FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. PATRICK F. HARTE, Jr. (CRD No. 1865650), Respondent.	Disciplinary Proceeding No. 2006003672401 Hearing Officer – LBB **HEARING PANEL DECISION** August 31, 2009

Respondent is suspended in all principal capacities for six months, fined $10,000, and ordered to re-qualify as a principal before functioning in any principal capacity, for failing to supervise registered representatives engaged in the sale of unregistered securities, in violation of NASD Conduct Rules 3010 and 2110.

Appearances

Jonathan I. Golomb, Senior Special Counsel, and Gregory R. Firehock, Senior Litigation Counsel, Washington, D.C., for the Department of Enforcement

Patrick F. Harte, Jr., *pro se*

DECISION

The Complaint in this matter was filed on June 20, 2008. The Complaint named as Respondents Barron Moore, Inc.; Katherine Ann Moore, the firm's president and majority owner; and Patrick F. Harte, Jr. ("Respondent"), a principal of the firm. Moore and Barron Moore settled soon after the Complaint was filed. The Complaint was amended in September 2008 to incorporate charges pending against Respondent Harte in a related case[1] and to eliminate the charges against Moore and Barron Moore. The Complaint was amended again in March 2009 to eliminate one of the two remaining charges against Respondent, leaving a single cause of

[1] *See Dep't of Enforcement v. Midas Securities, LLC*, No. 2005000075703 (O.H.O. May 12, 2009) (appeal pending).

action against Respondent for failure to supervise registered representatives at Barron Moore in connection with the sale of unregistered securities, in violation of NASD Conduct Rules 3010 and 2110.[2]

A two-day hearing was held on April 20 – 21, 2009, before a Hearing Panel consisting of a Hearing Officer and two former members of the District 6 Committee.

I. Respondent

Respondent was registered with FINRA member firm Barron Moore, Inc. from July 1, 2004, until June 10, 2008. CX-83.[3] Respondent came to Barron Moore from then member firm RichMark Capital Corporation. Tr. 355.[4] Moore hired Respondent to be the firm's head trader to supervise both trading and retail sales, and to serve as the firm's second principal. CX-16a. He was initially a registered representative, but in the fall of 2004 he became executive vice president, general securities principal, and head of trading. CX-18; CX-90 at 11 – 12. He was registered with a total of 17 firms from his first registration in 1989 until his registration with

[2] As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA Consolidated Rulebook. The first phase of the new consolidated rules became effective on December 15, 2008, including certain conduct rules and procedural rules. *See* Regulatory Notice 08-57 (Oct. 2008). This decision refers to and relies on the NASD Conduct Rules that were in effect at the time of Respondent's alleged misconduct. In addition, because the Complaint was filed before December 15, 2008, the NASD Procedural Rules were applied in this disciplinary proceeding.

[3] References to the testimony set forth in the transcripts of the hearing are designated as "Tr. __," with the appropriate page number. References to the exhibits submitted by the Department of Enforcement are designated as "CX-___." Respondent did not offer any exhibits.

[4] Respondent was registered with RichMark from September 24, 2002, until June 30, 2004. CX-83 at 2. As discussed below, a number of those involved in this matter, including the representatives whom respondent supervised, were involved with RichMark.

Barron Moore ended in 2008. He is not currently registered with a member firm. CX-83; Tr. 355.[5]

II. Origin of the Investigation Leading to the Complaint

The investigation that led to the Complaint began as a result of an investigation of a promotional campaign for the stock of iStorage Networks ("IOGN"), which came to FINRA's attention in connection with a spam e-mail touting IOGN stock. The initial review of the IOGN e-mails and press releases suggested that it was likely that the sellers were engaged in the sale of unregistered stock, leading to an investigation of Barron Moore and three other broker-dealers that had sold the stock. Tr. 27 – 30; CX-45; CX-46.

III. Barron Moore and Its Penny Stock Business

Barron Moore, a broker-dealer located in Dallas, was formed in 2003. CX-84. The firm remained very small. By January 2005, Barron Moore had only five brokers. CX-5; Tr. 340. The firm initially focused on oil and gas placements. In the fall of 2003, the firm hired two representatives who had been at RichMark, bringing with them a business of liquidating penny stocks. At the time, RichMark and its owner, Doyle Mark White, were responding to FINRA disciplinary actions, including fraud charges in connection with the sale of penny stocks. RichMark had also recently been suspended by the Securities and Exchange Commission ("SEC"). RichMark was eventually expelled from FINRA, and White was barred from the industry. Tr. 34 – 39, 356. Respondent worked for White for two years at RichMark. Tr. 389.

After the brokers from RichMark came to Barron Moore, most of Barron Moore's retail business was accepting penny stocks and liquidating them into the market. CX-88 at 41 – 42;

[5] Although Respondent has not been registered with any FINRA member firm since the termination of his employment with Barron Moore, he remains subject to FINRA's jurisdiction for purposes of this proceeding pursuant to Article V, Section 4 of FINRA's By-Laws, because the Complaint was filed within two years after the termination of his registration with a member firm, and it charges him with misconduct while he was registered with a member firm.

