This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C01040001.

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

Respondent IA

and

Respondent GH

Respondents.

Disciplinary Proceeding
No. C01040001

Hearing Officer—Andrew H. Perkins

HEARING PANEL DECISION

August 19, 2004

Respondents violated Exchange Act Rules 15c2-4 and 10b-9, and NASD Conduct Rule 2110 by participating in contingent offerings where the seller failed to establish a proper escrow account at a bank and failed to ensure that the seller sent investors timely reconfirmation offers when it extended the closing date for one of the offerings. For these violations, the Respondents are jointly and severally fined $5,000. In addition, the Respondents violated NASD Conduct Rules 3010 and 2110 by failing to establish and maintain written supervisory procedures relating to Exchange Act Rules 15c2-4 and 10b-9. For this violation, the Respondents are jointly and severally fined $2,500.

Appearances

David A. Watson, NASD, San Francisco, CA; Rory C. Flynn, NASD Chief Litigation Counsel, Washington, DC, Of Counsel, for the Department of Enforcement.

JS, Eugene, OR, for the Respondents.

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DECISION

I. INTRODUCTION

On January 6, 2004, the Department of Enforcement ("Department") filed a three-cause Complaint against the Respondents. The first cause of action alleges that the Respondents participated in three contingent offerings for which investor funds were deposited into a non-qualified bank account, in violation of Exchange Act Rule 15c2-4 and NASD Conduct Rule 2110; and the second alleges that one of the offerings was extended without first sending a reconfirmation letter to the investors, in violation of Exchange Act Rule 10b-9 and NASD Conduct Rule 2110. The final cause of action alleges that the Respondents failed to establish written supervisory procedures to ensure compliance with Exchange Act Rules 15c2-4 and 10b-9, in violation of NASD Conduct Rules 2110 and 3010.

On February 2, 2004, the Respondents filed their Answer and admitted that they committed the violations alleged in the Complaint. Nonetheless, the Respondents requested that the Complaint be dismissed and that all reference to the investigation and Complaint be expunged from NASD's public records, including the Central Registration Depository ("CRD"). In addition, the Respondents requested a hearing.

On June 10, 2004, the hearing was held in San Francisco by a hearing panel composed of the undersigned Hearing Officer and two current members of NASD's District 1 Committee. At the beginning of the hearing, the Hearing Officer confirmed that the Respondents admitted each violation charged in the Complaint. Thereupon, the Department moved all of its exhibits into

evidence and advised that it would not call any witnesses to testify. The Respondents then moved all of their exhibits into evidence and called Respondent GH to testify.[1]

II. JURISDICTION

NASD has jurisdiction over the Respondents. IA has been an NASD member since June 1986,[2] and GH has been registered as a General Securities Principal and a General Securities Representative since June 1987.[3]

III. FINDINGS OF FACT

A. The Respondents

1. Respondent GH

GH started in the securities industry as an examiner with the Missouri Secretary of State's office where he ultimately held the position of Chief of Market Surveillance.[4] After three years, GH left the Missouri Secretary of State's office and joined Equitech Financial Planning in California. After a short stint with Equitech, GH joined Financial Planner Equity Corporation. GH worked for Financial Planner Equity for five years and successively served as its compliance officer, compliance auditor, and controller.[5]

In 1987, FTF, the predecessor to IA, hired GH as its President.[6] GH ran the brokerage business at FTF, which, at its largest, had approximately 55 registered representatives.[7]

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[1] The Department's exhibits are labeled C–1 through C–26, and the Respondents' exhibits are labeled R–1 through R–25.

[2] Ex. C–1, at 3.

[3] Ex. C–2, at 3. In addition, in May 1988, GH registered as a Financial and Operations Principal. (*Id.*)

[4] Tr. 21–22.

[5] *Id.* at 23.

[6] *Id.* at 24.

In or about 1989, GH purchased FTF's brokerage unit and moved its home office from Oakland to Petaluma. In 1991 or 1992, GH changed the name of the firm to IA.[8]

2. IA

GH and AD own IA, which has four employees and 38 registered representatives.[9] GH is the firm's president and controller, and he is in charge of the firm's due diligence.[10] IA primarily deals with managed accounts that hold mutual funds. IA also does some variable annuity and life insurance business, and it participates in some partnership and specialty products, such as the three offerings that underlie this proceeding.[11]

Neither Respondent has a disciplinary history.

