NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. STERLING SCOTT LEE (CRD No. 1848950) and DENNIS TODD LLOYD GORDON (CRD No. 1614614), Respondents.	Disciplinary Proceeding No. C06040027 Hearing Officer – DRP **PANEL DECISION** December 29, 2005

Respondents Lee and Gordon are barred from association with any member firm in any capacity for permitting an unregistered individual, who they knew or should have known was subject to a statutory disqualification, to act as principal of a member firm for more than three years, and for failing to disclose to NASD the individual's ownership or control of the firm during the same period, in violation of Article IV, Section I and Article V, Section 1 of NASD's By-Laws, NASD Membership and Registration Rule 1021 and NASD Conduct Rule 2110.

In light of the bars, no suspension or fine is imposed on either Respondent for having caused the firm to charge markups in excess of 10 percent in 31 transactions from June 2002 through August 2002, which were not fair and reasonable under the relevant circumstances, nor disclosed on customer confirmations, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rules 10b-5 and 10b-10(a)(2)(ii)(A) thereunder and NASD Conduct Rules 2110, 2120, 2230, 2440 and IM-2440. For these violations, Respondents are ordered, jointly and severally, to pay restitution to the firm's customers in the amount of $22,657.40, plus prejudgment interest calculated pursuant to Section 6621 of the Internal Revenue Code, 26 U.S.C. 6621(a)(2).

Appearances

For the Department of Enforcement: Karen E. Whitaker, Regional Counsel, Dallas, TX, and Gene E. Carasick, Regional Counsel, Atlanta, GA (Rory C. Flynn, Washington, DC, Of Counsel).

For the Respondents: Phillip W. Offill, Jr., Esq., Godwin Gruber LLP, Dallas, TX.

DECISION

I. Procedural History

On August 12, 2004, the Department of Enforcement filed a two-count Complaint charging that Respondent Sterling Lee, in his capacity as President, Chief Compliance Officer, Chief Operating Officer and indirect owner of member firm Lloyd Scott and Valenti, Ltd. (LSVL), and Respondent Dennis Gordon, in his capacity as Chairman, Chief Executive Officer and indirect owner of LSVL, violated Article IV, Section I and Article V, Section 1 of NASD's By-Laws, Membership and Registration Rule 1021 and Conduct Rule 2110 by permitting an unregistered, convicted felon to act as a principal of LSVL from approximately February 2000 to at least May 2003, without disclosing the individual on the firm's Form BD.[1]

The Complaint further charges that from on or about June 6, 2002 through on or about August 30, 2002, LSVL, acting through Respondents Lee and Gordon, violated Section 10(b) of the Exchange Act of 1934 and Rules 10b-5 and 10b-10(a)(2)(ii)(A) thereunder, and NASD Conduct Rules 2110, 2120, 2230, 2440 and IM-2440, by charging customers who purchased Pacific CMA, Inc. (PCCM), a security traded on the OTC Bulletin Board, prices that were not fair and reasonable under the relevant circumstances, and that LSVL, acting through Respondents, failed to disclose markups on customer confirmations.

[1] The Complaint refers to the unregistered individual as "John Doe." He was identified during the hearing as an attorney from Russia with one or more aliases and is referred to as MG in this Decision.

Respondents filed an Answer on September 9, 2004, in which they admitted that they were responsible for the business operations of LSVL, either directly or through their supervision of others, but denied any knowledge that a person associated with LSVL was statutorily disqualified. Respondents asserted they did not allow any unlicensed individuals to act in any capacity that required registration. Respondents also asserted that prices paid by customers who purchased PCCM were approximately the same as the best offer in the market and that the compensation received by LSVL was reasonable, particularly in light of the time and effort involved in arranging the transactions. Respondents did not admit or deny the allegation that the firm failed to disclose markups on customer confirmations during the relevant period.

On March 29-31, 2005, a three-day hearing was held in Dallas before the Hearing Officer and two current members of NASD's District 6 Committee. Enforcement called four witnesses: Jeffrey Chicola, Carol Holden and Valerie Vega, each of whom was formerly registered or associated with LSVL, and NASD Special Investigator Gene Davis. Enforcement also introduced 20 exhibits in evidence.[2] Respondents testified on their own behalf.[3] The parties filed post-hearing submissions on May 23, 2005.

II. Findings of Fact and Conclusions of Law

A. Respondents Lee and Gordon

Sterling Scott Lee (Respondent Lee or Lee) entered the securities industry in January 1989 as an investment company and variable products representative with an NASD member

[2] Many of Enforcement's exhibits are copies of emails taken from Respondent Lee's computer at LSVL. Rather than mark each email as a separate exhibit, Enforcement grouped them chronologically by year so that CX-3, CX-4 and CX-5 consist of emails from 2001, 2002 and 2003, respectively. The Panel reviewed more than 100 email exchanges that were admitted in evidence, but only the most germane are referenced in this Decision.

[3] References to the hearing transcript are noted as follows: Tr. I refers to the first hearing day, Tr. II to the second hearing day, and Tr. III to the third hearing day. Enforcement's exhibits are cited as CX. The exhibits Respondents offered were also offered by Enforcement and were admitted in evidence as CX-19, CX-21 and CX-22.

firm. He became licensed as a general securities representative and general securities principal in May 1993, and worked at several member firms before he registered with LSVL in May 2000. Lee was President, Chief Compliance Officer and an indirect owner of LSVL. His registration with LSVL was terminated in April 2004, and he is not currently registered with a member firm.[4] (Complaint ¶¶ 1, 10; Answer ¶ 1A; Tr. III at 277; CX-1.)

Dennis Todd Lloyd Gordon (Respondent Gordon or Gordon) entered the securities industry in April 1988, as an investment company and variable products representative and investment company and variable products principal with an NASD member firm. He subsequently became registered as a general securities representative and general securities principal, as well as a financial and operations principal. He was registered with LSVL from February 2000, as a general securities representative, general securities principal, municipal principal, options principal and financial and operations principal. As Chairman and CEO of LSVL, he supervised Respondent Lee.[5] He also was an indirect owner of the firm. Gordon's registration with LSVL was terminated on October 30, 2003. He works as a consultant and is currently registered with several member firms as a financial and operations principal.[6] (Complaint ¶¶ 2, 12; Answer ¶ 1A; Tr. III at 57, 61; CX-2.)

B. Lauren Capital Becomes LSVL

Respondent Gordon testified that he did not recall who introduced him to MG, an attorney from Russia, but in late 1999, MG told Gordon he was interested in purchasing a

[4] Respondent Lee is subject to NASD jurisdiction pursuant to Art. V, Section 4 of NASD's By-Laws, because the Complaint, which was filed within two years of the termination of Respondent's registration, alleges misconduct that occurred while he was registered.

[5] According to the firm's written supervisory procedures, Gordon and Lee supervised each other. (Tr. III at 127-130; CX-22 at 237.)

[6] Respondent Gordon is subject to NASD jurisdiction, because he was registered with a member firm at the time of the alleged violations and when Enforcement filed the Complaint.

brokerage firm on behalf of ES, a business associate who resided in Russia. As a result, Gordon, who was associated with several member firms as a financial and operations principal, put MG in touch with the owner of member firm Lauren Capital. After NASD approved the sale of Lauren Capital to Devonshire Forte Ltd. (Devonshire), a holding company owned by ES, Lauren Capital was renamed Lloyd Scott and Valenti, Ltd. (LSVL). (Tr. I at 33; Tr. III at 63-64, 67-69, 72-73, 76-77, 287; CX-10 at 3; CX-12; CX-21 at 76; CX-22 at 72, 116-118.)

