BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of	DECISION
District Business Conduct Committee For District No. 8	Complaint No. C8A960094
Complainant,	District No. 8 (CHI)
vs.	Dated: November 11, 1998
Norman M. Merz Brookfield, Wisconsin,	
Respondent.	

The January 30, 1998 decision of the District Business Conduct Committee for District No. 8 ("DBCC") regarding Norman M. Merz ("Merz") was called for review pursuant to NASD Procedural Rule 9312.[1] After a review of the entire record in this matter, we affirm the findings of the DBCC that Merz engaged in private securities transactions without prior notice to, and approval of, his employer firm and failed to give prompt written notice to his employer of compensation received from outside business activities, in violation of Conduct Rules 2110, 3040, and 3030. As to sanctions, we affirm the censure, $110,000 fine, requirement to requalify by examination as a general securities representative, and DBCC hearing costs of $2,472.25. We also impose a bar in all capacities.

Background

Merz entered the securities industry in 1964 as a general securities representative of an NASD member firm. In 1984, he became a general securities principal while registered with another member firm. On January 29, 1990, Merz became registered in the same capacities with Aegon USA Securities, Inc. ("Aegon" or "the Firm"). Merz is currently registered as a general securities representative with member firm First Midwest Securities, Inc.

[1] We called this case for review to determine whether the sanctions imposed by the DBCC were appropriate in light of the findings of violations.

The DBCC issued the complaint on December 13, 1996, following an investigation into the circumstances surrounding the termination of Merz by Aegon. Cause one of the complaint alleged that on July 10, 1990, Merz participated in private securities transactions by participating in the sale of promissory notes ("Hess Notes") issued by Douglas M. Hess ("Hess"), of Doug Hess and Associates, for FDIC Package 11 from Proceeds of Package D0011, as reflected on Exhibit A, attached hereto. Cause one further alleged that Merz participated in the sale of promissory notes ("Cooperative Notes") issued by Producer Direct Cooperative ("Cooperative") on June 1, 1993, as reflected on Exhibit B, also attached hereto. The complaint alleged that both the Hess Notes and the Cooperative Notes transactions were effected on a private basis in that Merz failed to give Aegon written notice of his intention to engage in such activities and, accordingly, did not receive written approval from Aegon prior to engaging in the transactions, in violation of NASD Conduct Rules 2110 and 3040.

Cause two alleged that from June 1993 through January 1994, Merz was employed by and/or accepted compensation from Cooperative, without giving his employer prompt written notice of his participation in such outside business activity, in violation of NASD Conduct Rules 2110 and 3030.

Facts

Undisputed Facts. Prior to the hearing, counsel for the DBCC and Merz reached agreement concerning certain facts that would not be disputed at hearing and submitted a document captioned "Agreement and Stipulation" ("Stipulations"). The Stipulations contained an agreement by Merz that the customers listed in Schedule A to the complaint (now Exhibit A attached hereto) bought Hess Notes on July 10, 1990 in the amounts listed in Schedule A, with stated returns of 20 percent of the amount of each note due, along with principal, in 180 days. The Stipulations also contained an agreement by Merz that the customers listed in Schedule B to the complaint (now Exhibit B attached hereto) bought Cooperative Notes on June 1, 1993 in the amounts listed on Schedule B, with a stated return of 29 percent of the amount of each note due, along with the principal, on September 30, 1994.

The Hess Notes. In 1990, Merz was contacted by a friend, JH, who had provided funds to an acquaintance, Hess, to purchase three FDIC loan packages. These loan packages consisted of pools of non-performing bank loans that Hess intended to refinance. Hess was looking for additional people to fund the purchases, and JH thought Merz might be interested. Merz called Hess, who stated that he would borrow money for a specified period of months at interest rates of 20 percent for five months, 25 percent for seven months, 30 percent for nine months, and 40 percent for a 12-month maturity. Hess was looking for funds in $100,000 increments, and he told Merz that each dollar invested by an individual would be backed by $2.50 in collateral. Merz personally loaned Hess $100,000, and Hess purchased three loan packages with Merz' and other investors' funds for $4,600,000.[2]

[2] One of Merz' witnesses, Dr. RF, who also lent money to Hess for one of these first

After the first three loan packages were purchased and Hess had begun collection efforts, Hess told JH that he wanted to purchase a fourth loan package. JH and Merz traveled to Wyoming, where the collection efforts were taking place, to see how the efforts were going. On a second trip to Wyoming, Hess asked Merz if he could help Hess find money to purchase a fourth loan package, referred to in the complaint as Package D011, and said he would compensate Merz for his efforts. Merz testified that he was reluctant to get involved because of his insurance and securities activities, but he told Hess that if the funding did not involve securities and Hess paid Merz for his time, he would help Hess find investors.[3]