B. The Offerings

GH testified that since the early 1980s he has been involved with Rancon Financial, a real estate brokerage firm in Riverside County, California. One aspect of Rancon's business is creating limited partnerships and limited liability companies to purchase real estate for investment. In broad terms, Rancon identifies property that is likely to appreciate in value due to surrounding development or road improvements and then creates an entity to acquire the property.[12] To raise funds for the purchase of the property, the acquiring limited partnership or

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[7] *Id.* at 25.

[8] *Id.*

[9] *Id.* at 25–26.

[10] *Id.* at 26.

[11] *Id.* GH estimated that less than 10% of IA's revenue came from the sale of limited partnership and limited liability company interests. (Tr. 86.)

[12] In some cases, the acquiring company developed the property as well.

limited liability company sells limited liability interests or membership interests to qualified investors.[13]

The present case concerns three of Rancon's projects known as Rancon Winchester Valley 63, LLC; Rancon Opportunity Fund, LLC; and Rancon Winchester Valley 200, LLC. Each is a California limited liability company formed to acquire a specific parcel of real estate for investment. The companies offered limited liability interests (herein referred to as "Membership Interests") to qualified investors in California without registration pursuant to Section 3(a)(11) of the Securities Act of 1933 (collectively referred to as the "Offerings").[14] To sell the Membership Interests, the companies entered into selling agreements with IA and other broker-dealers.

Each was a "minimum-maximum" offering, also known as a "mini-max" or "part or none" offering. Under the terms of the Offerings, the issuers were required to sell a minimum number of Membership Interests by a specific deadline. If the minimum number were not sold by the deadline, the offering was to be canceled and the funds were to be returned to the investors. If the minimum were reached, the issuers had the right to sell up to the maximum number of Membership Interests on a best efforts basis.

[13] *Tr.* 32–33.

[14] *See* Ex. C–3, C–9, and C–15 (portions of the prospectuses for company); and Ex. C–4, C–10, and C–16 (the selling agreements for each offering). Section 3(a)(11) of the Securities Act provides an exemption from registration for transactions in any security that is part of an issue offered and sold only to persons residing in a single state, when the issuer is a person residing and doing business within such state.

1. Rancon Winchester Valley 63

Under the terms of the offering, Rancon Valley 63 was required to sell a minimum of 1450 Membership Interests (raising a total of $1,450,000) by September 30, 2001.[15] If the minimum were not sold by the deadline, the offering was to be canceled and the funds were to be returned to the investors. If the minimum were reached, Rancon Valley 63 had a right to sell up to 1800 Membership Interests on a best-efforts basis.[16] The Rancon Valley 63 Selling Agreement provided that all investor funds were to be placed in an escrow with Preferred Properties, Inc. ("Preferred") on the condition that it not release any funds to Rancon Valley 63 until the minimum amount of investor funds were received.[17] Preferred is a California corporation run by JH, a former Rancon employee.[18] Preferred also provided other services to Rancon and its affiliates, such as sending correspondence to investors.[19] Preferred is not a "bank," as that term is defined in Section 3(a)(6) of the Securities Act of 1933.[20] Under the escrow agreements, Preferred was obligated to deposit all investor funds in an interest-bearing account with Wells Fargo Bank.[21]

The Rancon Valley 63 offering closed successfully.[22] Preferred escrowed investor funds and then paid the proceeds to Rancon Valley 63 at the closing. IA sold Membership Interests in

[15] Ex. C–3, at 1, 6.

[16] *Id.*

[17] Ex. C–4, at 1.

[18] Tr. 62–63, 99.

[19] *Id.* at 98.

[20] Ex. C–25, at 1.

[21] Ex. C–5, at 2; Ex. C–11, at 2; Ex. C–17, at 2.

