the branch locations as well as in the corporate location and that Mr. CD did need some help in accomplishing those goals.
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> * * *
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> . . . issues with regard to Mr. CD's experience and his ability arose maybe within the first 60 days of my employment. . . .Some of those weaknesses became clear with regard to record keeping, with regard to handling complaints, with regard to continuing education, with regard to branch examinations and several other similarly related areas. The written supervisory procedures probably had not been updated in a period of time.

Tr. 240-41. After HS told Respondent 2 that CD was not the best person for the job, a determination was made that CD would have to be replaced. Tr. 251-52. In October or November 1998, CD stopped doing compliance work for Respondent 1, and he was replaced as Chief Compliance Officer by the branch compliance officer in the Florida office. CD's employment with Respondent 1 was terminated in April 1999. Tr. 180, 257-58; CX 2. From late September 1998 to late December 1998, NASD began the examination of Respondent 1 that led to the Complaint in this case. Tr. 24.

CD's replacement turned out to be a recovering alcoholic who had a relapse. As a result, HS took over the compliance function himself in early 1999. Tr. 260-61. HS determined that the WSPs needed to be updated, and he began that process immediately by modifying procedures

that he had utilized at a previous firm. The project substantially revised the WSPs and was completed over a period of several months. Tr. 295; RX 19.[6] When he informed Respondent 2 that he was going to prepare new procedures rather than modifying existing ones, Respondent 2 commented: "Do what you think you need to do to make things the way they need to be." Tr. 251. To track customer complaints, HS created a written log of such complaints. Tr. 283, CX 40.[7] When HS learned that a registered representative had converted firm and customer funds, to prevent future instances, he prepared procedures that required the direct supervisor of a representative to approve customer documents such as letters of authorization, requests for monies from third parties, changes of address, and similar documents. Tr. 280; CX 15.

Because his additional compliance duties were time consuming, HS hired an experienced controller to help him with his responsibility for the accounting function in the firm. Tr. 304-05. HS also held several meetings with the Operations support staff to discuss performance and steps to help the firm move forward. It was at that point that he hired temporary help to clean up and file records in an orderly fashion. Both HS and Respondent 2 helped in that effort. Tr. 305-06.

NASD Examinations and Books and Records Deficiencies

Enforcement and Respondent 2 stipulated that NASD examinations found the following books and records deficiencies at Respondent 1:[8]

1. During a 1998 routine examination by NASD, Respondent 1 was unable to produce any correspondence from its Philadelphia office and only 30 pieces of correspondence from its

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[6] The new WSPs were dated November 1999.

[7] The log was introduced into evidence by Enforcement. It is undated, and there was no testimony as to the date of its creation. However, the log tracks complaints from January 1997 through October 1999. Most of the complaints concerned the New York and Florida offices.

[8] The stipulations are noted in JX 1, at ¶¶12-22. While the parties have stipulated to 11 findings, this Decision notes only those that are probative of the allegations in the Complaint.

20 OSJs and branch offices. The correspondence that was produced to the NASD staff lacked written evidence of a supervisory review by one of the firm's principals. JX 1, at ¶12.

2. During the course of the 1998 and 1999 NASD examinations, Respondent 1 was unable to produce written evidence demonstrating that it had conducted inspections of the majority of its OSJ/branch offices or that it had conducted annual compliance meetings during the same time period, as required by NASD Rule 3010 and the firm's written supervisory procedures. JX 1, at ¶13.

3. Respondent 1 failed to report 24 of 38 customer complaints received between June 1, 1997, and December 31, 1998, and 6 customer complaints received in 1999. JX 1, at ¶20.

4. During the NASD staff's 1998 examination of Respondent 1, the firm was unable to produce a number of order tickets and confirmations, or complete Purchase and Sale Blotter pages pertaining to transactions in three securities: 800 Travel Systems, Inc. ("IFLY"), Planet Entertainment Corporation ("Planet"), and National Health Trends Corporation ("NHTC"). JX 1, at ¶21.