Upon his return home from Wyoming, Merz contacted a friend, RB, who had been registered as a general securities representative and general securities principal, and asked RB if he thought that loans of money to Hess through promissory notes would be considered securities. RB suggested that they visit an attorney, JD, at a securities law firm and ask him for his advice. Merz and RB met with JD sometime in June 1990 and provided him with copies of a promissory note and a collateral pledge agreement regarding the Hess Notes.[4] Merz testified that, after hearing the facts, JD indicated that it was his opinion that because the terms of the various notes were going to be for less than seven months, the notes would not constitute securities transactions. JD told Merz and RB that he would research the matter further and send them a letter. Merz testified that he left the meeting with JD with the understanding that the Hess Notes were not securities.

After the meeting, Merz and RB received a letter from JD, dated June 28, 1990 ("the JD Letter"), which set forth JD's understanding of Hess' financing arrangement as follows. Hess was purchasing non-performing loans from the FDIC that would be funded by various individual lenders. In exchange, Hess would provide each lender with a promissory note and a collateral pledge agreement substantially in the form provided to JD by Merz at their meeting. Each note

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three loan packages, testified that Hess also was supposed to pay a bonus to the "primary" investors, consisting of a portion of the profits left over after the fixed interest payments were made. This bonus, however, was never paid.

[3] JH, who testified for Merz, corroborated Merz' testimony that he and Merz traveled to Wyoming to check on Hess' collection efforts and that Hess asked Merz to help Hess find other investors to fund the fourth FDIC loan package.

[4] Merz testified that a similar promissory note and collateral pledge agreement had governed the first three of Hess' FDIC loan packages. Merz had attempted to revise the original promissory note and collateral pledge agreement because he did not like the language, and he had a law firm prepare a more detailed collateral pledge agreement. These were the documents presented to JD as those that were intended to govern the fourth Hess FDIC loan package. When these documents were presented to Hess, however, he refused to sign them. Instead, Hess drafted the promissory notes in evidence as Exhibit 20 in this case and sent them to the 16 investors. No collateral pledge agreement accompanied the 16 Hess Notes at issue.

would be for a six-month period with a return of 20 percent and the lender would be granted a security interest in the FDIC loan packages as reflected in the collateral pledge agreement.

After reviewing the facts, the JD Letter summarized the legal principles on which courts rely to determine whether a note is or is not a security. The letter pointed out that the critical distinction was whether the funds were lent for commercial or investment purposes and that courts use a multi-factor test to make that determination. The letter then stated: "[W]e are not in a position to provide our legal opinion on whether these notes will be considered to be a securities (sic)." (Emphasis added.)

The JD Letter then mentioned "several factors mitigating in favor of classifying these notes as non-securities." These included: the notes had a short maturity; the notes would be fully collateralized and would provide for a fixed payment amount; and the intent of the transactions would be commercial, not for investment purposes, and would be so presented to lenders.

Although the JD Letter specifically stated that the law firm was not providing an opinion on whether the notes Merz intended to sell were securities, Merz testified that based on the meeting with JD and Merz' unfamiliarity with legal opinions, he believed he had a legal opinion that the promissory notes were not securities.[5]

After receiving the JD Letter, Merz sold Hess Notes totaling $770,000 to 16 investors, many of whom were his customers. Each of the promissory notes had a six-month maturity, with a 20 percent return. None of the Hess Notes sold by Merz were collateralized. Merz admitted that he was paid a fee of $46,000 for selling the Hess Notes.

The NASD examiner who investigated Merz' involvement in this matter sent questionnaires to each of the 16 investors concerning their investments in the Hess Notes. Four of the 16 investors, VB, JG, TW and RD, returned completed questionnaires. All of these investors stated that they did not receive any explanatory information with the notes, that their only contact regarding the investment was with Merz, and that they bought their notes for investment purposes. None of the four was involved in the business of funding loan packages.

