

PLEASE NOTE THE LATER CASE HISTORY OF THIS DECISION FOLLOWING THE TEXT OF THE DECISION.

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of the Association	Redacted Decision
of:	
X	<u>Notice Pursuant to</u>
as a	<u>Rule 19h-1</u>
Registered Representative	<u>Securities Exchange Act</u>
with	<u>of 1934</u>
The Sponsoring Firm	Decision No. SD99004

This proceeding arises as a result of a remand by the Securities and Exchange Commission ("SEC" or "the Commission") following its review of action by the National Association of Securities Dealers, Inc. ("NASD") revoking prior approval of the continued association of X¹ as a registered representative of the Sponsoring Firm ("the Sponsoring Firm"). The Commission remanded that matter to elicit clarification regarding the basis for the NASD's action or for further consideration of X's application, without suggesting any particular outcome of the proceeding.

X, who is currently associated with the Sponsoring Firm, was previously subject to two statutory disqualifications. In February 1988, X was enjoined, with his consent, from violating the reporting and recordkeeping provisions of the federal securities laws.² As a result, X became subject to an ongoing statutory disqualification.³ In addition, X was convicted in 1988 of violating the Currency and Foreign Transaction Reporting Act, a misdemeanor. He was sentenced to two months' imprisonment and fined \$2,500. The criminal conviction, dated March in 1988, constituted a statutory disqualification for a period of 10 years.⁴ As a result of the statutory disqualification

¹ The names of the Statutorily Disqualified individual, the Sponsoring Firm, the Proposed Supervisor, and other information deemed reasonably necessary to maintain confidentiality have been redacted.

² Also in 1988, X was suspended for six months by the Commission in parallel administrative proceedings.

³ See Section 3(a)(39) of the Securities Exchange Act of 1934 (the "Exchange Act").

⁴ Under Sections 3(a)(39) and 15(b)(4)(A) of the Exchange Act, a person is subject to a

represented by his February 1988 injunction, X cannot associate with any NASD member absent NASD consent.⁵

In 1988, the NASD consented to X's association with the Sponsoring Firm as a 50 percent owner, a principal, municipal securities principal, municipal securities financial and operations principal, and an investment company and variable contracts products representative. In 1991, the NASD expanded its approval to include X's association with the Sponsoring Firm as a corporate securities representative and general securities principal, and, in 1995, as a financial and operations principal. Following requisite notification of each of these three actions, the Commission did not object to the NASD's determinations.

In 1996, in an action brought by the Commission, X consented to findings that he and an unregistered back office employee aided and abetted and caused the Sponsoring Firm's improper hypothecation of customer securities and violations of various recordkeeping provisions, and that X failed to supervise the other employee with a view to preventing those violations.⁶ X was censured, ordered to cease and desist from causing any violations and future violations of rules governing recordkeeping and the hypothecation of customer securities, fined \$25,000, barred from acting in a supervisory capacity with any broker, dealer, investment company, investment adviser or municipal securities dealer, and suspended from association with any of these entities for six months.⁷ X explained at the October 1998 hearing that these violations arose from problems associated with the hypothecation function of an internal computer program that took \$80,000 to replace.

Following the Commission's 1996 action, the NASD instituted a proceeding to determine whether X's continued association with the Sponsoring Firm was in the public interest. As part of this proceeding, the Sponsoring Firm filed in March 1997, an MC-400 member continuance application seeking the NASD's consent to X's continued association with the Firm. A hearing was held on the matter in April 1997. In a decision dated in June 1997, the NASD noted that X had been subject to "serious disciplinary actions," found that the Sponsoring Firm's proposed plan of supervision for X was inadequate, and determined that X could not remain associated with the Sponsoring Firm. The NASD decision allowed X to retain his 50 percent ownership interest in the Sponsoring Firm. X thereafter sought review of the NASD decision by the Commission.

Following the Commission's July 1998 remand decision, a subcommittee of the Statutory Disqualification Committee of NASD Regulation, Inc. ("NASD Regulation") held a hearing in this

statutory disqualification if he "has been convicted within ten years. . . of any felony or misdemeanor . . . which . . . arises out of the conduct of the business of a broker, dealer . . ." The statutory disqualification represented by the March 1988 conviction thus expired in March 1998.

⁵ See Article III, Section 4(h) of the NASD By-Laws.

⁶ [Footnote Redacted].

