FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS[1]

DEPARTMENT OF ENFORCEMENT, Complainant, v. MISSION SECURITIES CORPORATION (CRD No. 41779), and CRAIG M. BIDDICK (CRD No. 2382884), Respondents.	Disciplinary Proceeding No. 2006003738501 Hearing Officer—DMF **HEARING PANEL DECISION** December 18, 2008

Summary

Respondent Mission Securities Corporation is expelled from FINRA membership and Respondent Craig M. Biddick is barred from association with any FINRA member in any capacity for converting and misusing customer securities, in violation of NASD Rules 2330 and 2110. In addition, Mission violated Section 15(c) of the Securities Exchange Act of 1934, SEC Exchange Act Rule 15c3-1 and NASD Rule 2110 by conducting a securities business while below its required minimum net capital, and Biddick violated Rule 2110 by causing Mission's violation, but, in light of the expulsion and bar, no sanctions are imposed for these violations. Finally, in light of the expulsion and bar, the Panel declined to determine whether Mission, acting through Biddick, violated California law by failing to inform customers and potential customers that Mission was recording their calls, and thereby violated either NASD Rule 3010(b)(2) or Rule 2110.

Appearances

Cynthia A Kittle, Esq., Los Angeles, CA, for the Department of Enforcement.

John P. Cione, Esq., Solana Beach, CA, for Respondents.

[1] As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD.

DECISION

I. Introduction

On February 4, 2008, the Department of Enforcement filed a Complaint against Respondents Mission Securities Corporation and Craig M. Biddick charging that: (1) Mission and Biddick violated NASD Rules 2330 and 2110 by misusing and converting customers' securities; (2) Mission violated Section 15(c) of the Securities Exchange Act of 1934, SEC Exchange Act Rule 15c3-1 and NASD Rule 2110 by engaging in a securities business while failing to meet its required minimum net capital and Biddick violated Rule 2110 by causing Mission's violation; and (3) Mission and Biddick violated California law by failing to provide notice to customers and potential customers that Mission was recording their telephone calls, and thereby violated NASD Rule 3010(b)(2) or Rule 2110. Respondents contested the charges and requested a hearing, which was held on October 6 and 7, 2008.

II. Respondents

Mission has been a FINRA member since 1998.[2] It is a California corporation with its principal place of business in San Diego. Biddick is registered through Mission as a General Securities Principal, General Securities Representative and Financial and Operations Principal (FINOP). At all times relevant to this proceeding, he was Mission's president, owner, Chief Compliance Officer, Chief Financial Officer, Chief Executive Officer and FINOP. (CX 1-2; Tr. 143, 263-64, 281-83.)[3]

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[2] Following the hearing, Mission submitted a Form BDW to resign from FINRA membership. Pursuant to Article IV, Section 5, of FINRA's By-Laws, a member firm's resignation does not take effect "so long as any complaint or action is pending against the member under the Rules of the Corporation" unless FINRA in its discretion allows the resignation to become effective. But even then, pursuant to Article IV, Section 6 of the By-Laws, Mission would remain subject to FINRA jurisdiction for purposes of this proceeding. Biddick's registrations with Mission were voluntarily terminated after the hearing, but he remains registered with two other FINRA members.

[3] In this Decision, "Tr." citations refer to the transcript of the hearing, "CX" citations refer to Complainant's Exhibits, and "RX" citations refer to Respondents' Exhibits.

From July 1993 until July 2001, Biddick was associated with Centex Securities Incorporated, a firm owned by his brother. Biddick's association with Centex ended when the firm closed and it was expelled from FINRA membership. The customer accounts that are at issue in this proceeding were originally Centex accounts, and were transferred to Mission, which Biddick already owned, after Centex closed. (CX 1-2; Tr. 283, 285.)

III. Conversion and Misuse of Customer Securities

A. Facts

In February 2005, Biddick, on behalf of Mission, sent a request to Mission's then-clearing firm, North American Clearing, Inc., asking North American to "journal all positions and balances" in 18 specifically identified customer accounts "to Mission Securities['] Segregated [Reserve] Account." [4] (CX 11.16A; Tr. 140-41, 283-84.)

Although the request referred to all positions and balances in the identified accounts, Biddick testified that he had previously advised North American—and North American understood—that the request was limited to the accounts' holdings of Chartwell International, Inc. stock. In any event, North American did not transfer any stock from the customers' accounts. Biddick resubmitted the request to North American on April 29 and July 20, 2005, but North American still did not comply. Biddick continued to press the request orally, however, and on September 30, 2005, North American transferred all of the accounts' Chartwell holdings

[4] The description of the account as a "Segregated Reserve Account" has no significance in this context. It was a proprietary account of the firm and was treated by the firm as such. (Tr. 141-43.)

to Mission's Segregated Reserve Account.[5] (CX 11.16, 11.16A, 13, 13A; Tr. 284-85.)