Two of the investors who returned completed questionnaires, TW and RD, also testified at the hearing that Merz first contacted them about investing with Hess, that they bought the notes for investment purposes, that they never received a collateral pledge agreement, and that

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[5] RB testified for Merz and corroborated his testimony about the meeting with JD. RB stated that he also left this meeting with the distinct impression that the loans were not securities. RB further testified that when he read the letter and noted that JD had not provided an opinion on whether or not the notes to be sold were securities, he called JD to ask him why he did not provide a legal opinion after Merz had paid him $500. JD told RB that a legal opinion would have cost Merz 10 times as much and "it would basically say the same thing." RB did not remember if he relayed this conversation with JD to Merz.

they were not in the commercial or investment banking business. Merz' witness, JH, who also purchased Hess Notes, testified that he too bought the notes for the expected 20 percent rate of return.

The Cooperative Notes. On May 5, 1993, Merz met with a client named LG, a veal farmer. LG told Merz that LG and 24 other farmers had formed a cooperative earlier that year to enter into the business of processing their own animals. The Cooperative had been unsuccessful in obtaining bank financing. Merz volunteered to help the Cooperative raise funds. He told LG that he would introduce representatives of the Cooperative to Dr. RF, who might be able to help them. Merz called Dr. RF and arranged a meeting with the Cooperative directors. JI, the president of the Cooperative, and his brother, BI, met with Dr. RF and others and provided a pro forma of the Cooperative's operation and its business plan. JI and BI stated that the Cooperative would be willing to offer an interest rate of 29 percent. Dr. RF called Merz the next day and said he was willing to put money into the Cooperative. Merz suggested that an attorney be contacted to make sure that the proper documentation was in place to protect Dr. RF and anyone else who provided money to the Cooperative. Merz thereafter contacted an attorney who looked at the documents provided by the Cooperative and stated that they were inadequate. The attorney referred Merz to RJ, an attorney at another law firm (the "Law Firm").

On May 25, 1993, Merz, JI, and BI met with RJ and another attorney, KM, from the Law Firm ("the May 25th Meeting"). Merz testified that he identified himself as a registered securities representative who was being paid for putting the Cooperative program together and stated that JI, BI, and Merz needed a formal determination that the funding of the Cooperative by Dr. RF and others would not constitute securities transactions.

JI also testified on Merz' behalf about the May 25th Meeting. He testified that the producer members of the Cooperative also did not want the funding provided by Dr. RF and others to be deemed a security because the Cooperative's state charter provided that only the veal farmers who were members of the Cooperative could have an equity interest in the Cooperative. JI testified that when he and Merz expressed their concern that the transaction not be structured as a security, RJ told them that he was "pretty sure" it would not be a security and that JI, BI, and Merz did not have to worry.

Another witness who testified for Merz about the Cooperative was TA, a lawyer who represented Dr. RF and other investors in a subsequent malpractice lawsuit against the Law Firm. TA testified that he learned through depositions of RJ and KM that during or shortly after the May 25th Meeting, RJ asked KM to research the securities question and KM reported back to RJ that investments in the Cooperative would be exempt securities. This report was never relayed to Merz, JI, or BI.

After the May 25th Meeting, the Law Firm drafted a credit agreement dated June 1, 1993 ("Credit Agreement"), which governed the promissory notes purchased by Dr. RF and others. Under the terms of the Credit Agreement, each promissory note would return 29 percent interest and be due on September 30, 1994. Dr. RF testified that he bought his $1,000,000 promissory

note for investment purposes and another investor, RD, testified that he bought his $30,000 note for the 29 percent return. The Credit Agreement explicitly stated:

> Investment Intent. Each Note is being acquired solely for the Lender's own account, as principal, for investment purposes and not with a view to the resale or distribution of any part thereof . . . .
>
> Restricted Securities. The Lender understands that the Notes are not registered under the Securities Act on the ground that the sale provided for in this Agreement and the issuance of Notes hereunder is exempt from registration under the Securities Act pursuant to Sections 3(b) and 4(2) thereof and Regulation D promulgated thereunder, and under the Wisconsin Uniform Securities Act pursuant to an analogous exemption, and that the Company's reliance on such exemptions is predicated on each Lender's representations set forth herein . . . .

Merz testified that he did not read the Credit Agreement.

The Law Firm also drafted a consulting agreement, dated June 1, 1993, between Merz and the Cooperative ("the Consulting Agreement"). The Consulting Agreement provided that the Cooperative desired to engage Merz' services in obtaining financing to purchase a processing facility and equipment, and to provide working capital. For such services, the Cooperative agreed to pay Merz $42,500 upon execution and $35,000 upon such date as the Cooperative obtained at least $1,550,000 in financing. The testimony of Dr. RF, RD, and JI was that Merz introduced RF, RD, and DD (through his son RD) to the Cooperative as potential investors. For those introductions and his services in structuring the transaction, Merz testified that he received $47,500 from the Cooperative.