⁷ The Sponsoring Firm also consented to findings of violations and was censured, ordered to cease and desist from further violations of the same provisions, fined \$50,000, and ordered to disgorge \$7,085. The Sponsoring Firm also agreed to a series of undertakings relating to its back office operations.

matter in October 1998. X appeared and was accompanied by his proposed supervisor ("the Proposed Supervisor"). BK and JH appeared on behalf of the Department of Member Regulation ("Member Regulation").

Discussion

The Sponsoring Firm is organized as a private corporation owned by the President (with 50 percent ownership), and X (with 50 percent ownership).⁸ The Sponsoring Firm became a member of the NASD in 1975 and is engaged in a general securities business. The Firm is fully disclosed, clearing through Firm A, and it employs 13 registered representatives, 15 associated persons, and two general securities principals.

X, born in 1939, has been registered with the Sponsoring Firm in various capacities since 1973. No customers have lodged complaints against him in his role as a registered representative.

The Sponsoring Firm proposes to continue to employ X as a municipal securities representative, investment company and variable products representative, and corporate securities limited representative to work from the Firm's home office. The Sponsoring Firm proposes that the Proposed Supervisor, who has no disciplinary history, be responsible for X's direct supervision. The Proposed Supervisor has been registered with the Association as a general securities principal since January 1998 and in various representative capacities since February 1984.

In a pre-hearing statement of position dated in October 1998 and in argument presented at the October 1998 hearing, Member Regulation recommended that X's association with the Sponsoring Firm be denied. Member Regulation cited, as discussed above, X's statutory disqualification and disciplinary history, including relevant intervening disciplinary and regulatory history after he was permitted to associate with the Sponsoring Firm in 1991 and 1995, as well as the disciplinary history of the President and the Firm. In addition, Member Regulation cited violative activity engaged in by an individual supervised by X ("Employee 1"); customer complaints lodged against the Sponsoring Firm and arbitrations settled by and pending with respect to X; and the Sponsoring Firm's recent examination history. Finally, Member Regulation questioned the adequacy of the supervision to be accorded X by the Sponsoring Firm.

Member Regulation noted that the Sponsoring Firm had received several customer complaints during 1997 and 1998. Three of these customer complaints arose from misconduct on the part of the former Sponsoring Firm employee ("Employee 1").⁹ Member Regulation also cited an

⁸ The President is subject to a statutory disqualification and is associated with the Sponsoring Firm pursuant to NASD approval. In February 1988, the President, like X, was enjoined, with his consent, from violating the reporting, recordkeeping, and record retention provisions of the federal securities laws. As an injunction, this statutory disqualification remains in effect. A second statutory disqualification for the same misdemeanor violation as engaged in by X arose pursuant to the President's guilty plea in March 1988, and expired 10 years later, in March 1998.

⁹ X discovered Employee 1's wrongdoing as a result of his review of a request for the issuance of a check to a customer. After an investigation, he contacted each of Employee 1's customers to alert them to the possibility of improper activity in their accounts. The Sponsoring Firm suspended Employee 1, notified the NASD, fired Employee 1 in June 1996, and made whole each of Employee

NASD arbitration, which alleged mutual fund churning on the part of Employee 1 and improper supervision by the Sponsoring Firm, the Firm President and X. This arbitration proceeding was settled between the claimants, the Sponsoring Firm, the Firm President, and X. Member Regulation represented that the matters alleged in this arbitration proceeding were the subject of an ongoing investigation by NASD.¹⁰

In addition, Member Regulation questioned the Sponsoring Firm's proposal that the Proposed Supervisor supervise X. Member Regulation observed that that the Proposed Supervisor has been eligible to act in a supervisory capacity only during the last year, and that there was no proof that the Proposed Supervisor had supervisory experience sufficient to assure that he would effectively carry out the heightened supervision required for a statutorily disqualified individual. Member Regulation also questioned the ability of the Firm to supervise effectively an individual requiring heightened supervision, in light of supervisory deficiencies noted with respect to its existing staff and the statutory disqualification of both owners of the firm.

Member Regulation thus objected to X's association with the Sponsoring Firm in any capacity on three grounds: (1) the serious nature of the activities that created X's statutory disqualification; (2) intervening regulatory concerns since X was permitted to reenter the securities industry; and (3) the limited ability of the Firm and the Proposed Supervisor to supervise effectively a statutorily disqualified individual. After carefully considering these arguments and the record, however, we conclude that the Application should be approved, subject to the conditions stated herein.

As a threshold matter, we have considered the serious nature of the regulatory event, resulting in a permanent injunction, which formed the basis of X's present statutory disqualification. We have also considered X's misdemeanor conviction for violation of currency transaction reporting requirements, which we observe no longer constitutes a statutory disqualification. We also note that

1's aggrieved customers with the exception of one who brought suit. The Sponsoring Firm represents that it has escrowed \$75,000 in anticipation of her settlement.