5. During the NASD staff's 1998 examination, Respondent 1 was able to produce only 3 of 30 new account forms, and it could not find two "hot issue" questionnaires for two offerings that the NASD Corporate Financing Department had previously sent to the firm. JX 1, at ¶22.

The NASD examination of Respondent 1 began on September 22, 1998. The Respondent 1 Compliance Manual (Rev. April 1998) listed DH as the firm's registered Financial and Operations Principal, with responsibility for, inter alia, books and records. CX 12. DH voluntarily terminated her employment with Respondent 1 in September 1998. HS was designated as the point person responsible for providing the examiners with information, including documents, they requested. Tr. 268-69. When he informed Respondent 2 that he

could not find certain documents, Respondent 2 "insisted that these records must be available somewhere." Tr. 272. HS directed the support staff to go into the basement to look for documents, and to look into piles and boxes of paper upstairs that had not yet been taken down to storage. *Id.* Both HS and Respondent 2 became involved in the search for records. Tr. 273.

Sales of International Mercantile Corporation to Retail Customers

Between April and December 1998, with the exception of the period from July 24 to September 14, 1998, Respondent 1 effected 181 transactions with retail customers involving IMTL. Tr. 196-97; CX 37. Prior to those transactions, ST, who held a Series 24 license and was both a senior analyst at Respondent 1 and the firm's Vice President for Investment Research, determined that IMTL was not a penny stock. On January 23, 1998, ST wrote to Respondent 2, stating that he had reviewed financial material on IMTL, including, among other items, 10-K and 10-Q reports, and had spoken to company management. ST concluded that IMTL had a "strong asset value," and was not a penny stock, i.e., a designated security that required a "bulletin board" disclosure letter. RX 99. However, on July 24, 1998, ST told CD and GC[9] that, in his opinion, after his review of the most recent 10-K filing for the 1997 calendar year, IMTL no longer qualified as a non-designated security, and that, therefore, customers who purchase the stock must sign a penny stock disclosure letter. CX 32.[10] ST specifically found that a letter from IMTL's counsel, which claimed IMTL was exempt from penny stock designation, was insufficient to justify the conclusion that IMTL was not a penny stock. *Id.*, RX 101. Respondent 1 stopped trading IMTL immediately after ST concluded that it was not exempt from penny

[9] GC first became associated with Respondent 1 in 1993. He had been working in the trading department until 1999, monitoring trading, reviewing accounts, commissions, markups, and markdowns, and supervising regulatory reports and traders. He became Respondent 1's President and Compliance Officer in 1999. Tr. 334.

[10] CX 32 is a July 27, 1998, memorandum to CD and GC in which ST confirmed his earlier verbal comments to them on the penny stock status of IMTL.

stock designation. Finally, at some time prior to September 14, 1998, ST notified the firm that IMTL no longer qualified as a penny stock, and Respondent 1 resumed transactions in IMTL at that time. Tr. 364.[11]

Payment of Trading Profits on Globus International Resources Corp.

At the suggestion of the owners of the OSJs in New York and Florida, Respondent 1 began making a market in the stock of Globus International Resources Corp. ("Globus") in March or April 1997. Because those OSJs would guarantee any losses on trading the stock, the owners of the OSJs suggested to Respondent 2 that Respondent 1 share any trading profits with those branch offices. Tr. 90-93, 400-02.[12] Respondent 2 met with a securities attorney in New York and called Ralph Heil at NASD to confirm that sharing profits with the OSJs was lawful. Respondent 2 was told that such profit sharing was lawful. Respondent 2 was unaware that AS and others were paying some of those profits to the brokers in OSJ offices, rather than keeping the funds themselves. Tr. 409-10.

Although SD testified about a purported discussion regarding additional compensation for brokers above their commissions, the Hearing Panel does not credit that testimony as evidence of Respondent 2's acquiescence in, or knowledge of, any plan to compensate registered representatives with trading bonuses. SD's testimony was not clear or direct, and he did not explicitly state to whom he was speaking when the concept of a trading bonus was discussed with him:

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[11] IMTL's 10-K for the period ending December 31, 1997, filed on July 16, 1998, disclosed that the company had net tangible assets of less than $2 million and no revenues. It described its business as "the organization and sale of purchase, refinance, home equity, home improvement and debt consolidation loans" from residential customers. CX 35. The NASD examiner based his conclusion that IMTL was a penny stock solely on two consecutive 10-Ks. No 10-Qs for the company were offered into evidence. ST did not testify at the hearing, nor did the NASD examiner speak to him to determine the bases on which ST reached his penny stock conclusions.