In late 1993, the Cooperative stopped making interest payments on the promissory notes. The investors, led by Dr. RF, called the notes and moved to freeze the assets of the Cooperative. The producer members of the Cooperative sued Dr. RF and Merz in September 1994 alleging violations of state and federal securities laws. An agreement was later reached by the attorneys for both parties, funds were distributed, and the complaint was withdrawn. In addition, the Cooperative investors filed a malpractice action against the Law Firm for failing to protect the investors' interests by providing that they be given a first lien over the assets of the Cooperative. This action was also settled out of court.

Merz' Knowledge of NASD Rules and Lack of Notice to Aegon. Lisa Wachendorf ("Wachendorf"), a compliance officer employed at Aegon, testified that there had been two compliance manuals in force at Aegon during the period relevant to this case -- the 1990 Aegon Manual and the 1993 Aegon Manual. She was instrumental in producing both compliance manuals. The 1993 Aegon Manual prohibited an Aegon representative from selling or soliciting the sale of an interest in any security unless the Firm: had entered into a selling agreement with the issuer; had otherwise agreed to act as a participant in any selling or related activities on behalf of an issuer; or had previously approved such activity in writing. The 1993 Aegon Manual

also prohibited a registered person from being employed by, or accepting compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his or her relationship with the Firm, unless he or she had provided prompt written notice to the Firm. Although revisions to the 1990 Aegon Manual were made in the 1993 Aegon Manual, Wachendorf stated that the prohibitions on private securities transactions and outside business activities remained identical. Merz initially had been employed by a former subsidiary to Aegon, MidAmerica Management Corporation ("MidAmerica"). Wachendorf testified that the prohibitions on outside business activities and private securities transactions were also the same in the 1990 MidAmerica Manual as in the 1993 Aegon Manual. Merz received the 1993 Aegon Manual in the spring of 1993 and the 1990 MidAmerica Manual on March 12, 1990.

Merz also completed the Firm's annual registered representative questionnaire on April 12, 1990, February 11, 1991, February 15, 1993 and April 7, 1994. In each questionnaire, Merz was asked whether he maintained any other businesses and he responded only that he maintained an insurance business away from the Firm.

The record also shows that in the summer of 1993 there was an inquiry into Merz' activities by the Wisconsin Office of the Commissioner of Securities ("the State"). The State conducted an audit of Merz' office in June 1993. In the course of that audit, the State Examiner, Helen Kluever ("Kluever"), asked Merz whether he had been arranging financing for anyone, or had been involved in raising venture capital for a fee, and he responded "no." After the State's audit, a staff attorney with the State, William C. Lloyd ("Lloyd"), wrote to Merz on June 27, 1993 and stated that Lloyd had received a report that Merz was holding himself out to others as being able to offer venture capital for a fee. The June 27 letter asked Merz to reconsider his answer to Kluever that he had not been transacting business that was not reflected on the records of his employing broker/dealer without written permission from the broker/dealer to do so. In a reply letter dated June 30, 1993, Merz stated that the only situation he could think of that would prompt such a report to the State was some activity in which Merz had been involved with Hess in 1990. Merz explained in his June 30, 1993 letter to Lloyd that there was a legal opinion from a law firm regarding the Hess Notes that indicated that Merz was not intending to sell a security. Merz did not mention his activities for the Cooperative.

Aegon received notice of the State's inquiry when Merz copied Aegon on his June 30 reply letter to the State and enclosed a copy of Lloyd's June 27 letter. When Aegon received the letters from Merz, Wachendorf called and asked him to explain the State's inquiry. Merz told her about his participation in the sale of the Hess Notes, and that he had the JD Letter that gave the legal opinion that the notes were not securities. He did not mention the Cooperative activities to Wachendorf.

Following this discussion, Wachendorf sent Merz a Letter of Caution dated July 12, 1993 ("the Aegon Letter of Caution"). The Firm stated that it had learned that Merz had engaged in sales of participation in pools of non-performing FDIC loans to customers for the customers' financial gain and that neither the proceeds from these sales nor the commissions were directed

through Aegon.[6] The Firm cautioned Merz against the sale of this or any similar product without first notifying Aegon and receiving its written approval. Aegon also warned Merz that if he engaged in any private securities transactions without express written permission from Aegon he could be subject to "further warnings or a fine and possible termination of license."