Mission and Biddick did not seek or obtain the customers' authorizations for these transfers, and the only notice to the customers of the transfers was an entry on each customer's account statement for the period ending September 30 indicating that the customer's Chartwell shares had been "delivered" to an unspecified recipient on September 30 and were "worthless." In fact, however, the Chartwell stock was not worthless. Adjusted for a 10 to 1 reverse stock split on June 29, Chartwell traded during June, July, August and September 2005 at prices ranging from a low of $3.00 to a high of $5.00 per share. The last trade prior to the transfer was at $5.00, on September 27, 2005. (CX 11.9, 11.16, 12, 13, 13A, 14, 14A, 14B; Tr. 43-45, 75-76, 90.)

North American transferred a total of 21,061 shares of Chartwell stock from the customers' accounts to Mission's Segregated Reserve Account. Like the customers' account statements, the "Securities Received" portion of Mission's account statement for the period ending September 30, 2005, described the Chartwell stock as "worthless." But, inconsistently, the "Securities Positions" portion of Mission's account statement valued the transferred Chartwell stock at $5.00 per share on the same date, September 30, 2005, for a total value of $105,305. (CX 11.12B, 14, 14A; Tr. 192-99, 286.)

In December 2005, Biddick began selling the customers' Chartwell shares from Mission's account to the market in 500 share blocks. He made sales on December 19, 22, 23, 27 and 28, 2005—a total of 2,500 shares. The sales on December 19, 22 and 23 were at $3.50 per

[5] Mission's request represented that:

> In the future, should the client contact us and request the balances in their account, Mission will immediately comply with their wishes relying on the paper trail we have established. This practice will comply with the SRO rules in place currently. Furthermore, these accounts should be closed as no future business is anticipated.

(CX 11.16A.)

share; the sale on December 27 was at $3.25 per share; and the sale on December 28 was at $3.00 per share. Biddick continued to sell the customers' Chartwell shares from Mission's account in 500 share blocks in January and February 2006, with the last three sales, totaling 1,500 shares, on March 3, 2006. With the exception of one 500 share sale at $2.25 per share, Mission sold the Chartwell stock at prices ranging from $3.00 to $4.00 per share. Altogether, Mission sold 12,500 shares of the customers' Chartwell stock for a total of $38,946.06. Biddick subsequently transferred those funds from Mission's Segregated Reserve Account to its bank account, and used at least a portion of the funds for Mission's general business purposes. Mission did not pay any of the sales proceeds to the customers.[6] (Tr. 149-52, 295-97, 301-02; CX 11.33, 19, 25.)

Mission did return some of the Chartwell stock to a few customers. In October 2005, Mission returned 1,010 shares of Chartwell to the account of a customer who had arranged for his account to be transferred to another broker-dealer. In December 2005, after customer KN complained to the SEC and FINRA about the transfer of his Chartwell stock (noting that although his statement described the stock as worthless there was actually a market in the stock), Mission returned 930 shares to his account. In a disdainful letter to KN dated December 22, 2005, which was copied to the SEC and FINRA, Biddick told KN that his Chartwell stock "has very little or no value" and that he "would like nothing more than to assist you in selling your shares," but "the stock has little or no volume and is difficult at best to sell." These statements were false. In fact, Biddick had sold 500 shares of the customers' Chartwell stock on December 19, 2005 at $3.50 per share; he sold 500 shares on December 22, the day he wrote the letter, and 500 shares the following day at the same price; and he continued to sell Chartwell stock with no

[6] During his testimony, Biddick initially claimed that Mission had Chartwell holdings of its own, in addition to the stock transferred from customer accounts, but that claim was effectively discredited by documentary evidence. Similarly, Biddick testified that the sales proceeds he transferred from the Segregated Reserve Account to the firm's bank account were "still there," but again the documentary evidence belied this claim. (Tr. 296-98, 301-02.)

apparent difficulty and at substantial prices during the rest of December and throughout the following January and February. In January 2006, Mission returned 1,200 shares of Chartwell to one customer who questioned the transfer from his account and 430 to another for unexplained reasons. Finally, Mission returned 517 shares of Chartwell to another customer in 2007. Mission kept the unsold remainder of the customers' Chartwell stock, as well as all the sales proceeds. (CX11.12C, 11.16E, 22, 25; Tr. 43-47, 74-75, 85, 91.)

In preparing for a March 2006 routine FINRA examination of Mission, FINRA examiners discovered that the number of trades in Mission's account during January and February 2006, including the Chartwell sales, had exceeded the annual maximum number of proprietary trades (10) allowed during any one calendar year under Mission's FINRA membership agreement. The examiners told Biddick that Mission could not make any additional proprietary trades during 2006, so Mission stopped selling Chartwell stock from its account. The examiners later discovered that the Chartwell stock had come from customer accounts and began an investigation, which led to the conversion and misuse charges in the Complaint.[7] (Tr. 130-31, 138-40, 153, 299; CX 11.35.)

