NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. L.H. ROSS & COMPANY, INC. (BD No. 37920), Respondent.	Disciplinary Proceeding No. CAF040056 Temporary Cease and Desist Proceeding Hearing Officer – DRP August 30, 2004

Pursuant to NASD Procedural Rule 9840, a temporary cease and desist order is imposed on Respondent for: (1) violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110, by making material misrepresentations and omissions of fact in connection with the offer, sale or purchase of securities issued by L.H. Ross & Company, Inc.; and (2) violating NASD Conduct Rule 2110 by placing unauthorized transactions in at least one customer account involving securities issued by L.H. Ross & Company, Inc., because Respondent's violative conduct or continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding.

Appearances

Gary M. Lisker, Roger D. Hogoboom and Brian D. Craig (Rory C. Flynn, Of Counsel) for the Department of Enforcement.

Franklyn R. Michelin for L.H. Ross & Company, Inc.

DECISION

I. Procedural History

On May 23, 2003, the Securities and Exchange Commission granted NASD the authority to impose and enforce temporary cease and desist orders for violations of certain securities laws

and NASD rules.[1] On July 23, 2004, the Department of Enforcement filed a Notice initiating this temporary cease and desist proceeding, marking the first time NASD has sought this remedy.

In the Notice and accompanying Declaration, Enforcement charged that L.H. Ross & Company, Inc. (LH Ross or Respondent) violated antifraud provisions of the federal securities laws (Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder), as well as NASD Conduct Rules 2120 and 2110, by making material misrepresentations and omissions of fact in connection with the offer and sale of LH Ross preferred stock in private placement self-offerings in 2003 and 2004. Enforcement also charged that LH Ross violated NASD Conduct Rule 2110 by placing unauthorized transactions in customer accounts involving purchases of LH Ross preferred stock. Finally, Enforcement contended that the alleged violations and continuation thereof were likely to result in dissipation of significant assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding, and requested the issuance of a temporary cease and desist order.[2]

A hearing on the request for a temporary cease and desist order was held in Deerfield Beach, Florida, on August 9-11, 2004.[3] The Hearing Panel included the Hearing Officer, a former member of NASD's Board of Governors, and a former member of NASD's National Adjudicatory Council, as required by Rule 9820(a). Both industry panelists are associated persons.

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[1] See NASD Procedural Rule 9810 et seq. and NTM 03-35.

[2] In conjunction with the Notice requesting the temporary cease and desist order, Enforcement filed a Complaint against Respondent, pursuant to Rule 9211, related to the subject matter of the temporary cease and desist proceeding. As of the date of this Decision, Respondent has not filed an Answer pursuant to Rule 9215.

[3] Rule 9830(a) requires the hearing to be held not later than 15 days after service and filing of the Notice initiating a temporary cease and desist proceeding. The parties agreed that scheduling the hearing to begin not later than 15 days after the Notice was served and filed would constitute compliance with the rule.

During the hearing, Enforcement called Charlene GooDéy, an NASD investigator, and nine customers who had invested in LH Ross private placement offerings. Respondent called AF, an attorney for LH Ross involved in the private placement, Adam Simon, a manager at LH Ross, and Franklyn R. Michelin, CEO and President of LH Ross, who represented Respondent in this proceeding. The Hearing Officer also admitted in evidence 184 exhibits.[4] Pursuant to Rules 9840 and 9138(b), the Hearing Panel is issuing this Decision not later than ten days after receipt of the hearing transcript.

II. Findings of Fact and Conclusions of Law

A. LH Ross

LH Ross has been a member of NASD since 1995, and its registration remains in effect.[5] Franklyn R. Michelin is CEO, CFO, COO, President and Chief Compliance Officer of LH Ross, a retail brokerage firm with executive offices in Boca Raton, Florida. In January 2003, LH Ross reported that it had 46 registered representatives and approximately 2,500 investor accounts; in January 2004, the firm reported that it had 100 registered representatives and approximately 6,800 investor accounts. (Tr. 844-845, 900; CX-10, pp. 13, 37-38; CX-11, pp. 40-41; CX-184, p. 1.)[6]

B. 2003 Private Placement

In January 2003, LH Ross initiated a private offering consisting of 5,000 units of LH Ross, priced at $1,400 per unit. According to the 55-page private placement memorandum

[4] NASD's Code of Procedure applies to all proceedings set forth in the Rule 9000 Series unless a rule specifically provides otherwise. Accordingly, after the Notice was served and filed, the Hearing Officer ordered discovery pursuant to Rule 9251, which Enforcement agreed to provide on an expedited basis. The Hearing Officer also ordered the parties to exchange pre-hearing submissions pursuant to Rule 9242 and admitted evidence during the hearing in accordance with Rules 9145, 9261(c) and 9263.

[5] Respondent is subject to NASD jurisdiction, because it was a member at the time of the alleged violations and when Enforcement filed the Notice in this case.

[6] References to the hearing transcript are noted as Tr. Enforcement's exhibits are cited as CX; Respondent's exhibits are cited as RX.

(2003 PPM) dated January 6, 2003, a unit contained 100 shares of convertible preferred stock, valued at $14 per share, with a dividend of 6% per annum, payable quarterly. The preferred stock was convertible to two shares of common stock after the closing of a public offering of LH Ross securities that the firm intended "to proceed with at some point in the near future as may be required by the underwriters of the IPO or the NASD." The total amount to be raised in the private offering was $7 million. Assuming the sale of 5,000 units, LH Ross planned to use the proceeds to cover the cost of the offering (approximately $1 million), repay debt ($125,000), expand the business ($3.5 million), and market the firm ($1 million). The rest was earmarked for working capital ($1.1 million). (CX-10, pp. 1, 14-15, 19, 24, 28, 36.)

According to the 2003 PPM, the offering price was arbitrarily determined by LH Ross and may not "bear a relationship to [the firm's] financial position, book value or any other generally accepted criteria of value." The 2003 PPM indicates that the investment involves a "high degree of risk" and should only be considered by investors who can "afford to sustain a loss of their entire investment … [and] have no need for liquidity in this investment," as there is "no market for the [u]nits." The units were not registered with the SEC or in any state and could not be sold or transferred until registered or an exemption from registration applies. LH Ross brokers earned a commission of 10% of the price per unit sold. (CX-10, pp. 1-3, 16-17, 20, 29, 32.)

Several "risk factors" specific to LH Ross were outlined in the 2003 PPM. These included the firm's net loss of more than $2.2 million in fiscal year 2001 and more than $1.1 million in fiscal year 2002, as well as the possible need for additional financing to fund operational needs and meet capital requirements, in addition to proceeds from the offering. The 2003 PPM also disclosed that as of January 2003, there were approximately nine arbitration

claims pending against the firm, and that it had been involved in actions brought by the following regulatory authorities: NASD (for violating the taping rule, characterized in the PPM as a technical violation), the Utah Division of Securities (temporarily suspended the firm's license for failing to cooperate during an on-site inspection of a branch office, which the firm was contesting), the State of Florida Department of Banking and Finance (for operating unregistered branch offices and selling securities through an unregistered person, which was settled to avoid litigation according to the PPM), and the State of Connecticut Department of Banking (for actions of brokers not registered in the state, which are described in the PPM as mistakes). (CX-10, pp. 22-23, 31-32, 53, 55.)