Tr. 365; CX-97 at 11 – 12. Most of the penny stock liquidation business was brought to Barron Moore by Joshua Lankford, a registered representative who had come to the firm in November 2003 after a brief stay at RichMark.[6] CX-87; CX-97 at 12, 78. Although he was never a principal, Lankford became an indirect owner of 24.9% of Barron Moore. Tr. 36; CX-18; CX-96 at 9.[7]

IV. Sales of Unregistered Securities

The Complaint focuses on Respondent's failure to supervise the firm's registered representatives in connection with the receipt and subsequent sale of three unregistered securities through seven Barron Moore accounts.[8] All told, 9,925,000 unregistered shares of IOGN, Consolidated Sports Media Group ("CSGU"), and Structures USA ("STUS") were transferred into the accounts, and 7,214,567 shares were sold out of those accounts and into the public market, often to accounts at online broker-dealers, netting proceeds of $1,016,483. CX-25; Tr. 167 – 171, 318.[9] As shown in subsequent sections, Respondent made no efforts to ensure that the registered representatives subject to his supervision took the steps required to determine whether the stocks could be sold in compliance with the Securities Act.[10]

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[6] In a settlement with the Department of Enforcement, Lankford agreed to be barred from associating with any member firm for failing to provide information in violation of Rules 8210 and 2110. He was indicted for a variety of offenses related to securities fraud, and is now a fugitive from justice. Tr. 99 – 100; CX-9; CX-9A.

[7] Barron Moore was owned by a holding company, Barron Moore Holdings, Inc. Lankford owned 24.9% of the holding company, and Moore owned 75.1%. CX-18.

[8] The FINRA investigator testified that the deposit of very large blocks of the stocks of "previously untraded, unregistered, unseasoned issuers," followed shortly by the liquidation of the shares and wiring out of the proceeds, was occurring "on a wholesale basis" in "staggering" quantities at Barron Moore. The investigator focused the investigation on a limited number of stocks or "we'd never finish." Tr. 33 – 34, 299.

[9] Those shares that could not be sold were transferred to other broker-dealers, journaled to other accounts, or stayed in the accounts into which they were originally deposited. Tr. 315 – 317.

[10] Section 5(a) of the Securities Act of 1933, 15 U.S.C. §77(e)(a), prohibits any person, directly or indirectly, from selling a security in interstate commerce unless a registration statement is in effect as to the offer and sale of that security or there is an applicable exemption from the registration requirements.

A. Accounts Assigned to Registered Representative Seth Botone

Seth Botone, an inexperienced registered representative who reported to Respondent, was the firm's registered representative on four accounts that received and sold shares of unregistered securities.[11]

1. Matthew Crockett Accounts: Phalanx Holding Corporation, Homer Capital Consulting LLC, and Gilgamesh, Inc.

In 2004, Lankford referred three customers, Phalanx Holding Corporation, Homer Capital Consulting LLC, and Gilgamesh, Inc., to Botone. CX-17; CX-91 at 24 – 25. All three customers received large blocks of unregistered shares of penny stocks, and quickly liquidated the shares into the public market. Matthew Crockett, Lankford's 20-year-old half brother, was the president and secretary of all three companies. It was common knowledge at Barron Moore that Crockett was Lankford's half brother. CX-17.[12] Although Crockett identified himself as a consultant, Respondent never found out what type of consulting Crockett claimed to do. Tr. 365; CX-88 at 71; CX-66 at 2. Respondent also did not know anything about Crockett's three companies, or how they had acquired their stock. Tr. 416 – 417; CX-88 at 121, 149 – 150.

a) Phalanx Holding Corporation

The Phalanx Holding Corporation account was opened on April 14, 2004, prior to the time Respondent joined Barron Moore. The new account form identifies Phalanx and Crockett as the account holders. The form identifies Botone as the registered representative for the account. There is no response to the form's question of whether Crockett is related to an employee of the firm, although Lankford had joined the firm six months earlier. According to

[11] Botone was first registered in November 2003. CX-86.

[12] Although Respondent denied that he knew that Crockett was Lankford's half brother until after the transactions at issue in the case, Respondent testified in an on-the-record interview ("OTR") that Lankford told him around the end of 2004 that he and Crockett were half brothers. Tr. 416; CX-88 at 141. In light of his earlier testimony and the evidence that the familial relationship was common knowledge in this very small firm, the Hearing Panel finds that Respondent knew, at least by the end of 2004, that Crockett was Lankford's half brother.

the form, Crockett had just turned 20 years old, and had one year of investment experience in stocks, three in bonds, and none in options or trading on margin. Crockett's liquid net worth is stated as in excess of $500,000, with his annual income at more than $150,000. CX-62.

Although Respondent was not at Barron Moore when the Phalanx account was opened, he became aware of the account after he joined the firm. He signed a change of address form for Phalanx in August 2004, and another on March 11, 2005. Both forms were signed in his capacity as a principal of Barron Moore. CX-62 at 8, 35. On behalf of Barron Moore as the "correspondent,"[13] Respondent also approved a corporate resolution on January 7, 2005, signed by Crockett, permitting the firm to engage in stock transactions. CX-62 at 23.

Phalanx invested solely in penny stocks. CX-63; Tr. 123. The typical transaction involved the deposit of physical certificates, followed soon thereafter by the sale of the stock, the wiring out of the proceeds, and the beginning of another, similar transaction. CX-63; Tr. 123 – 124. Jim Locklear, who was not otherwise identified, transferred 1,200,000 shares of CSGU into the Phalanx Holdings account on September 1, 2004. CX-25; CX-63; Tr. 167 – 168.[14] Two hundred thousand shares were sold from October 1, 2004, until March 15, 2005, and 1,000,000 shares were transferred out of the account to other broker-dealers. CX-26; CX-27; CX-63; Tr. 179.

b) Homer Capital Consulting, LLC

Crockett opened the Homer Capital account with Barron Moore on July 30, 2004. CX-66. Respondent signed the new account form as the approving principal. Botone was assigned as the registered representative on the account. CX-66 at 4. Where the form asks if the applicant

[13] The form appears to be one provided by the clearing firm, Computer Clearing Services, Inc., and includes a pre-printed signature block for the approval of the correspondent.

