

**NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS**

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| DEPARTMENT OF ENFORCEMENT, | : | |
| | : | |
| Complainant, | : | Disciplinary Proceeding |
| | : | No. C8A980097 |
| v. | : | |
| | : | |
| ADAM GALAS | : | |
| (CRD #2209858), | : | HEARING PANEL DECISION |
| | : | |
| DAVID H. SHAPIRO | : | |
| (CRD #2586431), | : | Hearing Officer - SW |
| | : | |
| JOHN J. FLYNN | : | |
| (CRD #1444023), | : | |
| Rowayton, CT | : | |
| | : | |
| | : | |
| PROTECTIVE GROUP SECURITIES | : | |
| CORPORATION | : | |
| (BD #6757), | : | |
| Minneapolis, MN | : | |
| | : | |
| | : | |
| MICHAEL F. FLANNIGAN | : | Date: July 28, 2000 |
| (CRD #1135700), | : | |
| Excelsior, MN | : | |
| | : | |
| | : | |
| Respondents. | : | |

Digest

Enforcement filed a Complaint on December 28, 1998 naming as respondents Adam Galas, David H. Shapiro, John J. Flynn, Protective Group Securities Corporation (“Protective Group”), and Michael F. Flannigan. The allegations against David H. Shapiro and Adam Galas

(principals of AGS Financial Services, Inc. (“AGS”)) were resolved prior to the Hearing.

Accordingly, the Hearing Panel only considered the allegations of the Complaint included in count four relating to Respondents Protective Group, Flannigan, and Flynn.

The Complaint alleged that the Respondents violated Rules 1031 and 2110 when AGS representatives, including Respondent Flynn, solicited indications of interests and confirmed trades in Rooms Plus securities for Protective Group customers. In addition, the Complaint alleged that Respondents improperly exercised discretion in customers’ accounts in violation of Rules 2510 and 2110 when Respondent Protective Group, through Respondent Flannigan, executed solicited and unsolicited trades in Protective Group customers’ accounts based on instructions from AGS, including Respondent Flynn. The Complaint further alleged that Respondent Flynn violated Rules 3110 and 2110 by failing to create a record of the instructions regarding trades in customers’ accounts that he relayed to Respondent Protective Group.

The Hearing Panel found that Respondents Flannigan and Protective Group violated Rules 1031, 2510, and 2110. The Hearing Panel determined that Enforcement did not prove that Respondent Flynn violated Rules 1031 or 2510, as alleged. However, the Hearing Panel found that Respondent Flynn violated Rules 3110 and 2110.

Accordingly, the Hearing Panel fined Respondents Flannigan and Protective Group (i) \$15,000, jointly and severally, for violating Rules 1031 and 2110, and (ii) \$10,000, jointly and severally, for violating Rules 2510 and 2110. In addition, the Hearing Panel barred Respondent Flannigan in any supervisory capacity for violating Rules 1031, 2510, and 2110.

The Hearing Panel fined Respondent Flynn \$2,500 and ordered him to requalify as a principal for violating Rules 2110 and 3110.

Respondents Protective Group, Flannigan, and Flynn were also each assessed one-third of the \$4,732.90 cost of the Hearing.

Appearances

Richard S. Schultz, Esq., Regional Attorney, Chicago, Illinois, for the Department of Enforcement.

Charles Clayton, Esq., Minneapolis, Minnesota, for Protective Group Securities Corporation and Michael F. Flannigan.

Samuel F. Abernethy, Esq., New York, New York, counsel for John J. Flynn.

DECISION

I. Procedural Background

A. The Complaint

The NASD Regulation, Inc. (“NASDR”) Department of Enforcement (“Enforcement”) filed the Complaint in this proceeding against Respondents Protective Group, Flannigan, and Flynn (collectively, the “Respondents”) on December 28, 1998.¹ Enforcement served the Complaint on the Respondents on December 24, 1998 at their addresses of record in the NASD’s Central Registration Depository. Respondents Protective Group and Flannigan filed their answer to the Complaint on January 19, 1999. Respondent Flynn filed his answer to the Complaint on January 21, 1999. In their answers, the Respondents denied that they had violated any NASD rules.

¹ The Complaint also named Adam Galas and David Shapiro as respondents. Prior to the Hearing, the National Adjudicatory Counsel accepted Mr. Shapiro’s offer of settlement in an order dated May 19, 1999, and the Hearing Panel granted Mr. Galas’ motion to dismiss the Complaint for lack of jurisdiction in an order dated October 11, 1999.

B. The Hearing

The Parties presented evidence in two days of hearings, on October 19, and 20, 1999, to a Hearing Panel, consisting of the Hearing Officer and two then current members of the District Committee No. 8, in Chicago, Illinois.² Enforcement presented eight witnesses, Respondents Flannigan and Flynn, Michael Pardaowski (an NASD examiner), Thomas Heinzen (a trader at Protective Group), and four AGS employees, David Shapiro, Donald Bauman, Gregory Keller, and Andrew Eisnitz. At the Hearing, the Hearing Panel admitted all but 10 of Enforcement's 47 exhibits.³

Respondent Flannigan and Respondent Flynn testified on their own behalf. In addition, Respondent Flynn presented one customer witness, KH, and two exhibits, both of which were admitted.

II. Findings of Fact and Conclusions of Law

A. Jurisdiction

Respondent Protective Group Securities Corporation ("Protective Group") became a member of the NASD on April 12, 1983. (CX- 3, p. 1). Its membership currently remains in effect. (CX-3, p. 1).

Respondent Flannigan registered as a general securities principal of Protective Group on February 22, 1989. (CX-4, p. 1). During the relevant period from September 1996 to

² References to the testimony set forth in the transcript of the October 19 and 20, 1999 Hearing will be designated as "Tr." References to exhibits presented by Respondent Flynn will be designated as "RX-," and references to the exhibits presented by Enforcement will be designated as "CX-." Respondents Protective Group and Flannigan did not submit any exhibits.

³ The Hearing Panel excluded exhibits pertaining to trades by Protective Group customers in the securities of Mama Tish International Foods, which trades were not referenced in count four of the Complaint.

December 1996, Respondent Flannigan was the president of Protective Group and registered as a general securities principal. (CX-4, p. 1). He remains so registered. (CX-4, p. 1).

