This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C10030030.

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent Respondent.	Disciplinary Proceeding No. C10030030 Hearing Officer – AWH **HEARING PANEL DECISION** Disciplinary Proceeding No. C10030030 October 12, 2004

Associated person found not liable for (1) engaging in activities requiring registration as a principal and/or representative, in violation of Registration Rules 1021, 1031, and 1041 and Conduct Rule 2110; (2) failing to provide truthful, non-deceptive, accurate or complete written statements and testimony, in violation of Procedural Rule 8210 and Conduct Rule 2110; (3) preparing false, misleading, and/or inaccurate records, in violation of Conduct Rules 3010 and 2110; and (4) failing to implement, maintain, and enforce an effective supervisory system, in violation of Conduct Rules 3010 and 2110. Complaint dismissed.

Appearances:

Jay M. Lippman, Esq. and Frank Weber, Esq. for the Department of Enforcement

TM, Esq. and CF, Esq. for Respondent

DECISION

Introduction

On June 27, 2003, the Department of Enforcement ("Enforcement") filed the four-cause Complaint in this matter, alleging that Respondent (1) permitted persons not registered with NASD to act in capacities that required registration as representatives and/or assistant

representatives-order processing and, while unregistered himself, engaged in activities that required registration with NASD as a principal and/or representative, in violation of NASD Membership and Registrations Rules 1021, 1031, and 1041 and NASD Conduct Rule 2110; (2) failed to provide truthful, non-deceptive, accurate, or complete written statements, and failed to respond truthfully, accurately, non-deceptively, or completely, in on-the-record ("OTR") testimony, in violation of NASD Procedural Rule 8210 and Conduct Rule 2110; (3) prepared false, misleading, and/or inaccurate records, in violation of Conduct Rules 3010 and 2110; and (4) failed to implement, maintain, and enforce an effective supervisory system, in violation of Conduct Rules 3010 and 2110.

On August 19, 2003, Respondent filed an Answer to the Complaint, denying the allegations against him, asserting a number of affirmative defenses, and requesting a hearing. Hearings were held in New York, New York, on January 27, 2004, March 4, 2004, and March 5, 2004, before a hearing panel composed of the Hearing Officer and two current members of District No. 10. Both parties filed post-hearing briefs.[1]

Findings of Fact

Background of Respondent and his Employment with SC

Respondent is a West Point graduate who first entered the securities industry in January 1995, when he was employed in a non-registered capacity with NASD member firm Prudential Securities, Inc. ("Prudential"). He remained with Prudential until August 1998. Tr. 668-74. In 1997, while employed with Prudential, he received his law degree and became a member of the New York and New Jersey state bars. Tr. 674. From August 1998 until 1999, Respondent

[1] On March 18, 2004, the Panel granted Enforcement's motion for leave to withdraw allegations in Paragraph No. 7 of the First Cause of Complaint that: (i) Respondent permitted five associated persons to engage in unregistered activities; and (ii) those persons were required to be registered as assistant representatives-order processing under NASD Membership and Registration Rule 1041.

worked as a sales practice compliance officer at Morgan Stanley. Tr. 674. From July 1999 until November 2000, Respondent was employed in a non-registered capacity by SC. Tr. 677, 679-80. He has no disciplinary history. CX-1. Currently, Respondent is a non-registered associated person employed as a compliance officer at another member firm.

SC was founded by LH and GS. Tr. 30, 136, 358. LH, SC's Chief Executive Officer, and GS, SC's President, were on the board of directors and the primary decisionmakers of the firm. Tr. 319, 359, 537-38, 608, 786-87. VL was also on the board of directors, and was SC's Chief Financial Officer and original compliance director listed on the firm's Form BD. Tr. 315, 333, 359. In 1995, the firm established an over-the-counter ("OTC") trading desk, co-managed by JP and WK. Tr. 29-30, 315. Over the next three years, SC experienced a rapid expansion of its business, which necessitated hiring someone to assume VL's compliance responsibilities, and to meet NASD's requirement for a separate compliance officer. Tr. 34, 45, 101, 316, 321-22, 359-60, 610. At some time in 1998, SC hired ED as its first full-time compliance officer. Following her resignation about a year later, in July 1999, the firm hired Respondent to be its compliance director.[2] Tr. 243, 315-16, 322.

LH and GS knew that Respondent did not have a Series 7 or a Series 24 license, and they approved his employment as head of compliance with the mutual understanding that his role was largely advisory or administrative in nature, and did not require registration. Tr. 335, 370-71, 375, 383, 546, 629, 656, 676. Respondent was hired to (1) ensure that the firm's departments were fully compliant and that the department supervisors were enforcing what was in the compliance manual; (2) answer regulatory inquiries; and (3) revise the firm's compliance manual. Tr. 48-49, 324, 328, 362, 374, 547. During the period of Respondent's employment at

[2] Respondent was also called the "Head of Compliance" which VL and LH deemed synonymous with "compliance director" and "compliance officer". Tr. 362, 616-17. At SC, there was no emphasis on official titles. Tr. 358, 614-17.

SC, VL was listed as the chief compliance officer on the firm's Form BD. Tr. 333. Although Respondent mainly reported to LH and GS, during the earlier period of his employment, he had VL review compliance memoranda before issuing them. Tr. 364-66, 547-48, 607-08. LH instructed Respondent that his job responsibilities were to conduct spot checks and branch audits to ensure that the entire firm was compliant and to rewrite and update SC's compliance manual. Tr. 548-49.

Before and during Respondent's 16 month tenure as compliance officer, MS was SC's general counsel. Until June 2000, MS reviewed and drafted contracts, provided legal advice to SC, and conducted or assisted with the quarterly branch examinations. Tr. 225-28, 245-47, 379-80, 595, 637, 714-15. Although not specifically hired to provide legal services in his capacity as head of compliance, Respondent assisted MS on various general in-house legal matters as an unofficial associate general counsel, including representing the firm in dispute resolutions, drafting settlements and trade adjustments, and reviewing contracts. Tr. 371-73, 631-33, 678-79, 782.