[14] Locklear received his shares directly from the issuer. CX-25; Tr. 167 – 168.

is related to an employee of Barron Moore, the response checked is "No." The form lists Crockett's income as between $80,000 and $150,000, and his net worth as between $100,000 and $500,000, both less than the Phalanx new account form that had been filled out in April. For Homer Capital, Crockett represented his investment experience as five years of experience in stocks, options, and margin trading, but no experience in bonds, all inconsistent with representations on the form for Phalanx, and dubious for a 20-year-old. CX-66 at 3.

The account activity for Homer Capital was essentially the same as for Phalanx: large blocks of stock certificates for penny stocks were deposited, followed by quick sale and wire transfers out of the account, and a new cycle of similar transactions. CX-67; Tr. 135. Paul Johnson, a former RichMark customer, received large blocks of shares directly from the issuers and transferred 3,200,000 shares of CSGU stock and 200,000 shares of IOGN stock into the Homer Capital account. CX-17; CX-25; Tr. 167 – 170, 356 – 357. Another 700,000 shares of CSGU were deposited from an unidentified source. CX-26; CX-27; CX-67; Tr. 179. 1,489,567 shares of CSGU were sold from the account between October 1, 2004, and April 27, 2005, and 2,410,433 shares were transferred out of the account to other broker-dealers. All 200,000 shares of IOGN that were deposited into the Homer Capital account were sold between December 22, 2004, and January 7, 2005. CX-26 – CX-28; CX-67; Tr. 179.

c) Gilgamesh, Inc.

The account for Gilgamesh, Inc. was opened on September 1, 2004, with Botone again assigned as the registered representative, and Crockett signing the new account form as the customer. According to the new account form, Gilgamesh was going to be engaged only in day trading. The "No" box was checked for the question of whether the applicant was related to an employee of the firm; a check in the "Yes" box was scratched out. The form states that Crockett had five years of experience in stocks, three years in options, five in margin, and none in bonds,

again inconsistent with prior new account forms for Crockett entities. The form describes the account holder as a consultant, with an income of more than $150,000, and a liquid net worth of more than $500,000. Respondent signed the form as principal. CX-68. Respondent also signed the corporate resolution for the firm as "correspondent," authorizing securities transactions. CX-68 at 5.

Paul Johnson transferred 75,000 unregistered shares of IOGN stock into the Gilgamesh account on November 16, 2004. CX-25; CX-26; CX-69; Tr. 167 – 170. All of the shares were sold in January 2005, and the proceeds were wired out. CX-25; CX-26; CX-28; CX-69; Tr. 153.

2. Paul B. Johnson, Jr.

In addition to depositing shares into other accounts, Johnson opened his own account at Barron Moore into which he deposited unregistered shares of penny stocks, and quickly sold them. Lankford referred Johnson to Botone, who opened an account for Johnson on June 23, 2004. None of the financial or investment experience information was filled out on Johnson's new account form. CX-17; CX-71. Although the account was opened shortly before Respondent joined Barron Moore, Respondent had met Johnson at RichMark, where Johnson had been a customer. Respondent admitted that he did not know much about Johnson. CX-17; CX-88 at 78; Tr. 356 – 357. Lankford talked to the client, while Botone handled such things as certificates and trading. CX-91 at 144.

The account activity for Johnson was similar to the activity for the Crockett accounts. Large blocks of penny stock certificates were deposited; they were sold; and the proceeds were wired out. CX-72; Tr. 157. Johnson deposited 50,000 shares of CSGU; 25,000 shares of IOGN; and 5,000,000 shares of STUS into his account, after receiving them directly from the issuers. All the CSGU shares were sold on October 4, 2004; the IOGN shares were sold at the end of December 2004. CX-25 – CX-29; CX-72; Tr. 167 – 170. The shares of STUS were deposited

into Johnson's account at Barron Moore on October 5, 2004, and sold between October 5, 2004, and March 4, 2005. CX-29; CX-72.

B. Accounts Assigned to Registered Representative Ryan Kirkpatrick

1. Daystrike Marketing, Inc.

On August 2, 2004, a margin account was opened for Daystrike Marketing, a company owned by White, the former owner of RichMark Capital. Lankford opened the account, which was shared with Ryan Kirkpatrick, a Barron Moore broker. CX-74; CX-94 at 76; Tr. 158. Respondent signed the form as principal. CX-74 at 12. At the time the account was opened, RichMark was still serving a 90-day suspension imposed by the SEC, and was the subject of a FINRA disciplinary proceeding filed in April 2004, alleging manipulation. Tr. 159. When Respondent approved the opening of the Daystrike account, he knew it was White's account and that White had been twice charged with fraud and was suspended by the SEC. Respondent did not look into nature of the fraud charges against White. He did not know if the charges related to transactions involving penny stocks. Tr. 366 – 367. Kirkpatrick spoke to White only a couple of times, and not on matters of substance. CX-94 at 77.

Daystrike's transactions were largely similar to those for the Crockett entities and Johnson – the deposit of large blocks of penny stock certificates, the liquidation of those positions, and the wiring out of the proceeds. CX-75; Tr. 161. Johnson transferred 75,000 unregistered shares of IOGN into the Daystrike account, all of which were sold between December 22, 2004, and January 7, 2005. CX-25; CX-26; CX-28; CX-75; Tr. 167 – 170.

