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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	Disciplinary Proceeding No. 2005001514501
Complainant,	:	**HEARING PANEL DECISION**
v.	:	
	:	Hearing Officer - SW
	:	Dated: February 28, 2007
Respondent.	:	

Respondent violated NASD Conduct Rule 3030 by failing to disclose to his employer that he participated in an outside business activity in violation of NASD Conduct Rules 3030 and 2110. The Hearing Panel imposed a $7,500 fine on Respondent for the violation.

Appearances

Joel R. Beck, Esq., Regional Counsel, Atlanta, GA, and Nancy B. Goldstein, Esq., Senior Regional Attorney, Boca Raton, FL, for the Department of Enforcement.[1]

S. M. Chris Franzblau, Esq., Livingston, NJ, for Respondent.

DECISION

I. Introduction

On August 28, 2006, the Department of Enforcement ("Enforcement") filed a one-count Complaint against Respondent. The one-count Complaint alleges that Respondent failed to disclose to his employer, Citigroup Global Markets, Inc., f/k/a Solomon Smith Barney, Inc.

[1] Andrew A. Favret, Esq., Regional Chief Counsel, Department of Enforcement, New Orleans, LA, also attended the Hearing.

("Citigroup"), that he had participated in an outside business activity at _____, LLC (the "Company"), in violation of NASD Conduct Rules 3030 and 2110.

Respondent answered that his participation in the Company did not constitute an outside business activity but rather was a passive investment, which he disclosed to his employer.

The Hearing Panel, consisting of two current members of the District 7 Committee and a Hearing Officer, conducted a Hearing in Miami, Florida, on December 13 and 14, 2006.[2]

II. NASD Conduct Rule 3030 Violation Proven

A. Background

Respondent entered the securities industry in 1968. (Tr. p. 300; Stip. at ¶ 1). From May 1989 to May 2005, Respondent was registered as a general securities principal and general securities representative with NASD member Citigroup. (CX-8, pp. 3-4; Stip. at ¶ 2). Since June 9, 2005, Respondent has been registered with Morgan Keegan & Company, Inc. (CX-8, p. 2).

The major facts are not in dispute. In June 2003, Respondent attended a golf outing and lunch with a real estate developer, SM, and six other friends, who were clients of Citigroup. (Tr. p. 313). During the outing, Respondent and his six friends agreed to loan funds to a company owned by SM and his partner ("Borrower") to purchase and develop property in Malden, Massachusetts. (CX-2, p. 2; Tr. pp. 313, 316). The loan was collateralized by the Malden property. (CX-2, p. 2). Respondent had successfully invested in prior real estate projects with SM. (Tr. pp. 343-344, 351).

[2] Hereinafter, "Tr." refers to the transcript of the Hearing held on December 13 and 14, 2006; "CX" refers to Enforcement's exhibits; "RX" refers to Respondent's exhibits; and "Stip." refers to the Stipulations of Fact and Authenticity of Documents filed by the Parties on December 7, 2006.

At the June 2003 meeting, the potential investors agreed that an entity should be created to hold the mortgage on the Malden property to provide the investors with some liability protection. (Tr. pp. 315-316). The potential investors also agreed that Respondent would take the necessary steps to create the entity and operate the entity. (Tr. pp. 316, 352-353). Respondent and the six other potential investors viewed the loan as a passive investment and had no intention or desire to participate in the development of the Malden property. (Tr. pp. 313-314).

Respondent was subsequently contacted by Borrower's counsel, who provided the necessary documents to form the Company, a Florida limited liability company, on behalf of the investors. (Tr. p. 318). Borrower's counsel electronically filed the Company's Articles of Organization with the State of Florida on July 3, 2003, listing Respondent as the manager and listing the address of Respondent's employer as the mailing address of the limited liability company.[3] (CX-1; Stip. at ¶¶ 4, 5, 6). Respondent and the six other investors executed an operating agreement and became members of the Company. (Tr. p. 320; Stip. at ¶ 7).

Borrower's counsel also prepared the necessary documents for Respondent to (i) open a bank account for the Company, (ii) be the sole signatory on the account, and (iii) disburse to the investors the interest payments to be received from Borrower. (Tr. pp. 319-321). Ultimately, Respondent and the six other investors funded the Company with $1.35 million in total. (CX-3, p. 2; CX-4, p 1; Stip. at ¶ 7). On July 23, 2003, Respondent instructed the Company's bank to wire $1.35 million to Borrower, in exchange for a one-year 12½% fixed rate promissory note

[3] Borrower's counsel filed the Company's Articles of Organization without Respondent's prior review. (Tr. p. 318).

executed by Borrower. (CX-2; CX-3, p. 2). Respondent personally invested $200,000 of the $1.35 million total. (Tr. p. 347; CX-4, p. 1).