Wachendorf testified that Merz called her to acknowledge receipt of the Aegon Letter of Caution and stated that he would not engage in any further private securities transactions without notifying Aegon. Merz again did not disclose his activities with the Cooperative to Wachendorf.

After the Aegon Letter of Caution was sent to Merz, Wachendorf conducted a branch audit of Merz' office on August 6, 1993. During this audit, she discussed the Firm's prohibition on outside business activities with Merz and asked him if there were other activities in which he was, or had been, engaged about which Aegon should receive notice. Merz responded that there were not. After the audit, Wachendorf sent Merz a letter dated September 16, 1993 which reminded him that Aegon must be notified prior to Merz' engaging in any activity that might be construed as a private securities transaction, such as coordinating a business transaction, even in the case of a non-security. Merz called Wachendorf to acknowledge receipt of the letter, but again did not reveal his activities with the Cooperative.

On January 28, 1994, Lloyd sent Merz another letter stating that the report Lloyd had received about Merz' activities in June 1993 did not concern the Hess Notes. Lloyd asked Merz to give him a full, fair, accurate, and complete response to the State's inquiry concerning every aspect of his activities to date in arranging loans for Hess or others. Merz sent Lloyd two reply letters, dated March 18, 1994 and April 13, 1994, in which he revealed his activities for the Cooperative for the first time. Wachendorf testified that Merz did not tell her about the State's January 1994 inquiry and his replies and did not send Aegon copies of this exchange of letters. Wachendorf testified that she did not see these 1994 letters until shortly before the DBCC hearing in this matter[7] and that Aegon did not receive notice of Merz' involvement with the Cooperative until Merz notified the Firm that he anticipated being sued shortly before the lawsuit by producer members of the Cooperative was filed on September 26, 1994.

Merz testified that he knew he was prohibited by NASD rules from participating in any manner in the sale of a security without prior written authorization by his Firm and that he has known about that rule since he entered the industry in 1964. He further testified that he did not know that he was supposed to give his Firm prompt written notice of any outside business activities, but he acknowledged receiving the 1990 MidAmerica Manual and agreeing to its provisions. He testified that he signed the certificate of acceptance for the manual, but did not read it.

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[6] The letter erroneously stated that Merz was involved in this activity in 1991; the evidence shows that Merz participated in the sale of Hess Notes in 1990.

[7] Merz testified that he did not recall whether he had sent Wachendorf the 1994 letters between himself and the State, although he "thought" he had.

Merz also stated that he told Kluever during the June 1993 State audit that his only other business was insurance because he assumed she was inquiring only about securities business and he did not think the Cooperative Notes were securities. Moreover, Merz stated that his June 30, 1993 response letter to Lloyd mentioned only his participation in the sale of the Hess Notes, because that was the only activity he thought someone might report to the State. Merz admitted that he did not report his efforts on behalf of the Cooperative to Aegon after his receipt of the Aegon Letter of Caution, after the August 6, 1993 branch audit conducted by Wachendorf, or after the September 16, 1993 follow-up letter to him from Wachendorf, but he asserted that he did not do so because he did not think the Cooperative Notes were securities.

Discussion

Cause One - Private Securities Transactions. Conduct Rule 3040 prohibits any person associated with a member firm from participating in any manner in a private securities transaction outside the regular course or scope of his or her employment without providing prior written notice to the member. The Commission outlined the importance of the prohibition on private securities transactions in In re Anthony J. Amato, et al., 45 S.E.C. 282, 285 (1973):

> The regulatory scheme under the Exchange Act, in which the NASD is assigned a vital role, imposes on broker-dealer entities and NASD member firms the responsibility to exercise appropriate supervision over their personnel for the protection of investors. Where employees effect transactions for customers outside of the normal channels and without disclosure to the employer, the public is deprived of protection which it is entitled to expect. Moreover, the employer may also thus be exposed to risks to which it should not be exposed. Thus, such conduct is not only potentially harmful to public investors, but inconsistent with the obligation of an employee to serve his employer faithfully . . . . There is always a possibility in these situations that some improper conduct may be involved or that the employer's interests may be adversely affected. At the least, the employer should be enabled to make that determination. (Footnotes omitted).