2. G. David Gordon & Associates, P.C.

An account was opened for G. David Gordon & Associates, P.C., a Tulsa law firm, on September 14, 2004. Respondent signed the new account form as the "Authorized Supervisor."

Kirkpatrick was the registered representative assigned to the account. CX-80; CX-90 at 139. Gordon had been a customer at RichMark. CX-90 at 139; Tr. 359.

Johnson transferred 75,000 unregistered shares of IOGN into Gordon's account on November 16, 2004, all of which were sold between December 22, 2004, and January 7, 2005. CX-25; CX-26; CX-28; Tr. 167 – 170.

C. Account for Gary W. Zinn, Assigned to Unidentified Registered Representative

According to the new account form, an account was opened for Gary W. Zinn in October 2004. The new account form is dated October 2004, but does not reflect a specific date in October. Respondent signed as principal, but there is no date for his signature. CX-77. The signature of the registered representative is indecipherable. Respondent testified that he did not know who the registered representative was for the Zinn account. Tr. 420.

Johnson transferred 25,000 unregistered shares of IOGN into Zinn's account on November 16, 2004. The shares were sold on January 3, 2005. CX-25; CX-26; CX-28; Tr. 167 – 70; CX-78 at 1, 9; Tr. 163.

V. Respondent's and Barron Moore's Reliance on the Transfer Agent and Clearing Firms to Determine if the Stocks Could Be Freely Traded

Respondent and Barron Moore made no effort to determine whether the unregistered securities the firm sold on behalf of its clients were freely tradable. Rather, they assumed that if the transfer agent was willing to transfer the certificates and the clearing firm was willing to execute the trades, the trades were permissible. As Respondent testified, "[W]e're relying, number one, on the clearing firm, number two on transfer agents. They're the gatekeeper at the end of the day." CX-90 at 92; Tr. 348 – 349, 353, 377; *see also* CX-90 at 33 – 34. The procedure was that once a stock cleared transfer, it was "free trading." Tr. 377, 379, 383. Respondent paid no attention to registration issues. "My focus really is if I can get – if the cert

clears transfer, if I can deliver what I sell or take delivery what I buy from a customer, that's all I'm really concerned with. Whether it's registered or not, that's really up to the issuer or the investors." CX-90 at 32.

The registered representatives similarly believed that it was sufficient to rely on the clearing firm to determine if a stock was tradable. Botone testified that Barron Moore took no steps to determine if a stock was tradable, but relied on the clearing firm. CX-91 at 44 – 46. Kirkpatrick similarly testified that it was up to the clearing firm to determine if stock could be re-classified from Type IV, which was restricted, to Type I, or freely tradable. CX-94 at 93.

Despite his and the firm's reliance on the clearing firm and the transfer agent, Respondent did not know what they did. Tr. 408; CX-90 at 33 – 34. All dealings with the transfer agent were left to Barron Moore's administrative staff. Respondent was not certain of the procedures followed by the administrative staff. Tr. 377, 421; CX-90 at 93. To his knowledge, the clearing firm did not contact customers to determine how they acquired their shares, the percentage of shares of the issuer owned by the customer, or if the customer was an officer, director, or control person of the issuer. CX-90 at 93 – 94. Barron Moore also did not ask customers how they acquired their shares. CX-88 at 57.

Although Respondent never saw Barron Moore's agreement with its clearing firm, the clearing agreement allocates responsibility to Barron Moore to know its customer, and further states that the clearing firm will not be bound to make any investigation into the facts surrounding any transaction. Tr. 397; CX-3a at 3. The parties stipulated that the clearing firm "did not consider itself responsible for determining whether stock deposited in certificate form by customers of Barron Moore was free trading" and that the transfer agent "did not consider itself responsible for determining whether stock was free trading on behalf of the brokers as a

general practice." *See* Stipulations as to Testimony of Stephen Worcester and Jason Freeman, April 7, 2009.

VI. Respondent Was a Supervisor for Barron Moore's Registered Representatives

Respondent denies that he was a supervisor of the sales representatives, except that he admits that, at some point, he supervised Botone when Botone wanted to learn to be a trader. (Tr. 347). Despite Respondent's denials, he clearly was a supervisor for the registered representatives.

"Determining if a particular person is a 'supervisor' depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue."[15] The evidence clearly establishes that Respondent had the responsibility, ability, and authority to supervise the sales representatives. During the relevant time period, Respondent was one of only two principals at Barron Moore, and the only principal who had the knowledge or experience to supervise the sales force. Further, he was identified in Barron Moore's documents, including its written supervisory procedures and filings with FINRA, as a supervisor, and both Katherine Moore and the sales representatives regarded him as a supervisor of the sales representatives.

According to Barron Moore's Supervisory and Sales Practice Manual, Moore was the firm's "Designated Supervisor and Compliance Officer," and was responsible for the supervision of every employee. The Manual designated Respondent as the "second principal" of the firm. CX-3 at 9. Despite his denials that he was a supervisor, Respondent admitted that, as second principal, "everybody at the firm saw me in a supervisory role …." Tr. 374, 407.

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[15] *Steven E. Muth*, Securities Act Rel. No. 8622, Exchange Act Rel. No. 52551, 2005 SEC LEXIS 2488, at *55 (Oct. 3, 2005).

