NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding
	:	No. C07000058
v.	:	
	:	Hearing Officer - Alan W. Heifetz
RUSSELL MONTGOMERY, JR. (CRD #1012980),	:	**Hearing Panel Decision**
Tampa, FL	:	
	:	March 23, 2001
Respondent.	:	

Registered representative engaged in four private securities transactions for compensation without giving his employer prior written notice and without receiving prior written approval. Respondent found liable for violations of Conduct Rules 2110 and 3040, fined $20,000, suspended for 1 year, and ordered to disgorge commissions.

Appearances:

William Brice LaHue, Esq., Atlanta, Georgia, for the Department of Enforcement.

Russell Montgomery, Jr., *pro se*.

DECISION

I. Introduction

The Department of Enforcement ("Enforcement") filed the Complaint in this proceeding on August 7, 2000. The Complaint alleged that from May to September 1997, in violation of NASD Conduct Rules 2110 and 3040, Respondent Russell Montgomery, Jr. ("Montgomery") sold promissory notes issued by Medco, Inc. ("Medco") to four customers, without disclosing to his employer his involvement with Medco and without obtaining from his employer authorization to participate in the sale of those notes.[1] On September 13, 2000, Montgomery filed an Answer to the Complaint. Montgomery admitted that NASD retains jurisdiction over him for the purpose of this proceeding, claimed insufficient information to answer the remaining allegations of the Complaint, and waived his right to a hearing. Pursuant to Order, Enforcement timely filed its written submission in lieu of a hearing. Montgomery filed no further pleadings or other submissions. This proceeding has been decided on the basis of the written record by a Hearing Panel composed of an NASD Regulation Hearing Officer and two current members of District Committee No. 7.

II. Findings of Fact

From April 1990 to November 1998, Montgomery was registered as a general securities representative with Securities America, Inc. ("SAI"), a member of NASD. CX-1, at

[1] The Complaint also named John H. Tribble, III, and Robert L. Cicetti as Respondents. On November 22, 2000, NASD Regulation, Inc. issued Orders accepting offers of settlement by Respondents Tribble and Cicetti.

4. [2] From May 1997 through September 1997, Montgomery solicited and sold promissory notes of Medco, Inc. ("Medco") to four public customers in the following amounts:

1. $21,553.70 to MA on May 23, 1997
2. $12,400.00 to MG on July 18, 1997
3. $39,000.00 to DH on August 26, 1997, and
4. $10,000.00 to NC on September 19, 1997.

Montgomery received $4,147.65, or approximately 5% of the customers' $82,953.70 investments in Medco as a commission. CX -8, at 30.[3]

In 1994, three years prior to his involvement with the Medco notes, Montgomery had requested and been denied permission by the compliance department of SAI to sell commercial notes of a California company. He was informed that the notes were securities and that offering them without the approval of SAI would constitute "selling away." CX-8, at 10. However, with regard to the Medco notes, Montgomery admitted that he failed to disclose his involvement with Medco to anyone at SAI, or to contact anyone at the Securities and Exchange Commission or the NASD to inquire whether the Medco notes were securities. Affidavit of Joel R. Beck ("Beck Aff."); CX-8-10.

From about September 1996 to October 1997, Medco offered and sold promissory notes to the general public, raising approximately $16 million from nearly 400 investors across the country. Medco claimed that the money raised would be used to purchase medical

[2] References to Enforcement's exhibits are cited as "CX-_"
[3] The Complaint alleged that customer MG bought only $12,000 of Medco notes, and that the total amount of notes sold by Montgomery was $82,553.70. Complaint ¶¶12,13. However, CX-8, at 30 is Montgomery's letter admitting that he sold $12,400 of Medco notes to MG. In its submission, Enforcement relies on the letter admission. See also CX-7, at 10.

equipment that would be leased to medical providers and secure the promissory notes. Medco promised investors returns of between 12% and 16% per year, depending on the maturity of the note and the amount invested.[4] There was no minimum or maximum investment level. No registration statement was ever filed or was in effect with the SEC for the offering of Medco's promissory notes. Beck Aff.