SC's Over-The-Counter ("OTC") Department

JP and WK both supervised the OTC department, which consisted of the trading and agency desks. Tr. 29, 33, 489, 492, 513-14, 521, 559-60. TZ, a licensed trader, headed the agency desk. Tr. 35-37, 180. TZ reported to JP and WK. Tr. 427-28, 489. Primarily, the agency desk handled orders from institutional buyers and sellers who wanted shares of stock in which SC did not make a market. Tr. 33, 483-85, 519-20. Clerks on the desk did not deal with public customers. Tr. 442, 520. They used BRASS, the firm's electronic, automated trading system, which routed order flow directly from institutional buyers and sellers to traders at preferenced broker-dealer firms that made a market in the particular stock. Tr. 38-39, 88-89,

483-87. Personnel on the agency desk were assigned to BRASS terminals divided by various letters of the alphabet. Tr. 88-89, 109, 131, 198-99, 430. TZ set these market-maker preferences based on their prior business relationships and trading practices with SC. Tr. 37, 484, 511. Traders at the preferenced firms were responsible for executing trades once they were automatically routed to them through BRASS. Tr. 178-79.

With the preferences already in place, the clerks working on the agency desk did not have to enter the orders into BRASS manually, unless there were trade breaks[3] or computer errors. Tr. 116-117, 178-79. Because their functions were restricted to routing orders and resolving trade breaks, the clerks on the agency desk did not assume any financial risk or commit firm capital. Tr. 507-08. For large preferenced orders that stalled on the computer or were not automatically routed, the clerk would check the BRASS machine to see which market-making firm was preferenced for the order, send the order electronically, and then call the firm directly to notify it that the order was being transmitted. Tr. 486.

When Respondent joined SC, the trading activity at the OTC desk was extremely busy, with phones ringing constantly. Tr. 34, 101, 569-71. In addition to monitoring automatic order flow, the clerks received orders internally from SC's retail and institutional desks, and answered the phones both on the agency desk, and sometimes for traders who were too busy to take their own calls. Whenever the agency desk received an order through BRASS for stock in which SC did not make a market and that had not already been preferenced, the clerk assigned to that particular terminal was supposed to check with TZ, JP, or WK to determine which broker-dealer was to get the preference, although one clerk believed he had permission from TZ to send it to the firm he believed would provide the best bid or offer for the order. Tr. 180, 413-16, 440-41,

[3] The term "trade break" is jargon that describes a situation when an error in the terms of a trade (usually in price, quantity, or stock symbol) causes a disagreement between a trader and a contra party or a customer.

484-85. TZ told the clerks on the agency desk that they had a duty to seek "best execution." Tr. 496, 514. The firm providing best execution could either execute or reject the order that was transmitted through BRASS. Tr. 440, 485. SC's agency desk clerk would usually alert the market-maker's trader by telephone as the non-preferenced order was being transmitted. Tr. 486.

If the agency desk happened to receive an order through BRASS or by phone for stock in which SC made a market, the clerk would shout out the order to one of the traders on the trading desk, and wait for further instructions from the SC trader either to transfer the phone call to that trader or, if the trader was too busy, fill the order as directed by the trader. Tr. 38, 134, 414-15, 421, 512. The clerks on the agency desk were required to check with TZ, JP, or WK before routing or filling non-preferenced orders. Tr. 180, 431-34, 440-41, 521. Finally, although the clerks were given authority to resolve trade-breaks, JP and WK signed off on BRASS exception reports as supervisors, and decided on any corrections or adjustments that might have to be made. Tr. 257-58.

JP and WK created a volatile "fish bowl" environment or "fortress," which essentially discouraged others, including LH and personnel who were not involved with the OTC desk, from entering or interfering with its operations. Tr. 621, 648-49. JP and WK were the line supervisors responsible for assigning certain functions to their employees and ensuring that they were registered if they were required to be. Tr. 390-91, 505, 651. When the clerks on the agency desk wanted to become assistant traders, JP and WK would advise them to take the Series 7 examination. Tr. 142. JP decided that employees in entry-level positions in the OTC department were not required to be licensed because of their limited routing functions. Tr. 505. JP and WK also had the power to hire and fire the employees in their department without consulting LH and GS. Tr. 565, 650. LH acknowledged that JP and WK "ran the department

with an iron hand," and stated: "The firm got away from us in the OTC department. No other department in the firm ran like they did." Tr. 651, 653.

Respondent's Activities as SC's Head of Compliance

Shortly after Respondent became head of compliance, he began revising the firm's written supervisory procedures. Tr. 365-66, 678, 680-84. Respondent updated and republished a few chapters of the firm's compliance manual every week and issued compliance notices and memoranda, addressing certain issues not specifically covered in the manual. Tr. 685-87. During the course of his 16 months at SC, Respondent issued more than 250 compliance memoranda. RX 1-256; Tr. 373-74, 633. With MS's assistance, Respondent also conducted routine branch office audits. Tr. 459, 689. On a daily basis, Respondent examined exceptions reports produced by BRASS to ensure compliance with order handling and trade reporting rules. Tr. 690-91.

During his 16 month tenure at SC, Respondent implemented a number of practices and procedures to remedy previous compliance problems: he gave continuing education presentations at each of the branches once a quarter; published weekly compliance memoranda and invited SC principals to discuss the revised rules and foreseeable compliance concerns; conducted evening educational seminars for all interested employees on options and municipal bond principles; and held weekly departmental meetings or training sessions in which he instructed the branch managers on NASD rules and registration requirements. Tr. 183-84, 213-14, 568, 695-96, 711-13. Respondent also voluntarily tutored those who were required to pass licensing examinations in order for them to be promoted to the trading desk. Tr. 562.