Barron Moore submitted documents to FINRA that identified Respondent as a supervisor of the sales representatives. In February 2005, Moore submitted a response to a pre-examination information request from FINRA, stating that Respondent had functioned as the supervisor of trading and retail sales since July 2004. CX-20 at 17. Barron Moore's key contacts information, submitted to FINRA, shows Respondent as the head of retail as of January 31, 2005. CX-2.

As of February 16, 2005, Barron Moore's website stated that Respondent joined Barron Moore "to help structure and manage efforts in equity sales and trading." CX-1. The firm's organization charts also identified both Respondent and Moore as the supervisors of trading, sales, and investment banking. The charts show the representatives reporting to Lankford as the Senior Account Manager, and Lankford reporting to Respondent. Lankford was never registered as a principal or supervisor. Tr. 49 – 50; CX-18; CX-19; CX-21; CX-96 at 9. Moore testified in an OTR that Lankford had no supervisory responsibilities. CX-96 at 18 – 19, 29.

Although his review of documents was perfunctory, Respondent signed, as a principal of the firm, a number of documents that are relevant to the charges in the Complaint that expressly required the signature of a principal. He signed the new account forms for several of the accounts that are at issue in this case. On behalf of Barron Moore, he approved corporate resolutions for Crockett's companies permitting the companies to engage in stock transactions. He signed a change of address form for Phalanx, the Crockett account that had been opened before Respondent joined Barron Moore.

The registered representatives regarded Respondent as a supervisor. Botone identified Respondent as one of his supervisors, and Respondent admitted that, at some point, he began to supervise Botone because Botone wanted to become a trader. CX-17; CX-91 at 39; Tr. 347. Kirkpatrick testified that when he had issues that he needed to discuss with firm management he would go to either Respondent or Moore. If there was a large order, either in dollars or number

of shares, Respondent would approve it. CX-94 at 53, 62 – 63. Kirkpatrick testified that Respondent supervised more on suitability, compliance, and the broker side, and Moore supervised more on such things as administrative matters and punctuality. CX-94 at 64 – 65; Tr. 375. Respondent testified that representatives came to him for advice. Tr. 347.

When Moore hired Respondent, she told him that she expected him to supervise equity transactions by the firm's registered representatives. CX-16a. Furthermore, it should have been clear that he was the only principal who could supervise them. Although Moore was designated as a supervisor, she did not supervise the representatives' activities with respect to trading or working with customers, and she lacked the experience to supervise those activities. Moore had more experience in bonds, private placements for oil and gas, firm administration, and back office operations. Respondent had considerably greater experience than Moore in equities, and she relied on him to supervise the trading of equities. Tr. 34; CX-16a; CX-96 at 149 – 150.

The Hearing Panel finds that Respondent was a supervisor of the registered representatives.

VII. Respondent Failed to Supervise the Registered Representatives, Violating Rules 3010 and 2110

Rule 3010(a) requires that "[e]ach member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." At Barron Moore, there was no system of supervision to prevent the unlawful sale of unregistered securities, and Respondent failed to supervise the registered representatives who were under his supervision.

A supervisor is responsible for reasonable supervision, a standard that is determined based on the particular circumstances of each case.[16] Supervision is important to prevent the unlawful sale of unregistered securities.[17] Respondent completely abdicated his supervisory responsibilities. He regarded supervision of a representative's dealings with customers as an intrusion on the relationship between the brokers and the customers. When asked if the other brokers asked customers how they acquired their shares, he testified, "These are other brokers' accounts. I don't know what they may or may not have asked them." Tr. 381 – 382.

Respondent testified that when he approved the opening of new accounts, he would have a brief discussion with the brokers when he signed new account forms, asking them where they met the client and what the client was going to do. Tr. 360, 418. In his view, the significance of his signature on the new account form was that the information on the form actually came from the customer. Tr. 386 – 387. In general, Respondent did nothing to ensure that information on the new account forms was accurate. He believed that if the broker who was going to handle the account had questions, the broker should raise those questions. Tr. 387 – 388.[18]

In fact, nobody at Barron Moore undertook any inquiry to determine whether the shares were tradable. It was not part of the firm's procedures to ask how shares were acquired by the account owner. CX-88 at 57. Instead, Barron Moore relied completely on the transfer agent and the clearing firm to determine whether the shares were tradable. A broker may not delegate

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[16] *Ronald Pellegrino*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843, at *33 (Dec. 19, 2008).

[17] *Cf. John A. Carley*, Exchange Act Rel. No. 57246, 2008 LEXIS 222, at *72 (Jan. 31, 2008), *aff'd sub nom. Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. June 23, 2009); *Dep't of Enforcement v. Morgan Keegan & Co.*, No. CAF040073, 2006 NASD Discip. LEXIS 24, at *40 – *41 (O.H.O. July 21, 2006); *J. Alexander Securities, Inc.*, 2005 NASD Discip. LEXIS 42, at *47 – *53; *Sales of Unregistered Securities by Broker-Dealers*, 1971 SEC LEXIS 19, at *4.

[18] Moore eventually recognized Respondent's inattention to his duties in approving new accounts. At some point after the period covered by the Complaint, she stopped letting Respondent approve new accounts because he did not pay attention to what he was signing. CX-99 at 125.

responsibility completely to others; it has an independent duty to determine whether shares are freely tradable.[19] As the SEC made clear in a release in 1962, "[W]hen a dealer is offered a substantial block of a little-known security … where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for."[20] For Respondent's supervision to have been adequate, he would have had to ensure that the representatives conducted such a searching inquiry.