As of December 31, 2003, LH Ross had raised slightly more than $7 million in this offering. As sole Director of LH Ross, Michelin increased the maximum amount to be raised in the offering to 7,500 units or $10.5 million on January 9, 2004. (CX-11, p. 15; CX-14A.)

C. 2004 Private Placement

Three days after Michelin increased the amount to be raised in the 2003 offering, LH Ross initiated a new private offering, consisting of 10,000 units of LH Ross at a price of $2,800 per unit. According to the 48-page private placement memorandum (2004 PPM) dated January 12, 2004, a unit contained 100 shares of convertible Series F preferred stock, priced at $28 per share, and paying a dividend of 4% per annum. The 2004 PPM acknowledges that LH Ross had not paid dividends since the end of 2001. (CX-11, pp. 1, 13, 19.)

According to the 2004 PPM, the preferred stock would only be convertible if there were a public offering of LH Ross common stock, though "no public offering … is contemplated in the foreseeable future." Unlike the 2003 offering, the 2004 offering was limited solely to accredited investors. LH Ross paid brokers a higher commission than in 2003, at the rate of 12% of the subscription price per unit, plus an "expense allowance" of 3%. (CX-11, pp. 1, 9, 20, 38.)

The 2004 PPM made the same disclosure as the 2003 PPM regarding the firm's net operating loss of more than $1.1 million in 2002, and revealed a net loss of more than $3.2 million in 2003. The 2004 PPM stated that there were approximately six pending claims against the firm by customers seeking a total of $1.13 million. (CX-11, pp. 22, 34.)

The 2004 PPM included the same disciplinary history as the 2003 PPM, with several additions. The firm disclosed matters pending before the following regulatory authorities: North Dakota Securities Division (initiated proceedings to deny the firm's application for registration), Securities Commission of the State of North Dakota (ordered firm to cease and desist selling securities not registered in the state and offering investments unless LH Ross and brokers register as dealer and agents), Securities Division of the State of Missouri (initiated proceedings to revoke registration), and NASD (filed complaint charging LH Ross and Michelin with selling unregistered securities, market manipulation, excessive and fraudulent markups, unauthorized trading, material misrepresentations and omissions, and other charges). (CX-11, pp. 31-34.)

The 2004 offering was intended to raise a total of $28 million. According to the 2004 PPM, LH Ross estimated the cost of the offering at $4.35 million and intended to use the additional proceeds to expand the business ($13.49 million) and market the firm ($4.1 million), while preserving the remaining funds for working capital, which included payment of bonuses to LH Ross brokers ($6 million). LH Ross has raised approximately $3 million in the 2004 offering.[7] (CX-11, pp. 24, 38.)

[7] No document offered at the hearing definitively shows the amount raised in 2004. According to the 2004 PPM, slightly more than $7 million was raised in the 2003 offering; Michelin testified that the firm has raised $10 million in the two offerings. The firm's 2004 FOCUS reports appear to confirm that Respondent has raised approximately $3 million in the current offering. The Panel notes that LH Ross has not provided information about the current offering to Enforcement staff, despite several Rule 8210 requests for documents and information. (Tr. 39-40, 42-44, 59-64, 835-839, 860; CX-11, p.15; CX-183; CX-184; CX-191 - CX-197.)

D. Investors in the 2003 Offering

Approximately 150 LH Ross customers purchased units in the 2003 self-offering. After some customers complained to NASD about the offering, the Department of Enforcement opened an investigation in April 2004. Investigators contacted a few customers by phone prior to sending a letter to 149 customers regarding their experience with the LH Ross private placement. Approximately 65 customers responded to the letter and were interviewed by Enforcement staff. Investigator Charlene GooDéy personally participated in 45 interviews. (Tr. 26-29, 149-150, 152-153, 159-162; CX-12.)

GooDéy testified that most of the customers who were interviewed complained about representations made by LH Ross brokers soliciting them to purchase the firm's preferred stock that had not proven to be true. For example, many customers complained that LH Ross brokers had promised dividends. No dividends have been paid. Many customers reported that brokers had told them an initial public offering of LH Ross stock was imminent and predicted a return of two to four times their investment.[8] No public offering has occurred, nor has a registration statement been filed with the SEC.[9] (Tr. 29-30, 85-86, 249, 904-908.)

Many of the customers did not understand – and were not told by LH Ross brokers – that there is no market for the preferred stock, rendering them unable to obtain any return on their investment. Customers who later called to question their brokers or sell stock back to the firm were told that they had already doubled their money, because shares in the 2004 offering were

[8] FK, an 81-year-old retired engineer from Michigan, invested in a previous private offering of LH Ross preferred stock in July 2002. LH Ross representative Sean Ryan recommended that FK buy the stock because he would get a "better return" for his money. Ryan told him Goldman Sachs had said the price would triple after the IPO, which Ryan said should occur shortly after the end of fiscal year 2002. Ryan also told FK that the papers for the IPO were "all but finalized." (Tr. 407-408, 412-415.)

[9] AF, whose firm was counsel to Respondent for the 2003 and 2004 private offerings, testified that they started drafting a registration statement in May 2004. (Tr. 598.)

valued at $28, twice the price they had paid in 2003. Brokers did not explain that LH Ross had arbitrarily determined the value of the shares in 2003 and 2004. (Tr. 31-33.)

When questioned by NASD, customers said LH Ross brokers had not told them about the firm's operating losses, regulatory history, or the number of arbitration claims pending against the firm. Moreover, at least seven investors discovered unauthorized purchases of the preferred stock in their LH Ross accounts, after money was transferred from their brokerage account without their knowledge, or when NASD contacted them regarding the self-offering. (Tr. 33-35.)

As for the 2003 PPM, many customers had signed subscription agreements authorizing the purchase of LH Ross preferred stock but had no idea they should have also received a private placement memorandum. Many did not receive the PPM until a month after their investment. Fourteen investors never received the 2003 PPM. (Tr. 35-36.)

1. Customers GB, LB and SE

Three of the seven customers who testified about their investment in the 2003 offering never received the PPM.

GB, who is 77 years old and resides in New York, has an account at LH Ross. His broker, Kristian Sierp, mentioned the private offering to him, but a different broker, Sean Ryan, phoned GB in October 2003 to recommend LH Ross preferred stock. Ryan recommended that GB invest $25,000 and told him there would be an initial public offering of the stock in the latter part of 2003. Ryan stressed that GB needed to act quickly because the IPO was scheduled to occur in the next month or two and told GB the price would rise "considerably." Ryan also told GB the stock would be traded on Nasdaq. GB agreed to invest $7,000, though the firm originally sent correspondence showing he had made a $14,000 investment. (Tr. 254-263; CX-70.)

GB's wife signed the purchaser questionnaire and subscription agreement and sent a check for $7,000 to LH Ross on October 9, 2003. When the purchase did not appear on his monthly account statement, GB and his wife called LH Ross and its clearing firm several times and finally received a stock certificate in late February 2004. At approximately the same time, GB asked about the IPO; Sean Ryan told him it had been delayed but should occur in April 2004. (Tr. 259-262, 265-270; CX-72; CX-73; CX-74; CX-75.)