[22] Ex. C–22, at 3.

this offering to ten investors for a total of $355,000.[23] Under the Rancon Valley 63 Selling Agreement, IA earned commissions and due diligence fees totaling $31,950 on these sales.[24]

2. Rancon Opportunity Fund

Rancon Opportunity Fund had to sell a minimum of 2000 Membership Interests (raising a total of $2,000,000) by August 31, 2000.[25] If the minimum were not sold by the deadline, the offering was to be canceled and the funds were to be returned to the investors. If the minimum were reached, Rancon Opportunity had a right to sell up to 3209 Membership Interests on a best-efforts basis.[26]

The Rancon Opportunity offering closed successfully.[27] Preferred escrowed investor funds and then paid the proceeds to Rancon Opportunity at the closing. IA sold Membership Interests in this offering to 21 investors for a total of $952,750.[28] Under the Rancon Opportunity Selling Agreement, IA earned commissions and due diligence fees totaling $85,747.50 on these sales.[29]

[23] Ex. C–8. In each case, the balance of Membership Interests were sold by other participating dealers.

[24] Ex. C–22, at 1. The Selling Agreements for each Offering provided that the selling broker-dealer would receive commissions of 8.5% and due diligence fees of 0.5% of the proceeds paid to the issuer.

[25] Ex. C–9, at 1, 6.

[26] *Id.*

[27] Ex. C–22, at 3.

[28] Ex. C–14.

[29] Ex. C–22, at 1.

3. Rancon Winchester Valley 200

Rancon Winchester had to sell a minimum of 2500 Membership Interests (raising a total of $2,500,000) by December 31, 2001.[30] If the minimum were not sold by the deadline, the offering was to be canceled and the funds were to be returned to the investors. If the minimum were reached, Rancon Winchester had a right to sell up to 3000 Membership Interests on a best-efforts basis.[31]

Rancon Winchester did not receive payment for the minimum number of Membership Interests by the deadline in the prospectus.[32] Although investors had subscribed to all of the Rancon Winchester Membership Interests, some were not able to meet the payment deadline of December 31, 2001. Accordingly, Rancon Winchester extended the termination date, as it had the right to do under the prospectus.[33]

On February 3, 2002, Rancon Winchester sent notice to each investor that the offering of 3000 Membership Interests had been extended to April 30, 2002, and the deadline to reach the minimum investment had been extended to February 28, 2002.[34] In addition, Rancon Winchester notified the investors that SEC Rule 10b-9[35] required that they reconfirm their investment by

[30] Ex. C–15, at 1, 6.

[31] *Id.*

[32] Tr. 73.

[33] Ex. C–15, at 1.

[34] Ex. C–25, at 13–20. The letters also represented that the minimum investment had been raised from $2,000,000 to $2,350,000.

[35] Exchange Act Rule 10b-9 is an antifraud provision that requires that the terms of contingency offerings be honored.

February 22, 2002. Each investor signed and returned a copy of the letter reconfirming their investment.

Initially, Preferred was the designated escrow agent for the Rancon Winchester offering, and investor funds were deposited to the Preferred escrow account at Wells Fargo Bank in accordance with the terms of the escrow agreement.[36] But, on or about February 4, 2002, after NASD questioned the escrow arrangement, Rancon Winchester established an escrow account with Mission Oaks National Bank.[37] The Rancon Winchester offering eventually closed, and, on or about February 21, 2002, the escrowed funds were released.[38]

IA sold Membership Interests in this offering to 15 investors for a total of $800,875.[39] Under the Rancon Winchester Selling Agreement, IA earned commissions and due diligence fees totaling $72,078.75 on these sales.[40]

C. Supervisory Procedures

Before January 10, 2003, IA did not have written procedures relating to Exchange Act Rules 15c2-4 and 10b-9.[41] IA implemented such procedures after NASD raised questions about the Respondents' understanding of the rules. On January 29, 2003, GH provided NASD with a copy of its new written procedures.[42]

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[36] Tr. 63–64; Ex. C–25.

[37] Ex. C–25, at 23.

[38] Ex. R–5, at 2.

[39] Ex. C–20.

[40] Ex. C–22, at 1.

[41] Tr. 110; Ex. C–24, at 3.

[42] Ex. C–24.