From October 3, 1996 to June 25, 1997, Respondent Flynn was registered as a general securities representative with AGS Financial Services, Inc. (“AGS”). (CX-2, p. 3). Respondent Flynn was approved as a general securities principal and general securities representative with Greenwich Global, L.P. on January 12, 1998. (CX-2, p. 3). He remains so registered. (CX-2, p. 3).

Accordingly, the Hearing Panel concluded that the Association has jurisdiction over Respondents Protective Group, Flannigan, and Flynn.

B. Background

1. NASD Investigation

In 1996, Rooms Plus, Inc. (“Rooms Plus”), a New York corporation, offered its securities for sale in an initial public offering. (CX-6). The steps in an initial public offering involve the development and filing of a registration statement with the Securities and Exchange Commission (“SEC”) followed by the marketing of the securities by a group of broker-dealers, a syndicate. The marketing process includes the distribution of preliminary prospectuses to prospective purchasers, i.e., retail and institutional customers, who are invited to submit indications of interest as to how many shares of the offering they would take. The indications of interest do not obligate or bind the customers to purchase the securities because sales of securities in an initial public offering are prohibited by the SEC until the applicable registration statement has been declared effective by the SEC. On the day the registration statement becomes effective, the customers confirm their indications of interest with the broker-dealer

members of the syndicate, the broker-dealers execute their customers' trades, and, subsequently, the broker-dealers send the customers written confirmations of the executed trades.

Respondent Protective Group was a member of the syndicate for the Rooms Plus initial public offering. (CX-26, p. 4). The NASD began a review of the Rooms Plus offering to determine whether the broker-dealers who participated in the syndicate had complied with the free riding and withholding interpretation. (CX-26, p. 4). In connection with the Rooms Plus review, the NASD began an investigation of Respondent Protective Group and AGS, which resulted in the filing of the Complaint. (CX-26, p. 1).

2. AGS's Participation in the Rooms Plus Offering

Adam Galas owned AGS, a broker-dealer, based in Chicago, Illinois, with a net capital requirement of \$5,000. (Tr. pp. 206, 257). As a \$5,000 broker-dealer, AGS could not participate in public offerings except on a "best efforts" or an "all or none basis."⁴ (CX-15, p. 1). In order to expand the scope of AGS's operations and permit AGS to act as a member of the syndicate in the Rooms Plus offering, Mr. Shapiro invested \$150,000 in AGS, and became a minority owner, in August 1996. (CX-17, p. 19).

In August 1996, Mr. Galas and Mr. Shapiro explored the possibility of AGS participating in the Rooms Plus offering. In October 1996, Mr. Shapiro and Mr. Galas entered into negotiations with the NASDR staff to amend the AGS membership agreement to permit, among other things, AGS's participation in the Rooms Plus offering, AGS's execution of market

⁴ This restriction was also set forth in AGS's restrictive membership agreement, dated June 9, 1995. (CX-15, p. 1).

making trades, and AGS's opening of an office in New York. (CX-17, p. 4). Consistent with such plans, AGS employed Respondent Flynn as a trader, Mr. Andrew Eisnitz as the operations manager, and Messrs. Donald Bauman and Gregory Keller as sales representatives in October 1996. (Tr. pp. 89-90, 109, 208, 332). While AGS's request to expand was pending with NASDR, Respondent Flynn assisted Mr. Galas and Mr. Shapiro with AGS's administrative operations. (Tr. p. 441).

3. Contingency Plan

At the NASDR staff's suggestion, AGS formulated a contingency plan in the event it did not receive NASDR approval before the effective date of the Rooms Plus offering.⁵ (Tr. p. 235). To formulate the contingency plan, AGS contacted its clearing agency, RPR Correspondent Service, Inc. ("RPR"). (Tr. p. 235). On October 20, 1996, RPR introduced AGS to one of its other clients, Protective Group, as providing a possible solution to AGS's problem. (Tr. p. 362).

On October 20, or 21, 1996, Respondent Protective Group, through its president, Respondent Flannigan, agreed to act as a standby for AGS in the Rooms Plus offering. (Tr. p. 364). If AGS did not receive NASDR approval to participate in the Rooms Plus offering, Protective Group agreed to: (1) take AGS' syndicate allocation; (2) open accounts for AGS customers⁶ and fill the customers' Room Plus orders; (3) pay AGS the commissions earned for

⁵ There was no evidence or testimony that the actual contingency plan was submitted to, or approved by, the NASDR staff.

⁶ Some of the individuals solicited by AGS representatives did not become customers of AGS prior to opening an account at Protective Group. However, for the purposes of this Decision, all individuals who were solicited by AGS representatives, opened accounts at Protective Group, and purchased Rooms Plus securities will be referred to as AGS customers.

executing Rooms Plus trades in the aftermarket, minus two cents per share and minus any expenses sustained by Protective Group for the Rooms Plus offering; (4) act as a market maker for Rooms Plus;⁷ and (5) return the customer accounts back to AGS after AGS received NASDR approval to expand its business. (CX-21, p. 1; Tr. pp. 364-367, 442). The arrangement was never put in writing. (Tr. p. 370).

To implement the contingency plan, AGS' attorney created form letters, dated October 31, or November 1, 1996, which were sent to those AGS customers who expressed an interest in the Rooms Plus offering. (Tr. pp. 230-231, 445). The form letters, which were sent approximately ten days prior to the October 31, and November 1, 1996 dates shown on the letters, advised the AGS customers of the possibility of purchasing the Rooms Plus securities through Protective Group. (Tr. pp. 223, 230-231). By signing and returning the form letters to AGS, the AGS customer authorized the opening of a brokerage account at Protective Group and authorized the transfer of funds from his or her AGS account to a new Protective Group account. (CX-29). However, the form letters did not direct or authorize AGS or Protective Group to purchase a specific amount of Rooms Plus securities on behalf of the customers in the initial public offering, and the form letters did not authorize purchases or sales of Rooms Plus securities in the aftermarket.⁸ (CX-29, pp. 1-134; Tr. pp. 195-196).

⁷ Rooms Plus was the first NASDAQ Small Cap stock in which Respondent Protective Group made a market. (Tr. p. 367). Respondent Protective Group generally was a market maker in bulletin board stocks. (Tr. p. 366).