While GB and his wife were in Boca Raton in June 2004, they visited the LH Ross branch office to ask for a refund, because the IPO was "taking too long." There was no sign on the office and the door was locked. They were eventually directed to the main office, where they met Michelin. He told them the shares had doubled in price from $14 to $28 and guaranteed the IPO would occur in November or December 2004, unless market conditions were not conducive to a public offering at that time. Michelin discussed how the firm was growing and gave GB a list of LH Ross offices throughout the country. Michelin suggested that GB and his wife "talk it over" and get back to him. GB phoned a few days later to say he wanted his money returned. Michelin agreed, but said he first had to obtain releases from his attorneys. To date, GB has not received a refund, despite several calls to Michelin and another visit to his office. (Tr. 271-284, 289, 297, 299-300; CX-71.)

When soliciting GB to purchase the preferred stock in October 2003, Ryan did not tell him this was a risky investment or that the IPO might not take place. Ryan did not inform GB that LH Ross had suffered operating losses in 2001 and 2002, nor did he disclose the firm's regulatory issues. GB never received the 2003 PPM, which outlined the risk factors. On the purchaser questionnaire, GB and/or his wife indicated that "in evaluating the merits and risks of

this investment [they intended] to rely upon the advice of [another] person," listing LH Ross brokers K. Sierp and S. Ryan. (Tr. 263-265; CX-73, p. 9.)

LB, who is 84 years old and resides in Florida, had a similar experience with LH Ross broker Dan Fernandez. Fernandez phoned LB several times in mid-2003, recommending the purchase of LH Ross preferred stock. Fernandez told LB he would double his money once the firm went public and started trading on Nasdaq, which he said would occur shortly. LB ultimately purchased 4.7 units (470 shares) at a cost of $6,580, which he agreed to wire to LH Ross on June 26, 2003. (Tr. 351, 353-354, 357-359; CX-98, p. 25.)

LB requested a stock certificate but never received one. He recently spoke with Fernandez about this investment. Fernandez told him everything was fine and LB would double his money, from $14 to $28 per share, as soon as the stock begins trading on Nasdaq. Fernandez said that Michelin had told him the IPO would take place by the beginning of November 2004. (Tr. 355-356, 361, 370.)

When Fernandez recommended LH Ross preferred stock, he did not tell LB that it was a highly speculative investment or that the IPO might never occur. Fernandez did not disclose that LH Ross had operating losses in the previous two years, nor did he discuss any risks or possible "downside" to the investment. This was the first private placement LB had invested in, and he did not understand that there was no market for LH Ross preferred stock. He completed a subscription agreement, but did not remember receiving a copy of the 2003 PPM. (Tr. 354-355, 359-361, 368-369, 371, 373; CX-98.)

SE, a 52-year-old Florida resident who owns and manages commercial properties, also received several calls from his LH Ross broker, Jeff Esposito, regarding the 2003 offering. Esposito told SE that LH Ross would soon go public by merging with a publicly-traded

company. According to Esposito, this merger, which was easier to accomplish than an IPO, would take place in the next three months or so. Esposito told SE this was inside information, which presented an opportunity to do better than he had with prior investments. SE told him the merger would go through, "without a doubt." SE agreed to sell other securities in his account to buy LH Ross preferred stock, and on August 28, 2003, SE sent a check to LH Ross for $14,000. (Tr. 441-445, 455, 465; CX-92; CX-94.)

SE was disturbed that after mailing his check, he received nothing in return, and the purchase did not appear on his monthly account statements. SE spoke to Esposito about the situation, and on January 12, 2004, SE sent a letter to Michelin demanding his money be returned immediately. In response, he received a stock certificate for the shares he had purchased in August. His money was not refunded. (Tr. 449-450, 455, 464-466; CX-95; CX-96.)

When Esposito recommended that SE purchase LH Ross preferred stock, the broker did not tell him this was a highly speculative investment. Esposito did not disclose that LH Ross had suffered operating losses, nor did he discuss the firm's regulatory issues. Esposito did not discuss risks or any potential disadvantages, he only talked about the "upside" – that LH Ross was growing and doing well, and the merger was an opportunity for further expansion.[10] (Tr. 447-448.)

On September 2, 2003, SE signed a purchaser questionnaire and subscription agreement in connection with this investment. On the questionnaire, a box was checked that indicated he understood that his investment was not liquid. Another box was marked, showing that SE was

[10] According to the transcript of an on-the-record interview with customer CN, Dan Fernandez called him frequently during the spring of 2003, soliciting him to purchase in the private offering. Fernandez repeatedly told CN that LH Ross was going to merge with another company in six to nine months. He explained that this was equivalent to an IPO, and the price would "shoot up" after the merger. (CX-44.)

relying on Jeff Esposito's advice in evaluating the merits and risks of the transaction. SE, who never before invested in a private offering, did not receive the 2003 PPM. In fact, the first time he saw the PPM was when it was placed before him during this hearing. (Tr. 445-446, 448, 464, 470-472; CX-92; CX-93.)

2. Customers JE, GP and LE

Two of the seven customers who testified about the 2003 offering received the private placement memorandum well after they had purchased LH Ross preferred stock. Another customer could not recall when he received the 2003 PPM.

JE, a 49-year-old computer application salesman in Ohio, is in the process of closing his three LH Ross accounts. In April 2003, his broker, Kristian Sierp, solicited him to invest in the private placement offering of LH Ross. Sierp told JE what a great company LH Ross was and how it had grown. He said the stock price would double or triple after the IPO, which would take place in six to nine months. Sierp characterized this as "a sure thing" and said that with a 6% dividend, it was like putting money in the bank. He said this was a limited opportunity and JE would need to act quickly. On May 9, 2003, JE agreed to wire $28,000 to LH Ross for the purchase of 20 units or 2,000 shares of preferred stock. Because he was convinced this was "such a great thing," JE then purchased 21.25 units for $29,750 in June 2003. (Tr. 610-614, 616; CX-124; CX-125.)

JE met Adam Forman and Michelin when he visited LH Ross during the summer of 2003 at Sierp's invitation and the firm's expense. During the visit, Sierp solicited JE to purchase additional shares in the private placement. JE bought 108.75 units for $152,250 in September 2003, bringing his total investment to $210,000. (Tr. 619-620, 661-665; CX-127.)

When soliciting JE to purchase the preferred stock, Sierp did not disclose the firm's operating losses or regulatory issues. He did not tell JE the IPO might not occur or that the firm

had not paid dividends in almost two years. JE repeatedly asked for a prospectus, but Sierp told him it was outdated and being revised. JE did not receive the 2003 PPM until December 2003, several months after he had invested in the private placement.[11] (Tr. 616-619, 631.)

After reading the PPM, JE became concerned about his investment and tried to reach Sierp. After discovering Sierp had left the firm, he spoke with Adam Forman to discuss promises Sierp had made that were contradicted by the PPM. In response, Forman told him about the 2004 offering, where the preferred stock was priced at $28. Forman suggested that JE invest another $100,000 while he could still buy the stock at $14, then sell it for $28 per share to compensate for losses in his account. JE did not pursue this strategy. Instead, he called Michelin several times to complain, and finally wrote to him in May 2004 to request that his LH Ross accounts be closed and all funds returned. He received no response to his letter. He ultimately complained to NASD. He testified that while he would love to get his money back, he would be satisfied if this proceeding kept other investors from being hurt by the LH Ross private placement offering. (Tr. 622-626, 629-630, 644-645, 649, 652, 659-660; CX-128; CX-130.)