In July 1997, a District Business Conduct Committee issued a complaint which alleged that Employee 1 converted from three customers funds totaling \$68,775, in violation of NASD Rule 2330, and failed to respond to requests for information made pursuant to NASD Rule 8210. In December 1997, a default decision was entered against Employee 1 that imposed sanctions including a censure, a bar, and a fine in the amount of \$350,000. This disciplinary action was preceded by a parallel civil suit, filed in October 1996. X was dismissed from the civil suit pursuant to a grant of partial summary judgment in March 1998.

¹⁰ In his post-hearing brief, X objects to Member Regulation's failure to provide documentation to support assertions made in its October 1998 letter and at the hearing, particularly with respect to ongoing or pending NASD reviews relating to customer complaints. We have taken this objection into consideration in our evaluation of the evidence and argument in this matter. We also find that the objection is equally germane to references to actions characterized as Letters of Caution or as requiring compliance conferences that were not independently substantiated by documentary evidence in advance of the hearing and thus not squarely placed into issue. Cf. Excel Financial, Inc., Gary R. Beynon and Robert L. Sperry, Exchange Act Rel. No. 39296 (Nov. 4, 1997).

notwithstanding the serious nature of the foregoing violations, the NASD approved, subject to stringent conditions, X's continued association with the Sponsoring Firm in various capacities in 1988, 1991, and 1995.

We also acknowledge that X thereafter engaged in significant intervening misconduct resulting in the 1996 administrative proceeding in which the Commission found that X was involved in the improper hypothecation of investor securities and the willful aiding and abetting of violations of various recordkeeping provisions. We agree with the Commission's assessment of the gravity of those violations set forth in its remand decision in this matter, as well as its conclusion that these violations demonstrate that there is a risk to be considered that X may engage in such violations in the future even though he seeks permission for continued association with the Sponsoring Firm only as a salesperson.

We have also considered the evidence of additional intervening regulatory concerns raised by the staff. As to the customer complaints received by the Sponsoring Firm in 1997 and 1998, three are of no regulatory significance,¹¹ and the remainder appear to be associated with misconduct by Employee 1. As noted above, in the single civil case against X, which stemmed from Employee 1's misconduct, the court dismissed the claims against X.¹² Also as noted above, an NASD arbitration arising from Employee 1's misconduct was settled in February 1997, and all claims against the Sponsoring Firm, X and the Firm President were dismissed.¹³

Since the Sponsoring Firm employs two individuals who are subject to statutory disqualification, it is subject to periodic Statutory Disqualification examinations by NASD staff. We have considered letters from NASD staff dated in September and December 1998 that represent that such examinations conducted as to the Firm President and X, respectively, found general compliance with rules and regulations reviewed based on sampled aspects of their business activities.

We observe that the Sponsoring Firm has engaged in an ongoing dialogue with NASD staff in response to suggestions for improvement of its supervisory procedures. In response to potential problems noted by the staff during the Sponsoring Firm's most recent cycle examination, the Firm has

¹¹ For example, customer KM's complaint involved a representative who had not been employed with the Sponsoring Firm since 1993. The matter was resolved by an August 1998 letter to the representative requesting a compliance conference. Customer LR's complaint involved alleged "parking" of securities in his account, a matter closed by the NASD without action in a letter dated in November 1997. Customer NF's complaint, received by the Sponsoring Firm seven years after the transaction, alleged that bonds purchased for him should have been, but were not, placed in an IRA rollover account. The Sponsoring Firm maintains that it never received NF's instructions, but nevertheless undertook to contact the IRS for permission to transfer the bonds to an IRA account without penalty, and is awaiting the IRS' determination.

¹² Counsel for X represents that there is no ongoing NASD investigation of this matter, and no recommendation by the NASD that the Sponsoring Firm or any of its employees be sanctioned.

¹³ Counsel for X similarly represents that there is no ongoing NASD investigation of this matter, and no recommendation by the NASD that the Sponsoring Firm or any of its employees be sanctioned.

instituted new policies and has retained Firm B, an outside consulting firm specializing in the creation and maintenance of supervisory procedures and compliance manuals. The Sponsoring Firm has retained this firm to create and maintain a current, comprehensive compliance manual, updated quarterly. The Sponsoring Firm has also employed a former SEC official, to audit the Sponsoring Firm's compliance with the updated procedures semi-annually.