[12] Although the term "trading bonus" was used by counsel for Enforcement and explained from SD's perspective in his testimony, Respondent 2 eschewed that term, and consistently referred to "trading profits" that were shared with the branch offices.

> Q. How did that concept come to your attention?
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> A. The concept was kind of - - the way I understood it was like a mix of combination of MS, Respondent 2, [GC], lawyers. It was a discussion on how and can brokers be compensated additionally through the firm other than the normal commission.

Tr. 92.

SD did not testify that anyone claimed that compensating the registered representatives above their normal commissions would be lawful. SD eventually pled guilty to stock fraud with regard to Globus stock. He was awaiting sentencing at the time of the hearing in this case, and his testimony in this case could affect that sentencing. To the extent his testimony could be taken to suggest involvement in such a decision by Respondent 2 and GC, the Hearing Panel gives it no weight. It is uncorroborated, and it is contradicted by the testimony of Respondent 2 and GC, both of whom the Hearing Panel find to be credible. Tr. 103-05. GC specifically testified that he did not believe that the money, representing so-called "trading bonuses," went to the registered representatives. He believed it went to the branch managers who owned the offices. Tr. 353. GC was responsible for calculating the amounts to make sure they were correct. Tr. 342. GC's testimony corroborates Respondent 2's understanding of paying a portion of trading profits to the OSJs, and the Hearing Panel concludes that GC, who has not been charged with any wrongdoing, had no motive to be less than candid. MW, the supervisory principal at William Street, was unaware of any trading bonuses being paid on top of straight commissions.[13] Tr. 323-24. Finally, as the NASD examiner noted, the main office in

[13] It is not surprising that MW was unaware that trading bonuses were, in fact, being paid to certain brokers at the William Street office. AS, SD, and FP pled guilty to fraudulent manipulation of Globus securities. AS pled guilty to paying excessive commissions to representatives at the Broad Street OSJ in 1997 to induce them to buy shares of Globus, knowing that the brokers were not disclosing the size of those commissions to customers. CX 25. FP pled guilty to supervising representatives at the William Street OSJ who were paid a trading bonus to sell Globus in 1997, knowing that the representatives were making misrepresentations to their customers in order to pump up the price of the stock. CX 23. SD was terminated from his employment with Respondent 1 for failing to disclose his position in Globus stock and his accounts at other broker-dealers. Tr. 125; CX 9.

Philadelphia was cutting gross commission checks to the branch office owners. As a result, no one in Philadelphia could know whether that money was paid to registered representatives. Tr. 63-64.

Discussion

The first cause of the Complaint alleges that Respondent 2 failed to ensure that Respondent 1 established, maintained, and enforced an effective supervisory system. NASD Conduct Rule 3010 provides that each member shall establish and maintain a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [NASD]," and that such supervisory system shall include written procedures "reasonably designed to achieve" that same compliance. Senior managers are not held strictly liable for violations of the securities laws and regulations committed by their subordinates. Rather, their liability depends on whether they have reasonably discharged their supervisory duties under the attendant circumstances. *See Arthur James Huff*, Exch. Act Rel. No. 29,017, 1991 SEC LEXIS 551, at *10-11 (Mar. 28, 1991); *Louis R. Trujillo*, Exch. Act Rel. No. 26,635, 1989 SEC LEXIS 480, at *10 (Mar. 16, 1989).

The president of a member firm is responsible for compliance "unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient." *John H. Gutfreund*, Exch. Act Rel. No. 31,554, 1992 SEC LEXIS 2939, at *44 (Dec. 3, 1992). Whether supervision was reasonable "is determined based on the particular circumstances of each case. The burden is on [Enforcement] to show that the respondent's procedures and conduct were not reasonable. It is not enough to demonstrate that an individual is less than a model supervisor or that the

supervision could have been better." *Dist. Bus. Conduct Comm. No. 7 v. Lobb*, 2000 NASD Discip. LEXIS 11, at *16 (NAC Apr. 6, 2000) (citations omitted).