B. <u>Discussion</u>

Enforcement argues that Respondents' transfer of the customers' Chartwell shares to Mission's account, their subsequent sale of a portion of those shares, and their retention of the proceeds of the sales and the remainder of the stock violated Rule 2330, which prohibits "improper use of a customer's securities or funds." Conversion—"an intentional and

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[7] In preparing for the examination, the examiners noted a substantial increase in the value of Mission's reported assets, which was attributable to the Chartwell stock. When they asked Biddick for an explanation, he first told them that one of the firm's stock holdings had "hit." After the examiners discovered that the stock had come from customer accounts, Biddick told them that the stock had been "journaled from customer accounts for tax purposes," which the examiners understood to mean that the customers had transferred worthless stock in order to claim a tax loss. It was only after they asked to see letters from the customers authorizing the transfers that Biddick admitted he had initiated the transfers without notifying the customers or obtaining their authorizations. (Tr. 130-31, 135-41, 145-47; CX 11.16, 11.35.)

unauthorized taking of and/or exercise of ownership over property by one who neither owns the property nor is entitled to possess it"[8]—is a particularly egregious type of improper use.[9] In this case, it is undisputed that Biddick, on behalf of Mission, caused Chartwell stock to be transferred from customer accounts to Mission's account, sold much of the stock, transferred the proceeds of the sales to Mission's bank account and spent at least a portion of the funds for Mission's business purposes, all without the customers' knowledge or consent. A clearer prima facie case of misuse and conversion is difficult to imagine.

In his testimony, Biddick attempted to defend his actions on several grounds. He argued that the initial transfer of the stock from the customers' accounts to Mission's account was justified because the customers had abandoned their accounts, and, because the Chartwell stock was worthless, Mission was being forced to pay $5 per quarter "safekeeping fees" to North American for every customer account that held Chartwell. According to Biddick, because he was unable to communicate with the customers, he made a "business decision" to transfer the Chartwell stock to Mission's account, so that North American would charge only a single $5 quarterly safekeeping fee, rather than separate fees for each customer account in which Chartwell was held. (Tr. 274-78.)

The evidence, however, does not support Biddick's claims. Although the 18 customer accounts from which the Chartwell stock was transferred were inactive and their holdings, apart from Chartwell, had little value, there is no evidence that they were "abandoned." As the SEC

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[8] FINRA Sanction Guidelines (2007) at 38 n. 2.

[9] See, e.g., Department of Enforcement v. Kendzierski, Complaint No. C9A980021, 1999 NASD Discip. LEXIS 40 (Nov. 12, 1999) (registered representative barred for converting customer funds where he altered the customer's check to substitute his name for his firm's name on the payee line, deposited the check into his personal bank account and used the money to pay personal expenses); Joel Eugene Shaw, 51 S.E.C. 1224 (1994) (registered representative barred for converting customer funds where he deposited customer checks into his personal bank account and failed to return them until after the conversion was discovered); Joseph H. O'Brien II, 51 S.E.C. 1112 (1994) (president of broker-dealer barred for converting customer funds where he withdrew them from a customer's account without authorization and failed to repay them).

has explained, "Before a brokerage account can be considered abandoned or unclaimed, the firm must make a diligent effort to try to locate the account owner." Accounts—Abandoned or Unclaimed, available at http://www.sec.gov/answers/escheat.htm. Respondents failed to prove that they made diligent efforts to locate the customers from whom the Chartwell stock was transferred and were unsuccessful.[10] Further, Biddick returned Chartwell stock to several of the accounts, demonstrating that at least those customers had not abandoned their accounts.

Moreover, even if the accounts had been abandoned, Respondents could not simply confiscate the accounts' Chartwell holdings. Again, the SEC has explained:

> If the firm is unable to [locate the account owner], and the account has remained inactive for the period of time specified by state law, the firm must report the account to the state where the account is held. The state then claims the account through a process called "escheatment," whereby the state becomes the owner of the account.
>
> As part of the escheatment process, the state will hold the account as a bookkeeping entry, against which the former account owner may make a claim. States tend to sell the securities in escheated accounts and treat the proceeds as state funds. When a former account owner makes a valid request, however, the states will normally provide the former owner with cash equaling the value of the account at the time of escheatment. This amount of cash does not include any dividends or interest covering the time after escheatment.

Id. Respondents did not notify the states in which the customers lived that the accounts had been abandoned or turn over the accounts' holdings to the states in accordance with escheat procedures, but rather arranged for the accounts' Chartwell holdings to be transferred to Mission.

Further, the Chartwell stock was not worthless. On the contrary, as noted above, although the stock was not heavily traded, prior to September 30, 2005, when Biddick succeeded in having the stock transferred, Chartwell was quoted and traded at substantial value, as much as $5.00 per share.