SC lacked a human resources department and formal procedures to monitor the licensing and registration of its employees. Tr. 694-95, 713. Realizing this deficiency, Respondent began

to check the registrations of SC's employees quarterly and to determine from their supervisors what the employees' functions were within the firm. Tr. 566-69, 695, 771-72. Respondent would recommend to supervisors that if employees desired to assume additional responsibilities and get promoted, they should pass required licensing examinations and become registered. Tr. 157, 568-69. For example, non-registered agency clerks who were interested in getting promoted to assistant trader positions were encouraged to get registered. Tr. 434-35, 566-68, 707-08. Respondent reported to LH on personnel who needed registrations or were in the processing of getting licensed. Tr. 566-69, 573.

Respondent had the authority to establish compliance policies and recommend actions to supervisors regarding unlicensed persons engaging in activities that required registration. JP and WK had the actual supervisory authority to enforce Respondent's recommendations. Tr. 188, 605-07, 651, 768-70, 772-73. VL explained that the practice at SC was to have the compliance department instruct department managers on the compliance measures that needed to be taken, and if a manager did not follow through, the matter was referred to LH and GS for resolution. Tr. 319, 321, 325-26.

Unregistered Employees

The Complaint referred to five unregistered employees who worked on the agency desk in the OTC department. Those employees were FM, CG, PK, BF, and AS. WK and JP directly supervised their activities, and both assumed that, as long as the clerks on the agency desk were only processing orders and working under registered individuals, they did not need to be registered. Tr. 73, 505. These clerks answered phones and routed orders, that came in electronically through BRASS, to traders for execution. Tr. 167-68, 202-04, 426-27, 494-95, 499, 520. Unlike the traders at the trading desk, who assumed financial risk and committed SC's

capital on trades, clerks sitting on the agency desk did not, and were not authorized by SC management to "execute" orders. Tr. 178-79, 512.

When FM was not working on the agency desk, he attended conventions to promote the firm and generate business for the OTC department. Tr. 66-69, 389-90, 623. He received a salary and bi-yearly bonus, based on SC's profitability.[4] Tr. 91, 114, 214. As a promoter for SC, he "wined and dined" other traders from brokerage firms in an effort to market SC and generate "goodwill" among SC's competitors.[5] Tr. 389-90, 393, 578, 623, 710. The other agency clerks were also expected to help generate business for SC's OTC department. Tr. 93, 517-18. The "goodwill" activities of FM and the other individuals did not involve contract negotiations or entering into any legal obligations. Tr. 518-19.

While working on the agency desk, FM and the other four specified individuals routinely processed trades and resolved trade breaks and system delays at their BRASS terminals. Tr. 71, 132-34, 411-14, 493-96. Because BRASS automatically routed the order flow for preferenced trades, they were not required to manually input orders, unless there were computer errors or the traders specifically requested that they fill in an order for them. Tr. 178-79, 485, 507-08, 512. None of those individuals ever negotiated the price or terms of a trade. Tr. 513.

In 2000, Respondent became aware of an advertisement in a trade magazine that described FM as co-head of the agency desk at SC. Respondent advised WK and JP to remove that job description and, instead, list him as a contact person because he had not passed a licensing examination and was not registered. Tr. 154, 157, 169-71. Consequently, at

[4] He was not compensated, as Enforcement alleges, on how much business *he* brought in to SC. DOE Post-Hearing Brief, at 8-9. He was compensated, as were others in the firm, in part, on how much business SC did overall, i.e., how profitable it was prior to the award of bonuses to its employees. FM did not receive a commission on any order flow.

[5] FM's nickname on the Street was "the Mayor," and his business card identified his function as "broker-dealer relations." Tr. 114, 194, 622.

Respondent's suggestion, WK and JP took FM off the agency desk for a period of time. Tr. 171. However, because of the heavy order flow, JP and WK decided to bring FM back to the agency desk to resume answering the phones and processing orders, contrary to Respondent's recommendation. Tr. 172-74.

NASD was putting pressure on SC to answer phones and route orders more quickly. Tr. 659. Realizing that SC was short-staffed, that help was scarce, and order flow was increasing tremendously, LH and Respondent concluded that agency clerks, although unregistered, could work on the agency desk because of the limited routing functions they performed under the supervision of licensed traders. Tr. 571, 646-47. According to LH: "They weren't dealing with the general public. There were no customers calling in. They were not trading any of the firm's capital or committing any of the firm's money. They were simply a liaison. They were passing orders along." Tr. 659.

NASD Investigation

In early October 2000, MSNBC published two articles reporting allegations of scandalous misconduct at SC and allegations that unregistered individuals on the trading desk were engaging in activity that required them to be registered. Tr. 80, 743; CX-28. NASD began an investigation of SC after the publication of the first article. Tr. 335-36, 743-44; CX-29. During its examination of SC, NASD staff inquired into the job functions and registration status of both employees working on the agency desk and Respondent, as well as the firm's system of supervision. CX-29.

Discussion

I. Violation of Membership and Registration Rules

A. Registration Rules 1021 and 1031 Did Not Require Respondent To Be Registered.

In the first cause of its Complaint, Enforcement alleges that from July 1999 to November 2000, Respondent engaged in activities that required registration with NASD as a principal and/or representative. He was not registered in either capacity. NASD Registration Rule 1021 *requires* that all principals must be registered, and defines "principals" as those sole proprietors, officers, partners, managers of Offices of Supervisory Jurisdiction, and directors of corporations

> "who are actively engaged in the management of the member's investment banking or securities business, including supervision, solicitation, conduct of business, or the training of persons associated with a member for any of these functions."

NASD Registration Rule 1031 is similarly worded and *requires* that all representatives must be registered. The Rule defines "representatives" as:

> [p]ersons associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions.