<u>Respondent 2's Oversight of the Firm's Supervisory System</u>

Respondent 2 reasonably delegated his compliance responsibilities to CD, a person with a background in compliance who had been a principal for more than two years prior to joining Respondent 1. Respondent 2 gave CD full authority to perform his compliance responsibilities. Although each OSJ had a Series 24 supervisory principal, Respondent 2 decided to locate the Compliance Director in New York rather than in Philadelphia because the New York offices concentrated on equities and retail customers. In that way, Respondent 2 sought to assure that the new offices, which were independently owned, received careful supervision. Accordingly, Respondent 2's offer letter to CD stressed his responsibility for continuing education, supervisory procedures, and all customer related compliance issues. *Cf. Market Reg. Comm. v. La Jolla Capital Corp.*, No. CMS950110, 1998 NASD Descip. LEXIS 26, (NAC Feb. 17, 1998) (firm president, who was also chief executive officer, supervisor of trading, and chief compliance officer, did not reasonably delegate compliance responsibility to person who had passed Series 24 examination the day after he was hired and only days before remote office he was to supervise opened, and who never visited remote office or took action to supervise it).

One of CD's first responsibilities was to update the firm's existing written supervisory procedures. Documentary evidence demonstrates that CD was active in a broad range of compliance issues, and had significant correspondence with Respondent 2 on various compliance matters. To the extent that CD, or anyone else, brought a compliance issue directly to Respondent 2's attention, he phoned or wrote to CD to discuss the matter or pursue its resolution.

When Respondent 2 hired HS as the firm's Chief Operating Officer, he told HS that CD needed some help in accomplishing the compliance goals that Respondent 2 had set for him. Within the first two months of HS's tenure, he had to confront a number of issues that placed in question CD's ability to function as the Director of Compliance. Shortly thereafter, HS told Respondent 2 about his concerns with CD's performance, Respondent 2 agreed that CD should be replaced. CD's tenure as Director of Compliance lasted only 16 or 17 months. In removing CD from his compliance function, after having hired a Chief Operating Officer who was to help CD improve his performance as Director of Compliance, and after having given CD a reasonable period of time to demonstrate his willingness and ability to perform as Director of Compliance, the Hearing Panel concludes that Respondent 2 acted reasonably and responsibly in discharging his own supervisory duties under the attendant circumstances.

Respondent 2 immediately replaced CD with the branch compliance officer in the Florida office. Because this new Chief Compliance Officer relapsed into alcoholism, his tenure in that job lasted only two or three months. HS then took over the compliance function, with full authority from Respondent 2 to do whatever was necessary to bring the firm into full compliance with laws and regulations. Among his other accomplishments, HS completely rewrote the compliance manual. The written supervisory procedures in that manual are not alleged to be deficient. Again, the Hearing Panel concludes that Respondent 2 acted reasonably and responsibly in removing CD's successor and giving responsibility for the compliance function to HS.

<u>Adequacy of Written Supervisory Procedures</u>

The written supervisory procedures at issue were originally prepared and copyrighted by a third-party regulatory services corporation. RX 17-18 (immediately following the Table of

Contents). Respondent 2 knew that those procedures were not adequate for his growing firm. Consequently, Respondent 2 hired CD and gave him specific directions to update those procedures. The WSPs that were in effect at the time CD joined Respondent 1 preceded *Notice to Members* 99-45 (June 1999), which provided guidance to members on their supervisory responsibilities.[14] Those WSPs and CD's subsequent revisions do not meet the enhanced standards contained in that Notice to Members, but they cannot be judged by standards that were not in effect when those WSPs were written.