Respondent Gordon, a minority owner of Devonshire, was originally slated to assume the position of President and Chief Compliance Officer of LSVL. When Gordon decided he did not want day-to-day responsibility for the firm, he contacted Respondent Lee, who agreed to join the Texas-based firm as President and Chief Compliance Officer in May 2000. In addition to his ownership interest in the holding company, Gordon became Chairman and CEO of LSVL. (Tr. I at 36-37; Tr. III at 66-67, 81, 281-282; CX-12 at 5; CX-22 at 116-118.)

MG, who was ES's representative in the United States, had no formal position with Devonshire or LSVL.[7] MG was not listed on the firm's Form BD, nor registered with NASD. Nevertheless, in late 1999 or early 2000, MG recruited Jeffrey Chicola to manage a New York-based branch of LSVL. Chicola testified that MG was not licensed, because he did not want to fall under NASD's jurisdiction, but was interested in owning a brokerage firm to enhance his ability to conduct investment banking deals.[8] Chicola testified that his personal attorney thought that MG was "untrustworthy," because he had experienced some "problems" in Russia and with

[7] MG held a power of attorney to handle all of ES's business affairs in the United States, including Devonshire and LSVL. In a letter to NASD prior to the sale of Lauren Capital to Devonshire, Gordon represented that ES would not be involved in day-to-day activities at the firm. Respondents testified that they spoke to ES by telephone a few times but never met her. (Tr. III at 76-77, 133, 287-288; CX-3 at 46; CX-12 at 49, 128-131; CX-19 at 12-13, 83-84.)

[8] According to Respondent Gordon, MG worked as an "investment banking consult[ant]" by helping companies raise money, frequently through a merger or acquisition. Gordon concurred with Chicola that MG did not want to be registered with NASD. (Tr. III at 103, 145-146.)

the IRS. Despite his attorney's warning, Chicola joined LSVL in June 2000 and brought several brokers with him. (Tr. I at 28-29, 36, 104-105; Tr. III at 76-77, 79-80, 91-92, 132, 137-139.)

Chicola testified that both Respondents "took direction" from MG, who made "all the major decisions." According to Chicola, he talked to Respondent Lee daily about back office issues, but spoke to MG about "big picture" issues such as broker production, business deals and the like. Chicola testified that he resolved disagreements with Respondents Lee or Gordon by phoning MG, who would "handle it." Chicola's tenure at LSVL was short-lived. He left the firm in February 2001.[9] (Tr. I at 38-39, 48-49, 59-60, 89, 91, 101, 109.)

C. EVI Acquires LSVL

In May 2002, LSVL became a wholly-owned subsidiary of Envision Ventures, Inc. (EVI). According to papers filed by Gordon with NASD, the principal owner of EVI was KS, a former fashion model, who had no securities industry experience.[10] She was married to MG, who acted as her representative in all matters related to EVI and LSVL, though he held no formal position with either entity. MG was not listed on the firm's Form BD, nor registered with NASD. LSVL ceased operations and filed a Form BDW in June 2004.[11] (Tr. III at 89-91, 98-99; CX-10 at 4; CX-11 at 1; CX-21 at 95-96.)

D. MG's Role at LSVL

Respondents take issue with Chicola's testimony that MG was involved in managing LSVL. While Respondents concede that MG voiced his opinion, they assert that he did not

[9] Before Gordon brought Lee into the firm, Chicola was slated to own 20% of Devonshire. LSVL filed a Form U-5 stating that Chicola was terminated for cause, which he disputed at the hearing. (Tr. I at 62-63; CX-20 at 19-20, 67-69, 72-73; CX-22 at 116-118.)

[10] In a March 2002 letter to NASD, KS wrote that she will not be involved in LSVL in any way "other than as an indirect shareholder." (CX-10 at 5.)

[11] In May 2004, NASD brought a disciplinary action against LSVL and MG, which was settled. (Complaint ¶¶ 4-8; Answer ¶ 1B.)

directly or indirectly engage in any securities business that would have required registration in any capacity. Moreover, Respondents testified that they admonished MG if he appeared to be "overstepping his bounds" by venturing into an area that might be considered securities-related. Gordon testified that while MG had "greater" authority with respect to running the holding company, he and Lee rejected all of MG's investment banking proposals for LSVL. (Tr. III at 79-82, 87-88, 104-105, 107, 111-113, 222-223.)

According to Respondents, MG was skilled at web-based commerce, and thus he developed LSVL's online trading platform, NexStox.com. He was also responsible for hosting and maintaining LSVL's website. Gordon testified that in connection with those responsibilities, MG "may have discussed contracts" with other companies, but denied that MG could legally bind LSVL. (Tr. I at 152-153, 157-158; Tr. III at 92, 98-99, 101-102, 288-289, 295.)

After reviewing dozens of emails between MG and Respondents, the Hearing Panel credits Chicola's testimony and rejects Respondents' argument that MG played a limited role at LSVL. There is overwhelming evidence that Respondents were acutely aware that MG was involved in virtually every aspect of LSVL. In fact, it appears that MG was the principal owner of the firm.[12]

1. Personnel issues

LSVL's business plan involved hiring independent contractor representatives and establishing branch offices or Offices of Supervisory Jurisdiction (OSJ), while maintaining a central location in Texas. Gordon testified that with respect to hiring brokers, MG's role was limited to "identifying opportunit[ies]" from BrokerHunter.com, an Internet service where

[12] NASD initiated a cause examination of LSVL in January or February 2003, after a former employee called to report suspicious activity by MG, including possible money laundering. During an unannounced site visit in March 2003, NASD investigators retrieved thousands of emails from Respondent Lee's personal computer. (Tr. I at 258-261, 275-278.) In this Decision, all excerpts from LSVL emails are direct quotes.

brokers posted their resumes. According to Gordon, MG forwarded hundreds of resumes to him without screening applicants, though MG occasionally commented when he thought a specific broker "look[ed] like a good one." Gordon denied that MG had authority to hire or fire brokers, but conceded that MG had "a lot of input," because he represented the company's largest shareholder. According to Gordon, Lee hired the firm's brokers, as well as the administrative staff, who were put on the holding company's payroll to minimize the brokerage firm's expenses.[13] (Tr. III at 81, 85-88, 290-294.)

Several emails that MG authored, regarding hiring and firing LSVL brokers and administrative staff, demonstrate that when it came to personnel matters, MG played a leading role. For example, in a January 2002 email exchange on which Gordon was copied, Lee wrote to MG about a call he had received from a broker who wanted to work at LSVL.

Lee wrote:

> M., received a call from Chris and he said he has spoken to you and Miron. He wants to come on board. Anything I should/need to know?

MG responded:

> Please get him registered (with pre-hire dated of 1/15/2002). He will come on board in a couple of weeks and will start an OSJ […] in FL. He is a high-growth prospect and we will support him in several ways for a test period of time in hope that he could add a lot of production.

Lee replied:

> M., please share with me the necessity of a prehire date of 1/15? Do we want a hire date of 1/15 (for U-4/NASD purposes) or a prehire date? …

[13] Devonshire (succeeded by EVI) had a management agreement with LSVL, whereby the holding company assumed all operating liabilities and paid all operating expenses on behalf of the brokerage firm, which was then obligated to reimburse the holding company for all expenses incurred, based on a monthly invoice prepared by the holding company. This "management fee" was due from LSVL to Devonshire (then EVI) on the 15th of each month, unless payment would cause the firm to fall below net capital requirements. Interest at a rate of 10% accrued if LSVL failed to pay on time. Gordon testified that this type of arrangement, i.e., holding company-brokerage relationship, was common during this period and "eased" a firm's net capital computation. (Tr. III at 68-70; CX-18; CX-22 at 116.)

> Please share with me what he needs to achieve during this test period. Thanks.