⁸ The form letter on AGS letterhead stated in part:

“[Y]ou have indicated a desire to purchase securities of Rooms Plus, Inc. in a planned initial public offering of its securities. In order to assist you and to provide you with the best opportunity to obtain such securities, arrangements have been made with Protective Group Securities Corp., who, we understand, plans to be a selected dealer in the above offering. To accomplish the foregoing, you are required by our clearing agent RPR [C]orrespondent Services, Inc. to transfer a

On October 28, 1996, AGS made the final determination that it would not be able to participate in the Rooms Plus offering because of the lack of NASDR approval. (Tr. p. 222). Then, RPR, AGS's clearing agent, told Respondent Flynn what steps to take to transfer accounts from AGS to Protective Group. (Tr. p. 221). Beginning on October 28, 1996 with the receipt of executed form letters from AGS customers, AGS, primarily through Respondent Flynn, sent information concerning the AGS customers' net worth, income, and investment objectives to Respondents Protective Group and Flannigan to open accounts for those individuals. (Tr. pp. 446-447; CX-13). Respondent Flynn faxed the AGS account forms to Mary Dupske at RPR and to Respondent Flannigan at Protective Group. (Tr. p. 225).

Respondent Flannigan set up new Protective Group accounts for the AGS customers based primarily on information supplied by AGS. (Tr. p. 401). In some cases, Respondent Protective Group simply copied the information concerning the customers' net worth, income, and investment objectives from the AGS account forms to its own account forms. (Tr. p. 373). If the information was not included on the AGS account form, Respondent Flannigan attempted to contact the customer. (Tr. p. 401). If Respondent Flannigan could not reach the customer, he contacted AGS. (Tr. p. 401). Respondent Flannigan did no independent investigation to check the accuracy of the information provided by AGS.⁹ (Tr. p. 400).

cash balance to Protective Group Securities Corp. Please sign the authorization below so that we may assist you in your investment objectives.

To RPR Correspondent Services, Inc.

Please transfer the amount of \$ _____ from my account at AGS Financial Services, Inc. to Protective Securities Group, Corp.”

⁹ At least four of the new account forms did not contain any information concerning the income or net worth of the new customer. (CX-27, pp. 5, 24, 80, and 153).

Respondent Flannigan opened 155 new Protective Group accounts in this manner. Each Protective Group new account form listed Respondent Flannigan as the broker of record. (CX-27, pp. 1-155). All of the account forms were dated between October 29, 1996 and mid-November 1996.¹⁰ (Tr. p. 170).

Although AGS knew Protective Group would execute the trades, AGS representatives continued to solicit indications of interest. (Tr. pp. 439-440). Mr. Keller and Mr. Bauman, associated with, but not registered with, AGS, testified that they solicited indications of interest in the Rooms Plus offering from their customers. (Tr. pp. 90, 333).

C. Rooms Plus Trades

1. Rooms Plus Initial Public Offering

Rooms Plus offered 1,100,000 shares of its common stock at \$5.00 per share and 2,200,000 redeemable common stock purchase warrants at \$.10 per warrant through its initial public offering.¹¹ (CX-6, p. 1). Protective Group, as a member of the syndicate, received an allocation of 200,000 shares of common stock and 20,000 warrants, as set forth in Respondent Flannigan's November 1, 1996 statement to the lead underwriter. (CX-20, p. 1).

Respondent Flannigan's requested allocation of Rooms Plus securities was based on the list received from Mr. Shapiro, who listed those individuals who had expressed and confirmed an interest in purchasing the Rooms Plus securities to AGS brokers. (Tr. p. 383). According to

¹⁰ More than 70 of the of the new account forms were dated on November 11, 1996 or later, well after the November 1, 1996 effective date of the Rooms Plus offering. (CX-27).

¹¹ Each warrant entitled the holder to purchase one share of common stock at a price of \$5.50 per share, commencing November 1, 1997 until November 1, 2000 and was redeemable by Rooms Plus at a redemption price of \$.05 per warrant on 30 days prior written notice, subject to certain conditions. (CX-6, p. 1).

Mr. Shapiro, AGS representatives called AGS customers in the 48 to 72 hour period after the effective date of the offering to confirm their indications of interest. (Tr. pp. 453-454). Mr. Keller, an AGS representative, testified that he confirmed his customers' indications of interest. (Tr. p. 337). The Hearing Panel finds that AGS representatives confirmed their customers' indications of interest on or about November 1, 1996, the effective date of the Rooms Plus offering, for Protective Group.¹² (Tr. pp. 439-440).

RPR had instructed Protective Group not to fill a customer's order unless the customer had a completed account form with Protective Group and had funds in that account. (Tr. p. 383). Some AGS customers who had expressed, and confirmed, an interest in purchasing Rooms Plus securities did not meet these requirements and, therefore, did not receive any securities.¹³ The distribution of Rooms Plus securities to the AGS customers was also modified by Mr. Shapiro and RPR because of numerous account input errors by RPR and Protective Group, address corrections, and bounced checks, which resulted in numerous cancels and rebills in the Protective Group accounts of the AGS customers.¹⁴ (Tr. pp. 383, 453; CX-25).

The final allocations of Rooms Plus securities to the customers were not made until November 6, 1996.¹⁵ (Tr. p. 244). Customers learned of their final allocations through the

¹² Approximately, six brokers, originally from New York, were temporarily housed in Chicago, Illinois, to solicit indications of interest in the Rooms Plus offering. (Tr. pp. 134, 337). Mr. Shapiro obtained and paid for hotel rooms for the brokers. (Tr. p. 213).

¹³ Nevertheless, some AGS customers who had not completed Protective Group new account forms by the November 1, 1996 effective date did receive Rooms Plus securities. (Tr. p. 402). Approximately twenty AGS customers whose Protective Group accounts were not opened until after November 1, 1996 purchased Rooms Plus securities as of the effective date of the initial public offering. (CX-28).

¹⁴ Respondent Flynn had no input in determining the initial customer allocations or the cancels and rebills. (Tr. p. 325).