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[10] Biddick claimed that he "was unable to get ahold [sic] of these people," but testified that, even as late as 2007, when he sent correspondence to the customers, only one letter was returned as undeliverable. He said Mission had no telephone numbers for the customers, but did not claim to have made any effort to use the customers' names and addresses to obtain telephone numbers for them. (Tr. 270-74.)

Finally, there is little evidence that Mission was forced to pay substantial safekeeping fees for the customers' Chartwell holdings. Although Biddick insisted that the accounts were being assessed such charges, there is no documentary evidence showing that safekeeping fees were imposed in the customer accounts for Chartwell except in June 2005. Further, insofar as safekeeping fees were assessed, many of the customer accounts held cash or other securities that could have been, and in some cases were, used to pay them, but in arranging for the transfer of the customers' Chartwell stock to Mission's own account, Respondents made no effort to distinguish between accounts that had sufficient cash or other assets to pay safekeeping fees and those that did not. Instead, Biddick simply arranged for the transfer of all the Chartwell holdings in all customer accounts to Mission's account. Finally, even as to customer accounts that lacked sufficient assets to pay safekeeping fees, Respondents failed to demonstrate that the customers refused to pay them. On the contrary, when Mission did contact one customer who owed safekeeping fees for several securities in his account, but did not have sufficient cash in the account to pay them, he promptly sent Mission a check to pay the charges. (Tr. 47-48, 68-70, 148, 199-201, 276-77, 287-88, 290-92; CX 11.16N, 13, 13A, 23.)

Nevertheless, Biddick argued that, after transferring the customers' Chartwell stock to its Segregated Reserve Account, Mission was justified in selling the stock and retaining the proceeds to offset safekeeping fees that it was required to pay on behalf of the accounts, and that this was consistent with industry practice. The Panel rejected this contention. Even assuming that Mission was required to pay some safekeeping fees charged to a particular customer account, Respondents did not sell out a portion of that customer account's holdings to offset the fees Mission paid. Instead, Respondents first arranged for the wholesale transfer of the Chartwell stock from all customer accounts, without regard to whether a particular account had sufficient cash or other holdings to pay safekeeping fees, commingled the transferred stock, sold

portions of the commingled stock, and, rather than crediting the customers with the proceeds, treated them as belonging to the firm. This is not industry practice; it is misappropriation and conversion.

In short, Respondents' purported justifications for their actions are both legally and factually without merit. Accordingly, the Panel found that Respondents converted and misappropriated customer securities, as charged, in violation of Rules 2330 and 2110.[11]

C. Sanctions

For conversion, the Sanction Guidelines direct adjudicators to "[b]ar respondent regardless of the amount converted." FINRA Sanction Guidelines (2007) at 38. Conversion of customer securities by a member firm and its president, as in this case, represents a breach of the most fundamental duty of a broker-dealer to its customers, and establishes a danger to the investing public that cannot be countenanced. As the SEC stated in an analogous conversion case, "Such misconduct is extremely serious and patently antithetical to the 'high standards of commercial honor and just and equitable principles of trade' that [FINRA] seeks to promote." Wheaton D. Blanchard, 46 S.E.C. 365, 366 (1976).

Moreover, in this case there are many aggravating factors including: (1) Respondents have accepted no responsibility for their actions; (2) Respondents offered no evidence that they sought or relied on any competent legal advice to support their actions; (3) the initial conversion of the stock from the customers' accounts to Mission's account required persistent demands from Biddick to North American over a period of months, and the sales of the customers' stock from Mission's accounts also took place over a period of months, and were halted only at the direction of FINRA staff; (4) Respondents' actions were intentional; and (5) Respondents' actions resulted

[11] A violation of a specific rule, such as Rule 2330, is also a violation of Rule 2110's general requirement that member firms and associated persons "observe high standards of commercial honor and just and equitable principles of trade."

in substantial gains for the firm at its customers' expense. In addition, the Panel finds highly aggravating Biddick's misrepresentations to customer KN in December 2005 that his Chartwell stock had little or no value and was essentially unmarketable at the same time he was selling Chartwell stock from Mission's account. There are no mitigating facts.

The Panel, therefore, will expel Mission and bar Biddick from being associated with any member firm in any capacity for this violation.

IV. Net Capital Violation

A. Facts

The Complaint also charges that Mission engaged in a securities business when it was below its required net capital. Mission's FINRA membership agreement requires it to maintain minimum net capital of $5,000. (CX 16; Tr. 132.) SEC Exchange Act Rule 15c3-1, however, governs the capital requirements for broker-dealers, and it requires that a "dealer" must maintain minimum net capital of $100,000. A "dealer" is, inter alia, "[a]ny broker or dealer that effects more than 10 transactions in any one calendar year for its own investment account."