Prior to selling the notes, Montgomery had been provided "training on Medco" in the Spring of 1997 by Bobby Maggi and Kevin Speranza of Florida Health Plans & Investments, Inc. ("FHPI") CX-8, at 30. FHPI was an unregistered broker dealer. *See, In re Kevin Speranza and Robert Maggi*, Exch. Act Release No. 7571, 1998 SEC LEXIS 1876 (Sept. 3, 1998). FHPI provided their agents with a sales presentation book that contained sample Medco forms, sales literature, questions and answers about the notes, and other information on Medco. The book also contained a copy of the standard Medco promissory note and security agreement. Beck Aff. The book describes the "Medco Investor Program" and continually refers to its "investors" CX-2. A Disbursement Agreement in the book specifically states that the buyer of the notes is "investing" money in Medco, as "evidenced by a separate Promissory Note and Security Agreement;…." CX-2, at 40.

III. Discussion and Conclusions

Conduct Rule 3040 prohibits any person associated with a member of the NASD from participating in any manner in a private securities transaction without first providing the member with written notice of the proposed transaction and the person's proposed role in the

transaction. If the associated person has received, or may receive selling compensation, the associated person must obtain written notice of the member's approval under Rule 3040(c). A violation of Rule 3040 constitutes conduct that contravenes the standards of commercial honor and just and equitable principles of trade required by Rule 2110. *See In re Stephen J. Gluckman*, 1998 NASD Discip. LEXIS 8, *15.

Montgomery admits that he participated in the sale of Medco notes, that he received compensation for his participation in the transactions, and that he did not give prior written notice of his participation to SAI, the member with which he was associated. However, Montgomery claims to have been "cleared" to sell the Medco notes by an investigator from the State of Florida who purportedly told Montgomery that the notes were not securities.[5]

Regardless of any purported "clearance" by a state investigator, the Medco notes were "securities" within the meaning of § 3 (a)(10) of the Securities Exchange Act of 1934. The United States Supreme Court adopted the "family resemblance" test to determine whether a note is a security. *Bob Reves, et al.v. Ernst & Young*, 494 U.S. 56 (1990). Under that test, a note is presumed to be a security unless it bears a strong resemblance to certain notes recognized to be outside the securities laws,[6] or, based on certain enumerated factors, should be added to the list of non-securities. The Court held that the following four factors apply in deciding whether a transaction involves a security: (1) the motivations of the buyer and seller to

[4] Montgomery's sales literature indicated a 12% annual return on 1-year investments that ranged from $1,000 to $50,000; a 14% annual return on 2-year investments that ranged from $50,000 to $100,000; and a 16% annual return on investments that exceeded $100,000. CX-6, at 2.

[5] Montgomery's assertion that a Florida official told him that the notes were not securities is not credible. Not only is the assertion uncorroborated, but it is also flatly contradicted by the same Florida official who gave a statement to the compliance examiner for NASD Regulation, Inc. Beck Aff.

enter into the transaction; (2) the plan of distribution of the instrument, to determine whether there is common trading for speculation or investment; (3) the reasonable expectations of the investing public; and (4) the existence of another regulatory scheme that significantly reduces the risk of the instrument. *Id.* at 62-70.

Analyzing the facts of this case in the context of the four *Reves* factors, the Panel concludes that the notes were securities for the following reasons:

(1) Ostensibly, Medco issued the notes to enable it to purchase, and then lease, medical equipment, which Medco described as its "ONLY" business. CX-2, at 3. Its purpose was to raise capital for its general business operations, not to facilitate the purchase of a minor asset, to correct any cash-flow difficulty, or to advance any other commercial or consumer purpose. The buyers entered into the transactions for the purpose of making a profit on their investments, consistent with the representations Medco made about its "Investor Program."

(2) Medco offered its promissory notes over a 13 month period to a broad segment of the public, raising approximately $16 million from nearly 400 investors. The notes were sold to individual retail customers, rather than to a limited group of sophisticated institutional investors. That evidence is sufficient to conclude that there was common trading of the notes for investment. *See e.g. Stoiber v. SEC*, 161 F.3d 745, 751 (D.C. Cir. 1998); *District Bus. Conduct Comm. For Dist. No. 5 v. John P. Goldsworthy*, Complaint No. C05940077, 2000 NASD Discip., LEXIS 13, at *20 (October 16, 2000).

[6] Notes issued in a purely commercial or consumer context, such as notes secured by a home mortgage or certain short-term notes, are excluded from the definition of a security. *Reves*, 494 U.S. at 65-66.