MG wrote:

> If you can, all the new hires as long as reasonably possible should go in for pre-hire as well as NASD/U4 purposes as of 1/16 or before. … Chris [ ] will be let to work out of the office … in [Florida] and we will pick up some of his expenses (still in negotiation). Test period is 3 months an[d] he has to show at least $15K worth of production. (CX-4 at 27-28.)

In an email to Gordon in December 2002, on which Lee was copied, MG discussed an interview he scheduled with a broker.

MG wrote:

> What would it take to set LSVL up to be a commodities dealer? I am interviewing a broker tomorrow who comes from Morgan Stanley and would like to deal in commodities. Please advise ASAP. Thanks.

Two weeks later, **Gordon asked MG:**

> What is the status of this? I had inquired and was expecting a call back from [LSVL's clearing firm] to see if they could accommodate us. (CX-4 at 840.)

With respect to firing employees, Lee referred to MG as the "powers that be," who had "the power to tell [Lee] to fire people."[14] MG's authority was directly corroborated in a January 2003 email on which Gordon was copied, in which MG instructed Lee to ask Carol Holden to tender her resignation.

MG wrote:

> In relation to [Holden]'s email below: please ask her to resign effective immediately (if the payments to the brokers for the month of November have been all settled). I would like to hear your suggestions as regards an interim bookkeeping solution for LSVL. I can get us an outsourced bookkeeper (with a FINOP license) at once. Please place an ad for a ser[ies] 7/24 licensed employee. As soon as that employee is found, please get rid of G[ ]. New employee has to take up all the licensed

[14] Tr. I at 208; CX-4 at 41-42.

> functions that were spread between [Holden] and G[ ]. I will take up as much unlicensed duties that can be carried out in a long-distance mode as necessary in the meantime. (CX-5 at 6.)

The following day, MG sent Lee an email containing a draft letter regarding termination of Holden's employment at LSVL. The draft bears the name of MG's wife, the principal shareholder of EVI. MG sent a copy of the email to Gordon.

MG wrote:

> Gentlemen,
>
> It has come to our attention through review of trading losses of the past year, inappropriately conducted tape recordings of trading-related calls, complaints by LSVL reps related to trading issues as well as multiple accounting-related complications that LSVL has been facing over the months as the result of Mrs. Carol Holden's failures to provide timely and professional services as from time to time required, that EVI's employee Mrs. Carol Holden has shown a pattern of conduct irreconcilable with the position she has been employed in. It therefore has been our decision to terminate the respective position and employment of Mrs. Carol Holden with EVI effective immediately. Please submit proposals related to outsourcing of such functions previously assigned to Mrs. Carol Holden, that do not require an din-office (sic) licensed personnel. Thanks. (CX-5 at 11.)

A January 2003 email from MG to Lee once again shows MG making significant personnel decisions.

MG wrote:

> Hi Sterling, A[W] in [Florida] is fired as of today….

Lee responded:

> Wow… she was short-lived…. (CX-5 at 62.)

These emails demonstrate that MG did more than simply forward brokers' resumes to Respondents while adding an occasional comment. The Panel rejects Respondents' testimony

that personnel decisions were theirs alone and finds that MG had significant and, at least in some instances, ultimate authority to determine whom LSVL employed.

MG also worked on deals to acquire existing firms in order to establish OSJs in New York, Florida and Southern California. In September 2002, he emailed Lee and Gordon about "exhausting" himself by "trying to figure out what to do about the crew from failed Florida Discount Securities" and his negotiations to "steal" brokers from Ryan, Beck. In February 2003, he copied Respondents on an email he sent to James Alexander regarding a proposed OSJ agreement with J. Alexander Securities. In the email, MG proposed that "my firm, LSVL, will upgrade its registration with NASD and will become a market maker … so that there is not discontinuation of any of [J. Alexander's] business … [and] will sign an OSJ Agreement which will provide for registering all [of J. Alexander's] brokers with LSVL…." (CX-4 at 575-576, 578; CX-5 at 148.)

Furthermore, it appears that MG determined compensation at LSVL. In a November 2002 email to Lee on which Gordon was copied, MG wrote about "two concessions" regarding an increase in Lee's salary and severance pay in the event of Lee's resignation.

MG wrote:

> … Tomorrow I intend to complete development of the 'leg up' compensation structure that EVI would offer to [Lee], including the details related to the issues of accountability, reporting and proactive management's involvement in facilitating the brokers' production. Of course I would also invent and weave in the rules under which management would qualify for performance-related bonuses etc…

Gordon responded:

> … If we are talking raises, compensation should be tied to net income for EVI … [and] both me and M[G] deserve some compensation … . At a minimum, I need to start at $1000.00, growing to $3000.000 … and M[G] should receive at least $3000.00 for the time he spends with EVI/LSVL.

Lee replied:

> …I am an EMPLOYEE which works over 50 hrs/wk. …The new proposal on the table continues to keep me underpaid for my position in this industry…

Gordon wrote:

> …We too work for the firm. I am definitely part-time … and M[G] is full time. Speaking of grossly underpaid. One must consider that M[G]'s family owns most of the firm, but still, we should all receive something before one gets everything… I put in "x" number of hours and receive "0".[15] (CX-4 at 747-749.)

While it is unclear if these specific compensation issues were resolved, the Panel finds that both Respondents regarded MG as the man holding the purse strings. This view was shared by others at the firm and is supported by the fact that the holding company paid LSVL's expenses, including Respondents' salaries. (Tr. I at 151; Tr. III at 500; CX-18.)

2. Representing LSVL

In addition to handling personnel issues, MG also interacted with customers of LSVL's online trading division, NexStox.com. According to Holden, MG brought clients, who were foreign and rarely spoke English, to LSVL through NexStox. (Tr. I at 142, 146.)

In one instance, MG helped an individual in Germany open a new account, while in another, he interceded on behalf of a Russian bank to ensure that a trade was cancelled. He also reviewed customer accounts, and once informed Valerie Vega, a person associated with LSVL who worked in the home office,[16] that a subsidiary of a major foreign financial institution had a margin (not cash) account. He asked to be notified immediately if the client needed to sign

[15] In February 2003, Gordon sent to MG and Lee a proposed consulting agreement between Gordon & Associates Strategic Investments, Inc. and EVI, which called for Gordon to be paid $2,250.00 per month to serve as LSVL's options and financial principal. (CX-22 at 121-124.)

[16] Though Vega was associated with LSVL, pursuant to the management agreement, she was paid by the holding company. The same was true for Carol Holden, who was registered with LSVL. (Tr. I at 121, 150, 195-196, 221, 241; CX-18.)

additional forms. Though Lee informed MG that the margin form was incorrect, MG nevertheless instructed Vega to ensure that the client had margin privileges as soon as the account was funded. Lee advised MG that "allowing [the client] to trade on margin ahead of this form puts us at risk. I hope you understand that." There was no email response from MG. (Tr. I at 195, 201; CX-3 at 214; CX-4 at 50-51, 267.)

MG also appears to have taken the lead in representing LSVL in business deals, as shown by a February 2003 email to LSVL's clearing firm, on which Gordon and Lee were copied. **MG wrote:**

> As you may remember a while ago we submitted a proposal of a new clearing agreement to you. Some time ago you wrote to me promising to get back by the end of the next week. That was on 2/12/03, i.e. your response was eagerly awaited by 2/21/03. Almost a week later there is still no word from you on that clearing agreement, to say nothing of the other issues that for all intents and purposes seem to have been tabled by [clearing firm]. Is everything all right? Are we still on track for a meeting? Please advise. Thanks. (CX-4 at 779.)