GP is another customer who received the 2003 PPM months after he purchased LH Ross preferred stock. He is 81 years old and resides in Florida. He transferred his brokerage account from Florida Discount Securities to LH Ross when his broker, Adam Forman, switched from one firm to the other in December 2002 or January 2003.[12] In late April or early May 2003, Forman and Jeff Esposito approached GP about investing in the 2003 private placement. Esposito told

[11] JE testified that he received and signed subscription agreements after each purchase. As he did with several customers, Michelin questioned JE about clause 6(B) in the subscription agreement, which reads in part: "Although I have had the opportunity to ask questions of, and to receive answers from, the Company and its representatives … I warrant and represent that I have not relied upon any information furnished to me other than the information which is set forth in the Offering Document." JE, who had never before invested in a private placement, testified that he thought the term "offering document" referred to the subscription agreement. (Tr. 646-648.) Michelin contends that the term refers to the private placement memo.

[12] NASD has recently charged Forman with engaging in a variety of fraudulent and deceptive sales practices while working in an alleged "boiler room" at Florida Discount Securities in September 2002. (CX-207.)

him the stock price would double when LH Ross went public, which Esposito said would occur within a year. In the interim, GP would receive dividends of 6 or 6.5%. Forman verified everything Esposito told GP. Based on their recommendation, GP agreed to wire $49,000 to the firm on May 6, 2003, for the purchase of 3500 shares of LH Ross preferred stock. He received documents about the offering, including the 2003 PPM, about a month later; the subscription agreement and purchaser questionnaire are dated June 27 and 29, 2003, respectively. (Tr. 302-310, 318-322, 337-340; CX-104 - CX-106.)

GP made two additional purchases of LH Ross preferred stock. In July 2003, Esposito told GP that the stock price was about to jump to $28 per share, but that he had a chance to buy at $14 per share. Esposito also promised GP he would give him 500 shares gratis. Based on these representations, GP invested $39,000 in July 2003. Dan Fernandez took over GP's account and solicited him to buy more preferred stock. Fernandez also told GP about the increase in value and that dividends would be forthcoming. In October 2003, GP bought another $40,000 worth of preferred stock. After calling several times to request stock certificates, GP received one in August 2003 (reflecting his first purchase) and two in October 2003 (reflecting his second purchase). (Tr. 306, 310-313, 323-324; CX-107 - CX-110.)

In early 2004, Fernandez told GP that LH Ross stopped paying dividends because the firm was putting money into opening new offices. In April 2004, GP spoke to Michelin about this issue. Michelin told him the firm had not paid dividends since 2001 or 2002, and it was never his intention to pay any.[13] Michelin said his brokers should not have promised dividends. GP asked about the IPO, which he thought was scheduled for the following month. Michelin

[13] The Panel notes that on the very first page of the 2003 PPM, it states that the investment "will pay a dividend of six (6%) per annum." (CX-10, p. 1.)

said the IPO would not occur that quickly but assured him it would happen and thought it would take place in the fall of 2004. (Tr. 314, 325-327, 331.)

The following month, GP met with Michelin and asked if he would pay him a certain amount per month. Michelin said that as soon as they started selling preferred stock again, he would pay GP. Michelin gave GP the first page of the 2004 PPM to corroborate that he was preparing to sell the preferred stock at $28 per share.[14] To date, GP has invested almost $130,000 but has not received any money from LH Ross. (Tr. 306, 325-326, 328-331, 334-337; CX-112.)

Neither the brokers nor Michelin told GP about the firm's operating losses or regulatory issues. They did not explain the risks involved in this investment and led GP to believe the investment was "safe as could be." GP received the 2003 PPM about a month after his first investment but only read the first page, which stated that each unit will pay a dividend of 6%. (Tr. 314-316, 318, 339, 347-349.)

LE is 50 years old and owns a vending company in Texas. He could not recall whether he received the 2003 PPM before purchasing LH Ross preferred stock in March 2003. He was solicited by Dan Hernandez, who recommended that LE liquidate his account in order to invest in the private placement, because there were only a few units remaining. Hernandez told LE the company would be going public soon, probably in six months, and said the stock would then triple. He also said that LE would receive a quarterly dividend of 7%. On March 24, 2003, LE agreed to wire $11,060 to LH Ross to purchase 7.9 units (790 shares) of preferred stock. After

[14] Contrary to Michelin's statement to GP, the firm had been selling the preferred stock at $28 per share since March 2004, if not before. Respondent's counsel, AF, informed customer RO by letter dated March 29, 2004, that LH Ross had commenced its 2004 private offering. AF's letter stated that the price had increased from $14 to $28 per share and would pay a dividend of 4%. On March 1, 2004, customer KB purchased 2000 shares of LH Ross preferred stock for $56,000. On or about July 1, 2004, KB's broker solicited him to buy additional shares in the 2004 offering. The broker said the IPO was going forward, and KB had the chance to make "some pretty good money" after the public offering. (Tr. 676-678; CX-54; CX-64; CX-139; CX-142.)

Hernandez solicited him to purchase more preferred stock, saying that LE would "thank him" for investing in this private placement, LE wired $4,500 to LH Ross for 3.2 units (320 shares) of preferred stock on June 26, 2003. (Tr. 374, 376-378, 381-382, 396, 400; CX-80; CX-81.)

Hernandez had told LE the first dividend would be distributed in August 2003. When that did not occur, LE called Hernandez, who told him dividends would be delayed until November 2003, because the firm was using proceeds from the offering to acquire other brokerage firms. Soon, LE's account was moved to a new broker, and then to another broker. Once when he called, another brokerage firm answered and informed him the LH Ross branch office had been closed. LE felt he was "getting the runaround" and phoned Michelin in March or April 2004 to complain. In response, he received an undated letter from Michelin informing him that LH Ross had doubled in size since the time of LE's investment and that a "follow-on" offering was priced at $28 per unit. On June 9, 2004, LE sent a complaint letter to LH Ross and Michelin, requesting a full refund, but has not received a response. (Tr. 382-387, 394, 397; CX-82; CX-83.)

When Hernandez solicited LE to purchase LH Ross stock, he did not give any indication that it was a risky investment. He did not tell LE there was no guarantee the IPO would occur; to the contrary, Hernandez said LH Ross intended to go public during 2003. Hernandez did not tell LE about the firm's operating losses in recent years or disclose any regulatory issues. After LE received and read the 2003 PPM, he questioned his broker about the risk involved in this investment. Hernandez assured him it was safe and that he would pay the dividend from his own pocket, if necessary.[15] (Tr. 378-379, 392-393, 397-398.)

[15] The record includes transcripts of on-the-record interviews with two customers who invested in the self-offering after receiving the 2003 PPM. AW asked if the PPM was "necessary legal language," and his broker, Dan Fernandez, confirmed that it was. GV also asked Dan Fernandez about the PPM. Fernandez told him it was just "standard procedure." (CX-19; CX-37.)

3. Customer KC

The seventh customer to testify about the 2003 offering did not authorize the purchase of LH Ross preferred stock.