As noted above, in December 2005 Mission, through Biddick, began selling Chartwell stock from its Segregated Reserve Account. From January 4, 2006, through February 28, 2006, Mission made more than 10 sales of Chartwell stock from that account. (CX 25; Tr. 156.)

As Mission's FINOP, Biddick prepared Mission's net capital calculation for February 28, 2006. Although Mission had effected more than 10 transactions in its Segregated Reserve Account during 2006 as of that date, he made the calculation as though Mission's required net capital was $5,000, rather than $100,000. By Biddick's calculation, however, Mission had net capital of $176,538.69; if that was correct, it would have met the $100,000 requirement. FINRA staff, however, reviewed Biddick's calculation and found that he had made several errors. Most

of those errors had little or no effect on whether Mission met a $100,000 net capital requirement, but one of the staff's adjustments did. (CX 11.33, 15; Tr. 165-72.)

The staff concluded that in computing Mission's net capital, Biddick improperly valued two stocks held in the firm's Segregated Reserve Account. Biddick valued those stocks at the value stated by Mission's clearing firm in its account statement, and then applied a standard 15% "haircut," reducing the value attributed to the stocks by that percentage for net capital purposes. The staff, however, researched the stocks and found that there was, in fact, "no ready market" for either stock. Therefore, the staff applied a 100% haircut to those holdings, as required by Exchange Act Rule 15c3-1(c)(2)(vii).[12] Applying this haircut, and correcting for Biddick's other, minor errors, the staff calculated Mission's actual net capital on February 28, 2006, as $94,372, which is less than the $100,000 it was required to maintain in light of the number of trades it had effected in its Segregated Reserve Account.[13] (Tr. 165-72; CX 11.33, 15.)

B. <u>Discussion</u>

When the net capital issue was first raised during the staff's examination of Mission in 2006, Biddick did not contest either the staff's recomputation of Mission's net capital or its conclusion that, as a result of the trades in its Segregated Reserve Account, Mission was required to have a minimum of $100,000 net capital. In their Amended Answer to the Complaint, however, and at the hearing, Respondents offered a net capital calculation prepared by a certified public accountant which indicates that Mission had net capital of $143,754 as of February 28, 2006. If this calculation, rather than the staff's, were correct, Mission was in net capital

[12] Rule 15c3-1(c)(2)(vii) requires that in calculating net capital, a broker-dealer's net worth be adjusted by "[d]educting 100 percent of the carrying value in the case of securities … in the proprietary or other account of the broker or dealer for which there is no ready market …."

[13] Mission engaged in a securities business on February 28, 2006, including, at a minimum, two sales of Chartwell stock from Mission's Segregated Reserve Account. (CX 11.33.)

compliance, even if its minimum requirement on that date was $100,000. (Tr. 173-74, 267-68; CX 11.29.)

The Panel concludes, first, that Mission was required to maintain $100,000 net capital as a result of the trading in its Segregated Reserve Account. Rule 15c3-1 is quite clear in that regard. Respondents point to a letter that Biddick, on behalf of Mission, wrote to FINRA District Office staff on April 5, 2006, requesting relief from the $100,000 net capital requirement. In the letter, Mission represented (falsely, with respect to the Chartwell trades that had triggered the issue) that it "does not trade for itself," but rather "sells securities it receives for compensation for consultation and investment banking services." Promising that it would not complete "even one proprietary trade during the remainder of the calendar year," Mission requested relief from the $100,000 net capital requirement "as of the date of the [FINRA] letter granting such relief," expressly acknowledging that even if such relief were granted it would "not [be] retroactive." Respondents contend that they never received any response to this letter; a FINRA examiner, on the other hand, testified that Respondents were advised that they were required to submit such a request for relief to a FINRA office in Washington, DC, rather than the District Office. The issue is immaterial, however, since, by the terms of Respondents' request, even if FINRA had granted the requested relief from the $100,000 net capital requirement, it would not have applied retroactively. (Tr. 182-86, 278-79; CX 21.)

Respondents contend they met the $100,000 requirement, relying on the accountant's calculations, which they argue are more reliable than the staff's. But Respondents did not call the accountant as a witness at the hearing, so it is impossible to determine the basis for his disagreements with the staff's calculations. It is apparent from a comparison of the two calculations, however, that the largest difference is that the staff, for reasons explained in testimony at the hearing and discussed above, applied a 100% haircut to two stocks held in

Mission's Segregated Reserve Account, while the accountant, for unexplained reasons, applied only a 15% haircut. This difference by itself is sufficient to explain why the accountant's figures indicate that Mission was in net capital compliance while the staff's indicate that it was not.

Because the staff's explanation for its adjustments, including the 100% haircut, was clear and credible, while there was no explanation at all for the accountant's failure to apply a 100% haircut or for his other adjustments, the Panel found that Enforcement proved by a preponderance of the evidence that Mission conducted a securities business on February 28, 2006, while below its net capital requirement of $100,000.[14] Accordingly, the Panel finds that Mission violated section 15(c) of the Securities Exchange Act of 1934, SEC Exchange Act Rule 15c3-1 and NASD Rule 2110, and that Biddick, as Mission's FINOP, was responsible for this violation, and thereby violated Rule 2110.