Moreover, MG contracted with issuers to conduct "corporate awareness" campaigns in which he guaranteed access to LSVL's website and brokers. In a November 2001 email to Gordon, on which Lee was copied, MG attached a "generic template" of such a contract. As "vice president" of Devonshire, MG pledged the company's "best effort to drive no less than 5 million investors" to LSVL's website, where a corporate profile or research report about the issuer would be posted. In addition, Devonshire promised to provide copies of an issuer's corporate profile or research report, as well as any sales leads, to a network of brokers, including LSVL brokers, and "encourage" them to solicit customers to buy the issuer's stock.[17] The

[17] MG offered to brokers who contacted LSVL via BrokerHunter.com the email addresses of those who registered on LSVL's website to view corporate profiles and research reports, terming them "free pre-qualified leads." (Tr. III at 407-410; CX-3 at 376-377.)

contract required the issuer to pay Devonshire a retainer of $10,000 and several hundred thousand shares of common stock in exchange for these services.[18] (CX-3 at 376-377, 379-382.)

3. Establishing LSVL policies and procedures

Despite his unregistered status, MG also established policies and procedures for LSVL. In a lengthy and significant email dated November 24, 2001, MG wrote to Lee regarding "policy" issues, copying Gordon and ES. MG discussed many topics, including "facilitat[ing] brokers' interest in our corporate sponsorship programs" by compensating them for order flow to "a friendly market maker."

MG wrote:

> [Devonshire] has invested a certain effort to build a relationship with [Market Maker A]. We expect LSVL to follow suite (sic). Therefore as the matter of corporate policy, please make sure that ALL the orders that can be routed to [Market Maker A] are in fact routed there. Please talk to [names] at [phone numbers] and commence routing of those orders at once.

Furthermore, LSVL management was expected to discuss with every broker the "advantages of participating in corporate sponsorship programs" and to submit to Devonshire a list of LSVL brokers who would so participate. (CX-3 at 397-398.)

In the November 2001 email, MG addressed many supervisory issues and imposed several significant requirements, including a "daily written report" outlining what each employee accomplished that day. According to MG, those who failed to comply more than three times in a

[18] The Panel questions the veracity of Lee's testimony that there were no "corporate awareness campaigns." In an email dated January 23, 2002, Gordon told Lee and MG that he "was pleased to hear about the [issuer] deal," asked whether the company had made "the down payment," and inquired if there was an escrow account for the stock. MG informed Respondents that the issuer had paid 30,000 shares of stock but owed more, plus the $10,000 retainer, and that he would talk to the company the next day. MG also listed three issuers who had "verbally committed to the deal" and mentioned another that was "in the works." Furthermore, on January 30, 2002, Lee responded to an email Gordon had forwarded about another advertising deal for an issuer. Lee wrote that the "agreement can be written better." (Tr. III at 417; CX-4 at 46, 52-53.)

pay period would be "subject to immediate termination." Every LSVL broker was ordered to submit a "digital photograph, bio[graphy], message to clients and 5 stock picks to be placed on their LSVL" web page. LSVL managers were required to place at least one weekly call to each broker regarding production, securities "the broker is working on," and other business matters. (Id.)

Furthermore, copies of all letters, emails or other communications sent by Gordon to current and former LSVL brokers regarding outstanding debts were to be faxed to Devonshire. Letters were to be followed by daily phone calls to those brokers still in arrears. In addition, newly-hired brokers were expected to consent to a credit check, and no brokers were to be permitted to register with LSVL absent a clean credit history and a Form 1099 with at least $24,000 "annual brokerage production." (Id.)

MG further stated that Devonshire expected employees to refresh their skills regarding opening NexStox accounts. All licensed employees were to be trained to operate the firm's quote system and to submit an "affidavit that such training has been completed and necessary skills in operating [quote system] have been acquired."[19] (Id.)

Though MG claimed that he and Respondents "successfully implemented a practice whereby [he did] not get involved with the brokerage operations,"[20] MG was engaged in virtually every aspect of the broker-dealer's business, from ordering business cards and stationery to designing client brochures to addressing securities-related issues.[21] In an email

[19] MG sent a follow-up email to Respondents on February 23, 2002, in which he noted that none of the policies or procedures had been implemented and asked for comments. (CX-4 at 161.)

[20] CX-4 at 175.

[21] In an email dated July 21, 2002, MG instructed Respondents to establish a "policy for reps' stationary (sic) orders" so that "NO stationary orders should be sent to printers unless and until the proper amounts are credited to EVI's bank account," and in an email to Respondents dated January 6, 2003, MG attached a draft of the inside cover of LSVL's client brochure. (CX-4 at 455; CX-5 at 18-19.)

dated February 23, 2002, which MG addressed to Lee and copied Gordon, he discussed stocks on LSVL's approved list.

MG wrote:

> We all know that OTC BB stocks are very risky and brokers selling these could bring substantial damages and arbitration upon the firm. In connection to that I would like to see a procedure established as to how OTC BB stocks land on the Approved Product List (hereinafter APL). Currently I assume that every time such stock gets on that list there should be someone pushing it.

Though Lee responded by pointing out that Devonshire need not know who is "pushing" certain stocks, which is "an LSVL function," MG disagreed.

MG wrote:

> … on behalf of [Devonshire] it IS my business to inquire and I need to know how desperately bad companies land on your APL …. Remember, it is all about risk elimination and if some of the items on LSVL's APL look dangerous and risky, please explain to me how it is something [Devonshire] doesn't need to know. (CX-4 at 165-166.)

While Respondents may have occasionally reminded MG that he was straying into a "gray area" by involving himself in an aspect of the firm that required registration, they often permitted MG to cross the line.[22]

4. Chain of command

The evidence establishes, and the Panel finds, that Respondents considered MG their boss and took orders from him on virtually every issue related to LSVL. In an email from Gordon to Lee dated December 11, 2001, Gordon explicitly outlined the "chain of command."

[22] Lee sometimes appeared to resent MG's role. In an email dated November 29, 2001, he wrote, "I am not sure why I must rethink the new corporate policies sent to me on behalf of [Devonshire]. They came across as demands. And as far as I have always been told… 'you and Dennis make the policies as it relates to LSVL.'" As a result, MG offered to "present a simplified version of those policies" on December 13, 2001, "expect[ing] constructive input and follow up" from Respondents. Lee testified that he felt compelled to deal with MG, because "his family had a large investment in the entire parent company and the subsidiary." (Tr. III at 497; CX-21 at 100, 106.)

Gordon wrote:

> … You are an employee of LSVL which is owned by [Devonshire].… I too am an employee, even if I am not paid. We both have bosses. You, as president, run the day-to-day, that's what a president does. I, as CEO, work with alliances, relationships and strategies. That is what a CEO does. As Elena's proxy, we both report to M[G]. He is our boss and yes, I am yours…. (CX-3 at 447.)

In his response, Lee took issue with the assertion that Gordon was his boss. He did not, however, dispute that they both reported to MG.[23] (CX-3 at 446-447.)

The evidence strongly suggests that Respondents regarded MG as their boss because he owned the firm. Though he denied it during a June 9, 2003 on-the-record interview with NASD staff, an email exchange on June 8, 2001 implies otherwise. In an effort to persuade Gordon to devote more time to LSVL, MG wrote how he had "dedicated all [of his] time to LSVL… [and] been leaning on [his] cash for expenses, financing LSVL, building [w]ebsites, etc…." Gordon responded that if he "owned half the firm … [his] priorities would be different," implying that MG, not ES, was the principal owner of LSVL. (CX-19 at 85-88.)