KC is a 65-year-old retiree who lives in Georgia. He transferred his account to LH Ross in October 2002, after his former broker from Florida Discount Securities, Dan Fernandez, convinced him to do so. In December 2002, Fernandez and Adam Forman sold securities in his account over his objection; however, KC then authorized Fernandez to deposit the proceeds in a six-month money market account paying 8% interest. (Tr. 494-499, 525, 545.)

On January 29, 2003, KC received a statement indicating he had purchased 15,000 shares of LH Ross preferred stock for $210,000. He did not authorize this investment and knew nothing about it. KC had not given Fernandez discretionary authority to trade his account. He did not sign a subscription agreement or purchaser questionnaire related to the 2003 offering and believes someone at LH Ross photocopied his signature (and his wife's) from their new account form onto these documents without his knowledge or consent.[16] The signature page of the purchaser questionnaire bears the signature and stamp of a notary public, Gale Markowitz. KC testified that Markowitz was a sales assistant for LH Ross and that he never signed a document in her presence.[17] (Tr. 502-509, 545-546; CX-117; CX-118; CX-121, p. 4.)

In May 2003, KC needed to withdraw funds from his account. Fernandez said his money was tied up in a private placement and could not be withdrawn until a public offering. KC repeatedly asked Fernandez to refund his money, to no avail. He sent a letter to Forman in July

[16] When contacted by NASD, KC saw a subscription agreement indicating he had made another investment in the 2003 offering for $8,527. KC also denied authorizing this purchase. (Tr. 499-501; CX-116.)

[17] Adam Simon, operations manager for LH Ross, testified that he remembered preparing a subscription package for KC, who was one of the first customers to purchase securities pursuant to the 2003 offering. According to Simon, the branch office hand delivered the package, which includes the PPM, purchaser questionnaire and subscription agreement, to KC. (Tr. 707.)

2003 that went unanswered and subsequently contacted Michelin, who suggested he have Fernandez sell KC's preferred stock to other investors. Completely frustrated, KC hired an attorney to pursue this matter, but has not received a refund from the firm. (Tr. 510-516, 532, 535-537; CX-119; CX-120.)

E. Respondent's Recent Financial History

LH Ross is the principal operating subsidiary of LH Ross Holdings Corp. (Holdings), which is wholly owned by Michelin. Holdings owns 100% of the 3.5 million shares of LH Ross common stock issued and outstanding. (Tr. 844-845; CX-11, pp. 12, 40, 44-45.)

Though LH Ross is the revenue-generating entity, the 2004 PPM states that Holdings pays monthly operating expenses for LH Ross. The PPM further states that LH Ross agrees to reimburse Holdings $50,000 per month as a "fixed obligation and is not subject to adjustment to reflect the actual [m]onthly [e]xpenses." In the firm's FOCUS report for the quarter ending March 31, 2004, the firm reported that $4.17 million was due from Holdings. In June 30, 2004, the firm reported that $6.44 million was due from Holdings. (Tr. 850-852; CX-11, p. 22; CX-183, p. 2; CX-184, p. 2.)

Michelin testified there is a "fluctuating amount each month" that goes between Holdings and LH Ross, and "every few years [our auditors] write off the amount [due from Holdings] if it gets too large." When the Panel asked Michelin why Holdings owed LH Ross $6.44 million as of June 2004, he testified, "I really don't know, and I don't want to give an answer that I'll be attacked for later when I can give you a plausible explanation in the morning…. I'll have an explanation for you. I'm sure that you will enjoy it." (Tr. 890-892, 934-935.)

The next morning, Michelin offered his explanation. He testified that $4.44 million due from Holdings was attributable to bonuses paid to 52 newly-recruited brokers, in the form of unsecured loans. He did not explain why another $2 million was due from Holdings. He also

testified that an accountant had only once written off a receivable due from Holdings to LH Ross. He testified that $3.17 million was written off on September 30, 2002 but gave no reason why. (Tr. 959-964.)

Michelin testified that the 2003 and 2004 self-offerings raised approximately $10 million total. He estimated that LH Ross spent $2.5 million on offering costs and used the remaining proceeds to open nine new branch offices.[18] Michelin touted the firm's growth and testified that since January 2003, the number of accounts, brokers, branches and revenue had "at least quadrupled." He testified that "for the most part, we made a diligent effort to insure that the [new brokers'] licenses are clean," due to his concerns about NASD scrutiny. LH Ross introduced two summary exhibits to demonstrate the firm's growth without any supporting documentation.[19] (Tr. 828-829, 860-861; RX-1; RX-3.)

Bank records show substantial deposits into an LH Ross account at Wachovia.[20] GooDéy testified that many deposits were in the amounts and near the dates when customers were purchasing LH Ross preferred stock. In addition, the Wachovia account number was included in

[18] While LH Ross owns some of its branch offices, Michelin testified that other branches are "like … a franchise … [similar] to a McDonald's structure." As Michelin first described it, the owner of a branch office is responsible for all expenses, including brokers' commissions, and pays LH Ross 10% of its gross revenue per month. Adam Simon also testified that each individually owned branch handles its own finances. Michelin subsequently testified that LH Ross actually pays the monthly expenses for these "franchises," then "charge[s] it back to the branch." The new "owners" did not pay LH Ross to buy their branch offices, however. According to Michelin, LH Ross paid the owners, in the form of a recruitment bonus. Michelin testified that in one instance, LH Ross paid a bonus of $1 million. (Tr. 789-790, 908-911, 913-918.)

[19] Respondent's only two exhibits were charts prepared by Adam Simon and/or Michelin. The exhibits purportedly show the growth in the number of registered representatives at the firm, and monthly cash receipts from the firm's clients. (Tr. 715-716, 738-740, 756-757; RX-1; RX-3.)

[20] Enforcement obtained Respondent's bank records from the State of Florida's Office of Financial Regulation. The hearing record contains Wachovia account statements from October 2002 through June 2003. (Tr. 44-45; CX-187.)

letters from LH Ross instructing customers to wire money to the firm for these purchases.[21] (Tr. 48-51; CX-40; CX-50; CX-80; CX-81; CX-106; CX-113; CX-124; CX-187.)

Disbursements from Respondent's Wachovia account were primarily made to other LH Ross accounts and to brokers and employees, though two checks for $4,410 each were issued to Homeside Lending to cover Michelin's mortgage payment for his residence. It appears that the Wachovia account was closed, with remaining funds used to open two LH Ross accounts at BankOne.[22] (Tr. 874-875; CX-186; CX-187; CX-187A; CX-187B.)

Many transactions in Respondent's BankOne account (ending in 543) consist of deposits received from the firm's Chase account (totaling $2.01 million in five months). Some of the money wired from Chase into the BankOne account (543) was then transferred to the other BankOne account (ending in 733), which is designated as an "operating account."[23] In response to questions from the Panel about these transfers, Michelin testified that they "have to move money around all the time in the normal course of business." (Tr. 877-881; CX-187A; CX-187B.)

Many expenditures from the operating account seem to have no business-related purpose. These include debit or credit card charges at clothing/accessory stores (Abercrombie and Fitch, Footlocker, Off Fifth, Sunglass Hut), a video store (Blockbuster), a music store (Sam Ash Music), casinos/nightclubs (Atlantis, Coconut Creek Casino, Opium), a cosmetics store (Sephora), and a lingerie store (Victoria's Secret). Other charges may or may not have had a

[21] The Panel notes that some customers investing in the self-offering were instructed to wire funds to an LH Ross account at Chase Bank in Long Island. Funds from an LH Ross account at Chase were then transferred to an LH Ross account at BankOne (ending in 543). No records from the Chase account were offered at the hearing. (CX-35; CX-55 - CX-58; CX-187A.)