¹⁵ A majority of the initial public offering was booked on November 4, 1996. (Tr. p. 237). The warrant allocation was not finalized until November 6, 1996. (Tr. p. 244).

confirmations received in the mail from Protective Group. (Tr. p. 241). Mr. Eisnitz, an AGS employee, spent a week in November at the offices of Protective Group attempting to sort out the problems. (Tr. pp. 116-117, 395; CX-25, p. 22-23).

Ultimately, Respondents Protective Group and Flannigan executed purchases in 155 accounts in the Rooms Plus initial public offering. (Tr. p. 244). Respondent Flannigan confirmed that everyone who bought Rooms Plus securities in the initial public offering was “in the group coming from AGS.” (Tr. p. 562). Respondent Protective Group mailed written confirmations, final prospectuses, and customer account statements to the 155 new customers.¹⁶ (Tr. p. 368). Respondent Flannigan stated that most of his telephone conversations with the AGS customers occurred after the allocations had been made; he admitted that he “did not make a concerted effort to contact 150 people,” prior to executing the purchases in the initial public offering. (Tr. p. 564).

Respondent Flannigan also admitted that representatives from Protective Group did not call every customer prior to the effective date of the offering to confirm the customers’ expressions of interest.¹⁷ (Tr. pp. 377, 240-241). Respondent Flannigan acknowledged that in a typical offering with five or ten customers, he would have called every customer “to let them know ahead of time what they got.” (Tr. p. 558). He admitted that in this particular case “we got in over our head.” (Tr. p. 558).

¹⁶ Approximately twelve of the customers, solicited by Mr. Bauman, an AGS employee, purchased Rooms Plus securities. (Tr. p. 91). Mr. Keller, an AGS employee, solicited approximately 11 customers who purchased Rooms Plus securities, through accounts at Protective Group. (Tr. pp. 333-334). Mr. Shapiro testified that he had between 50 and 100 customers who purchased Rooms Plus securities. (Tr. p. 471).

2. Rooms Plus Aftermarket Trading

Upon the November 1, 1996 effective date of the offering, Rooms Plus common stock and warrants were immediately tradable separately and could be purchased separately. (CX-6, p. 1). There were solicited and unsolicited customer requests for trades in Rooms Plus in the immediate aftermarket according to Mr. Shapiro.¹⁸ (Tr. p. 457). Messrs. Keller and Bauman testified that their customers communicated their orders to purchase or sell Rooms Plus in the aftermarket to them, and they communicated the orders to Mr. Shapiro. (Tr. pp. 91, 346). Some of the orders were subsequently executed by Respondents Protective Group and Flannigan. (Tr. pp. 91, 346).

In a number of the unsolicited aftermarket transactions, Respondent Flannigan testified that AGS customers placed their orders with AGS representatives without understanding that the orders to sell their Rooms Plus securities held in their Protective Group account had to be completed through Protective Group.¹⁹ (Tr. p. 393). On many occasions, those customers who did understand that they needed to contact Protective Group to purchase or sell Rooms Plus securities in their Protective Group accounts were unable to reach Respondent Flannigan or anyone at Protective Group, and therefore contacted their AGS representatives. (Tr. p. 393).

Upon receipt of customers' orders for the aftermarket, either solicited or unsolicited, the AGS representatives passed the orders on to Mr. Shapiro, who then passed them on to

¹⁷ Respondent Flynn confirmed that Protective Group did not call customers the morning of the offering based on his conversations with AGS customers. (Tr. pp. 240-241). Respondent Flynn testified that he was getting 30 or 40 calls an hour from customers asking, "Did I get an allocation?" (Tr. p. 238).

¹⁸ There was no evidence of how many of the trades in the Rooms Plus aftermarket were solicited.

Respondent Flynn. (Tr. pp. 263, 457). Respondent Flynn would call the Protective Group trader, Mr. Heinzen, and say “a fax is coming or there is a block of stock to buy or sell.” (Tr. p. 46). Respondent Flynn would then fax the customers’ orders provided by Mr. Shapiro to Respondent Protective Group. (Tr. p. 46). Mr. Heinzen received such phone calls and faxes several times a day. (Tr. p. 46).

The fax would go from the fax machine at AGS to the fax machine at Protective Group, then to Respondent Flannigan. (Tr. p. 48). Respondent Flannigan would look at the name and account number and then give the order to Mr. Heinzen, who would try to “fill the orders.” (Tr. p. 48). The faxed orders generally had the customers’ names, the number of shares or warrants the customer wanted to buy or sell, and the commissions to be charged. (Tr. p. 47).

When a customer was unable to reach his or her AGS representative and contacted Respondent Flynn directly, Respondent Flynn typically arranged a three-way conference call with the customer and Protective Group. (Tr. p. 391). If unable to reach Protective Group with the particular customer on the line, Respondent Flynn later informed Protective Group of the customer’s trade order. (Tr. p. 391).

Respondent Flannigan admitted that sometimes Respondent Flynn contacted him to tell him that customers wanted to purchase or sell Rooms Plus securities. (Tr. p. 392). Although Respondent Flannigan tried to contact the customers, he also admitted that sometimes

¹⁹ RPR would not permit AGS customers who wanted to sell their Rooms Plus stock to short the stock in their AGS accounts. (Tr. pp. 248-249).

Protective Group executed trades in the aftermarket before contacting the customer, especially if it was an order to sell in a falling market.²⁰ (Tr. p. 392).

Based on the number of phone calls Mr. Flannigan remembers and the number of times Mr. Flynn contacted Protective Group, the Hearing Panel determined that a substantial number of Rooms Plus customers placed their unsolicited trade orders in the aftermarket with AGS representatives and that Respondents Protective Group and Flannigan executed those orders based on instructions received from Respondent Flynn without direct contact with the customers.

3. Back Office Activities

Respondent Flannigan had numerous conversations with Mr. Shapiro and Respondent Flynn of AGS regarding the collection of funds from customers for whom Respondent Protective Group executed Rooms Plus trades, in both the initial public offering and the aftermarket.²¹ (Tr. p. 402; CX-25, p. 40). Respondent Flannigan sent to Mr. Galas and Mr. Shapiro a list of customers who had opened accounts at Protective Group that either did not have letters of authorization to transfer funds or had debits in their accounts. (Tr. pp. 405-406; CX-25, pp. 1-6). Despite the absence of written letters of authorization for at least five AGS customers, Respondent Flannigan permitted accounts to be opened and Rooms Plus securities to be allocated to those accounts on the recommendation of Mr. Shapiro. (CX-7; CX-28, pp.