Furthermore, when Devonshire sold the firm to EVI, MG told Respondents that his wife should "fit the shoes" to be an officer and director of the new holding company, thus corroborating Carol Holden's testimony that "[KS's] name was used so that M[G]'s would not be." During this transition, MG complained to Respondents in March 2002 about devoting all of his time to LSVL for two years. MG wrote about his frustration that his "very first and largest ever investment" in a broker-dealer "has not brought [him] a penny." He also told Respondents he was at their "complete mercy," because they could "flush this whole deal down the toilet" by resigning and placing "one phone call to [their] buddies at NASD…." Gordon replied that he

[23] MG confirmed that "in terms of chain of command Dennis [Gordon] is in charge of LSVL on behalf of [Devonshire]." (CX-21 at 106.)

was tired of "being pressured to work more … but if [they] disagree on the direction of the firm [he] will hold no grudges … [and] would never even consider contacting [his] buddies at the NASD… [because t]he firm is run according to the [r]ules." (Tr. I at 189; CX-19 at 98; CX-22 at 148-150.)

E. MG's Statutory Disqualification

In addition to permitting MG to act as an unregistered principal of the firm for more than three years, the Hearing Panel finds that Respondents knew, or should have known, that MG was subject to a statutory disqualification. During his on-the-record interview with NASD staff, MG testified that in 1996 he was convicted of money laundering and that he told Respondents in 2000 or 2001 about this felony conviction for "taxation matters and financial matters." According to MG, he believed Gordon and Lee needed to know about his conviction to understand why he "maintain[s] a very steady line of separation between what I do and what they do. It is important for them to know and understand why it is that I am not again involved in license activities." (CX-19 at 9, 15-16, 34-35.)

According to Lee and Gordon, MG told them that he had "tax problems" and refused to register with NASD. Respondents claim, however, that MG did not disclose the felony conviction that would have subjected him to a statutory disqualification. Respondents testified that they did not conduct a background check of MG and first learned of his felony conviction in October 2003, due to NASD's investigation. (Tr. III at 122-124, 137, 310-311.)

Respondents point to their occasional emails to MG, proposing he register with NASD in order to engage in certain securities-related activities, as evidence that MG failed to tell them about his conviction and statutory disqualification. The Panel finds that such emails may simply have reflected Respondents' frustration that, as licensed individuals, MG's activities were

putting Respondents at risk.[24] In any event, Respondents were required to conduct an inquiry into MG's background to determine whether he was subject to any disqualification. They failed to perform an investigation that would have revealed the relevant information. (Tr. 112-113, 491-493, 495-496; CX-4 at 165; CX-22 at 61.)

Furthermore, Respondents concealed MG's affiliation with the firm from NASD for more than three years. Prior to NASD's routine examination of LSVL in 2000 or 2001, Respondents instructed the firm's staff to remove documents bearing MG's name from view. They also directed LSVL staff to refrain from discussing MG with NASD examiners, telling them to say that MG was the firm's webmaster, if asked. (Tr. I at 143-145, 174-176, 211-212.)

Moreover, MG supervised many aspects of the firm's business and appears to have been the firm's de facto owner, yet Gordon did not disclose his involvement in membership application forms submitted to NASD when ownership changed from Lauren Capital to Devonshire, and then to EVI. In addition, Respondents failed to disclose that MG was a direct or indirect owner or control person in any of the firm's 30 Form BD filings between March 21, 2000 and March 24, 2003.[25] Had MG's involvement been disclosed during the application process or on the Form BD, NASD might have discovered the conviction that disqualified him from association with LSVL, even if Respondents did not. (Tr. II at 23, 27, 29-31; Tr. III at 136-138; CX-10; CX-11.)

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[24] Gordon testified that there were times when he told MG he needed to register to "level the playing field as far as risk goes with regards to the firm…." Furthermore, in a February 2002 email, Gordon insisted that the partnership be restructured in a way that protected his interests, suggesting that MG be named an officer and director of Devonshire. (Tr. III at 124; CX-19 at 99-101.)

[25] Members are required to name direct and indirect owners of the firm on Form BD filings, as well as any person who directly or indirectly controls the management of policies of the member through agreement or otherwise. (*See, e.g.*, CX-21 at 73, 76, 92, 95.) Though Respondents stipulated that MG was not named in any of LSVL's Form BD filings from 2000 through 2003, there are the only two Form BD filings in evidence. Gordon prepared and submitted one amendment, while Lee prepared and submitted the other.

Respondents' efforts to conceal MG's involvement with LSVL from NASD, and their failure to conduct an inquiry into his background, support the Panel's conclusion that Lee and Gordon knew, or should have known, that MG was subject to a statutory disqualification.

F. Trading in PCCM

In 2001, Gordon established an account at LSVL's clearing firm in order to conduct riskless principal cross trading.[26] He told Lee and MG that he wanted "to do as much principal cross trading as possible (which allows us to make a profit as if we were a market maker)…." In order to overcome objections from LSVL's clearing firm, however, Gordon advised that LSVL would not be acting as a market maker and represented that he had "cleared this type of account with the NASD." He also stated that any markup or markdown would be disclosed on customer confirmations. (Tr. III at 113-116, 231-233; CX-3 at 110, 189-190.)

According to Respondents, the riskless principal account was "used to facilitate the exchange of securities" between clients. LSVL representative Wayne Thaler actively sought corporate insiders or other large shareholders, usually of bulletin board companies, who wanted to sell a large block of stock. Thaler then found buyers. The buyers and sellers opened accounts at LSVL, and cross trades were executed through the riskless principal account at LSVL's clearing firm. Though the trades were reported, Gordon maintained that cross trading allowed sellers to put shares on the market without depressing the stock price. (Tr. III at 117-120, 181-183, 207, 314-318; CX-4 at 341-342.)

Respondents testified that when effecting cross trades through the riskless principal account, LSVL bought at the best bid and sold at the best offer. As a matter of firm policy, LSVL always retained the spread as compensation. Respondents asserted that LSVL was

[26] The transactions were riskless because LSVL executed the buy and sell orders simultaneously as cross trades.

entitled to the spread, because "quite a bit of time and energy" was involved in arranging these trades. (Tr. II at 86-91; Tr. III at 181-182, 392, 446.)

Only Respondents had authority to place trades through the account, but Gordon denied any involvement with riskless principal trading beyond having established the account. Lee testified that Gordon did not oversee trading in this account, because he was comfortable with Lee's ability to enter trades. (Tr. III at 181-182, 314-315, 380.)

In April 2002, Thaler recommended Pacific CMA, Inc. (PCCM) as a good candidate for riskless principal cross trading. In May, Lee "add[ed] PCCM to the list."[27] From June 6 to August 30, 2002, 31 cross trades in PCCM were executed through LSVL's riskless principal account. Though not a market maker in this, or any other, security, LSVL had a substantial percentage of the trading volume during the three-month period in this thinly traded stock.[28] (CX-4 at 341-341; CX-16A.)

In each of the 31 transactions, LSVL purchased PCCM from customer CYC at the inside bid, charged a markdown of approximately 5 percent, and sold the stock to another customer at the inside offer.[29] Lee caused all of the trades to be executed. LSVL retained the spread as compensation for each trade, resulting in markups ranging from 12.9 to 54.55 percent. According to Respondents, LSVL was entitled to the spread due to the amount of effort

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[27] The Panel believes Lee was referring to LSVL's "approved product list" or APL and notes that contrary to Lee's testimony, there is no evidence that the firm conducted any due diligence prior to adding PCCM to the list.

[28] In June, LSVL had approximately 82% of the total trading volume with 105,800 shares; in July, the firm had approximately 80% of total trading volume with 65,800 shares; in August, LSVL had approximately 90% of the total trading volume with 95,800 shares. (CX-16A.)

[29] Trading in PCCM immediately prior to LSVL's first cross trade on June 6 was not always effected at the inside. On June 3, the inside quote was .75-.97 when NITE bought 2,500 shares of PCCM at .8 and sold 2,500 shares at .82. The inside moved to .75-.85, at which point NITE bought 500 shares at .75. The inside quote was .60-.85 when LSVL effected the first cross trade in PCCM on June 6 at .60 and .75. Once LSVL began trading PCCM at the inside with great frequency, the rest of the market soon followed and effected trades at or about the inside.

expended in effecting the PCCM transactions, but they failed to offer documentation to support their claim.[30] The firm also failed to disclose its compensation on customer confirmations. (Tr. III at 320-321, 446-449; CX-16A; CX-17 at 31-61.)