[22] It appears these accounts were opened on July 30, 2003. The hearing record contains monthly statements for the period July 30, 2003 through January 30, 2004 for both BankOne accounts.

[23] The Panel observed that the amount withdrawn from the BankOne account (543) on a particular date matched the amount deposited in the BankOne operating account (733) on the same date. (*See e.g.*, CX-187A, p. 33 and CX-187B, p.11; CX-187A, p. 39 and CX-187B p. 19; CX-187A, pp. 29-30 and CX-187B, pp. 38-39.)

business purpose. These include: 1-800-Flowers, Boca Raton Florist, Amoco, Chevron, Exxon, Shell Oil, AOL, Comcast Cable, Dry Cleaning Depot, American Airlines, Chalks Airways, Continental, Delta, Jetblue, Renaissance Hotels, Movico Palace, Front and Center Tickets, Domino's Pizza, Morton's, P.F. Chang's, Rachel's Steakhouse, 7-Eleven, Publix and Walmart. (Tr. 865-885; CX-186; CX-187B.)

The Panel notes there were also many withdrawals from, and numerous checks drawn on, both BankOne accounts. Furthermore, Michelin's home address is listed on every bank statement in the hearing record. (Tr. 899-900; CX-187; CX-187A; CX-187B.)

LH Ross has not paid dividends since 2001 and had net operating losses in each of the last three fiscal years ($2.2 million in 2001, $1.1 million in 2002, and $3.2 million in 2003). Until last quarter, the firm reported net losses in nine consecutive quarters, from January 2002 to March 2004.[24] During June 2004, LH Ross solicited customers to lend funds to the firm for two months, with the promise of a 20% return. Michelin testified this was an attempt to raise a little extra money to close a million-dollar deal. (Tr. 903-908, 933-934; CX-10, pp. 22, 53, 55; CX-11, pp. 1, 22; CX-17; CX-18; CX-175 - CX-185.)

F. Discussion

The Hearing Panel considered whether Respondent, through its registered representatives: (1) violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and NASD Rules 2120 and 2110, by making material misrepresentations or omissions of fact in connection with the purchase, offer or sale of securities issued by LH Ross in the 2003 and 2004 private placement, and (2) violated NASD Conduct Rule 2110 by placing unauthorized transactions in customer accounts involving purchases of securities issued by LH Ross in the 2003 and 2004 private

[24] In the most recent quarter, ending June 30, 2004, LH Ross reported a net profit of $347,022. (CX-184.)

placement. In addition, the Panel considered whether Respondent's violative conduct or continuation thereof, if established, is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding.

1. Fraud

To establish that Respondent violated the antifraud provisions of the federal securities laws and NASD rules as charged, Enforcement must prove by a preponderance of the evidence that Respondent, through its registered representatives, made material misrepresentations, or failed to disclose material information to insure that statements were not misleading, in connection with the purchase, sale or offer of securities, and acted with scienter.[25]

a. Material misrepresentations or omissions

Information is material if there is a " 'substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest].' " *SEC v. Mayhew*, 121 F.3d 44, 51 (2nd Cir. 1997) (citations omitted). To be material "[t]he information need not be such that a reasonable investor would necessarily change his investment decision based on the information,

[25] Section 17(a) of the Securities Act makes it unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce, or by the use of the mails, directly or indirectly: (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (3) to engage in any transportation, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Exchange Act, makes it unlawful in connection with the purchase or sale of any security, for any person, directly or indirectly to use or employ "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe…." SEC Rule 10b-5, promulgated thereunder, renders it unlawful for any person: (a) to employ any device scheme or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

NASD Conduct Rule 2120 prohibits the use of any manipulative, deceptive or other fraudulent device or contrivance to effect a transaction in, or induce the purchase or sale of, any security. Rule 2120 is the equivalent of SEC Rule 10b-5. *Market Regulation Committee v. Shaughnessy*, No. CMS950087, 1997 NASD Discip. LEXIS 46, at *24 (NBCC June 5, 1997).

as long as a reasonable investor would have viewed it as significantly altering the 'total mix' of information available." *Id.*, citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Material facts include those investors would want to consider when making a decision whether to buy, sell or hold a stock. *Id.*

The Panel finds that LH Ross representatives made oral misrepresentations to investors, many of whom were elderly, while soliciting investments by telephone. They touted the private offering as a great opportunity for customers to double, triple or quadruple their money once the firm went public, which they said would happen soon. In reality, the firm had not taken substantial steps to have its stock traded publicly, such as filing a registration statement with the SEC. Furthermore, there was no reasonable basis for their predictions that the price would rise, particularly when LH Ross had arbitrarily set the price of the stock and was contending with financial problems and regulatory issues.

LH Ross representatives also told customers the investment would pay dividends that exceeded current interest rates. In truth, LH Ross had not paid dividends since 2001 and was struggling financially, having suffered net operating losses in 2001 and 2002.[26]

The Panel further finds that the brokers' misrepresentations and omissions were material. Baseless price predictions are inherently fraudulent and constitute material misrepresentations, even if stated as an opinion rather than a guarantee.[27] Moreover, there is a substantial likelihood that a reasonable investor would have found the information brokers omitted (the true status of

[26] The Panel credits the customers' testimony, because it was consistent with other evidence in the record, including letters they had sent to the firm, and GooDéy's testimony about interviews of other customers. Additionally, none of the customers had any apparent connection to each other, yet there were significant similarities in their testimony. The Panel also notes that Respondent did not call any registered representatives to rebut the customers' testimony, though at least two of them (Dan Fernandez and Kristian Sierp) were apparently running an LH Ross branch office as of June 2004. (Tr. 272-278; CX-71.) The Panel rejects Respondent's argument that NASD's investigation colored customers' testimony and notes that most, if not all, of the customers complained to the firm well before NASD contacted them.

[27] *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *16 (Feb. 10, 2004).

the IPO, the method for pricing the stock, and the financial situation of the firm, including the lack of dividends in recent months) important, if not crucial, to his or her investment decision. This is particularly true in a private self-offering, where there are few sources from which to obtain this type of information other than the firm or its representatives.

b. In connection with the purchase, sale or offer of securities

Statements made to persuade customers to purchase securities are made "in connection with" the purchase or sale of a security. *SEC v. Jakubowski*, 150 F.3d 675, 679 (7th Cir. 1998), *cert. denied*, 525 U.S. 1103 (1999).

There is no question that the material misrepresentations and omissions made by LH Ross representatives while offering to sell, and soliciting customers to purchase, LH Ross preferred stock were intended to induce customers to invest in those securities. Thus, this element is established.

c. Scienter

To be liable under Section 10(b) and Rule 10b-5, and therefore under NASD Rule 2120, a respondent must act with scienter.[28] Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976). Reckless conduct can satisfy the scienter requirement under Rule 10b-5. *SEC v. Burns*, 816 F.2d 471 (9th Cir. 1987); *Dep't of Enforcement v. Levitov*, No. CAF970011, 2000 NASD Discip. LEXIS 12, at *11 (NAC June 28, 2000). Scienter may be shown by circumstantial evidence. *U.S. v. Mylett*, 97 F.3d 663 (2nd Cir. 1996).