Both Registration Rules 1021(a) and 1031(a) also *permit* a member to:

> maintain or make application for the registration as a [principal or representative] of a person who performs legal, compliance, internal audit, back-office operations, or similar responsibilities for the member. . . .[6]

In the month prior to Respondent's employment, NASD issued a request for comments on a proposal to *require* the registration of "the chief compliance officer for a member firm (as identified on Schedule A of the From BD)." NASD Notice to Members 99-51, 1999 NASD LEXIS 26, at *3 (June 1999). The Notice to Members addressed the permissive provision of Rule 1021(a) that allowed members to maintain or make application for the registration as a

[6] At the time Respondent was employed by SC, the term "back-office operations" did not appear in Conduct Rules 1021(a) and 1031(a). That term was added in 2003 when the SEC approved NASD's proposal to do so. *Notice of Filing and Immediate Effectiveness of Proposed Rule Change by NASD*, SR-NASD-2003-24, SEC Release No. 34-47433, 2003 SEC LEXIS 521, at *18 (Mar. 3, 2003).

principal of, among others, compliance personnel. The Notice to Member stated that "[t]he negative implication of this provision is that compliance personnel are not required to be registered, but rather that a member, at its election, *may* register an individual with compliance responsibilities." *Id*., (emphasis added). NASD "believe[ed] that the chief compliance officer for a member firm (as identified on Schedule A of the Form BD) should be registered," and asked for comments on any interpretive issues that might arise "if a registration requirement is imposed for chief compliance officers." Notice to Members 99-51 did not propose any amendment to Registration Rule 1031(a), nor has that Rule been amended to require the registration of compliance persons as representatives.

It was not until June 19, 2001, almost seven months after Respondent left SC, that the SEC approved amendments to Rule 1022(a), to be effective as of January 1, 2002, which *required* "the chief compliance officer designated on Schedule A of a member's Form BD" to be registered as a general securities principal. NASD Notice to Members 01-51, 2001 NASD LEXIS 56, at *1 (Aug. 2001). Accordingly, the Hearing Panel concludes that, during Respondent's tenure at SC from July 1999 to November 2000, NASD Rules 1021 and 1031 did not require the registration of chief compliance officers as principals or of compliance personnel as representatives.

Even if the chief compliance officer were required to be registered under Rule 1021, during his tenure at SC, Respondent was never designated as chief compliance officer on Schedule A of SC's Form BD. VL was that designee, and retained the responsibilities of the chief compliance officer. VL hired Respondent to perform the functions of a compliance officer knowing that Respondent did not have a Series 24 license and, therefore, could not act as a principal for any purpose, including the requirement in Rule 3010(a)(8) that the firm must

designate and specify a principal to review its supervisory system, procedures, and inspections. Respondent was aware of the requirements of Rule 3010, and, as a result, ensured that SC designated in writing who its supervisory principals were. MS was the designated principal and "compliance officer" for purposes of Rule 3010; Respondent was to assume that role after he became licensed as a principal. CX 34, 35. In conformance with that designation of MS as "compliance officer," in September 1999, Respondent issued a written reminder to all principals at SC that their comments on the Rule 3010(a)(8) review were due to be sent to MS for inclusion in the firm's final report. RX 44.[7]

B. Respondent Was Not Actively Engaged in The Investment Banking or Securities Business

Registration Rules 1021 and 1031 apply to persons engaged in the investment banking or securities business of a member. Rule 1021(b) defines a principal as a person who is, among others, an officer or a manager of an Office of Supervisory Jurisdiction who is "actively engaged in the management of a member's investment banking or securities business, including supervision, solicitation, conduct of business or the training of persons associated with a member for any of these functions." Respondent was given the title of a vice-president. However, that title was merely nominal since he had no additional duties as vice-president other than those duties he had as a compliance officer. CX 25, at 1974. As Enforcement points out in its post-

[7] MS conducted quarterly branch office examinations, but claimed that, to his knowledge, he was never designated as a compliance principal. Tr. 235. However, he then admitted that he had seen CX 35, designating him as compliance principal, but that VL said that "they'll take care of it." Tr. 240. In an October 1999 compliance memorandum, VL was listed as the supervisor for an office in Florida that was titled "MS (compliance)." RX 64. MS moved from New York to Florida because of a lung disease. Tr. 222. VL testified that after MS moved to Florida, he "couldn't use MS any more to help me." The Hearing Panel concludes that MS more than likely received copies of the compliance memoranda designating him as principal, but that he did not focus on the significance of that designation at the time.

hearing brief, his "title is irrelevant to the issue of registration; rather the issue turns on whether [he] performed the functions of a principal or representative." DOE Post-Hearing Brief, at 36.[8]

The Hearing Panel concludes that Respondent was not engaged in the management of SC's securities business, nor did he supervise employees who engaged in SC's securities business. He did not manage an Office of Supervisory Jurisdiction, nor did he have any supervisory authority over employees other than those in the compliance department. As VL testified, LH and GS were the managers of SC. Tr. 319. LH reiterated that Respondent's authority extended only to making recommendations, not decisions. Decisions were left to LH and GS. Tr. 605.

Respondent had no supervisory responsibility or authority over the operations of the OTC desk. JP and WK "ran that department with an iron hand." Tr. 651. They had the power to hire and fire employees without telling anyone, including LH and GS. Tr. 650. LH stated that JP and WK "didn't feel that they answered into [sic] Mr. Respondent, which they didn't." *Id.* VL acknowledged that if managers failed to implement compliance policies or procedures, the matter had to be taken to LH and GS for enforcement. Tr. 321, 325-26. Clearly, Respondent's supervisory responsibility and authority was confined to the compliance department and did not extend to any line of business at SC.