Based on the evidence in the record, there is no question that both the Hess Notes and the Cooperative Notes were securities, and that Merz failed to give the requisite prior written notice to his employer of his intention to participate in their sales.[8]

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[8] We note that Merz admits that he sold the Hess Notes to the 16 customers listed in Exhibit A, but he has argued that his involvement with the Cooperative Notes was limited to "introducing" the customers to the issuer, for which he received compensation. We find that Merz' actions in connection with both the Hess Notes and the Cooperative Notes were violative of Conduct Rule 3040, which requires an associated person to give notice to the firm not only

In Reves v. Ernst & Young, 494 U.S. 56 (1990), the Supreme Court adopted the "family resemblance" test, as articulated by the Second Circuit in Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir. 1976), in concluding that demand promissory notes issued by a farmer's cooperative to support its general business operations were within the term "note" in the definition of a security in Section 3(a)(10) of the Securities Exchange Act of 1934 ("the 1934 Act"). The notes in Reves were uncollateralized, uninsured, and paid a variable rate of interest that was adjusted monthly to maintain a higher rate than that paid by local financial institutions.

The "family resemblance" test presumes that a note is a security, and this presumption may only be rebutted by a showing that: 1) the note, based on four factors described by the Reves Court, bears "a strong family resemblance" to certain enumerated instruments which fall outside the "investment market" regulated by the federal securities laws; or 2) based on the same four factors described by the Court, the particular note should become another category to be added to that list. The list identified included: (1) notes delivered in consumer financing; (2) notes secured by a mortgage on a home; (3) short-term notes secured by a lien on a small business or some of its assets; (4) notes evidencing a "character" loan to a bank customer; (5) short-term notes secured by an assignment of accounts receivable, or notes which simply formalize an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, they are collateralized); and (6) notes evidencing loans by commercial banks for current operations (this factor was added to the Exchange Bank list by the Second Circuit in Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 939 (2d Cir. 1984)). Reves, 494 U.S. at 65-68.

Reves stated that the following four factors should be utilized to determine whether an instrument has a family resemblance to those instruments enumerated in Exchange Bank, or otherwise should not be considered a security. In analyzing these factors, the Court also noted that "Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called."

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when "selling" a security, but also when participating "in any manner" in a securities transaction. In re Gilbert M. Hair, et al., 51 S.E.C. 374 (1993) (finding a violation of Article III, Section 40, predecessor to Conduct Rule 3040, when associated person acted as a "finder" and received a "referral fee" for introducing purchasers to the issuer of the notes in question); In re Charles A. Roth, 50 S.E.C. 1147 (1992), pet. denied, 22 F.3d 1108 (D.C. Cir. 1994), cert. denied, 115 S. Ct. 575 (1994) (finding a violation of Article III, Section 40, predecessor to Conduct Rule 3040, when registered representative, for a fee, assisted companies in locating and acquiring outstanding shares of their own stock or those of other companies, and helped companies locate potential purchasers of their business). We also note that at the National Adjudicatory Council ("NAC") review hearing, in response to questions from the NAC hearing subcommittee, Merz stated that he was not contesting the findings that the Hess and Cooperative Notes were securities and that he had failed to notify his Firm properly of his outside business activities.

1) Assess the motivations of a reasonable seller and buyer in entering into the transaction. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments, and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a security. If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, the note is less likely to be a security.

2) Examine the plan of distribution of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment."

3) Examine the reasonable expectations of the investing public. The Supreme Court stated that it would consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.

4) Examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, making application of the Securities Acts unnecessary.

Pursuant to the analysis enunciated above, the Hess Notes and Cooperative Notes are securities within the meaning of the 1934 Act. The notes bear no resemblance to any of the categories of instruments described in Exchange Bank -- they were not delivered through consumer financing; they were not secured by a mortgage on a home, a lien on a small business, or an assignment of accounts receivable; they did not formalize open-account debt incurred in the ordinary course of business; they did not evidence "character" loans to bank customers; and they did not evidence loans by commercial banks for current operations.

Moreover, an application of the four factors enumerated by the Supreme Court in Reves shows that the notes do not deserve their own non-security category. As to the first factor regarding the motivations of the borrower and lenders, given the generous rates of interest offered by the Hess and Cooperative Notes, it is not difficult to conclude that the purchasers were interested in the notes because they expected those notes to generate healthy profits. The Reves Court noted that if "the seller's purpose is to raise money for general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate," the transaction is presumed to be a security. Id. at 66. Indeed, the record here shows that the Credit Agreement that governed the Cooperative Notes explicitly stated that the notes were being acquired solely for investment purposes. Further, both the Hess and Cooperative Notes investors who returned questionnaires or testified stated that they bought the notes as investments and they were motivated to do so by the anticipated high rates of return. The Securities and Exchange Commission ("SEC" or "the Commission") has expressly stated that interest is recognized "as constituting a valuable return on an investment." In re Gerald

James Stoiber, Exchange Act Rel. No. 39112, at 7 (Sept. 22, 1997).[9] Moreover, there is no dispute that Hess sold notes to finance the purchase of FDIC loan packages, and the Cooperative sold promissory notes to raise money to fund its business.