²⁰ Respondent Flannigan testified that in November there were phone calls from his office to 64 or 65 different New York numbers as compared to phone calls to four different New York numbers in October. (Tr. p. 391).

²¹ On November 12, 1996, Respondent Flannigan sent Mr. Shapiro a fax labeled "List of no pays etc. Rooms Plus." (CX-26, p. 11).

9-11, 52-53, 64-65, 115-116, 125-129;CX-29). He intended Mr. Galas and Mr. Shapiro to contact those customers to provide funds to settle the trades. (Tr. p. 406; CX-25, p. 29).

If Respondent Flannigan received a customer complaint about an unauthorized trade in Rooms Plus, he would call Mr. Shapiro who would promise to investigate the matter. (Tr. p. 408; CX-25, pp. 26, 27, 28, 34). Typically, Mr. Shapiro would report back that a particular trade should be canceled and re-billed to another account so that the “customer would get exactly what he claimed he wanted.”²² (Tr. p. 409). Respondent Flannigan testified that Mr. Shapiro was of great assistance in getting money when checks bounced or when customers did not pay for their orders. (Tr. p. 413).

4. Compensation for the Rooms Plus Transactions

Respondent Flannigan earned \$86,000 in commissions on the Rooms Plus trading, which approximated 70% to 75% of the monthly gross commissions earned by Respondent Flannigan in November. (Tr. pp. 164-165). Pursuant to the oral agreement with AGS, Respondent Flannigan was to pay AGS the \$86,000 in commissions minus a number of expenses, including but not limited to: (i) the costs of temporary office help, back office overtime, and postage; (ii) RPR’s charges for cancels, rebills, and as of trades; and (iii) a \$.02 per share trading expense paid to Protective Group’s trader, Mr. Heinzen. (CX-21, p. 1).

After subtracting expenses totaling \$57,535.76, Protective Group owed AGS a net amount of \$28,947.24. (CX-21, p. 1). On December 6, 1996, Protective Group wired \$20,000 of the

²² Mr. Bauman testified that two of his customers complained that there were warrants in their account which they did not authorize. (Tr. pp. 92-93). Mr. Bauman relayed the customer complaints to Mr. Shapiro. (Tr. pp. 92-93).

\$28,947.24 to the personal account of Mr. Shapiro. (CX-21, p. 3). Protective Group never paid AGS the balance.²³ (CX-21, p. 3).

D. Discussion

1. Rule 1031: Registration of Representatives

Enforcement alleged that Respondents Protective Group and Flannigan violated Rules 1031 and 2110 by executing trades solicited and confirmed by AGS representatives, and Respondent Flynn violated Rules 1031 and 2110 by soliciting trades executed by Respondent Protective Group.²⁴

Rule 1031 requires that all persons engaged in the investment banking or securities business of a member who are to function as representatives shall be registered with NASD as representatives of the member. Persons associated with a member who are engaged in the solicitation of, or conduct of business in securities, are designated as representatives. Persons who introduce or refer prospective customers and receive commissions for such activities are engaged in a securities business for the member in the form of solicitation, which is the first step in the consummation of a securities transaction and is clearly a part of the conduct of a securities business.²⁵

²³ Mr. Galas agreed that the funds could be wired to Mr. Shapiro's personal account. (Tr. p. 550-551). It was anticipated that there would be additional expenses, *i.e.*, some trades that had not been paid for, which would increase the expenses and thereby eliminate the remaining \$8,947.24 balance owed AGS. (Tr. p. 433).

²⁴ Conduct Rule 2110 provides "a member, in conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

²⁵ District Bus. Conduct Comm. for Dist. No. 2 v. Hanmi Securities, Inc., Complaint No. C02950014, 1996 WL 1114525 at *5 (May 9, 1996).

a. Respondents Protective Group and Flannigan

The NASD issued Notice to Members 88-50 to clarify permissible activities of unregistered persons. Unregistered persons may contact prospective customers for purposes of extending invitations to firm sponsored events at which any substantive presentations and account or order solicitations may be made by appropriately registered personnel; inquiring whether the prospective customer wishes to discuss investments with a registered person; and determining whether the prospective customer wishes to receive investment literature from the firm. According to Notice to Members 88-50, unregistered persons may not discuss general or specific investment products or services offered by the firm, pre-qualify prospective customers as to financial status, investment history, and objectives, or solicit new accounts or orders.

It is undisputed that AGS representatives solicited and confirmed customers' indications of interest to purchase Rooms Plus securities after October 28, 1996, the date when AGS concluded that it would not be able to participate in the Rooms Plus offering. Respondents Protective Group and Flannigan knew that AGS representatives were engaged in these activities; knew that the transactions they were soliciting were to be executed through Protective Group; and knew that none of the AGS representatives was registered with Protective Group. (Tr. p. 407). Respondents Protective Group and Flannigan had agreed to pay AGS a fee for generating these transactions.²⁶

²⁶ See In the Matter of the Cambridge Group, 50 S.E.C. 752 (October 8, 1991), 1991 WL 294319 (1991) (a registration violation by Cambridge occurred when Cambridge permitted Lawrence Hold, who was a registered representative of Private Ledger Financial Services, to solicit securities business for Cambridge when he was not registered as a representative of Cambridge).

With respect to the initial public offering, Respondents Protective Group and Flannigan argued that: (i) with respect to the solicitations, the AGS customers were not Protective Group customers at the time the original solicitations of interests occurred, and they did not know that solicitations had occurred after October 28, 1996; and (ii) with respect to the confirmations, Protective Group did not rely on the confirmations of interests received by the AGS representatives, but instead confirmed the customers' indications of interest by sending the customers written confirmations of the trades. The Hearing Panel disagrees.

Respondents Protective Group and Flannigan may legitimately argue that prior to October 20, 1996, when Protective Group agreed to act as a standby for AGS, the solicitations were not made on its behalf. However, after October 20, 1998, Respondent Protective Group and Flannigan should have known that solicitations were occurring. The question of whether solicitations would continue should have been asked when Protective Group agreed to be a standby. Secondly, in an initial public offering, when the offer of the stock cannot be completed until the effective date of the registration statement, a written confirmation should not be sent unless there has been prior confirmation that the customer wants the trades. Respondents Protective Group and Respondent Flannigan, as the named broker, were responsible for confirming the trades. They permitted AGS representatives to confirm the trades, and they relied on the confirmations received by AGS representatives as set forth in the allocation list provided by Mr. Shapiro.