The Compliance Manual designates CD as the supervisory principal "responsible for reviewing the supervisory system, procedures, and implemented inspection system and [who] will be responsible for taking action, or recommending action to senior management, which will be reasonably designed to achieve compliance." RX 17, at 11, RX 18, at 11. During the period that CD was working on revisions to the Compliance Manual, he issued numerous memoranda on a variety of compliance and operations issues, including customer complaint reporting, penny stock transactions, trading, and market making, all of which addressed items that had not been treated fully in the Compliance Manual itself. For example, the Compliance Manual provided for annual inspections of OSJs by CD, the designated supervisory principal with that responsibility. However, CD scheduled those inspections by memoranda, and used a form, also not in the Manual, as a check list for auditing branch offices. RX 40. CD could easily have incorporated the procedures contained in his memoranda and forms into the WSPs which he was directed to update. The fact that he did not do so was one of the reasons that led to his removal from the compliance function. It took HS several more months to complete a new Compliance Manual that was satisfactory. Given his other concerns with a new accounting system, changing

[14] In its Pre-hearing Submission, Enforcement adverted to that Notice to Members in setting forth the standards it argues Respondent 1 was required to meet to conform its written supervisory procedures to Conduct Rule 3010.

clearing firms, cleaning up files, and his other operational responsibilities, the delay in preparing new WSPs was reasonable under the circumstances.

The Hearing Panel concludes that Respondent 2 reasonably delegated responsibility to CD, and later, HS, to update the firm's WSPs. In view of CD's memoranda on compliance issues, Respondent 2 could reasonably conclude that CD would follow through on updating the Compliance Manual. It took only a few months for Respondent 2 to realize that CD was not up the job, and that he needed to be replaced. HS's testimony, and the documentary evidence of his involvement in the compliance area, demonstrate that Respondent 2's delegation of authority to him for supervision of compliance, including issuing new WSPs, was thoroughly justified.

Based on standards applicable to the time period at issue, the firm's WPSs, as modified by CD's memoranda that supplemented the Compliance Manual, were reasonably designed to detect and prevent violations of securities laws and applicable NASD Rules. Respondent 2's delegation of compliance responsibility to CD was also reasonable. Accordingly, the first cause of the Complaint will be dismissed.

Penny Stock Rules

The second cause of the Complaint alleges that Respondent 2 and Respondent 1 violated Section 15(g) of the Exchange Act, SEC Rules 15g-2 through 5, and 9 thereunder (the penny stock rules), and NASD Conduct Rule 2110, when the firm recommended and sold shares of IMTL. The Hearing Panel concludes that Respondent 2 reasonably relied on the opinion of the firm's senior analyst that IMTL was not subject to the penny stock transaction and disclosure rules at the time the firm executed transactions in that security.

SEC Rule 3a51-1 provides that in order not to be considered a penny stock, an issuer must have net tangible assets in excess of $2 million, if the issuer has been in continuous

operation for at least three years, or $5 million, if the issuer has been in continuous operation for less than three years. The calculation of net tangible assets must be demonstrated by audited financial statements dated less than 15 months prior to the date of the transaction.

Enforcement's allegation that IMTL was a penny stock is based solely on two documents: a 10-K for the fiscal year ending December 31, 1996 (filed on July 17, 1997), and a 10-K for the fiscal year ended December 31, 1997 (filed on July 16, 1998). On brief, Enforcement states that the latter 10-K was the one closest in time to the IMTL transactions at issue, and that that 10-K reports net tangible assets of less than $2 million.

In making his initial determination that IMTL was not a penny stock, the firm's senior analyst, ST, based his opinion on discussions with management, 10-Q reports[15] and other financial material on IMTL, as well as 10-Ks that had been filed. The 10-K for the year ending December 31, 1996, was more than 15 months prior to transactions at issue (which occurred after March 31, 1998), and therefore, would not have been applicable to a penny stock determination from that date forward. However, ST later wrote that, after having reviewed the 10-K for FY 1997, which was not filed until July 16, 1998 (after Respondent 1 had been effecting transactions in the stock for three months), IMTL should be considered a penny stock, based on information in that 10-K. He rejected an earlier contrary opinion of counsel for IMTL. Respondent 1 immediately ceased trading the security, and did not resume until two months later, when ST determined that it no longer qualified as a penny stock. The NASD examiner did not know why Respondent 1 temporarily suspended its trading in IMTL, nor did he speak to ST to determine the basis upon which trading was interrupted from July 23 to September 15, 1998, and then resumed. Tr. 198, 212.