LH Ross representatives knew, or had easy access to information that demonstrated, that their statements to customers were inaccurate, and in some instances, completely false. Both the

[28] Proof of scienter is also required under Section 17(a)(1), but not under Sections 17(a)(2) or 17(a)(3). *U.S. v. Aaron*, 446 U.S. 680, 697-700 (1980).

2003 and 2004 PPM disclosed that investing in the private offering was fraught with risk, and customers could easily lose their entire investment. The Panel finds that the representatives knew (or were reckless in not knowing) of the adverse information contained in the private placement memoranda and concludes that the disclosures contained in the memo are precisely the reason why the firm's representatives did not send the PPM to several customers, or only sent it after customers had invested. The Panel notes that at least one broker characterized the PPM as containing "necessary legal language," while another broker called it "standard procedure." Yet another broker repeatedly told a customer who asked for the "prospectus" that it was being revised.[29]

In addition to making material misstatements and omissions and unfounded price predictions, LH Ross representatives also used high-pressure sales tactics. Brokers called some customers several times, and many brokers urged customers to act quickly before this "limited opportunity" expired. Some brokers offered free stock as an incentive, and one broker guaranteed he would pay dividends from his own pocket if necessary. Another broker had the temerity to suggest the customer invest another $100,000 before the price doubled, without divulging that the firm had arbitrarily doubled the stock price in the 2004 offering.

Based on all the credible evidence, the Panel concludes that LH Ross representatives, who stood to benefit from their material misrepresentations and omissions and high-pressure sales tactics, intended to deceive, manipulate or defraud investors, and therefore acted with scienter. Accordingly, the Panel finds that LH Ross, which is liable for the misconduct of its

[29] A broker who makes oral misrepresentations to customers violates the antifraud provisions notwithstanding distribution of a prospectus that discloses the risks associated with the investment. *Robert A. Foster*, Exchange Act Rel. No. 34408, 1994 SEC LEXIS 2107 (July 20, 1994).

registered representatives,[30] violated the antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, as well as NASD Conduct Rules 2120 and 2110.[31]

2. Unauthorized Transactions

Unauthorized trading in a customer's account is a violation of a member's ethical obligation to observe just and equitable principles of trade. *See Robert Lester Gardner*, Exchange Act Rel. No. 35899, 1995 SEC LEXIS 1532 (June 27, 1995), *aff'd*, 89 F.3d 845 (9th Cir. 1996).

Enforcement charges that LH Ross, through its representatives, executed unauthorized purchases of LH Ross preferred stock in customer accounts. Only one witness testified regarding unauthorized transactions. KC testified that in December 2002, he instructed his broker to deposit $210,000 in a money market account for six months but never authorized him to purchase LH Ross preferred stock. He further testified that his signature was taken from another document and affixed to the subscription agreement and purchaser questionnaire without his knowledge or consent.

KC's broker did not testify in this proceeding; however, Adam Simon disputed KC's allegation that he had not received the subscription package, including the 2003 PPM. Simon testified that KC was one of the first to invest in the 2003 offering, and he recalled preparing the package for hand-delivery to KC.

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[30] A broker-dealer is responsible for the conduct of its salesmen under the doctrine of *respondeat superior*. *Douglass and Co., Inc.*, Admin. Proc. No. 3-4981, 1977 SEC LEXIS 2778, at *31-32 (May 27, 1977) (citations omitted). A broker-dealer may be properly sanctioned for the willful acts of its agents. *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 362 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970).

[31] A violation of an SEC or NASD rule also constitutes a violation of Conduct Rule 2110's ethical obligation to observe high standards of commercial honor and just and equitable principles of trade. *See Steven J. Gluckman*, Exchange Act Rel. No. 41,628, 1999 SEC LEXIS 1395, *22 (July 20, 1999) (citations omitted).

The Panel finds KC a very credible and convincing witness and believes Simon's testimony was tailored to refute the customer's very serious accusations. Moreover, in comparing the documents by placing one signature over the other, the Panel noted that the handwriting and signatures on the pages at issue are identical. (CX-117, p. 8 and CX-118, p. 8). The same is true for Mrs. C's signature, as well as the printed entries on these pages.

The Panel believes these signatures were photocopied from another document and credits KC's testimony in its entirety. Accordingly, the Panel finds that LH Ross, through one or more of its representatives or employees, executed unauthorized transactions in KC's account and falsified two documents in furtherance of this misconduct.[32] In so doing, the firm violated NASD Conduct Rule 2110.

3. Significant Dissipation of Assets or Other Significant Harm to Investors

Having found by a preponderance of the evidence that LH Ross committed the violations charged in the Notice, the Panel turns to whether the violative conduct, or continuation thereof, is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding.

It is difficult to determine exactly how LH Ross is utilizing funds raised in the 2003 and 2004 self-offerings.[33] If Michelin is to be believed, most of the money is earmarked for LH Ross registered representatives. He testified that the firm has appropriated approximately $2.5 million

[32] In a slightly different vein, customer ME told Enforcement that after he agreed to invest in the 2003 private offering, his broker faxed him the signature pages from the subscription agreement and purchaser questionnaire, rather than sending the entire document. In reviewing these documents, the Panel notes that only the signature pages bear evidence of having been sent by facsimile transmission. (CX-25; CX-26; CX-27.)

[33] The Panel again notes that Respondent did not provide documents and information related to these self-offerings as requested by Enforcement under Rule 8210. Respondent also failed to introduce any reliable records at the hearing that might assist the Panel in determining whether customer assets had been dissipated or converted. Under the circumstances, it is reasonable to infer that such records do not exist or contain information that is detrimental to Respondent.

for offering costs.[34] According to the private placement memoranda, costs associated with these offerings primarily consist of commissions to LH Ross registered representatives, some of whom have made their money by fraudulently inducing customers to participate in these offerings.

Michelin claims the firm has used the remaining $7.5 million to acquire and establish new branch offices and to pay large recruitment bonuses to registered representatives. Michelin's explanation that many of the branch offices are independently owned, yet their expenses are paid by LH Ross, is simply inconsistent. More troubling is his testimony that he "tried to insure" that newly-hired registered representatives have "clean licenses" due to his fear of NASD scrutiny, not to protect LH Ross customers from unethical brokers.[35] Finally, the Panel questions the extent to which the proceeds have been used for business-related purposes, in light of the various transfers among LH Ross bank accounts and the nature of the expenses charged to the firm's operating account.

The Panel is also greatly disturbed by the financial relationship between LH Ross and Holdings. Michelin testified there is a "fluctuating amount each month" that goes between the two companies. Based on the record, specifically the firm's FOCUS reports, the Panel finds that funds flow only one way – from LH Ross to Holdings. Moreover, on at least one occasion, a debt of more than $3 million due from Holdings was simply erased, or written off, by an accountant, without reason or explanation. Since then, as proceeds from the self-offerings have poured in to LH Ross, the stream of money to Holdings has increased significantly. During the same period, LH Ross paid no dividends and reported significant operating losses. In 2004, LH

[34] Michelin's rough estimate exceeds the figures in the private placement memoranda by about $750,000.