C. Sanctions

For a net capital violation, FINRA's Sanction Guidelines recommend a fine of $1,000 to $50,000 and a suspension of the firm or the firm's FINOP for up to 30 days, unless the violation is egregious, in which case the Guidelines suggest a longer suspension or a bar. FINRA Sanction Guidelines (2007) at 29. Enforcement requests that Mission and Biddick be fined $15,000, jointly and severally, and that Biddick be suspended as a FINOP for two years. To support this request, Enforcement points out that Biddick has been disciplined as a FINOP on two prior occasions.

The Panel notes that the net capital violation relates to only a single day; while the firm may have been in violation for the same reasons on other dates, Enforcement did not allege or prove any broader violation. And while Biddick has two prior violations during the 16 years he

[14] Indeed, the staff's calculations actually understate the deficiency in Mission's net capital, because they give Mission credit for the value of the remaining Chartwell stock in its Segregated Reserve Account and the retained cash proceeds of the earlier Chartwell sales. Since neither the stock nor the proceeds properly belonged to Mission, Respondents should not have treated them as firm assets in calculating Mission's net capital.

has been registered as a FINOP, they were quite different from the current violation and Biddick offered explanations for each prior violation during his testimony at the hearing. (Tr. 264-66.) Finally, the violation was primarily attributable to Biddick's applying the values given by Mission's clearing firm for two stocks in Mission's account. While the Panel agrees that Biddick, as Mission's FINOP, had an independent obligation to confirm that there was in fact a ready market for those stocks, he did have a basis for the values he used in computing the firm's net capital.

For these reasons, if the net capital violation stood alone, the Panel would not necessarily impose the sanctions requested by Enforcement. The Panel concluded, however, that in light of the expulsion and bar imposed for Respondents' misuse and conversion of customer securities, imposing additional sanctions for the net capital violation would serve no regulatory purpose. Therefore, it will impose no separate sanctions for this violation.

V. <u>Alleged Taping Violations</u>

A. <u>Facts</u>

Rule 3010(b)(2) (the Taping Rule) requires a member firm to record all telephone conversations between its registered representatives and existing or potential customers under certain circumstances. In particular, a firm with at least five but fewer than 10 registered persons becomes subject to the Taping Rule if 40% or more of its registered persons have been associated with a "disciplined firm" in a registered capacity within the preceding three years. "Disciplined firm" includes a firm that has been expelled from FINRA membership in connection with sales practices involving the offer, purchase or sale of any security.

After Centex was expelled from FINRA membership for sales practice violations, Biddick's brother and certain other Centex representatives became associated with Mission, and in January 2003 FINRA staff notified Mission that it was subject to the Taping Rule. Mission

requested an exemption from the Taping Rule, but its request was denied and Mission began recording its telephone calls on or around December 23, 2003. In conducting a routine examination of Mission in 2006, FINRA staff reviewed some 1,700 recorded calls and discovered that Mission had provided no notice to the other parties to the conversations, including customers and potential customers, that the calls were being recorded.[15] At the hearing, Biddick acknowledged that the firm had no system or procedure in place, such as a "beep tone" or recorded announcement, to notify customers or potential customers that it was recording their calls, and that he was responsible for Mission's taping practices. (Tr. 202-08, 212-13, 303-04; CX 3-6.)

B. Discussion

Enforcement contends that Mission's failure to provide notice that it was recording calls violated California law, and that Biddick was responsible for the violation. Enforcement further argues that by failing to give notice as required by California law, Respondents violated the Taping Rule, or, alternatively, violated Rule 2110's requirement that members and associated persons "observe high standards of commercial honor and just and equitable principles of trade."

To resolve these charges, the Panel would first have to interpret California law. California is a "two-party" state; that is, Section 632 of the California Penal Code requires that both parties to a confidential telephone conversation be on notice that the call is being recorded.[16] (CX 11.41.) See Kearney v. Salomon Smith Barney, Inc., 39 Cal. 4th 95 (2006). Mission had no system in place to provide such notice to its customers and potential customers. Section 632 applies to a "confidential communication," i.e., "any communication carried on in

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[15] The lone exception was a call between Biddick and a potential employee. (CX 11.32.)

[16] Similarly, the rules of the California Public Utilities Commission prohibit the recording of telephone conversations without the consent of, or notice to, all parties. (CX 11.42.)

circumstances as may reasonably indicate that any party to the communication desires it to be confined to the parties thereto ….” Calls between a broker-dealer, such as Mission, and its customers or potential customers may well meet the confidentiality standard, but the record includes limited evidence in that regard. (Tr. 50-51, 92, 112-13.)