Accordingly, the Hearing Panel found that Respondents Protective Group and Flannigan violated Rule 1031 in connection with the initial public offering by allowing AGS representatives

who were not registered with Protective Group to function as representatives engaged in Protective Group's securities business. By violating Rule 1031, Respondent Protective Group and Flannigan also violated Rule 2110's requirement of just and equitable trade practices.

b. Respondent Flynn

In contrast, Enforcement failed to prove that Respondent Flynn violated Rule 1031 by functioning as a representative engaged in the securities business of Protective Group. Enforcement did not prove that Respondent Flynn solicited investors on behalf of Protective Group or that he was paid compensation by Protective Group. In fact, Respondent Flynn received no compensation for any trades done in Rooms Plus from either AGS or Protective Group.²⁷ (Tr. pp. 542-543).

Respondent Flynn testified that he did not call anybody and "pitch them on the phone." (Tr. p. 213). Respondent Flynn indicated that the two individuals with whom he spoke concerning Rooms Plus made their final decisions to purchase Rooms Plus securities after discussing the matter with Respondent Flannigan. Mr. H, one of Respondent Flynn's two Rooms Plus customers, testified that he spoke directly with Respondent Flannigan to authorize the trade in Rooms Plus. (Tr. p. 499).

There was no evidence presented that Respondent Flynn solicited other individuals to participate in the offering or to purchase or sell Rooms Plus securities in the aftermarket. When trades were canceled and rebooked to other customers, Respondent Flynn did not make

²⁷ Respondent Flynn was introduced to Mr. Galas of AGS by a headhunter. (Tr. p. 203). Prior to the introduction, he had never heard of AGS, Mr. Galas, or Mr. Shapiro. (Tr. p. 585).

judgments about which customer should receive the additional shares. (Tr. p. 456).

Respondent Flynn just acted as a conduit to provide information from Mr. Shapiro to Protective Group. (Tr. p. 254).

The Hearing Panel found that Respondent Flynn merely relayed to Protective Group information about customers' orders that he received from his principal, Mr. Shapiro, and that Respondent Flynn's activities in that regard were too limited to establish that he functioned as a representative engaged in the securities business of Protective Group. Accordingly, the Hearing Panel finds that Enforcement did not prove that Respondent Flynn violated Rule 1031.

2. Rule 2510: Written Discretionary Authority

In the Complaint, Enforcement alleged that Respondent Protective Group executed solicited and unsolicited orders in customer accounts without either confirming the transactions with the customers prior to the execution of the transactions or obtaining written discretionary authority from the customers authorizing reliance on the AGS representatives' instructions. At the Hearing, Enforcement contended that Respondent Flannigan executed transactions in the accounts for which he was the registered representative based on information from Respondent Flynn, without any type of written documentation from the customers granting Respondent Flynn discretionary authority. Enforcement argued that Respondent Flynn exercised discretionary authority by relaying customer orders to Protective Group without written customer authorization.

Rule 2510 provides that no member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written

authorization to a stated individual. The 155 accounts set up by Respondent Protective Group in connection with the Rooms Plus offering were non-discretionary accounts, in which trades should have been executed only after the customers or the customers' designees provided specific authorization to execute the trades.

a. Respondents Protective Group and Flannigan

The Hearing Panel found that Respondent Protective Group executed unsolicited transactions in a substantial number of the 155 customer accounts in the aftermarket, without direct authorization from the customers or authorized customer designees.²⁸ Neither Mr. Shapiro nor Mr. Flynn was an authorized customer designee. Respondent Flannigan did not have any written documentation appointing customer designees.

Respondent Flannigan admitted that several customers called AGS to execute trades, and Respondent Flynn would fax or call Respondent Protective Group with the trade information. (Tr. p. 393). The Hearing Panel found that Respondent Protective Group relied on the information provided by Respondent Flynn to execute trades in the accounts of its customers without obtaining written authorization from the customers to rely on a third party's directions.²⁹

²⁸ There was no definite information concerning how many of the aftermarket trades were solicited. There was testimony that some of the aftermarket trades were solicited at the time of the initial indication of interest. (Tr. p. 253). Accordingly, there was no finding that AGS representatives acted in the capacity of registered representatives by soliciting trades in the aftermarket after Protective Group agreed to act as a standby for AGS on October 20, 1996.

²⁹ District Bus. Conduct Comm. for Dist. Number 12 v. Jeffrey Alan Schultz, Complaint No. C10890002 (December 6, 1991) 1991 WL 840285 at *1-2 and fn 18 (1991) (a broker who failed to obtain a discretionary authority agreement from a customer, exercised discretion by following the trading instructions of the customer's ex-husband); District Bus. Conduct Comm. for Dist. Number 5 v. Thomas E. Warren, III, Complaint No. C05910075 (December 23, 1992) 1992 WL 897289 (1992) (a broker exercised discretion by accepting third-party instructions from the mother of the minor children, who owned the stock).

Respondents Protective Group and Flannigan argued that there was no discretionary authority exercised by anybody in this case because “they did exactly what the customer wanted, no more, no less.” However, Respondents Protective Group and Flannigan knew what the customers wanted, not by talking with the customers, but by relying regularly on the information provided by Mr. Shapiro via Mr. Flynn. Protective Group had no written authorizations for such reliance from the customers.

Accordingly, the Hearing Panel found that Respondents Protective Group and Flannigan exercised discretionary authority for a number of the customer accounts, in the aftermarket trading, by relying on information from AGS to execute transactions without obtaining written customer approval for such reliance in violation of Rule 2510 and thereby Rule 2110.

b. Respondent Flynn

Respondent Flynn in relaying the information provided by Mr. Shapiro regarding customer orders was simply relaying information provided by his employer. (Tr. p. 451). In those instances in which the customer contacted Respondent Flynn directly, Respondent Flynn testified he arranged three-way phone calls with Protective Group and the customer.