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[15] Form 10-Qs do not require audited financial statements. Bowne, SECURITIES ACT HANDBOOK, at pp. 6959 *et seq*.

The interruption in trading was due to ST's determination that, for that period of time, IMTL qualified as a penny stock. No other motive has been suggested for the interruption. ST did not testify at the hearing, nor was there evidence that he was asked for, or gave, a written or oral statement to NASD concerning his financial analysis of IMTL. Under these circumstances, while the evidence suggests that, based on the audited financials in the 10-K that was filed in July 1998, IMTL was subject to the penny stock rules when the firm resumed trading the security, the Hearing Panel concludes that Enforcement has not proved, by a preponderance of the evidence, that Respondent 2 had not properly delegated authority to ST to make the penny stock determination, or that Respondent 2 could not reasonably have relied on ST's determination that IMTL did not qualify as a penny stock, both before and after the firm interrupted trading in the security, even if either determination turned out to be erroneous. Accordingly, the second cause of the Complaint against Respondent 2 will be dismissed.

Customer Complaint Reporting

The parties have stipulated that Respondent 1 failed to report 24 of 38 customer complaints received between June 1, 1997, and December 31, 1998, and 6 customer complaints received in 1999. The majority of those complaints involved representatives in the New York City OSJs, and many involved sales practice violations. CX 39-40. However, CD was the designated supervisory principal in New York City responsible for sales practices, including customer complaints. As the Director of Compliance, he had ultimate responsibility for customer complaint reporting. As he noted in his testimony:

> All the branch managers were instructed to make a report on oral complaint or by a phone or written complaint as received within seven to ten days someone has to report it to me so I can file a report on time (emphasis added).

Tr. 151. The complaint reporting requirements of NASD Conduct Rule 3070 were fully set forth in the then current WSPs. Because Respondent 2 was not responsible for reporting to NASD statistical and summary information relating to customer complaints, nor was he informed by CD, or anyone else, that such reports were not being submitted to NASD, he is not liable for any violation of NASD Conduct Rules 2110 and 3070. Accordingly, the third cause of the Complaint will be dismissed.

Books and Records

The facts demonstrate that Respondent 1 was unable to produce a number of documents during the NASD staff examination that began in September 1998. However, Enforcement failed to prove by a preponderance of the evidence that Respondent 2 bore responsibility for that failure.

DH, the firm's FINOP until the month the examination began, was responsible for books and records, not Respondent 2. After HS's arrival at the firm, he noted that the Operations Manager put little pressure on his staff to be productive, and that operational records were not maintained in an orderly fashion. HS recommended, and Respondent 2 concurred, that certain employees be fired and replaced. When HS informed Respondent 2, during the NASD examination, that certain records could not be found, Respondent 2 assisted in the search for those records. Respondent 2 was not the person at the firm responsible for maintaining the books and records, and he reasonably delegated that responsibility to DH, the firm's FINOP. The evidence suggests that lack of operations staff diligence in filing and storing records was the problem; not that records had not been created in the first place. Respondent 2 responded appropriately when concerns about books and records were brought to his attention. Accordingly, the Hearing Panel will dismiss the fourth cause of the Complaint.

Conclusion

Respondent 2 is found not liable for (1) failure to supervise, in violation of NASD Conduct Rules 2110 and 3010; (2) violation of the penny stock transaction and disclosure rules, codified at Section 15(g) of the Securities Exchange Act of 1934, SEC Rules 15g-2 through 15g-5, and 15g-9 thereunder, and NASD Conduct Rule 2110; (3) failure to report customer complaints, in violation of NASD Conduct Rules 2110 and 3070; and (4) failure to make, keep current and/or maintain books and records, in violation of SEC Rules 17a-3 and 17a-4, and NASD Conduct Rules 2110 and 3110. The Complaint against him is *dismissed*.

SO ORDERED.

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Alan W. Heifetz
Hearing Officer
For the Hearing Panel