During the term of the promissory note, Borrower paid the Company interest at the rate of 12½%. (CX-2). Consistent with Respondent's suggestion and the investors' agreement at the June 2003 meeting that 2½% of the interest payments would be held back to pay any required expenses, Respondent disbursed interest payments to the investors at the rate of 10% during the term of the promissory note. (Tr. pp. 337-338, 360). The Company was dissolved in October 2004, and the investors received both their 10% interest payments and the 2½% holdback minus certain expenses. (Tr. p. 341; CX-1, p. 3).

Although Respondent had undertaken essential responsibilities and services for the Company, he received no salary or other benefits for his services, only the payments that were due to him as a member of the Company. (Tr. pp. 251, 335; Stip. at ¶ 9).

In July 2003, Respondent advised his branch manager at Citigroup of his intention to invest in the Company. (Tr. p. 49). Respondent completed an Outside Investments Form for the Company, dated July 7, 2003, which was dated by his branch chief as recommended for approval on July 8, 2003.[4] (Tr. p. 332; CX-7; Stip. at ¶ 10). The Outside Investments Form indicated Respondent intended to invest $200,000 in the Company's private placement. (CX-7). In addition, Respondent had Borrower forward to Citigroup's compliance department a hold harmless letter, dated July 23, 2003, acknowledging that Respondent's investment in the Malden

[4] During the period, Respondent had a number of outside investments and typically completed outside investments forms. (Tr. p. 301; RX-14-2; RX-15; RX-16; RX-17; RX-24-1; RX-25-2; RX-27-1; RX-28-2; RX-29-2).

property was a personal investment, which had no connection with the business activities of Citigroup. (RX-2).

Nevertheless, Respondent admitted that he never advised his Citigroup branch manager of his association with the Company other than as a passive investor in the entity. (Tr. p. 340). Respondent never advised Citigroup that he (i) executed a bank account for the Company, (ii) distributed interest payments to the investors, or (iii) wrote letters to the investors listing himself as manager of the Company. (CX-3, pp. 3-4; Tr. pp. 51, 340). In addition, Respondent never advised Citigroup that he wrote a check to pay the expenses of the Company, specifically to the Company's accountant who prepared the tax return and K-1 for the Company. (Tr. pp. 341-342). To the contrary, Respondent checked "yes" to the question on the Outside Investments Form, "Is your participation exclusively as a passive investor?" (emphasis added). (CX-7).

B. Respondent Engaged in an Outside Business Activity within the Meaning of NASD Conduct Rule 3030

The Complaint alleges that Respondent violated NASD Conduct Rule 3030. In 1988, when the NASD Board of Governors proposed Article III, Section 43 of the NASD Rules of Fair Practice, now Conduct Rule 3030, the Board concluded that "it would be appropriate for member firms to receive prompt notification of all outside business activities of their associated persons so that the member's objections, if any, to such activities could be raised at a meaningful time and so that appropriate supervision could be exercised as necessary under applicable law."[5]

[5] Proposed Rule Change by NASD Relating to Outside Business Activities of Associated Persons, Exchange Act Release No. 26,063, 1988 SEC LEXIS 1841 (Sept. 6, 1988); NASD Notice to Members 88–86, 1988 NASD LEXIS 207 (Nov. 1988).

NASD Conduct Rule 3030 provides in part that "[n]o person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member. Such notice shall be in the form required by the member."

Accordingly, NASD Conduct Rule 3030 provides for notice if the representative is an employee of another entity outside the scope of his relationship with his employer, or, if the representative accepts compensation from any other person as a result of any business activity, other than a passive investment.

Enforcement alleges that Respondent was an employee of the Company and failed to provide notice of that affiliation to Citigroup. Respondent argues that he was not an employee of the Company because he was not paid by anyone for his services to the Company and that such services were inconsequential, ministerial services. In addition, Respondent argues that because his investment in the Company was a passive investment, he was not required to provide notice to Citigroup.

There is no dispute that Respondent's activities at the Company were outside the scope of Respondent's relationship with Citigroup.

The Hearing Panel noted that Respondent: (i) was listed on the organizing documents of the Company as the manager; (ii) was the sole signatory on the Company's bank account; and (iii) disbursed funds to the other investors under a letter identifying himself as the manager of the Company. There was no one else authorized, and no one else undertook, to act on behalf of the Company. In fact, Respondent admitted that, from the beginning, he and other investors agreed

that Respondent would not only invest in the Company but would take the active role in the operation of the Company as well. (Tr. p. 316).

Accordingly, the Hearing Panel finds that the services that Respondent provided to the Company were not merely ministerial but were essential, and that Respondent was in fact an employee of the Company. The Hearing Panel specifically finds that Respondent's lack of compensation for his services, separate and apart from the interest payments that he received, does not preclude a finding of employment.[6] Conduct Rule 3030 attaches potential liability to a respondent regardless of whether he received compensation for an outside business activity.[7]

In addition, the Hearing Panel finds that Respondent's investment in the Company was not a passive investment because Respondent provided services to the Company that were material to its business activity. In discussing the passive investment exception, the Securities and Exchange Commission has specifically stated, "we did not intend for the 'passive investment' exception to include activities in which the associated person materially participates. To permit a passive investment exemption for a registered representative's material participation would frustrate the stated purpose of the rule."[8]

The purpose of Conduct Rule 3030 is to give the firm a meaningful opportunity to review the representative's activity and determine the extent to which it should supervise a representative's involvement. Regardless of whether Respondent's branch manager knew that Respondent had invested $200,000 in the Company, the knowledge of the investment does not

[6] Dep't of Enforcement v. Andrew P. Schneider, Complaint No. C10030088, 2005, NASD Discip. LEXIS 6, *15 (NAC, Dec. 7, 2005).