Accordingly, the Hearing Panel determined that Enforcement did not prove that Respondent Flynn exercised discretionary authority with respect to customer accounts by forwarding customer trade information from his principal to Protective Group.

3. Rule 3110: Recordkeeping by Respondent Flynn

Enforcement alleged that Respondent Flynn received trade instructions in the Rooms Plus aftermarket from customers and an AGS principal, Mr. Shapiro, which he relayed to Respondents Protective Group and Flannigan without creating a record of such instructions.

Rule 3110 provides that each member shall make and preserve books, account records, memoranda, and correspondence in conformity with all applicable laws, rules, and regulations.³⁰

The applicable rules include Securities and Exchange Commission Rule (“SEC”) 17a-3. SEC

Rule 17a-3 (a)(6) provides that every member shall make and keep:

A memorandum of each brokerage order, of any other instructions, given or received for the purchase or sale of securities, whether executed or unexecuted. Such memorandum shall show the terms and conditions of the order or instructions and of any modification or cancellation thereof, the account for which entered, the time of entry, the price at which executed, and, to the extent feasible, the time of execution or cancellation The term “instruction” shall be deemed to include instructions between partners and employees of a member, broker, or dealer. The term “time of entry” shall be deemed to mean the time when such member, broker or dealer transmits the order or instruction for execution, or if it is not so transmitted, the time when it is received.

Respondent Flynn admitted that he did not complete order tickets or create records of the instructions that he received from Mr. Shapiro or the customers, which he forwarded to Protective Group.

Accordingly, the Hearing Panel finds that Respondent Flynn received instructions regarding trades in Rooms Plus from customers and Mr. Shapiro without creating a record of such instructions in violation of Conduct Rule 3110 and thereby in violation of Conduct Rule 2110’s requirement of just and equitable trade practices.

³⁰ NASD General Provision Rule 0115 provides that persons associated with a member shall have the same duties and obligations as a member under the Rules of the Association.

III. Sanctions

A. Respondents Protective Group and Flannigan

The Sanction Guidelines for registration violations of Rule 1031 and 2110 suggest a fine of \$2,500 to \$50,000 and suspension of the individual in any or all capacities for 30 business days to two years, or a bar for egregious cases.³¹

The Sanction Guidelines for exercising discretion without a customer's written authority in violation of Rules 2510 and 2110 suggest a fine of \$2,500 to \$10,000 and in egregious cases suspension in any or all capacities for up to 10 to 30 business days.³² The adjudicator may increase the recommended fine amount by adding the amount of respondent's financial benefit.

For violations of Rules 1031, 2510, and 2110, Enforcement recommended that Respondent Flannigan be suspended in all capacities, or as a principal, for up to 30 business days, and that Respondents Flannigan and Protective Group be fined \$135,000, jointly and severally (\$20,000 plus the \$85,000 in commissions earned on the trading in Rooms Plus, and the \$30,000 reallowance fee³³ earned on the initial public offering).

The NASD has previously stressed that the registration requirement provides an important safeguard in protecting investors, and, consequently, strict adherence to the requirement is essential.³⁴ Without adherence to the registration requirement, a number of

³¹ NASD Sanction Guidelines, p. 43 (1998).

³² NASD Sanction Guidelines, p. 78 (1998).

³³ Pursuant to the dealer agreement, Respondent Protective Group received a reallowance of \$.15 per share for the Rooms Plus common stock and no reallowance for the warrants. (CX-20, p. 1). Consequently, Respondent Protective Group earned \$30,000 as a member of the syndicate for the Rooms Plus initial public offering. (Tr. p. 398).

³⁴ Gary D. Cohee, Exchange Act Release No. 25210, 1987 SEC LEXIS 2985 at *4 (1987); District Bus. Conduct Comm. for Dist. No. 3 v. Kevin D. Kunz, Complaint No. C3A960029 (July 7, 1999).

customer safeguards are not effectively in place. Respondent Flannigan admitted that, with respect to a majority of the AGS customers, he had no direct knowledge of: (i) who at AGS actually solicited customers for indications of interest or for aftermarket trading; (ii) what representations were made to the AGS customers about Rooms Plus offering; (iii) what the AGS customers' net worth, income, or investment objectives were; or (iv) how many shares of Rooms Plus each AGS customer wanted to purchase. (Tr. p. 396).

This case is a prime example of the lack of customer safeguards when a member executes trades solicited by persons who are not registered with the member. In the initial public offering, Respondent Flannigan undertook to execute trades for a majority of his 155 new customers without: (i) determining the customers' suitability for the initial public offering; (ii) confirming the customers' trade instructions to prevent unauthorized transactions; (iii) confirming the customers' account information; or (iv) determining whether a particular customer was subject to the free riding and withholding interpretation.³⁵

The Hearing Panel found Respondent Flannigan's actions to be particularly egregious. Although Respondent Flannigan confirmed that everyone who bought Rooms Plus securities in the initial public offering was an AGS customer, Protective Group did not have a completed authorization form to open a Protective Group account for approximately nine of the AGS customers who purchased Rooms Plus securities. In at least four instances, Protective Group

³⁵ On October 31, 1996, Mr. Shapiro in his capacity as vice president of AGS made a written representation to Respondent Protective Group that none of the new Protective Group accounts was restricted from the purchase of Rooms Plus securities by the free riding and withholding interpretation. (CX-19, p. 1). Mr. Shapiro provided the October 31, 1996 representation at the request of Respondent Flannigan, who relied on the representation to execute trades in the customers' accounts. (Tr. p. 447). The representation was false; Mr. Shapiro knew it was false at the time that he sent it to Respondent Flannigan. (Tr. p. 447).

did not have a completed Protective Group new account form for AGS customers purchasing Rooms Plus securities who had completed an authorization form to open a Protective Group account.

Respondent Flannigan opened accounts in some instances with no information concerning the customer's net worth or net income on the Protective Group new account form. More than 70 AGS customers purchased Rooms Plus securities at the November 1, 1996 initial public offering price after the November 1, 1996 effective date. Despite RPR's explicit directions, more than 20 customers purchased Rooms Plus securities prior to having funds in their Protective Group accounts. Despite RPR's instructions, at least two customers sold the Rooms Plus securities short. (CX-28, pp. 81, 127-128).