IV. CONCLUSIONS OF LAW

A. Escrow Violations

Exchange Act Rule 15c2-4[43] provides that it is "a fraudulent, deceptive or manipulative act or practice" for a broker or dealer, participating in a distribution of an offering, which is contingent on the receipt of a minimum investment by members of the public, to accept any part of the sale price unless the investors' funds are held in an escrow account until the minimum amount of units are sold."[44] The purpose of the Rule is to insulate the proceeds of an offering from possible unlawful activities by, or financial reversals of, the broker or dealer participating in the offering.[45] In a minimum-maximum offering, the "minimum sale/escrow mechanism protects investors by assuring that others in the market are willing to share the risk and by insuring that the completed offering will adequately capitalize the company."[46]

The Respondents violated Exchange Act Rule 15c2-4 when they received investors' funds that were not deposited in a bank escrow account pending the satisfaction of the contingency.[47] The Respondents admit that IA received investor funds, which it sent to Preferred, and that Preferred deposited those funds in its accounts at Wells Fargo Bank. Moreover, GH testified that when he first reviewed the due diligence documentation he noticed that the

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[43] 17 C.F.R. § 240.15c2-4.

[44] *District Bus. Conduct Comm. v. Mains*, No. C8A950016, 1997 NASD Discip. LEXIS 3, at *21 (N.B.C.C. Jan. 3, 1997).

[45] Exchange Act Release No. 11,532 (July 11, 1995).

[46] *SEC v. The Electronics Warehouse*, 689 F. Supp. 53, 58 n.8 (D.C. Conn. 1984).

[47] *See* NASD Notices to Members 98-4, 1998 NASD LEXIS 5, at *2 (Jan. 1998) (stating that no person other than a bank may act as an escrow agent).

investors' funds were to be held by Preferred, which he knew was not a bank.[48] GH questioned this arrangement, but he ultimately accepted the wholesaler's assurance that Rancon's attorney had reviewed and approved the escrow agreement.[49] The Respondents did not conduct an independent legal review of the offering documents because Rancon's attorney was "well respected in the securities industry,"[50] and GH wanted to save the expense of an independent legal review.[51]

GH was responsible for this firm's violation of Exchange Act Rule 15c2-4 and NASD Conduct Rule 2110.[52] GH was in charge of IA's participation in the Offerings. He signed the selling agreements and retained responsibility for the firm's due diligence. GH failed to consult an outside attorney for IA despite his awareness that the investors' funds would not be held in a bank escrow account. As a general securities principal, GH had a duty to ensure that he understood the rules governing a broker-dealer's conduct when participating in a contingent offering. In short, the Hearing Panel finds that the Respondents' failure to seek guidance from an independent expert was reckless.[53]

B. Extension of Rancon Winchester Offering Period

Exchange Act Rule 10b-9 prohibits any person from representing that a security is being offered on an "all-or-none" basis unless the amount due from the investors is to be refunded if all

[48] Tr. 96–97.

[49] *Id.* at 97.

[50] Ex. C–22, at 2 (Letter from GH to NASD received Oct. 21, 2002). *See also* Tr. at 60.

[51] Tr. at 93–94.

[52] *See Department of Enforcement v. Gerace*, No. C02990022, 2001 NASD Discip. LEXIS 5, at *9-11 (May 16, 2001).

of the securities being offered are not sold or the seller does not receive the total amount due by a specific date.[54] The purpose of the Rule is to

> ensure that those that invest in a venture under the condition that it will not go forward unless adequately capitalized are not at risk of losing their investment if that condition is not met. Rule 10b-9 also provides investors the protection of knowing 'that unless [their] judgment to take the risk is shared by enough others to sell out the issue, [their] money will be returned.[55]

Where the minimum will not be met by the deadline, the seller may extend the offering date if—*before* the extension—each investor receives a reconfirmation disclosing the extension and all material information.[56]

Hearing Panel finds that respondents violated Rule 10b-9, as they stipulated. GH knew that the offering documents would have to be amended and a reconfirmation offer would have to be sent to the investors;[57] nevertheless, he failed to ascertain whether either had been done. IA and GH had a duty to investigate to determine whether in fact the offering deadline had been

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[53] *Id.* at *11.

[54] *Id.* at *12-13.

[55] *National P'ship Investments Corp.*, Exchange Act Release No. 38,773, 1997 SEC LEXIS 1347, at *9 (June 25, 1997) (citation omitted).

[56] The reconfirmation offer must be made sufficiently in advance of the expiration date so investors who ask for refunds receive them promptly after the expiration date. (*See* Interpretive Release on Regulation D, Securities Act Release No. 6455, 1983 SEC LEXIS 2288, at *58-59 (Mar. 3, 1983).)