Enforcement also cites *Dist. Bus. Conduct Comm. v. Knapp*[9] to suggest that Respondent should have been registered because of his role in training OTC employees to pass licensing examinations. Enforcement equates examination preparation with "engagement in the securities

[8] In arguing that function, not title, is dispositive of the registration requirement, Enforcement cites *Gordon Kerr*, Exch. Act Rel. No. 43418, 2000 SEC LEXIS 2132 (Oct 5, 2000). That case is distinguishable from the instant one and does not support a finding that Respondent was a supervisor, as that term is used to connote a person who is required to hold a Series 24 license. Kerr, in addition to being the Compliance Director, reviewed all current transactions, initialed trade tickets, approved new accounts, and directly supervised a registered representative.

[9] No. CHI-980, 1989 NASD Discip. LEXIS 48 (Bd. of Governors June 19, 1989); *aff'd.*, Exch. Act Rel. No. 30391, 1992 SEC LEXIS 430 (Feb. 21, 1992).

business." However, the Panel declines to reach the same conclusion, and finds that *Knapp* is distinguishable on its facts.

Respondent did not train SC's line-of-business employees on how to perform their assigned job functions. Tr. 116, 183-84. The reference to training in Rule 1021(b) must be read in the context of persons "who are actively engaged in the management of the member's . . . securities business." Helping persons prepare for qualifying examinations required for NASD registration cannot amount to management of the member's securities business. If it did, every associated person who helps non-registered employees to prepare for such examinations would have to be registered as a principal – a proposition that makes no sense.

In *Knapp*, however, the respondent hired and fired personnel, conducted weekly sales meetings, recommended securities for sale to the public, directed the conduct of business, and supervised the registered sales force. His training of personnel was not for the purpose of taking licensing examinations; he trained them in mock telephone conversations to practice sales pitches for various stocks. *Id*., at *27.

The Hearing Panel concludes that Enforcement has failed to prove by a preponderance of the evidence that Respondent engaged in activities requiring registration as a principal and/or representative, in violation of Registration Rules 1021, 1031, and 1041 and Conduct Rule 2110.

II. Failure to Supervise

Although the fourth cause of the Complaint is entitled "Failure to Supervise," in violation of NASD Conduct Rules 3010 and 2110, the Complaint alleges that Respondent failed to implement, maintain, and enforce an effective supervisory system to enable the firm "to comply with federal securities laws and NASD rules, including, but not limited to, the registration of SC's personnel with NASD." NASD Conduct Rule 3010 provides that each member shall

establish and maintain a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [NASD]," and that such supervisory system shall include written procedures "reasonably designed to achieve" that same compliance. As Enforcement's post-hearing brief makes clear, this cause of the Complaint is based on allegations that the activities of five employees on the OTC Desk required that they be registered with NASD, and that because they were not registered, Respondent is liable for SC's failure to comply with NASD's registration rules.

The Hearing Panel finds that there is no evidence that SC's written supervisory procedures were inadequate or that they did not provide an effective supervisory system to enable the firm to comply with NASD Rules. Enforcement did not allege that any specific procedure was deficient. The gravamen of the Complaint is that, merely because an employee who was not registered acted in a manner that required registration, Respondent did not implement, maintain, and enforce an effective supervisory system that would enable the firm to comply with securities laws and regulations. However, the mere existence of an underlying violation of a law or regulation does not, by itself, establish that procedures are not reasonable.

Regardless of whether some employees were required to be registered, Respondent acted reasonably in issuing at least three compliance memoranda regarding the requirements for the registration of traders. One included a list of those employees who were not registered, and another requested that supervisors identify any employees who were either exempt from registration, trainees, or unregistered cold-callers. CX 36, 37, 38. One noted specifically that "department supervisors are responsible for ensuring that each employee is properly licensed and registered prior to conducting business." CX 36, at 02091.

Contrary to Enforcement's contentions, Respondent was not the supervisor of the employees working in the OTC department. As WK testified, he and JP were responsible for the day-to-day supervision of employees assigned to the agency desk, and they were responsible for regulatory compliance in trading and market-making activities. If Respondent became aware of a compliance issue, he would bring that issue to the attention of WK and JP. If they refused or did not resolve the issue, Respondent would have to bring it to LH' or GS's attention for enforcement. Respondent was empowered only to make recommendations, not to take direct action. VL stated: "The compliance department would go to managers and . . . enforce what was in our manual, tell them . . . what needed to be done. After that if people weren't . . . paying attention, again it went to LH and GS." Tr. 321.

On at least one occasion, Respondent did bring to WK's and JP's attention a compliance issue with respect to FM. After he did so, they took FM off the agency desk. However, WK and JP, on their own, and without informing Respondent, put FM back on the desk to help ease the burgeoning workload. Respondent could not have done more. He did not have the authority to hire, fire, control, or discipline employees who were supervised by other department heads. As the SEC has acknowledged, it is rare for it to proceed against a broker-dealer employee for failure to supervise where he or she "did not have line responsibility, *i.e.*, where the power to hire, fire, reward and punish was not present."[10] Under those same circumstances, here the Hearing Panel does not find that Respondent was a supervisor in any SC department outside of compliance, or that his actions as a compliance officer were not reasonable in light of his

[10] *Arthur James Huff*, Exch. Act Rel. No. 29,017, 1991 SEC LEXIS 551, at ** 19-21 (Mar. 28, 1991) (Commissioners Lockner and Schapiro, concurring).

knowledge of the activity in the OTC department and to the extent he was given authority over the closed environment in that department.[11]

The Hearing Panel concludes that Enforcement has failed to prove by a preponderance of the evidence that Respondent failed to implement, maintain, and enforce an effective supervisory system, in violation of Conduct Rules 3010 and 2110.