(3) The sales presentation book that was provided by Medco to its agents was rife with references to the promissory notes as investments. Nothing in that literature, or in any other evidence of record, would lead a reasonable person to characterize the notes as anything other than investments with the expectation of profits from the efforts of others.

(4) There is no evidence of any risk-reducing factor to suggest that the notes are not in fact securities. The notes are purportedly insured by Medco's "all risk insurance policy" (CX-2, at 53), but they are not insured by the Federal Deposit Insurance Corporation, nor are they subject to any "regulatory scheme" as contemplated by *Reves*. *Stoiber*, 161 F.3d at 751.

Because Montgomery was a person associated with a member of the NASD, who participated in a private securities transaction for compensation without first providing the member with written notice of the transaction and without obtaining written notice of the member's approval of such participation, he violated Conduct Rules 3040 and 2110.

IV. Sanctions

Enforcement argues that the violations were deliberate and prevented SAI from reviewing the notes and supervising Respondent's sales. Enforcement seeks a fine of $20,000, representing $5,000 for each violation, and a suspension from association with any member firm in all capacities for at least 120 days, representing a 30-day suspension for each violation. Enforcement also recommends that Montgomery be ordered to disgorge his ill-gotten commissions of $4,147.65. Although Montgomery did not file a written submission in lieu of a hearing, a letter in the record, written by Montgomery, states that because he had been told by an official of the State of Florida that the notes were not securities, he did not inform SAI about the transactions.

For violations of NASD Conduct Rules 2110 and 3040, NASD Sanction Guidelines recommend fines of from $5,000 to $50,000, and consideration of suspensions in any and all capacities for up to two years. In egregious cases, the Guidelines provide for consideration of a bar. The Guidelines also provide that where a respondent has obtained a financial benefit from his misconduct, the Panel may require disgorgement of the ill-gotten gain.

The Hearing Panel finds that Montgomery intentionally failed to notify his member/employer of his participation in the sale of Medco notes. Prior to his involvement with the Medco notes, he had sought permission from SAI to sell promissory notes offered by another issuer. SAI denied him that permission, telling him that if he sold those notes, he would be "selling away." As noted previously, Montgomery's claim that he was cleared to sell the notes by a Florida official is neither credible nor a defense to his failure to give prior notification to SAI. Even assuming that he had been "cleared" to sell the notes by a Florida official, Montgomery would still have been required by Conduct Rule 3030 to inform SAI of his outside business activities. Under *federal* securities law, the notes were clearly securities. Montgomery never claimed to have sought competent legal advice on the status of the notes under federal law. Because he received selling compensation, he was required, under Conduct Rule 3040, to obtain written permission for the sale of the notes and, if given, to have each transaction recorded on the books and records of SAI. SAI would have been, in turn, required to supervise his participation "as if the transaction were executed on behalf" of SAI. Conduct Rule 3040(c)(2).

Montgomery's involvement with the Medco notes was not an isolated incidence. Over a four month period, he sold notes worth almost $83,000 to four customers, and received more than $4,000 in commissions. Having previously sought, and been denied permission by SAI to sell promissory notes offered by another issuer, Montgomery was well aware of his obligations under Conduct Rule 3040 when he deliberately chose to ignore them. However, because there is no record evidence of a history of relevant misconduct nor of any quantifiable loss suffered by anyone as a result of Montgomery's misconduct, the Panel concludes that appropriate sanctions fall in the middle range. Accordingly, weighing the nature and gravity of the offense, the Panel has determined to fine Montgomery $5,000 for each of the four violations, to suspend him for a period of one year, and to order him to disgorge his ill-gotten commissions.

Having found that Montgomery violated Conduct Rules 2110 and 3040, it is

ORDERED that (1) Montgomery shall pay a fine of $24,147.65 (including $4,147.65 in ill-gotten commissions); and (2) Montgomery is suspended in all capacities for a period of 1 year.

The fine and suspension shall become effective on a date set by the Association, but not earlier than 30 days after this decision becomes the final disciplinary action of the Association, except that if this decision becomes the final disciplinary action of the Association, the

suspension shall become effective with the opening of business on May 21, 2001, and end on May 21, 2002.

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Alan W. Heifetz
Hearing Officer
For the Hearing Panel

Copies to:
Via Overnight & First Class Mail
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