[7] Id.

[8] Joseph Abbondante, Exchange Act Rel. No. 34-35066, 2006 SEC LEXIS 23, *46 (Jan. 6, 2006).

satisfy the requirement of Rule 3030 that the firm receive prompt written notice of employment involving non-passive investments.

Accordingly, considering all of the evidence, the Hearing Panel finds that Respondent's services to the Company constituted an outside business activity, and that Respondent failed to provide the requisite notice to Citigroup, in violation of NASD Conduct Rules 3030 and 2110, as alleged in the sole count of the Complaint.

III. Sanction

For violations of Conduct Rules 2110 and 3030 that do not involve aggravating circumstances, the NASD Sanction Guidelines recommend a fine of $2,500 to $50,000, and a suspension of up to 30 business days. When the outside business activities involve aggravating conduct, the Guidelines provide for a longer suspension of up to one year.[9]

Citing what it considers aggravating circumstances, i.e., (i) the amount of the loan, (ii) the duration of the outside activity, and (iii) the misleading information on the Outside Investments Form, Enforcement requested a three month suspension and a $10,000 fine for Respondent.

The Hearing Panel begins its analysis of the appropriate sanction with the Principal Considerations listed in the applicable Sanction Guidelines: (i) whether the outside activity involved customers of the firm; (ii) whether outside activity resulted directly or indirectly in injury to customers of the firm and, if so, the nature and extent of the injury; (iii) the duration of the outside activity, the number of customers, and the dollar volume of sales; (iv) whether the respondent's marketing and sale of the product or service could have created the impression that

[9] NASD Sanction Guidelines, p. 14 (2006).

the employer (member firm) had approved the product or service; and (v) whether the respondent misled his or her employer member firm about the existence of the outside activity or otherwise concealed the activity from the firm.[10]

In this case, although the friends who participated in the Malden loan through the Company were Citigroup customers, the Citigroup relationship had nothing to do with Respondent's agreement to operate the Company or the decision of the friends to participate in the loan. Second, there was no evidence of injury to any of the investors. In fact, the investors received a 12½% return on their investment in 2003, and two investors explicitly expressed satisfaction with the Company investment. (RX-9; RX-10). Third, the activity involved (i) six personal friends who happened to be Citigroup customers, (ii) a single loan, albeit for $1.35 million, and (iii) took a total of approximately 1½ hours of Respondent's time over the year and a half term of the loan. (Tr. pp. 340, 347). Fourth, there was no evidence that Respondent in any manner created the impression that Citigroup approved the business transaction. Respondent credibly testified, and a number of the investors corroborated, that the loan was an informal arrangement among friends. (RX-9; RX-10).

Finally, contrary to Enforcement's implication that Respondent deliberately failed to disclose his Company activities to his employer, the Hearing Panel finds that Respondent was not trying to hide his involvement with the Company because he discussed the company, albeit not in sufficient detail, with his branch manager. Believing that the most important attribute was his $200,000 investment through the Company in the loan collateralized by the Malden property, knowing that the investment in the Malden property was passive, and neglecting to consider the

[10] Id.

importance of his role in the operation of the Company, Respondent submitted an Outside Investments Form that was because it described his activity at the Company as passive. The Hearing Panel finds that Respondent did not attempt to deceive Citigroup about the nature of his involvement with the Company, but that his failure to do so was simply an oversight.

Taking these factors into account, the Hearing Panel concludes that the appropriate remedial sanction for Respondent's conduct is a $7,500 fine. The Hearing Panel finds that imposing a suspension in addition to the fine would be punitive rather than remedial.[11]

IV. Conclusion

Therefore, having considered all of the evidence, Respondent is fined $7,500. Additionally, Respondent shall pay costs in the amount of $3,184.90, which includes an administrative fee of $750 and transcript costs of $2,434.90. The fine and the costs shall become payable on a date set by NASD, but not less than 30 days after this Decision becomes the final disciplinary action in this matter.[12]

HEARING PANEL.

_____

By: Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
February 28, 2007

[11] The Hearing Panel notes that this sanction is consistent with the previously cited Schneider case, in which the NAC fined a respondent $5,000 and suspended him for 60 days for engaging in an outside business arrangement. In Schneider, unlike Respondent in this case, the NAC noted that the respondent (i) deliberately directed business away from his employer, (ii) created the impression that his employer approved the business, and (iii) intentionally attempted to conceal his outside activity from his employer.

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