G. Discussion

The Hearing Panel considered whether Respondents: (1) violated Article IV, Section 1 and Article V, Section 1 of NASD's By-Laws, NASD Membership and Registration Rule 1021 and NASD Conduct Rule 211, by permitting MG, who they knew or should have known was subject to a statutory disqualification, to act as an unregistered principal of LSVL from approximately February 2000 to at least May 2003, and by failing to disclose his direct or indirect ownership and/or control of LSVL on the firm's Form BD during the same period, and (2) violated Section 10(b) of the Exchange Act and Rules 10b-5 and 10b-10(a)(2)(ii)(A) thereunder, and NASD Conduct Rules 2110, 2120, 2230, 2440 and IM-2440, from in or about June 2002 through August 2002, by causing LSVL to charge customers who purchased Pacific CMA, Inc. (PCCM), a security traded on the OTC Bulletin Board, prices that were not fair and reasonable under the relevant circumstances, charging markups in excess of 10% in 31 transactions, which LSVL, acting through Respondents, failed to disclose on customer confirmations.

1. Registration violations

NASD Membership and Registration Rule 1021(a) requires that "all persons engaged … in the investment banking or securities business of a member who are to function as principals shall be registered with NASD…." Principals are defined in Rule 1021(b) as "[p]ersons

[30] In a letter to the SEC requesting no-action relief, Gordon asserted that LSVL was entitled to the spread in riskless principal cross trades, because independent market makers determined the inside quote. Gordon did not suggest that the firm's compensation was justified by extraordinary efforts to effect the trades. The SEC denied LSVL's request, because it does not grant such relief retroactively. (CX-14 at 1-3.)

associated with a member … 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…."[31]

A person engaged in the investment banking or securities business while directly or indirectly controlling the firm, or who holds a status similar to a sole proprietor, partner, officer or director of the firm is an "associated person."[32] Being "actively engaged" in managing a firm means "day-to-day conduct of the member's securities business and the implementation of corporate policies related to such business."[33]

MG directly or indirectly controlled LSVL and was actively engaged in managing the firm by virtue of his financial stake in the holding company, as well as his involvement in, and supervision of, the day-to-day management of LSVL's securities business. MG arranged for the purchase of the firm from Lauren Capital, recruited Chicola and other brokers to generate income for the firm, and was involved in daily operations and management of the firm. MG also hired and fired LSVL registered representatives and administrative staff, interacted with customers of LSVL's online trading division, established policies and procedures at LSVL, and conducted business deals on behalf of the firm. By engaging in these activities, MG fell within the definition of a principal and was thus obligated to register as a representative and principal of LSVL.[34]

As president of LSVL, Lee was responsible for ensuring that the firm complied with all applicable securities rules and regulations, unless and until he reasonably delegated a particular

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[31] *See also Dep't of Enforcement v. Kerr*, No. C02980051, 1999 NASD Discip. LEXIS 35, at *5 (NAC Dec. 17, 1999), *aff'd*, 2000 SEC LEXIS 2132 (Oct. 5, 2000).

[32] NASD By-Laws Article I (dd).

[33] NASD Notice to Members 99-49 (June 1999).

[34] *Cf. Kerr*, 1999 NASD Discip. LEXIS at 35.

function to another person in the firm, and neither knew nor had reason to know that such person was not properly performing his duties.[35] There was no such delegation of authority here. Indeed Lee had day-to-day responsibility for the firm and also served as chief compliance officer.

As CEO, Gordon helped manage the firm and was also responsible for ensuring compliance with all applicable rules.[36] Both Respondents knew of MG's unregistered status and day-to-day involvement with LSVL. They also shared responsibility for running the firm, and according to the firm's procedures, supervised each other. They are thus equally culpable for failing to take reasonable steps to prevent MG from functioning as an unregistered principal of LSVL.

Respondents contend that MG was simply representing the indirect owners of LSVL and thus not acting as a principal of the firm. Their argument is flawed. Had ES and KS been as actively engaged in LSVL's securities business as MG, they would have been required to register as a principal of the firm.[37]

Accordingly, the Hearing Panel concludes that Respondents Lee and Gordon violated NASD Membership and Registration Rule 1021 and NASD Conduct Rule 2110, from approximately February 2000 to May 2003, by allowing MG to act as a principal of LSVL

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[35] *Dep't of Enforcement v. Block*, No. C05990026, 2001 NASD Discip. LEXIS 35, at *25-26 (NAC Aug. 16, 2001) (citations omitted).

[36] *John H. Gutfreund*, Exchange Act Release No. 31,554, 1992 SEC LEXIS 2939, at *44 (Dec. 3, 1992) (CEO who learns of wrongdoing within the firm has ultimate responsibility to ensure steps are taken to prevent further violations).

[37] *See* Notice to Members 99-49.

without the requisite license.[38]

Moreover, Article V, Section 1 of NASD's By-Laws provides that "[n]o member shall permit any person associated with the member to engage in the investment banking or securities business unless the member determines that such person … is not subject to a disqualification…."[39] Because MG had been convicted of a felony within ten years of becoming associated with LSVL, he was subject to a disqualification.[40] Respondents either allowed MG to engage in the firm's business despite their knowledge of his disqualification, or they failed to make the requisite determination that he was not subject to a disqualification. In either case, the Hearing Panel finds that Respondents violated Article V, Section 1 of NASD's By-Laws, as charged in the first cause of the Complaint.

Finally, Article IV, Section 1 of NASD's By-Laws outlines the application for membership process and requires that each applicant and member keep current its membership application by supplementary amendments filed with NASD within 30 days of learning of the facts or circumstances giving rise to the amendment. Form BD, the Uniform Application for Broker-Dealer Registration, requires the applicant or member disclose the names of all direct and indirect owners of the firm, as well as any person who directly or indirectly controls the

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[38] A violation of a Registration Rule is also a violation of Conduct Rule 2110. *William S. Mentis*, Exchange Act Release No. 37,952, 1996 SEC LEXIS 3192, at *5 (Nov. 15, 1996). Furthermore, IM-1000-3 provides that a member's failure to register an employee as a representative may be deemed a violation of Rule 2110. Though no comparable provision exists regarding the failure to register an individual as a principal, the Panel concludes that Respondents' failure to register MG for more than three years constitutes conduct inconsistent with just and equitable principles of trade, and is thus a violation of Rule 2110. *Cf. Fox & Co. Investments, Inc.*, Exchange Act Release 52,697, 2005 SEC LEXIS 2822, at *28-29 (Oct. 28, 2005) (affirming NASD's finding that president who permitted firm to operate with insufficient net capital violated Rule 2110).

[39] General Provision 115 states that NASD rules shall apply to all members, as well as to "persons associated with a member."

[40] NASD By-Laws Article III, Section 4(g).

management of policies of the applicant or member through agreement or otherwise, or who wholly or partially finances the applicant's or member's business.