III. Failure to Provide Accurate Testimony and Information

The second and third causes of the Complaint allege that Respondent provided untruthful, misleading, inaccurate, and incomplete written responses and testimony, in violation of NASD Procedural Rule 8210 and NASD Conduct Rule 2110, and prepared false, misleading and/or inaccurate records in violation of NASD Conduct Rules 3010 and 2110. At issue are (1) statements contained in the October 23, 2000 ("October Response") and November 1, 2000 ("November Response") letters to NASD responding to inquiries regarding job descriptions and compliance responsibilities of Respondent, VL, and MS, and the functions of unregistered employees on the agency desk; and (2) similar statements in Respondent's on-the-record testimony and his hearing testimony. The allegations pertaining to false, misleading and/or inaccurate records refer to the same issues.[12]

The failure to respond truthfully to NASD requests for information, whether in writing or in oral testimony, constitutes a violation of Procedural Rule 8210 and Conduct Rule 2110. *Dist. Bus. Conduct Comm. v. Doshi*, No. C10960047, 1999 NASD Discip. LEXIS 6 (Jan. 20, 1999). Providing misleading and inaccurate information to NASD, or omitting to provide information, is also conduct that contrary to high standards of commercial honor and is inconsistent with just

[11] *Huff*, 1991 SEC LEXIS 551, at *12 (concluding that respondent's supervision was reasonable under all the attendant circumstances).

[12] Enforcement's Post-Hearing Brief, at pp. 12-27.

and equitable principals of trade. *Brian L. Gibbons*, Exchange Act Release No. 37,170, 1996 SEC LEXIS 1291, at **9-10 (May 8, 1996), *aff'd.*, 112 F.3d 516 (table) (9th Cir. 1997). The Department of Enforcement is required to prove the allegations in the Complaint by a preponderance of the evidence. *Dist. Bus. Conduct Comm. v. Bruno*, 1998 NASD Discip. LEXIS 51 (NAC July 8, 1998).

Here, the Hearing Panel concludes that Enforcement did not prove, by a preponderance of the evidence, that Respondent violated Rules 8210 or 2110. Respondent may have exaggerated the importance of some of his duties, but he did not willfully give incomplete, misleading, or false testimony or responses to written questions. In addition, and as discussed below, while the testimony of other witnesses may have diverged from Respondent's responses, those witnesses merely testified from their perspectives of how a confused firm hierarchy worked and what their, and others', assigned duties and responsibilities were.

At the outset, the Hearing Panel notes three factors that place the allegations in context: (1) The Response letters were signed and approved by VL, although they were drafted by Respondent. The letters seeking the responses were addressed to LH. VL made no corrections to the drafts he signed as Vice President, CFO. (2) The records at issue modified templates, created before Respondent's employment, that were used by the firm to designate supervisors by name. (3) The on-the-record testimony was taken on August 1, 2002, almost two years after Respondent left the firm.

The statements in the letters and testimony must be viewed in light of the fact that SC's management did not place an emphasis on titles. There were no titles on office doors, and LH was averse to organizational charts. Tr. 358, 655. Neither JP nor WK could say they had a firm understanding of SC's corporate structure. They knew Respondent was referred to as

"compliance officer," "compliance director," or "head of compliance," but they could not distinguish those terms. Tr. 101, 185-86. SA and AD both worked in the compliance department, but they did not have a firm grasp of SC's entire management structure or the firm's description of job responsibilities. Tr. 267, 300-01.

Titles at SC were often conferred or assumed without any formal designation. Although employees at SC knew or assumed that Respondent was head of compliance, there was confusion about his, and others' actual titles, supervisory roles, and delegated responsibilities. For example, a number of witnesses were unfamiliar with MS, the fact that he was general counsel, or what his job functions were. Tr. 75, 158, 290, 492. Although it was clear to LH that MS was SC's in-house counsel, VL was unaware that MS was general counsel; VL used two outside law firms exclusively for legal matters. Tr. 372. Given the lack of formal management structure and the casual use of titles, it is not surprising that testimony on those matters was ambiguous and inconsistent. Tr. 227-28, 244-46, 358, 615-16, 636-39.

Statements About Himself, VL, and SA

Enforcement alleges that Respondent, in his on-the-record testimony, "failed to testify that he managed the compliance department, a fact which he admitted at the hearing." However, in the on-the-record testimony, he was never asked if he "managed" the compliance department. In the excerpt cited by Enforcement, he was asked to whom SA reported. Respondent responded that "[w]e all reported" to VL, and that VL was mostly involved in financial operations, but that because he, Respondent, was the most senior person in compliance, people who had questions generally came to him.

Citing the same question and answer, Enforcement alleges that Respondent provided misleading information by "evading a question asking if SA reported to him, answering, 'We all

reported into VL.'" That answer is alleged to be contradicted by testimony that SA and others reported to Respondent and had no professional contact with VL. However, the import of Respondent's answer was that, because VL was designated on the SC Form BD as the chief compliance officer, VL retained ultimate responsibility for the compliance department. Respondent did not deny that SA reported to him on a day-to-day basis.

Again citing the same passage of the on-the-record testimony, Respondent is accused of falsely testifying that "the compliance department did not have a reporting or management structure and that VL was more involved in compliance issues than was, in fact, true." Respondent testified that there was "no formal chain of command in the compliance department." However, as noted above, Respondent was explaining that, if someone had a question about compliance, there were a number of people, in and out of the compliance department, who might answer a particular question, rather than specified persons who were assigned to answer particular questions. The criticism of testimony about VL is grounded on VL's testimony that once a compliance person was hired, he "stepped away from compliance." However, VL explained that he was to remain listed on the firm's Form BD as chief compliance officer until Respondent became familiar with the firm, and the firm determined to allow Respondent to take over that position. Tr. 334. VL trained Respondent and was effectively his back-office supervisor during the early period of Respondent's appointment. Tr. 608. On occasion, Respondent would run compliance memoranda by VL before formally issuing them. Tr. 366. Under the circumstances, the degree of VL's involvement in compliance is a matter of opinion, not certitude.