Section 632 would clearly apply to calls between Mission, which is located in California, and customers or potential customers located in California, but, once again, there is very limited evidence regarding the locations of Mission's customers or potential customers, and insofar as they were in other states, the application of Section 632 is unclear. In Kearney, the California Supreme Court held that Section 632 applied to confidential telephone calls between a broker-dealer located in a "one-party" state and customers located in California, but the court based that determination on a conflicts of law analysis in which it emphasized that "the principal purpose of section 632 is to protect the privacy of confidential communication of California residents while they are in California …." 39 Cal. 4th at 119-20 (emphasis in original). Therefore, it remains uncertain whether Section 632 applies if the circumstances are reversed—i.e., if the broker-dealer is in California and the customer or potential customer is in a one-party state.

Even assuming the Panel were to find that Respondents violated California law, that would not end the inquiry. The Panel would also have to determine whether the California law violation was also a violation of the Taping Rule, or, if not, was a violation of Rule 2110.

No provision of the Taping Rule expressly requires member firms subject to the rule to comply with state notice requirements. Instead of the language of the Rule itself, Enforcement relies on a portion of the SEC's order approving the Taping Rule in which the SEC directed that, "upon approval, [FINRA] will inform [FINRA] members that, in complying with this Rule, they must also comply with federal and state civil and criminal statutes governing the tape recording of conversations." Exchange Act Rel. No. 39,883, 63 Fed. Reg. 20,232, 20,235 (Apr. 23, 1998)

(emphasis added). FINRA fulfilled this obligation in July 1998, after the Taping Rule was approved, by issuing Notice to Members 98-52 advising FINRA members that:

> In complying with the Taping Rule, members must comply with federal and state civil and criminal statutes governing the tape recording of conversations. … Firms [that became subject to the Taping Rule] would be required to independently determine that state laws are satisfied. The best practice in each case would be for member firms to notify their registered persons and customers that their telephone calls are being tape recorded.

Furthermore, when FINRA notified Mission that it had become subject to the Taping Rule, it specifically advised the firm, in a letter addressed to Biddick as its president, that:

> As described in Notice to Members 98-52, Mission Securities must also comply with federal and state statutes governing the tape recording of conversations, wiretapping, and electronic surveillance. In implementing the taping system required by the Taping Rule, it is Mission Securities' responsibility to obtain appropriate legal advice to comply with federal and state laws. (CX 3.)

Neither the SEC order nor FINRA's Notice to Members clearly indicates that state and federal privacy law requirements are incorporated in the Taping Rule, or that a violation of state or federal privacy laws will be deemed a violation of the Taping Rule, subjecting members to FINRA sanctions. The language that Enforcement relies on can be reasonably interpreted instead as simply a warning to affected firms that in complying with the Taping Rule's requirements, they remain subject to state and federal privacy laws. In short, while Enforcement's interpretation of the SEC's and FINRA's pronouncements may be plausible, it is by no means compelling.

As an alternative to its Taping Rule theory, Enforcement argues that by violating California law, Respondents also violated Rule 2110's general requirement that member firms and associated persons observe high standards of commercial honor and just and equitable principles of trade in the conduct of their business. Enforcement, however, cites no prior decision holding that a violation of state law—either as a general matter or with respect to privacy provisions—is, per se, also a violation of Rule 2110.

Plainly, at least in some circumstances, conduct that violates state law may also violate Rule 2110. As the National Adjudicatory Council has explained:

> Rule 2110 “is not limited to rules of legal conduct but rather . . . it states a broad ethical principle.” …
>
> The rule “sets forth a standard intended to encompass a wide variety of conduct that may operate as an injustice to investors or other participants in the marketplace.”
>
> In the caselaw developed under the rule, some types of misconduct, such as violations of federal securities laws and NASD Conduct Rules, are viewed as violations of Conduct Rule 2110 without attention to the surrounding circumstances because members of the securities industry are expected and required to abide by the applicable rules and regulations. … Other types of violations … are viewed as violations of Conduct Rule 2110 only if the surrounding facts and circumstances indicate that the conduct was unethical. The concepts of excuse, justification, and “bad faith” may be employed to determine whether conduct is unethical in these cases.
> …
>
> The concepts of excuse, justification, and good and bad faith also are employed in cases in which an associated person's obligations to a customer are at issue. The analysis that is employed is a flexible evaluation of the surrounding circumstances with attention to the ethical nature of the conduct. … “Bad faith” in the sense of malicious intent or deceitfulness need not be established. …

Department of Enforcement v. Shvarts, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *11-16 (June 2, 2000) (citations omitted).