[57] Tr. 73.

extended properly.[58] Accordingly, the Respondents violated Exchange Act Rule 10b-9.[59] The Respondents also thereby violated NASD Conduct Rule 2110.[60]

C. Supervisory Violations

Conduct Rule 3010(b)(1) requires that a member establish, maintain, and enforce written procedures to supervise the types of business in which it engages. The Respondents admit that they failed to do so. IA did not have written procedures relating to Exchange Act Rules 15c2-4 and 10b-9 at the time it participated in the Offerings. Accordingly, the Hearing Panel finds that the Respondents violated Rule 3010, as alleged in the Third Cause of Complaint.[61]

V. SANCTIONS

A. Violations of Rules 15c2-4 and 10b-9

For violations of Exchange Act Rule 10b-9, the NASD Sanction Guidelines recommend that the Hearing Panel fine the Respondents $5,000 to $50,000 and in egregious cases suspend the Respondents for up to two years.[62] For violations of Exchange Act Rule 15c2-4, the Guidelines recommend that the Hearing Panel fine the Respondents $1,000 to $10,000 and in egregious cases suspend the Respondents for up to 30 business days.[63] However, where the violations of Rules 10b-9 and 15c2-4 are so closely related, it is appropriate to impose a single

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[58] *Richard H. Morrow*, Initial Decision No. 70, 1995 SEC LEXIS 1935, at *11 (July 25, 1995). *See also Mains*, 1997 NASD Discip. LEXIS 3, at *21.

[59] The specific misrepresentations banned by Rule 10b-9 are always considered material. (*Morrow*, 1995 SEC LEXIS 1935, at *9.)

[60] Violations of Exchange Act Rules 15c2-4 and 10b-9 constitute a violation of Conduct Rule 2110. *See. Mains*, 1997 NASD Discip. LEXIS 3, at *21.

[61] *See, e.g., District Bus. Conduct Comm. v. L.H. Alton & Co.*, Nos. C01960003 and C01960024, 1997 NASD Discip. LEXIS 60, at *21 (N.B.C.C. Dec. 17, 1997).

[62] NASD Sanction Guidelines 28 (2001 ed.).

sanction for both violations.[64]

The Sanction Guidelines list certain Principal Considerations that bear specifically on violations of Rules 10b-9 and 15c2-4. A review of the relevant considerations shows no significant aggravating circumstances. The Respondents were not affiliated with the issuer. The investors' funds were not released before the contingencies were satisfied. And the Respondents did not use non-bona fide sales or other devices to mislead the investors. In addition, the Hearing Panel finds that the investors' funds were not exposed to substantial risk of loss. Although the escrow arrangements did not meet the requirements of Rule 15c2-4, all funds were held under an escrow agreement in separate bank accounts. There is no evidence that the arrangements were established to defraud the investors. Indeed, no investor lost any money, and each offering raised the minimum amount of capital required by the offering documents. Therefore, the Respondents will be fined $5,000, jointly and severally.[65]

B. Deficient Supervisory Procedures

For violations of NASD Conduct Rule 3010, the Guidelines provide for a fine of $1,000 to $25,000 and in egregious cases a suspension of up to one year for the responsible individual and up to 30 business days for the member firm.[66] Here, the Hearing Panel finds that the appropriate remedial sanction is a joint and several fine of $2,500. In determining the amount of the fine, the Hearing Panel noted that the Respondents promptly acted to correct the deficiency

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[63] *Id.*

[64] *District Bus. Conduct Comm. v. Hartman Securities, Inc*., No. C06950018, 1997 NASD Discip. LEXIS 11, at *18 n.12 (N.B.C.C. Mar. 12, 1997).

[65] Enforcement recommended a $5,000 fine for each violation.

[66] NASD Sanction Guidelines 109.

once NASD brought it to their attention.

VI. ORDER

Therefore, having considered all the evidence,[67] the Hearing Panel orders that the Respondents are jointly and severally fined $5,000 for their violations of Exchange Act Rules 15c2-4 and 10b-9 and NASD Conduct Rule 2110, and jointly and severally fined $2,500 for their violation of NASD Conduct Rules 3010 and 2110. In addition, the Hearing Panel orders the Respondents to pay costs in the amount of $1,690.14, including an administrative fee of $750 and hearing transcript costs of $940.14.

These sanctions shall become effective on a date set by the NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of the NASD.

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Andrew H. Perkins
Hearing Officer
For the Extended Hearing Panel

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