Respondent certainly could have been more direct in his responses. For example, he could have simply admitted that SA reported to him on a day-to-day basis, even though everyone

in the compliance department ultimately had to have reported to VL because he was the Chief Compliance Officer on the BD. Respondent was aware that VL was still on the BD, and he chose to fence a bit with the questioner to emphasize that VL, and not he, was that Chief Compliance Officer. Nevertheless, the Hearing Panel does not find that Enforcement has proved by a preponderance of the evidence that Respondent's testimony was false or misleading. The questions put to Respondent were not clear or clarified, and Enforcement did not follow up on any response thought to be vague.[13]

Statements About MS

In a compliance notice and a compliance memorandum that concerned the designation of supervisors, MS's name appeared in a grid as the "Compliance Officer" who was licensed as a principal and who had responsibility for compliance with the firm's policies and procedures contained in the compliance manual. CX 34, 35. In a parenthetical notation, the notice and memorandum stated: "Note: Respondent is currently identified to assume this position after appropriate review and licensing." Enforcement alleges that MS was not designated as the "Compliance Officer," that Respondent evaded questions concerning MS's duties as "Compliance Officer," and that Respondent falsely claimed that MS was a full-time "Compliance Officer."

The Hearing Panel does not find that a preponderance of the evidence demonstrates that Respondent's testimony or written statements in the firm's documents were false or misleading. NASD had told the firm not to have VL signing documents as both CFO and compliance officer. Accordingly, someone else had to be designated as a principal who was the "Compliance Officer," *i.e*. the designated supervisor of the compliance department. Respondent was not a

[13] *Cf. Bronston v. United States*, 409 U.S. 352, 360 (1973) (holding that for perjury, it is the burden of the questioner to pin the witness down to the specific object of the questioner's inquiry); *cf. also, United States v. Dezarn*, 157 F.3d 1042, 1049 (6th Cir. 1998) (holding that an ambiguous question can never form a basis for a perjury conviction).

Series 24 and, therefore, could not be so designated. VL was advised not to be designated. Accordingly, MS, who did hold a Series 24 and who had been performing branch office audits, was designated in the compliance notice and memorandum that Respondent prepared. Neither MS nor VL raised any objection to MS's designation, and, by virtue of that designation, MS could have been named as a respondent in this proceeding.

It may also be true that MS had little to do with the compliance function other than periodic branch reviews that required a licensed 24, and therefore had little contact with SC employees at headquarters. However, even if his name and Series 24 were used because no one else was available for the function, Respondent merely put the true facts in writing. Had Respondent intended to mislead NASD about his own role in compliance, he would not have included the parenthetical note that he was to assume the position of compliance officer upon appropriate review and licensing. The Hearing Panel does not pass judgment on the propriety of designating MS as the principal in the compliance department. The issue before the Hearing Panel is whether Respondent provided false or misleading statements.

Finally, when asked whether MS was a full-time compliance officer, Respondent answered: "Yes. He was an employee of the firm, and also general counsel." Again, Respondent could have been more forthcoming in his answer, explaining his understanding of the question and the import of his response. However, the question and answer may be interpreted in different ways. If Respondent intended to indicate that MS was a full-time employee who was the compliance officer as well as the general counsel, the answer is perfectly logical and true. If the question were whether MS functioned exclusively as compliance officer, it should have been clarified, rather than assumed that the answer was in the affirmative. Under

the circumstances, the Hearing Panel cannot conclude that Respondent's response was false or misleading.

Statements and Testimony About FM

Enforcement alleges that at his on-the-record testimony, Respondent "attempted to mislead the Staff into believing that FM was registered with NASD." DOE Post-Hearing Brief, at p. 19. The quoted testimony is reproduced as OTR Passage No. 12 in Exhibit A to its Post-Hearing Brief:

> Q. Do you know what was meant by the statement
> Mr. FM was NASD registered?
> A. I'm sure he filed a form U-4 and he was registered with NASD.

CX 33, at pp. 02066-67. However, earlier in his on-the-record testimony, Respondent testified as follows:

> Q. Do you recall whether Mr. FM, I think you mentioned FM was on the desk. Do you recall whether he had a license?
> A. Yes.
> Q. What do you recall?
> A. He was not registered.

CX 33, at p. 02030. Respondent's initial response was correct. FM was not registered. His later statement that FM was registered was a mistake, but Enforcement has not shown by a preponderance of the evidence that it was a deliberate misstatement. He was not shown FM's CRD or asked about the inconsistency during the on-the-record interview. FM's CRD record was readily available electronically to the Staff and clearly showed that FM had not passed any licensing examination. At the hearing, Respondent was asked about the inconsistency, and he said that, in his later response, he had equated registration merely with FM's having had a CRD number. That response may have been a rationalization of the prior inconsistency, but it does not

establish that the later response in his on-the-record testimony was an intentional misstatement, rather than an error.

In the October Response letter, Respondent wrote that FM was a "marketing consultant" and "helped process trade adjustments when he was not attending conferences or functions." Enforcement charges that FM "was not merely a consultant," but that "he actively marketed SC's OTC business to other broker-dealers and processed agency orders. . . ." The distinction between "marketing consultant" and "actively marketing" seems to the Hearing Panel to be a distinction without a difference, and cannot support a charge that the response was false or misleading.

Enforcement faults Respondent for making no reference that FM processed agency orders. It is not clear from any question propounded to Respondent what the reference to "processing" orders means or encompasses. The Hearing Panel finds that Respondent's statement that FM put in "trade corrections and adjustments into BRASS" describes what FM did, and does not imply that FM did anything less than any other clerk on the agency desk did. As described above, most agency orders were routed automatically and did not require further input from a clerk.