Respondent also failed to adequately supervise with respect to the wire transfers out of the accounts. He often approved wire transfers out of accounts, including a substantial number of wire transfers for several of the accounts discussed above, but his review was little more than a formality. CX-24. When Respondent approved wires, his only inquiries were whether the account number was accurate, the requestor was authorized to make the request, and whether the funds were in the account. CX-89 at 97 – 98. Similarly, when he approved transfers between accounts of different clients, he did not ask why the funds were transferred. CX-89 at 92.

Respondent suggested that he understood that Lankford was supposed to exercise supervisory responsibility over the representatives, pointing to an organization chart that showed the representatives reporting to Lankford, and Lankford reporting to Respondent. Tr. 354; CX-18. Even if Lankford occasionally advised the sales representatives, he was never a supervisor, nor could he be. "Supervision of firm personnel … come[s] within those management

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[19] *Jacob Wonsover*, Exchange Act Rel. No. 41123, 1999 SEC LEXIS 1, at *15 (Mar. 1, 1999), *aff'd*, *Wonsover v. SEC*, 205 F.3d. 408 (D.C. Cir. 2000) (finding that registered representative was not relieved of his obligation to explore whether shares are freely tradable "simply because the transfer agent and Restricted Stock Department eventually cleared the stock"); *Robert G. Leigh*, 1990 SEC LEXIS 153, at *14 (Feb. 1, 1990) (finding that, "as the courts and this Commission have held, the transfer agent's willingness to reissue the certificates without restrictive legends did not relieve [the registered representative] of his obligation to investigate).

[20] *Distribution by Broker-Dealers of Unregistered Securities*, Securities Act Rel. No. 4445 (Feb. 2, 1962).

responsibilities enumerated in [NASD Membership and Registration] Rule 1021(b) that are to be performed by a principal."[21] Respondent admits that he did not supervise Lankford, and because Lankford was an owner, he did not know if anybody really supervised him. Tr. 418.[22] To whatever extent that he thought Lankford was the day-to-day direct supervisor, Respondent's failure to supervise Lankford, and to ensure that the representatives were doing their jobs correctly, was itself a significant failure of supervision.

Respondent's failure to supervise Lankford was especially egregious because Lankford, who had been a registered representative for little more than a year (CX-87), was exercising practical control over the relationships with the penny stock liquidation clients that he brought to the firm. When Lankford and Kirkpatrick shared accounts, Lankford, as the "senior broker," would be the one to contact the client. Kirkpatrick's role in dealing with the clients was to handle such matters as order tickets upon Lankford's request. CX-94 at 22 – 23.[23] Similarly, for the three Matthew Crockett accounts, Lankford often communicated decisions about the accounts to Botone. CX-17.[24] Thus, with respect to the important decisions concerning these questionable accounts, Lankford was essentially supervising himself. This reflects a further failure of supervision by Respondent, as "a salesperson cannot supervise himself."[25]

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[21] *Hans N. Beerbaum*, Exchange Act Rel. No. 55731, 2007 SEC LEXIS 971, at *7 (May 9, 2007).

[22] Additionally, as discussed above, Lankford was never a supervisor. *See* CX-96 at 18 – 19, 29.

[23] Kirkpatrick was first registered in 2001 as a Series 22 (Direct Participation Programs Limited Representative). He got his Series 63 in 2001, and got his Series 7 in 2003. CX-94 at 11.

[24] Botone was first registered in August 2003. CX-86. If Lankford had been acting as a day-to-day supervisor, the need for close supervision by a principal was greater because Lankford, who had very limited securities experience, would have been supervising two representatives with very little experience. *Dep't of Enforcement v. Pellegrino*, No. C3B050012, 2008 FINRA Discip. LEXIS 10 (N.A.C. Jan. 4, 2008), *aff'd, Ronald Pellegrino*, 2008 SEC LEXIS 2843 (Dec. 19, 2008) ("reliance on an inexperienced, untrained person to fill several demanding supervisory roles was not reasonable, especially considering the ongoing red flags of sales practice abuses ….").

[25] *Beerbaum*, 2007 SEC LEXIS 971, at *7 n.8.

To the extent that Moore also had supervisory responsibilities, Respondent was not relieved of his responsibilities. Respondent had the primary responsibility for supervision of the sales representatives, while Moore's supervisory focus was on administrative matters, not the retail business. She had no background and little involvement in the firm's retail business.[26] Furthermore, even if Respondent and Moore shared supervisory responsibilities, Respondent retained his responsibility to supervise adequately. "As we have held, even where supervisory responsibility is shared, each individual can be held liable for supervisory failure."[27]

Respondent's supervisory failures are especially egregious in light of the many "red flags" that should have caused him to exercise greater supervision, rather than taking such care to maintain his "hands off" policy with respect to the accounts that he regarded as the brokers' accounts.[28] Respondent was fully aware of the risky nature of Barron Moore's business. Respondent testified that when Barron Moore received anti-money laundering training, a joke within the firm was that Barron Moore's business model of taking deposits of large blocks of penny stocks, liquidating them, and paying out the proceeds to customers, was one huge red flag. Tr. 425 – 426; CX-90 at 108 – 109.

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[26] Rule 3010(a)(6) provides that, as part of their supervisory system, members shall make reasonable efforts to determine that all supervisory personnel are qualified through experience or training to execute their assigned responsibilities. Reliance on an unqualified supervisor does not satisfy supervisory responsibilities. *See Pellegrino*, 2008 SEC LEXIS 2843, at *45 – *49 (reliance on unqualified subordinates to supervise sales staff not a defense to a charge of failure to supervise).