Under these standards, if Respondents’ failure to notify customers and potential customers that their calls were being recorded violated California law, it may well also have violated Rule 2110, but that conclusion would not flow automatically from the violation of state law. Instead, Shvarts emphasizes that, absent a violation of federal securities laws or other FINRA rules, to find a violation of Rule 2110 the Panel would have to consider all “the surrounding facts and circumstances” and conclude that they “indicate that the conduct was unethical.” In this case, because Enforcement urged that a violation of California law was per se

a violation of Rule 2110, the record contains very limited evidence of the surrounding facts and circumstances.[17]

Enforcement also argues that Respondents' failure to comply with California law violates Rule 2110 because it "prevents FINRA from enforcing its Taping Rule requirement designed to protect a customer's rights with respect to their broker-dealer." This is so, according to Enforcement, because under California law "FINRA may not use any such recorded but unnoticed calls in the pursuit of its regulatory mission." Specifically, Enforcement points to the provision of Section 632 of the Penal Code that provides, "no evidence obtained as a result of eavesdropping upon or recording a confidential communication in violation of this section shall be admissible in any judicial, administrative, legislative, or other proceeding."

There are several problems with this argument. First, it is by no means clear that the provision of Section 632 on which Enforcement relies would prevent FINRA from using the recorded calls in the pursuit of its regulatory mission, and Enforcement cites no cases applying Section 632 in such circumstances.[18] Moreover, because FINRA's regulatory mission is conducted pursuant to federal law, there is a strong argument that FINRA's use of calls recorded by Respondents pursuant to the Taping Rule would be governed by federal, not California law. See Zhou v. Pittsburg State Univ., 252 F. Supp. 2d 1194, 1204 (D. Kan. 2003) ("evidence obtained in contravention of [Section 632] is admissible in federal court [in cases arising under federal law], so long as no federal law is thereby violated"); see also Credit Suisse First Boston

[17] Enforcement relied on a transcript of a telephone call between Biddick and a prospective employee to prove that Biddick knew that California law required Mission to provide notice that it was recording calls, and that Biddick deliberately refrained from providing notice in the hope that it might allow Mission to use the calls to obtain a surprise advantage in customer arbitrations. (CX 11.32.) While some of Biddick's statements during the call are troubling, the evidence was somewhat unclear as to the date of the call and the circumstances in which it occurred.

[18] Certainly Respondents could not invoke Section 632 to preclude FINRA from utilizing the recorded calls; "allowing such offensive use of section 632 by the party who violated it offends fundamental notions of fairness." Frio v. Superior Court, 203 Cal. App. 3d 1480, 1493 n. 5 (1988). It would turn Section 632 on its head to find that a firm that violated its customers' privacy rights could use its wrongdoing to frustrate the efforts of federal regulators to determine whether the firm or its representatives had committed sales practice violations during the calls.

Corp. v. Grunwald, 400 F. 3d 1119, 1132 (9th Cir. 2005) ("if a state law prevents [FINRA] from complying with its rules or if it interferes with the Congressional goals underlying the Exchange Act, the state law is preempted by federal law"); Jevne v. Superior Court, 35 Cal. 4th 935 (2005) (same). In any event, even assuming that California law would preclude FINRA from using the recorded calls, once again, Enforcement has cited no prior cases finding a violation of Rule 2110 in analogous circumstances.

To resolve the alleged taping violations, therefore, the Panel would have to address several difficult legal issues of first impression, each of which could have significant ramifications beyond this case for FINRA members and associated persons. If it were essential to do so in order to protect the investing public, the Panel would, of course, address the issues. But in this case it is not necessary to resolve the alleged taping violations. As explained above, the evidence—generally undisputed—establishes that Respondents misused and converted customer securities, in clear violation of Rules 2330 and 2110, and, under the Sanction Guidelines and to protect the investing public, the sanctions for that violation can only be to expel Mission and to bar Biddick. Under these unusual circumstances, the Panel declines to determine whether Respondents violated California law, or whether, if they did, they violated the Taping Rule or Rule 2110, leaving those questions for another Panel to resolve in some future case in which they are material to the outcome.

VI. Conclusion

Respondents misused and converted customer securities, in violation of NASD Rules 2330 and 2110. For this violation, Respondent Mission Securities Corporation is expelled from FINRA membership and Respondent Craig M. Biddick is barred from associating with any member firm in any capacity. The expulsion and the bar will become effective immediately if this decision becomes FINRA's final action in this matter.

Respondent Mission also conducted a securities business while below its required net capital, in violation of Section 15(c) of the Securities Exchange Act of 1934, SEC Exchange Act Rule 15c3-1 and NASD Rule 2110, and Biddick caused Mission's net capital violation, in violation of Rule 2110, but no additional sanctions are imposed for this violation, in light of the expulsion and bar. Finally, in light of the expulsion and bar, the Panel declined to determine whether Respondents violated California law by failing to notify customers and potential customers that their calls were being recorded, or, if they did, whether by violating California law they also violated NASD Rule 3010(b)(2) or 2110.[19]

HEARING PANEL

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By: David M. FitzGerald
Hearing Officer

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[19] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.