Statements About TZ

Citing 11 different passages, covering 13 pages of the on-the-record testimony, Enforcement alleges that Respondent attempted to create the false impression that TZ was the

only person on the agency desk who "processed[14]" agency orders and who, with an assistant, "handled" order flow and "found best execution." Again, neither the questions put to Respondent, nor his responses, defined what was meant by the processing of agency orders or the handling of order flow. The vast majority of orders coming in on BRASS were automatically sent either to SC's traders or traders at other broker-dealers for execution. If an order was stuck on the screen and not immediately sent to one of those traders, the clerk on the order desk would merely punch a key to send the order on its way. According to WK, if an order was not automatically preferenced, the order clerk would have to go either to TZ, JP, or himself to determine which broker-dealer would get the preference and assure best execution; it "wouldn't be the clerk's discretion at all." Tr. 180. Respondent's view of how orders were routed, processed, handled, or executed was informed by what JP, WK, and TZ told him. As the record demonstrates, each of them had a different story to tell. Moreover, the employees on the agency desk had varying accounts of what they were permitted to do, what they actually did, and how they defined the functions that they performed. Under the circumstances, Respondent's statements were true if judged by the testimony of some witnesses, and inaccurate, if judged by the testimony of others. There is no evidence that JP, WK, TZ, or any other employee on the agency desk notified Respondent that any unregistered employee on the agency desk was engaged in functions that they knew required NASD registration. Accordingly, the Hearing Panel does not find that Respondent misrepresented TZ's desk activities or misrepresented the functions of other employees on the agency desk.

[14] It is clear that Respondent did not state that TZ was the only person on the agency desk who "processed" orders. In response to a question about FM's functions, Respondent responded that FM "would assist other admins. (sic) in processing data." As a follow-up, he responded in the affirmative when he was asked if he was referring to "repair data." The colloquy seems to refer to the correction of trade errors (or "trade breaks"), but it is not clear whether the questioner or Respondent considered "processing data" ("repair" data or any other data) the same thing as "processing orders." This casual use of terms is only one example of imprecise and ambiguous questions that led to similar responses.

In his on-the-record testimony, two years after he left SC, Respondent testified as follows:

> Q. So, well, Mr. TZ, he was a principal you mentioned?
> A. Yes.
> Q. So he had a 24?
> A. Yes.
> Q. Series 24?
> A. Yes.

That answer was incorrect. TZ was, in fact, registered, but only as a general securities representative at the time, not as Series 24 principal. TZ "ran the agency desk," and it is not surprising that looking back to a time two years before his testimony, Respondent may have thought TZ was registered as a principal. He was not shown TZ's CRD information and then asked if he would change his testimony. The Hearing Panel concludes that it would not be equitable to find Respondent liable for an inaccuracy that has not been shown to be intentional or even negligent under the circumstances.

Statements About Respondent's Titles and Responsibilities

Enforcement alleges that Respondent submitted misleading and inaccurate statements about his "primary functions" at SC in an effort to satisfy his "desire to conceal his compliance title." DOE Post-Hearing Brief, at p. 21. Later in its Post-Hearing Brief, Enforcement argues that Respondent's "title is irrelevant to the issue of registration; rather, the issue turns on whether [Respondent] performed the functions of a principal or representative." *Id*., at p. 36. Enforcement cannot have it both ways. In any event, it is clear that Respondent was known by a number of titles reflecting his compliance responsibilities, and, therefore, it is of no moment that he failed to specify one of them in a Response letter when he readily admitted that he headed SC's compliance effort. He could not claim to be the chief compliance officer, because VL was so listed on the firm's BD. He could not claim to be the compliance principal, because MS was

designated as the principal. Finally, there is no evidence that he was given any specific title when he was hired to head the firm's compliance effort.

The Hearing Panel also does not find misleading, as Enforcement argues, that although Respondent claimed that he *monitored* SC's overall compliance program, he did not disclose that he was responsible for *ensuring* SC's compliance with applicable securities rules and regulations. NASD staff asked for Respondent's job description. Respondent drafted a 26 line response for VL's signature. The word "ensure" does not appear in that response. However, there was no follow-up question regarding any responsibility he had for "ensuring" compliance, rather than monitoring compliance, as he described in the response. Respondent's more than 250 compliance memoranda, issued over his 16 months with SC, evidence his monitoring and ensuring SC's compliance with applicable rules and regulations. LH and GS approved his hiring for that very purpose.

Nor does it matter that, in the response to the staff inquiry for his job description and an explanation of why he was not registered with the firm, he mentioned his activities as "assistant general counsel" prior to his mention that he headed SC's compliance effort, or that he stated that "his duties include first and foremost being [SC's] in-house liaison to [its] regulatory agencies, including NASD." CX 29. The order in which he listed duties and responsibilities does not affect the question whether he should have been registered with NASD. As noted previously, regardless of his title and functions, he was not required to be registered during his tenure at SC. While Respondent may be criticized for the order in which he listed his duties and responsibilities, and the emphasis he placed on his role as liaison to regulatory agencies, he did, in fact, perform the functions he claimed to have performed, and there is nothing in his response to the staff inquiry that has been shown to be misleading or inaccurate.

After considering Respondent's participation in the preparation of responses to NASD requests for information, and his testimony both during his on-the-record testimony and the hearing in this matter, the Hearing Panel concludes that Enforcement has not proved by a preponderance of the evidence that Respondent failed to provide truthful, non-deceptive, accurate, or complete written statements or testimony, or prepared false, misleading, and/or inaccurate records, in violation of Procedural Rule 8210 and Conduct Rules 2110 and 3010.

Conclusion

Respondent is found not liable for (1) engaging in activities requiring registration as a principal and/or representative, in violation of Registration Rules 1021, 1031, and 1041 and Conduct Rule 2110; (2) failing to provide truthful, non-deceptive, accurate or complete written statements and testimony, in violation of Procedural Rule 8210 and Conduct Rule 2110; (3) preparing false, misleading, and/or inaccurate records, in violation of Conduct Rules 3010 and 2110; and (4) failing to implement, maintain, and enforce an effective supervisory system, in violation of Conduct Rules 3010 and 2110. The Complaint is dismissed.

SO ORDERED.

_____
Alan W. Heifetz
Hearing Officer
For the Hearing Panel