Regarding the second and third factors, the plan of distribution of the notes and the reasonable expectations of the investing public, the record shows that the Hess and Cooperative Notes transactions were effected with individual members of the general public who wished to make a profit by entities that wished to raise funding for their enterprises. Merz recommended the investments to the customers, some of whom had been long-standing insurance clients of his, and the record indicates that the transactions would have been effected with any person interested in the investment. The investors who returned questionnaires or testified all indicated that they were not in the business of commercial or investment banking[10] and that they wanted the "quick return" on the products recommended as good investments. Merz has not countered this evidence by showing that these customers were particularly sophisticated business investors or that they had access to the types of financial or business information that a bank would have concerning its customer in order to perform a proper credit analysis. See Stoiber at 6. As the SEC has indicated: "[t]he number of notes is not the sole controlling factor in determining whether there has been a public distribution. Rather, the focus of inquiry should be on the need of the offerees for the protections afforded by the federal securities laws." Stoiber at 9 (holding that the sale of 13 promissory notes constituted sales of a security).[11]

With regard to the fourth factor, there are no risk-reducing elements present here that would render the application of the federal securities laws unnecessary. Both the Hess Notes and the Cooperative Notes were very risky investments that had no statutory protections other than the securities laws. The notes were not subject to any other special regulatory system, such as state or federal banking laws, and the notes were not insured, secured, or collateralized.

Accordingly, we conclude that Merz has not presented sufficient evidence to meet his burden to rebut the presumption that the notes at issue were securities, and we find that the Hess Notes and the Cooperative Notes were securities subject to Conduct Rule 3040. In reaching this conclusion, we have considered and rejected Merz' argument that he relied on the advice of

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[9] The SEC in Stoiber also noted that a fixed return in the form of an interest rate does not rebut the presumption that the notes are securities. Stoiber at 7, n. 14.

[10] The record specifically shows that Cooperative had attempted and had been unable to obtain commercial financing and was thus forced to raise revenue by methods outside the normal course of borrowing.

[11] See generally SEC v. Ralston Purina Co., 346 U.S. 119 (1953) (registration requirements apply to a "public offering" whether to a few or many.) See also In re Charles E. French, Exchange Act Rel. No. 37409 (July 8, 1996) (holding that the sale of one promissory note to one individual constituted the sale of a security).

counsel that the Hess Notes and the Cooperative Notes were not securities. We note that intent is not an element of the alleged violations here, and thus we reject this argument as a defense to Merz' actions in this matter. In re John Thomas Gabriel, 51 S.E.C. 1285, 1292 n. 31 (1994).

We have found that the Hess and Cooperative Notes transactions were sales of securities in which Merz participated. There is no dispute that Merz did not provide the requisite notice of these transactions to Aegon until long after the sales had taken place, and accordingly, did not obtain permission to participate in those sales. Therefore, we find that Merz participated in private securities transactions in violation of Conduct Rules 2110 and 3040 as alleged in cause one.

Cause Two - Outside Business Activities. Conduct Rule 3030 provides that persons associated with a member in any registered capacity shall not be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his or her relationship with the employer firm, unless prompt written notice to the member has been provided. The record supports our finding that Merz violated Conduct Rule 3030 by failing to report his relationship with the Cooperative to Aegon.

Merz entered into a Consulting Agreement with the Cooperative on June 1, 1993, pursuant to which he was to render services in connection with the Cooperative's "desire to obtain financing necessary to purchase a meat processing facility in Oshkosh, Wisconsin and provide working capital." The Consulting Agreement stated that Merz was to receive compensation of "$42,500 upon execution and another $35,000 when the Cooperative has succeeded in obtaining at least $1,550,000 of financing." Merz admitted that he received a total of $48,346 in checks from the Cooperative for "consulting fees," and $53,000 in promissory notes.[12]

Merz provided no notice of the Cooperative activities to Aegon until shortly before September 1994, when he advised Wachendorf that a lawsuit was imminent. Merz' only "defense" to his failure to report the Cooperative activities was that he did not know that he had to advise his employer about outside business activities that did not involve securities,[13] and he

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[12] Merz maintained that he did not receive compensation for the Cooperative promissory notes.