Respondent Flannigan attempted to disassociate himself from responsibility for every aspect of the Rooms Plus trades, except for collecting the commissions on the trades. During the week between October 20, or 21, 1996, when he heard about the deal, and October 28, 1996, when he began receiving the account forms from AGS, a company about which he knew nothing, he did not ask about the number of accounts or the amounts of shares involved in his standby arrangement. Respondent Flannigan did not recall asking AGS how much money would be involved or how many accounts would be involved. (Tr. p. 560). He did no independent review of the accuracy of the customer information. (Tr. p. 400). Respondent Flannigan provided no reasonable explanation for his reliance on the representations of AGS and Mr. Shapiro regarding the customer orders, the account information, or the legitimacy of the standby arrangement.

Respondent Flannigan realized that he had an obligation to contact his customers or have registered Protective Group personnel contact the customers before he executed transactions on their behalf in order to implement the above safeguards, but he chose not to do so because of the number of customers involved. His actions were willful. It is well established that a finding of willfulness does not require an intent to violate the law. It is sufficient that the person charged with the duty consciously performs the acts constituting the violation.³⁶

The Hearing Panel noted that Respondent Flannigan engaged in numerous acts of misconduct,³⁷ that he received monetary gain from his misconduct,³⁸ that he was reckless in undertaking the transaction without knowing more about what it involved or the people with whom he was dealing,³⁹ and, most importantly, that he continues to fail to appreciate the gravity of his misconduct or the potential for danger to customers created by his conduct.⁴⁰

As mitigation, the Hearing Panel took into account that: (i) no customer experienced a loss as a result of Respondents Protective Group and Flannigan's actions; (ii) Respondents Protective Group and Flannigan attempted to execute what they understood to be the customers' orders; (iii) Respondents Protective Group and Flannigan were duped by Mr. Shapiro;⁴¹ and (iv) Respondent Flannigan acted, in part, to assist his clearing agent, RPR.

³⁶ Arthur Lipper & Co. v. S.E.C., 547 F.2d 171, 180 (1976).

³⁷ NASD Sanction Guidelines, Principal Consideration No. 8, p. 8 (1998).

³⁸ NASD Sanction Guidelines, Principal Consideration No 17, p. 9 (1998).

³⁹ NASD Sanction Guidelines, Principal Consideration No 13, p. 9 (1998).

⁴⁰ Respondent Flannigan testified that he did everything he could "to make sure that what we were doing was done correctly." (Tr. p. 539).

⁴¹ Mr. Shapiro owned a nominee account in the name of Customer DSTK. (Tr. pp. 520-521). Customer DSTK wrote a bad check in the amount of \$36,450 for Rooms Plus securities, which Respondent Protective Group

Weighing the aggravating and mitigating factors discussed above, the Hearing Panel determined that barring Respondent Flannigan from a supervisory capacity was warranted and in the best interest of the investing public. The Hearing Panel viewed imposing a substantial fine increased by the amount of financial gain, in addition to the bar, as punitive.⁴²

Accordingly, the Hearing Panel bars Respondent Flannigan in any supervisory capacity and fines Respondents Protective Group and Flannigan, jointly and severally, \$15,000 for violating Rules 1031 and 2110 and \$10,000 for violating Rules 2510 and 2110.

B. Respondent Flynn

The Sanction Guidelines for a recordkeeping violation suggest fines of \$1,000 to \$10,000 and, in egregious cases, suspension of the responsible party in any or all capacities for up to 30 business days.⁴³

With respect to Respondent Flynn, Enforcement argued that imposing the minimum fine for each of the three violations would result in a fine of \$6,000, which was insufficient. Accordingly, Enforcement proposed that Respondent Flynn be fined \$25,000 and suspended for 10 to 20 business days for violations of Rules 1031, 2510, 3110, and 2110.

The Hearing Panel found that Respondent Flynn violated Rule 3110 by failing to create a record of the instructions he received in those limited instances in which he was unable to set up a three-way call with the customer and Protective Group. He did not record the orders he

had to cover. (Tr. p. 547). In addition, Protective Group paid an AGS customer \$19,000 in a mediation for actions taken by AGS. (Tr. p. 540).

⁴² Respondent Flannigan testified that as a result of the AGS agreement, Protective Group, a \$100,000 broker-dealer, suffered a loss of approximately \$9,000. (Tr. p. 541).

⁴³ NASD Sanction Guidelines, p. 28 (1998).

received from customers, mistakenly assuming that because the customer orders' were being executed by Protective Group, Protective Group was solely responsible for creating a record of the transaction. Although Respondent Flynn's intent was to provide a service to the AGS customers, he does not appear to appreciate the regulatory issues involved in the standby arrangement as implemented.

Accordingly, the Hearing Panel fines Respondent Flynn \$2,500 and orders him to requalify as a principal for violating Rule 3110 and thereby Rule 2110.

IV. Conclusion

Based on the evidence submitted at the Hearing and the factors discussed above, the Hearing Panel sanctions Respondent Flannigan by barring him in any supervisory capacity for violating Rules 1031, 2510, and 2110. In addition, the Hearing Panel fines Respondents Protective Group and Flannigan, jointly and severally, \$15,000 for violating Rules 1031 and 2110, and \$10,000 for violating Rules 2510 and 2110.

The Hearing Panel fines Respondent Flynn \$2,500 and orders him to requalify as a principal for violating Rules 3110 and 2110. Respondents Protective Group, Flannigan, and Flynn are also each assessed one-third of the \$4,732.90 cost of the Hearing, consisting of a \$750 administrative fee and a \$3,982.90 transcript fee.

These sanctions shall become effective on a date determined by the Association, but not sooner than 30 days from the date this Decision becomes the final disciplinary action of the

NASD; provided, however, that the bar will become effective immediately upon this Decision becoming the final disciplinary action of the NASD.⁴⁴

SO ORDERED.

HEARING PANEL

Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
July 28, 2000

Copies to:

John J. Flynn (via Airborne Express and first class mail)
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Michael F. Flannigan (via Airborne Express and first class mail)
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Charles Clayton, Esq. (via facsimile and first class mail)
Richard S. Schultz, Esq. (via electronically and first class mail)
Roy C. Flynn, Esq. (via electronically and first class mail)

⁴⁴ The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.