The Panel believes Respondents allowed ES and KS to masquerade or "front" as owners of the firm due to MG's statutory disqualification. Even if Respondents thought that ES and KS were the true owners of the firm, however, they knew that MG directly or indirectly controlled the management of policies at LSVL. Nevertheless each Respondent failed to disclose MG's involvement with LSVL on the firm's Form BD amendments. Accordingly, the Hearing Panel concludes that Respondents also violated Article IV, Section I of NASD's By-Laws and Conduct Rule 2110, as charged in the first cause of the Complaint.[41]

2. Excessive and undisclosed markups

A member firm is obligated to deal with its customers honestly and must "buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that [the firm] is entitled to a profit."[42] Markups of more than 5 percent above the prevailing market price are generally considered excessive and violative of NASD Conduct Rules 2440 and 2110, though a markup of five percent or less may be unfair or unreasonable in certain situations.[43] Five percent is thus a guideline, not a rule, but a firm must nevertheless be "fully prepared to justify its reasons for the higher markup or markdown with adequate

[41] Pursuant to IM-1000-1, the filing of incomplete or inaccurate information with respect to membership that tends to mislead NASD, or the failure to correct such filing, may constitute a violation of Rule 2110. The Panel finds that Respondents' failure to disclose to NASD MG's involvement in owning, financing and/or managing LSVL for more than three years was conduct inconsistent with just and equitable principles of trade, and thus a violation of Rule 2110.

[42] NASD Conduct Rule 2440.

[43] IM-2440.

documentation."[44] Furthermore, undisclosed markups in excess of 10 percent of the prevailing market price are generally considered fraudulent under federal securities laws.[45]

The key issue in determining whether a markup is excessive is establishing the prevailing market price, the price at which dealers trade with one another.[46] When a dealer is not a market maker in a security, it must base its markups on the prices it pays in contemporaneous transactions to purchase the security, unless there is countervailing evidence of the prevailing market price.[47] In other words, a dealer's "contemporaneous cost" is the best evidence of the current market.[48]

Respondents acknowledge that LSVL was not a market maker in PCCM or any other security. It is undisputed that the transactions at issue were riskless principal cross trades, where LSVL purchased stock in several transactions from a single customer, then sold it to several other customers. LSVL priced these transactions based on the inside bid and offer and kept the spread as compensation, without disclosing the markup to the customer.

Respondents argue that LSVL was entitled to the spread as compensation, because independent market makers determined the quotations, and the cross trades involved extensive work. Respondents submitted no corroborating evidence regarding the expense or effort involved in these trades, however, nor any documentation to justify markups charged in this

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[44] *SEC v. Feminella*, 947 F. Supp. 722, 729 (S.D.N.Y. 1996).

[45] *See, e.g.*, *D.E. Wine Investments, Inc.*, Exchange Act Release No. 43,929, 2001 SEC LEXIS 222 (Feb. 6, 2001); *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1469 (2d Cir. 1996); *Alstead, Dempsey & Co., Inc.*, Exchange Act Release No. 20,825, 1984 SEC LEXIS 1847, at *2 (Apr. 5, 1984) (noting that since 1939, the SEC has found that excessive markup violates antifraud provisions).

[46] *Alstead*, 1984 SEC LEXIS 1847, at *3.

[47] *D.E. Wine Investments*, 2001 SEC LEXIS 222, at *11 (citation omitted).

[48] *Dist. Bus. Conduct Comm. v. Escalator Securities, Inc.*, No. C07950049, 1997 NASD Discip. LEXIS 78 (NBCC Dec. 31, 1997); *Alstead*, 1984 SEC LEXIS 1847, at *3 (citations omitted).

case. In fact, Lee admitted that LSVL did not consider the transactions individually but simply adopted a policy to take the spread as compensation in all riskless principal cross trades.

Respondents' argument is flawed, because LSVL was not permitted to rely on the inside quote as the prevailing market price for PCCM. Quotations often have little value in establishing the current market for thinly traded stocks, which frequently have wide spreads and may be subject to negotiation.[49] Furthermore, as a non-market maker, LSVL was not entitled to the spread on these transactions.[50] Finally, Respondents presented little countervailing evidence that contemporaneous cost is not the correct basis for its markups.

Applying these principles, the Hearing Panel finds that Enforcement correctly calculated the prevailing market price for 31 PCCM transactions using LSVL's cost, namely the amount paid to purchase the stock from the selling customer.[51]

Lee executed all PCCM transactions using the inside quote, and along with Gordon, established and implemented this pricing procedure for all of LSVL's riskless principal cross trades. Gordon also established the account to facilitate cross trading and misinformed LSVL's clearing firm about having obtained NASD approval for the account.

Furthermore, the firm's compensation was not disclosed on customer confirmations. Despite Gordon's assurances to the clearing firm that markups on riskless principal cross trades

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[49] *See Alstead*, 1984 SEC LEXIS 1847, at *6.

[50] The spread is designed to compensate a market maker for its risk involved in maintaining an active, competitive market. *See NASD Notice to Members* 92-16 (Apr. 1992). LSVL was not a market maker, and there was no risk involved in these riskless principal cross trades. Had a market maker been responsible for 80% of the trading in a security, as LSVL was here, the firm's trading would have dominated the market and controlled pricing, in which case, the firm would not have been entitled to take the spread. Rather, the firm would be entitled to a reasonable markup above its cost, absent countervailing evidence that cost was not the best indication of the prevailing market price. *Id.*

[51] Though Enforcement did not include the firm's commission or markdown when calculating markups based on LSVL's contemporaneous cost to purchase PCCM from the selling customer, this omission inures to Respondents' benefit. Had Enforcement subtracted the commission or markdown, the markup for the corresponding transaction would have been even higher. *See* Exhibit A.

would be disclosed, he and Lee, as principals of the firm, failed to ensure that such disclosures were made on customer confirmations, as required by NASD Conduct Rule 2230 and Section 10(b) of the Exchange Act and Rule 10b-10(a)(2)(ii)(A) thereunder.[52]

Based on all the relevant circumstances, the Hearing Panel concludes that in 31 riskless principal transactions in PCCM, LSVL, acting through Lee and Gordon, charged a total of $22,657.40 of markups in excess of 10 percent, which were excessive and unfair.[53] The Panel also finds that the markups violated anti-fraud provisions, because they were undisclosed and exceeded 10 percent, an amount that is generally considered fraudulent. In fact, in most instances, the markups exceeded 15 percent. Moreover, LSVL, through Lee and Gordon, acted with scienter, because they knowingly or recklessly disregarded the firm's obligation to price securities fairly by implementing a policy whereby the firm retains the spread as compensation for all riskless principal cross trades, without regard to any relevant factors, such as market conditions.

Accordingly, the Hearing Panel finds that Respondents violated NASD Conduct Rules 2110, 2440 and IM-2440, as well as Section 10(b) of the Exchange Act and Rules 10b-5 and

[52] Rule 2230 requires that firms provide customers with written confirmations disclosing, among other things, the amount of the firm's commission or other remuneration for the transaction. Rule 10b-10(a)(2)(ii)(A) requires a broker to disclose on a written confirmation the difference between the customer's and dealer's price for an equity security in a riskless principal transaction by a non-market maker.

[53] *See* Exhibit A. Enforcement does not explain why it used 10 percent rather than 5 percent in calculating the amount of excessive markups charged customers who bought PCCM. The Panel finds that a 10 percent markup was more than sufficient compensation for LSVL, even in light of any added expenses incurred in arranging these atypical transactions. Moreover, in computing the dollar amount of excess markups, and therefore, the amount of restitution due customers, Enforcement used the greater of 10 percent or $200, presumably for the same reason, i.e., to afford LSVL more than ample compensation for these riskless principal trades.

10b-10(a)(2)(ii)(A) thereunder and NASD Conduct Rules 2120 and 2230, as charged in the second cause of the Complaint.[54]

III. Sanctions

For the registration violations, Enforcement recommends that each Respondent be barred from association with any member firm in any capacity. For fraudulent markups, Enforcement recommends a one-year suspension for each Respondent, a joint and several fine of $50,000, and that Respondents be ordered to pay restitution of $22,657.40.

In determining appropriate sanctions, the Hearing Panel considered NASD's Sanction Guidelines for each violation, as well as the Guidelines' General Principles Applicable to All Sanction Determinations and Principal Considerations in Determining Sanctions.[55]

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[54] 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 Comm. v. Shaughnessy*, No. CMS950087, 1997 NASD Discip. LEXIS 46, at *24 (NBCC June 5, 1997).