[27] *Stephen E. Muth*, 2005 SEC LEXIS 2488, at *58; *see also Robert E. Strong*, Exchange Act Rel. No. 57426, 2008 SEC LEXIS 467, at *18 – *19 (Mar. 4, 2008) ("… Firm officials can be held liable for supervisory failures where … the officials have the 'responsibility, ability, or authority to affect the … conduct' of Firm personnel.") (citing *Steven P. Sanders*, 53 S.E.C. 889, 904 (1998), noting its holding that "even where supervisory responsibility is shared between firm executives, each can be held liable for supervisory failures").

[28] *Robert E. Strong*, 2008 SEC LEXIS 467, at *24, n.24 (citing cases); *Michael T. Studer*, Exchange Act Rel. No. 50543A, 2004 SEC LEXIS 2828, at *23 (Nov. 30, 2004) (citation omitted); *accord, George J. Kolar*, Exchange Act Rel. No. 46127, 2002 SEC LEXIS 1647, at *11 (June 26, 2002) ("Decisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations.").

The inexperience of all the brokers, including Lankford, was a red flag indicating the need for close supervision.[29] Barron Moore was a small new firm; nobody in the office had more than a year of experience as a retail broker. Respondent had no reason to believe that the brokers would recognize an improper sale of an unregistered security, or even to know the criteria to determine if any exemptions applied.

There were also red flags that were specific to the seven accounts. Respondent was aware that Crockett was 20 years old (Tr. 360), that he opened three accounts engaged in the liquidation of unregistered penny stocks, and that he was Lankford's half brother.[30] Respondent never found out why Crockett had three accounts, nor did he ever find out what sort of "consulting" Crockett did. Tr. 365. Respondent did not make any further inquiries when he learned that Crockett and Lankford were half brothers. For example, he did not ask Lankford if he had an interest in the companies being liquidated, or if he had any beneficial interest in the accounts. CX-88 at 145 – 146. He also ignored the discrepancies and anomalies on Crockett's new account forms, such as the differences between one form and the next, and the unlikelihood that a twenty-year-old had been trading in complex securities since he was fifteen. He admitted that he did not know how someone twenty years old could have gotten five years of experience with options and margin accounts, as listed on the new account forms for Homer and Gilgamesh. Respondent's explanation was that he "didn't pay that much attention." CX-88 at 129, 139.

Respondent also knew that Doyle Mark White, who opened the Daystrike account, had been suspended by the SEC and twice charged with fraud. Tr. 366 – 367. Respondent testified

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[29] *Cf. Richard F. Kresge*, Exchange Act Rel. No. 55988, 2007 SEC LEXIS 1407, at *30 (June 29, 2007) ("We have often stressed "the obvious need to keep [a] new office with … untried personnel under close surveillance.") (citation omitted).

[30] If he was unaware, as he claimed at one point, that Lankford and Crockett were half brothers, his failure to learn information that was known throughout this small firm demonstrates his failure to supervise diligently.

that he knew White, and believed that White was a decent man. Tr. 389 – 390. Regardless of Respondent's confidence in White, White's disciplinary history was another red flag calling for a searching inquiry into the nature of the transactions.

For these reasons, the Hearing Panel concludes Respondent failed to reasonably supervise, in violation of NASD Conduct Rules 3010(a) and 2110.[31]

VIII. Securities Act Exemptions, if Any Were Available, Are Not a Defense to Respondent's Failure to Supervise

Respondent argued that the unregistered shares of the three stocks were freely tradable because the shares were exempt from the registration requirements of the Securities Act. Respondent's failure to supervise the registered representatives would not have been excused by the fortuity of the absence of a violation. It is not necessary to establish a violation by those who are subject to a respondent's supervision in order to establish a violation for failure to supervise. "'A determination that a respondent has violated [FINRA's] supervisory rule is not dependent on a finding of a violation by those subject to the respondent's supervision.'"[32] In fact, compliance with FINRA's rules "has no bearing … on the reasonableness of supervision with a view to preventing rule violations."[33] Thus, this argument fails as a matter of law.

If a defense to a failure to supervise charge could be based on the applicability of an exemption, it would be Respondent's burden to prove the applicability of the exemption.[34]

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[31] A failure to supervise is a violation of NASD Rules 3010(a) and 2110. *Pellegrino*, 2008 FINRA Discip. LEXIS 10, at *47.

[32] *Pellegrino*, 2008 SEC LEXIS 2843, at *33, n.27, quoting *Robert J. Prager*, Exchange Act Rel. No. 51974 (July 6, 2005), 85 SEC Docket 3413, 3432-33 & n.52, 2005 SEC LEXIS 1558, at *47 (July 6, 2005); *see also* NTM 98-96 at 732, cited in *Prager*, n.52.

[33] *Pellegrino*, 2008 SEC LEXIS 2843, at *33, n.27.

[34] *Alvin W. Gebhart, Jr.*, 2006 SEC LEXIS 93, at *53 (Jan. 18, 2006), *aff'd in part, rev'd in part on other grounds, Gebhart v. SEC*, 255 Fed. Appx. 254, 2007 U.S. App. LEXIS 27183 (Nov. 21, 2007); *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 361-363 (S.D.N.Y.), *aff'd*, 155 F.3d 129 (2d Cir. N.Y. 1998).