We note that in reply to X's post-hearing submission dated in December 1998, Member Regulation: 1) reiterated its argument in favor of denial for the same reasons set forth in its October 1998 filing; and 2) stated that should the application be approved, specific enumerated supervisory conditions should be imposed. Hearing no objection to the specific supervisory conditions proposed by Member Regulation, we approve them and incorporate them into our decision in this matter.

We find that the Sponsoring Firm has addressed satisfactorily the risks represented by X's continued association with the Firm, subject to the qualifications and limitations set forth herein. X, who is subject to a Commission bar in all principal or supervisory capacities, does not seek to act as an officer, director, or control person of the Sponsoring Firm. In order to address concerns that he may in fact exercise control within the Firm by virtue of his ownership interest, he has agreed to divest himself of all voting rights regarding his shares except for the right to vote in the event of a proposed sale of the Sponsoring Firm. Since the hearing, the Firm has taken further steps to ensure X's proper supervision, including revision of its written Supervisory Policies and Procedures and its Broker/Dealer Compliance Manual. We direct that the final versions of these documents be submitted to Member Regulation upon completion.

Member Regulation argues that the Proposed Supervisor will be unable properly to supervise X because the Proposed Supervisor has been a general securities principal for only one year. The Proposed Supervisor has been registered as a representative of the Sponsoring Firm since 1984 and as a general securities principal since January 1998. The Proposed Supervisor is thus familiar with the Firm's business and its personnel, and there is no evidence that his relatively short tenure as a general securities principal will materially affect his ability to supervise X.¹⁴ The Proposed Supervisor also will be assisted with his other supervisory duties by the Firm President, a general securities principal.

Finally, the Proposed Supervisor and the Sponsoring Firm have proposed an effective plan of supervision, which has been supplemented and strengthened by the recommendations of Member Regulation, which we adopt as conditions of X's continued association in the requested capacities:

- (1) X and the Proposed Supervisor will be located in close proximity at the Sponsoring Firm's home office, and X will conduct business only from that office;
- (2) X and the Proposed Supervisor will meet weekly to discuss X's assignments and business;
- (3) The Proposed Supervisor will personally monitor and review all of X's incoming and outgoing correspondence, and will keep a written record evidencing review and

¹⁴ The Proposed Supervisor has no disciplinary history.

approval of all transactions (including order tickets prior to entry), the opening of new accounts, and all correspondence;

- (4) X will have no discretionary authority over any account that he services, and is prohibited from accepting funds in cash or in his own name;
- (5) All customer complaints, whether written or oral, must be referred immediately to the Proposed Supervisor for review. The Proposed Supervisor will thereafter prepare a memorandum to file describing the measures he took to investigate the merits of the complaint and the resolution of the matter;
- (6) For as long as X remains a statutorily disqualified person, X will grant to the President of the Sponsoring Firm, an irrevocable proxy to vote X's shares of the Sponsoring Firm stock on all matters that come before the shareholders other than transactions involving a sale or liquidation of the entire company, merger of the company in which the Sponsoring Firm is not the surviving entity, or the liquidation or dissolution of the company; and,
- (7) The Proposed Supervisor and the Firm President will certify their compliance with the foregoing procedures semi-annually.

Based on the foregoing, and subject to the foregoing supervisory conditions, we approve X's continued association with the Sponsoring Firm in the limited capacities requested.

The NASD certifies that: (1) X meets all applicable qualification requirements for the proposed employment; (2) the Sponsoring Firm is not a member of any other self-regulatory organization; and (3) X and the Proposed Supervisor have represented that they are not related by blood or marriage.

Accordingly, in conformity with the provisions of SEC Rule 19h-1, the registration of X as a municipal securities, investment company and variable products, and corporate securities limited representative associated with the Sponsoring Firm will become effective upon the issuance of an order by the Commission that it will not institute proceedings pursuant to Section 15A(g)2) of the Act. The NASD is also seeking relief under Section 19(h) of the Act. This notice shall serve as an application for such an order.

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Senior Vice President and Corporate Secretary

LATER CASE HISTORY:

After this notice was filed with the SEC but before it was approved by the SEC, the NASD issued a correction letter stating the following:

"NASD Regulation did not intend to require that the Securities and Exchange Commission issue an order in the X matter, as erroneously stated in the 19h-1 Notice, dated March 31, 1999.

It is thus our understanding that based on the foregoing clarification, the application X to become associated as a municipal securities, investment company and variable products, and corporate securities limited representative with a member firm, will become effective within 30 days of the Securities and Exchange Commission's receipt of this letter...."