[55] *NASD Sanction Guidelines* (2005 ed.) at 2-7.

A. Registration Violations[56]

Enforcement asserts that this is an egregious case, and the Hearing Panel concurs. For more than three years, Respondents permitted MG to perform duties at LSVL that required registration as a general securities principal, then misrepresented the truth. Their testimony regarding the limited nature of MG's involvement at the firm was consistently impeached by emails they received from MG on a regular basis. Contrary to Respondents' assertion that MG merely voiced his opinion on certain matters as representative of the firm's indirect owner, the record shows that MG was essentially in charge at LSVL.

Furthermore, Respondents knew that MG was involved in virtually every aspect of the firm's securities business for more than three years, and most likely, owned the firm. Yet Respondents did not insist that MG obtain a license.

Respondents' misconduct is compounded by the fact that MG was unable to obtain a license due to his felony conviction for money laundering, which subjected him to a statutory disqualification. Respondents either knew or should have been known of the disqualification. Their misconduct, by failing to conduct the requisite investigation of MG's background that would have exposed his disqualification or by associating with MG in spite of his disqualification, is a separate violation as well as an aggravating factor.

[56] For these violations, the Panel consulted the following Guidelines: Registration Violations, which recommend a fine of $2,500 to $50,000 plus the amount of a respondent's financial benefit and a suspension up to six months, with a lengthier suspension or bar for egregious cases; Filing of False, Misleading, or Inaccurate Forms or Amendments, which call for a fine of $5,000 to $100,000 and a supervisory suspension of 10 to 30 business days, with a lengthier suspension in all capacities or a bar in egregious cases, such as those involving false, inaccurate or misleading filings; and Disqualified Persons – Failure to Discharge Supervisory Obligations, which suggest a fine of $10,000 to $100,000 and a suspension up to a year, with a lengthier suspension or a bar if the disqualified person is involved in egregious misconduct about which the supervisor knew or should have known. *Guidelines* (2005 ed.) at 48, 74, 104.

Finally, Respondents took pains to conceal MG's association with the firm by instructing employees to hide any evidence of his involvement with LSVL prior to NASD's onsite examination. Respondents also failed to disclose MG's affiliation with LSVL as an owner or control person in any Form BD filings, which is yet another violation, as well as another aggravating factor.

The requirement that a principal be properly registered is vital to the policing of securities markets and ensures that "a person in a position to exercise some degree of control over a firm has a comprehensive knowledge of the securities industry and its related rules and regulations."[57] This requirement enhances investor protection, as do the obligations imposed on members to determine whether an associated person is subject to a statutory disqualification and to disclose to NASD the names of direct and indirect owners or other control persons of a firm.

Respondents' violations arise from a common cause -- their decision to allow an unregistered individual, who they knew or should have known was subject to a statutory disqualification, to finance and manage LSVL for more than three years, while concealing from NASD his involvement with the firm. Respondents' offenses, including their untruthful testimony at the hearing, demonstrate a blatant disregard of NASD Rules and an utter lack of integrity. The Panel concludes that any association by Lee or Gordon with a member firm would create an unacceptable risk of future violations of the securities laws and NASD Rules. Though Respondents' egregious misconduct justifies a separate bar for each violation, the Hearing Panel finds it appropriate to aggregate the misconduct for purposes of imposing sanctions.[58]

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[57] *Dist. Bus. Conduct Comm. v. Pecaro*, No. C8A960029, 1998 NASD Discip. LEXIS 13, at *22 (NBCC Jan. 7, 1998).

[58] *See Dep't of Enforcement v. J. Alexander Securities, Inc*., No. CAF010021, 2004 NASD Discip. LEXIS 16, at *69 (NAC Aug. 16, 2004).

Accordingly, Respondents Lee and Gordon are barred from association with any member firm in any capacity for the registration and related violations, as charged in the first cause of the Complaint.

B. Undisclosed and Excessive Markups

The Sanction Guidelines for Excessive Markups recommend a fine of $5,000 to $100,000, restitution, and a suspension for up to 30 business days. In egregious cases, a suspension for up to two years or a bar is suggested. Enforcement contends this is an egregious case and recommends a one-year suspension for each Respondent, a fine of $50,000 and restitution of $22,657.40 to the firm's customers.

Respondents established a riskless principal cross trading account to allow LSVL to act as a market maker, which it was not, and to retain the spread as compensation, which it was not entitled to do. By implementing this policy, Respondents intentionally or recklessly disregarded their obligation to price securities fairly and charged markups ranging from 12.9 to 54.55 percent in 31 transactions in PCCM during a three-month period. Respondents asserted that the high markups were justified by the substantial effort devoted to effecting these transactions but failed to produce any documentation to support this claim. Finally, Respondents failed to ensure the firm's compensation was disclosed on customer confirmations.

While the Panel concurs that Respondents engaged in serious misconduct for which substantial sanctions would be justified, in light of the bars, a suspension and fine would be redundant and would serve no remedial purpose.[59] However, the Panel orders Respondents, jointly and severally, to pay restitution to the firm's customers identified in Exhibits A and B, in

[59] *See, e.g.*, *Dep't of Enforcement v. Castle Securities Corp.*, No. C3A010036, 2004 NASD Discip. LEXIS 1, at *36–37 (NAC Feb. 19, 2004); *Dep't of Enforcement v. Hodde*, No. C10010005, 2002 NASD Discip. LEXIS 4, at *17 (NAC Mar. 27, 2002).

the total amount of $22,657.40, plus prejudgment interest calculated pursuant to Section 6621 of the Internal Revenue Code, 26 U.S.C. 6621(a)(2). Each customer shall be repaid the amount shown in the column labeled "Am[oun]t. in Excess 10%."[60]

IV. Conclusion

Respondents Lee and Gordon are barred from association with any member firm in any capacity for permitting MG, an unregistered individual, who they knew or should have known was subject to a statutory disqualification, to act as principal of LSVL, a member firm, for more than three years, and for failing to disclose to NASD MG's ownership or control of the firm during the same period, in violation of Article IV, Section I and Article V, Section 1 of NASD's By-Laws, NASD Membership and Registration Rule 1021 and NASD Conduct Rule 2110.

In light of the bars, no suspension or fine is imposed for causing LSVL to charge markups in excess of 10 percent in 31 transactions in PCCM from June 2002 through August 2002, which were not fair and reasonable under the relevant circumstances, nor disclosed on customer confirmations, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rules 10b-5 and 10b-10(a)(2)(ii)(A) thereunder and NASD Conduct Rules 2110, 2120, 2230, 2440 and IM-2440. For these violations, Respondents are ordered, jointly and severally, to pay restitution to the firm's customers identified in Exhibits A and B in the amount of $22,657.40, plus prejudgment interest calculated pursuant to Section 6621 of the Internal Revenue Code, 26 U.S.C. 6621(a)(2).[61]

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[60] Exhibit A, which is attached to the Decision, lists customers entitled to restitution by their LSVL account number, and in all but one instance, by initials. Exhibit B, which will only be provided to the parties and to NASD's Finance Department, identifies each customer by name.

[61] 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.

In addition, Respondents shall pay costs in the amount of $2,779, which includes an administrative fee of $750 and hearing transcript costs of $2,029.

The bars shall become effective immediately, should this Decision become NASD's final disciplinary action in this matter. All other sanctions shall become effective on a date set by NASD, but not earlier than 30 days after this Decision becomes the final disciplinary action of NASD.

SO ORDERED.

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Dana R. Pisanelli
Hearing Officer
For the Hearing Panel

Dated: December 29, 2005
Washington, DC

Copies to: Sterling S. Lee (*via overnight and first class mail*)
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