Respondent failed to prove that any exemptions are applicable.[35] Evidence in support of an exemption must be "explicit, exact, and not built on mere conclusory statements."[36] To the extent that Respondent was claiming that a specific exemption was applicable, he appeared to rely on Section 4(4) of the Securities Act, which exempts "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders" from the registration requirements of Section 5 of the Securities Act. His reliance on Section 4(4) is misplaced. "A registered representative relying on the Section 4(4) exemption must make whatever inquiries are necessary to determine that the transaction is not part of an unlawful distribution."[37]

Respondent made conclusory statements at the hearing and in his Answer to the Complaint that the transactions were exempt, but offered no reliable evidence that any exemptions were applicable. Nobody at Barron Moore performed any due diligence to determine if any exemptions were applicable. Respondent knew little about the companies whose shares were traded, the owners of the accounts at Barron Moore, or how the stock got into the accounts. Barron Moore relied on the transfer agent and clearing firm to determine if a stock could be traded, but Respondent did not know what the transfer agent or clearing firms did to determine if a stock was tradable. Additionally, as noted above, reliance on others does not satisfy a broker's obligations to determine if exemptions apply. Accordingly, the Hearing Panel finds that, because Respondent failed to establish that the three stocks were exempt from

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[35] Enforcement presented substantial evidence supporting its contention that no exemptions were applicable, and, in fact, suggesting that the sale of these stocks was part of a scheme to sell unregistered stocks, quite likely fraudulently. Because Respondent failed to meet his burden of proof with respect to the applicability of exemptions, it is not necessary to discuss this evidence.

[36] *Robert G. Weeks*, Securities Act Release No. 8313, 2003 SEC LEXIS 2572, *42 n.34 (Oct. 23, 2003).

[37] *John A. Carley*, Initial Decision Release No. 292, 2005 SEC LEXIS 1745, at *108 (July 18, 2005), *aff'd*, 2008 SEC LEXIS 222 (Jan. 31, 2008), *aff'd sub nom. Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009).

registration, they were sold in violation of Section 5 of the Securities Act, and the sale of these securities thereby violated NASD Rule 2110.[38]

IX. Sanctions

For failing to supervise, FINRA's Sanction Guidelines recommend that adjudicators consider a suspension of up to 30 business days, and in egregious cases, suspending the responsible individual in any or all capacities for up to two years or imposing a bar. The Guidelines also recommend a fine of $5,000 to $50,000.[39] The Department of Enforcement seeks a 90-day suspension in principal capacities and a $30,000 fine. The Hearing Panel finds that the suspension should be longer, and that Respondent should be required to re-qualify as a principal, but that the fine recommended by the Department of Enforcement is larger than necessary. The Hearing Panel finds that the appropriate sanction is a suspension of six months in all principal capacities, a fine of $10,000, and a requirement to re-qualify as a principal before functioning in any principal capacities.

The Hearing Panel considered a number of factors, including the Principal Considerations in the Sanction Guidelines for a failure to supervise. One of the Principal Considerations is whether Respondent ignored "red flags." Here, Respondent recognized that Barron Moore's entire business was a "red flag," yet he failed to exercise any supervisory responsibility. As discussed above, there were specific red flags concerning the activities in the seven accounts in the Complaint. In addition, the inexperience of the brokers, Katherine Moore's lack of experience with equities and her lack of involvement with the penny stock business, Lankford's

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[38] *Dep't of Enforcement v. Morgan Keegan & Co.*, No. CAF040073, 2006 NASD Discip. LEXIS 24, at *40 (O.H.O. July 21, 2006).

[39] FINRA Sanction Guidelines at 108.

exclusive substantive contact with the clients, and his focus on the liquidation of unregistered penny stocks, all demanded close supervision.

A second Principal Consideration is the nature, extent, size, and character of the underlying misconduct. The underlying misconduct here was substantial. The Department of Enforcement proved that millions of unregistered shares were sold, netting more than a million dollars for the seven accounts.

The third consideration specific to a failure to supervise is the quality and degree of a supervisor's implementation of the firm's supervisory procedures and controls. Here, the firm had no procedures or controls with respect to its main business, the liquidation of unregistered penny stocks.[40] As the only principal in the firm with experience with equities, Respondent should have recognized the need for such procedures, and should have supervised the sales representatives in conformity with proper procedures.

The Hearing Panel finds that a 90-day principal suspension is inadequate, and imposes a six-month suspension in all principal capacities. The Principal Considerations all support a substantial suspension, and Respondent has not accepted any responsibility for his actions. In addition, Respondent's insistence that he discharged his supervisory responsibilities appropriately demonstrates that he does not understand what a supervisor is supposed to do, and should be required to re-qualify as a principal. The Hearing Panel finds that a fine of $10,000 is adequate. Respondent claims that his share of the commissions for the transactions in the Complaint was about $5,000. Tr. 353. The Hearing Panel finds that the fine should deprive Respondent of the $5,000, and that an additional fine of $5,000 is appropriate.

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[40] Barron Moore settled a number of charges soon after the Complaint was filed and agreed to be expelled from FINRA. One of the charges was that it failed to have procedures for the sale of unregistered securities. CX-6.

X. Conclusion

For failing to supervise registered representatives in violation of NASD Conduct Rules 3010 and 2110, Respondent is suspended in all principal capacities for six months and fined $10,000. Respondent is also ordered to re-qualify as a principal before functioning in any principal capacity. In addition, Respondents shall pay costs in the amount of $3,701.75, which represents the cost of the hearing transcripts together with a $750 administrative fee.[41]

These sanctions shall become effective on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final action in this proceeding, except that if this decision becomes FINRA's final action Respondent's suspension in all principal capacities shall begin on Monday, October 19, 2009, and end on Sunday, April 18, 2010.

HEARING PANEL

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By: Lawrence B. Bernard
Hearing Officer

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