[35] During this period, LH Ross hired at least one registered representative with a criminal history. Lazar Kauderer joined LH Ross in October 2003, ten months after pleading guilty in federal court to conspiracy to commit mail and wire fraud. He was sentenced to two years' imprisonment in March 2004 but remains registered with the firm. (CX-204; CX-205.)

Ross reported that $4.17 million was due from Holdings as of March 31, and $6.44 million was due as of June 30.

Michelin, who controls both entities, appears to have moved investors' funds from LH Ross to Holdings, in amounts far exceeding the $50,000 mentioned in the 2004 PPM as reimbursement for monthly expenses. The Panel questions why Holdings pays the firm's monthly expenses and whether that actually occurs, but is primarily concerned that Michelin has moved customer money from the broker-dealer, whose books and records are subject to inspection by NASD and other regulators, to a company that is beyond scrutiny.

For all the reasons stated above, the Panel finds Respondent's violative conduct or continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding.

III. Temporary Cease and Desist Order

It is simply indefensible for an NASD member firm to offer and sell securities using material misrepresentations and omissions. Respondent's misconduct is particularly alarming because it involves private placement self-offerings. The registered representatives did not repeat misstatements authored by an unaffiliated issuer. They worked for the firm that issued the stock and had direct knowledge of the omissions and misrepresentations.

Enforcement takes the position that the firm's self-offerings are fraudulent and requests that the Panel issue an order requiring Respondent to cease and desist from offering any securities issued by LH Ross, including the private placement, promissory notes, or any other type of security or interest in LH Ross or Holdings.

The Panel agrees that Respondent's misconduct goes far beyond material misrepresentations and omissions made by LH Ross representatives in their phone solicitation of customers.

The firm's transgressions include a pattern of:

- failing to send the private placement memorandum to customers or sending it well after the purchase;

- failing to reflect the acquisition of preferred stock on customers' monthly account statements;

- telling customers their investment had doubled without divulging that the firm had simply doubled the price of the preferred stock in the 2004 offering;

- making additional material misstatements to customers who posed questionsabout the offerings;

- completely ignoring many customer complaints about the offerings;

- falsifying documents in connection with placing unauthorized transactions in at least one customer account; and

- dissipating or misappropriating a significant portion of the $10 million raised in these self-offerings, which appear to be little more than a scheme to defraud investors.

The Hearing Panel finds that Respondent's misconduct poses an extreme threat to the investing public and that a temporary cease and desist order encompassing any self-offering is warranted. The Panel rejects Respondent's argument that a temporary cease and desist order would be unduly harmful to the firm's customers. To the contrary, it would benefit customers by protecting them from exposure to additional serious violations and further dissipation or conversion of assets.[36]

ORDER

As set forth in the accompanying Decision, the Hearing Panel finds by a preponderance of the evidence that Respondent: (1) violated Section 17(a) of the Securities Act of 1933,

[36] Enforcement also requests an accounting, in the form of a sworn declaration from Michelin, which includes information regarding the private placement offerings. During the hearing, Michelin stated that an accounting was appropriate in this matter, and the Panel concurs. We believe, however, it is better left to Enforcement to request an accounting from Respondent pursuant to Rule 8210, than to require Respondent to provide an accounting to the Panel pursuant to a temporary cease and desist order.

Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110, by making material misrepresentations and omissions of fact in connection with the offer, sale or purchase of securities issued by LH Ross in the 2003 and 2004 private placement offerings, and (2) violated NASD Conduct Rule 2110 by placing unauthorized transactions in customer accounts of securities issued by LH Ross in the 2003 private placement offering, as specified in the Notice.

As set forth in the accompanying Decision, the Panel further finds that Respondent's violative conduct or continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding.[37]

Accordingly, it is hereby ordered that Respondent, L.H. Ross & Company, Inc.:

1. **CEASE AND DESIST** from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110. Specifically, Respondent is ordered to:

    a. cease and desist offering or selling securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 6, 2003;

    b. cease and desist offering or selling securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 12, 2004; and

    c. cease and desist offering or selling any securities issued by L.H. Ross & Company, Inc., including but not limited to promissory notes, or any other type of security or interest in L.H. Ross & Company, Inc.

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

2. **CEASE AND DESIST** from violating NASD Conduct Rule 2110. Specifically, Respondent is ordered to:

a. cease and desist placing unauthorized transactions in customer accounts of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 6, 2003;

b. cease and desist placing unauthorized transactions in customer accounts of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 12, 2004; and

c. cease and desist placing unauthorized transactions in customer accounts of securities issued by L.H. Ross & Company, Inc., including but not limited to promissory notes, or any other type of security or interest in L.H. Ross & Company, Inc.

3. **CEASE AND DESIST** from dissipating or converting customers' assets or causing other harm to investors. Specifically, Respondent is ordered to:

a. cease and desist paying commissions or any other form of compensation to registered representatives in connection with sales of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 6, 2003;

b. cease and desist paying commissions or any other form of compensation to registered representatives in connection with sales of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 12, 2004;

c. cease and desist paying commissions or any other form of compensation to registered representatives in connection with sales of securities issued by L.H. Ross & Company, Inc., including but not limited to promissory notes, or any other type of security or interest in L.H. Ross & Company, Inc.

d. cease and desist making loans, paying bonuses, or giving any other form of compensation to registered representatives as inducement to join, or as reward for having joined, L.H. Ross & Company, Inc.;

e. cease and desist making loans, paying bonuses, or giving any other form of compensation to branch managers or owners to be used to induce registered representatives to join, or as a reward for having joined, L.H. Ross & Company, Inc.;

f. cease and desist opening new branch offices;

g. cease and desist commingling funds between L.H. Ross & Company, Inc. and L.H. Ross Holding Corp.;

h. cease and desist transferring, lending or otherwise distributing funds to L.H. Ross Holding Corp. from L.H. Ross & Company, Inc.;

i. cease and desist forgiving, eliminating or writing off loans due from L.H. Ross Holding Corp. to L.H. Ross & Company, Inc.;

j. cease and desist converting for personal use or misappropriating funds derived from sales of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 6, 2003;

k. cease and desist converting for personal use or misappropriating funds derived from sales of securities issued by L.H. Ross & Company, Inc. pursuant to the private placement memorandum dated January 12, 2004;

l. cease and desist converting for personal use or misappropriating funds derived from sales of securities issued by L.H. Ross & Company, Inc., including but not limited to promissory notes, or any other type of security or interest in L.H. Ross & Company, Inc.; and

m. collect $2 million currently due from L.H. Ross Holding Corp. to L.H. Ross & Company, Inc. as soon as possible, but not later than September 29, 2004, and immediately deposit $2 million in an escrow account.

Pursuant to Rule 9870, this Order constitutes final and immediately effective disciplinary sanctions imposed by NASD. The Order shall be effective upon service.

SO ORDERED.

_____
Dana R. Pisanelli
Hearing Officer
For the Hearing Panel

Dated: August 30, 2004
10:00 a.m.
Washington, DC

Copies to: Franklyn R. Michelin (*via facsimile and overnight mail*)
Gary M. Lisker, Esq. (*via electronic and first class mail*)
Roger D. Hogoboom, Esq. (*via electronic and first class mail*)
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