[13] In Merz' answer to the complaint, he alleged that it was permissible for him to give notice of the outside activities to himself because he was a supervisory principal of Aegon. We concur with the DBCC's rejection of this argument, as such an interpretation would undercut Conduct Rule 3030's effectiveness as a tool to supervise employees, who could avoid the reach of the rule by becoming principals and thereby reporting to themselves. In addition, we note that Rule 3030 provides that prompt notification must be made to the member, and not simply to any registered securities principal of the member. During the period at issue, Wachendorf was designated as the appropriate person to receive such notice for the Firm.

did not believe that the Cooperative Notes, or his Consulting Agreement with the Cooperative were related to securities.[14] The SEC has repeatedly held that ignorance of the NASD's rules is no excuse for their violation. In re David A. Gingras, 50 S.E.C. 1286, 1291 n. 12 (1992), pet. dismissed, No. 93-1243 (D.C. Cir. 1993). Participants in the securities industry must take responsibility for compliance and cannot be excused for lack of knowledge, understanding or appreciation of these requirements. In re Kirk A. Knapp, 51 S.E.C. 115, 134 (1992).

Accordingly, we find that Merz' involvement with the Cooperative was an outside business activity about which he failed to provide the requisite notice to Aegon, in violation of Conduct Rules 2110 and 3030, as alleged in cause two.

Sanctions

In imposing sanctions on Merz, we have considered the factors enumerated in the NASD Sanction Guidelines ("Guidelines") for private securities transactions and outside business activities.[15] We consider Merz' actions to have been egregious, thereby meriting serious sanctions.

The Guidelines state that "serious cases" of private securities transactions involve situations that include numerous sales, significant commissions, or attempts to conceal. The Guideline for Outside Business Activities states that misconduct is egregious if it involved activity similar to the employing firm's business. All of those factors occurred in this case. Merz participated in the sale of securities on two separate occasions -- 16 Hess Notes transactions in 1990, and three Cooperative Notes transactions in 1993. The sales amounted to almost two million dollars worth of unregistered securities, which placed Aegon at risk of significant liability and the investors at risk of substantial losses from speculative investments. He earned a total of $86,000 from these activities: $38,500 from the sales of the Hess Notes and $47,500 from his efforts on behalf of the Cooperative.[16] He made no attempt to communicate his actions to Aegon, either orally or in writing, and he was evasive in his responses to direct questions posed by both the Firm and the State about his activities.

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[14] Merz maintains that he remained ignorant of the requirement to report any outside business activity to Aegon despite his receipt of Firm compliance manuals; the repeated inquiries from the State about any activities in which he was raising business capital in return for a fee; and the September 16, 1993 letter from Wachendorf, following her examination of his branch office, in which he was cautioned to notify Aegon prior to engaging "in any activity that may be construed as a private securities transaction, such as coordinating a business transaction even in the case of a non-security."

[15] See Guidelines (1996 ed.) at 45 and 36 (Private Securities Transactions and Outside Business Activities).

[16] Merz admitted that he received a total of $46,000 from the Hess transactions, but he stated that $7,500 of that amount represented interest from his ownership of Hess Notes.

The DBCC found it somewhat mitigating that Merz had "made some attempt" to obtain legal advice regarding whether the Hess and Cooperative Notes were securities. To the contrary, we find that Merz' actions in this regard were aggravating factors. We have previously noted that the argument of reliance on counsel is not a defense to misconduct that does not require proof of intent. Further, even if the defense were available, the SEC consistently has maintained that in order to sustain the defense of reliance on the advice of counsel, a respondent must prove that he or she: 1) made a complete disclosure to counsel of the intended action; 2) requested counsel's advice as to the legality of the contemplated action; 3) received counsel's advice that such action would be legal; and 4) relied in good faith on that advice. Gabriel, 51 S.E.C. at 1292. See also In re Richard J. Lanigan, Exchange Act Rel. No. 36028 (July 27, 1995).

This showing has not been made by Merz, and the record demonstrates that he did not receive actual legal opinions on which he reasonably could have relied. With regard to the Hess Notes, the JD Letter explicitly stated that his law firm was "not in a position to provide [its] legal opinion on whether these notes will be considered to be a [sic] securities." Moreover, Merz admitted that JD was given documents to review, upon which he based the JD Letter, that were never provided to the investors -- i.e., the Hess Notes at issue had no collateral pledge agreement. Thus, the JD Letter, rather than provide assurance to Merz, should have acted as a red flag that would have placed any reasonable person on notice that substantial questions existed. Yet Merz failed to conduct further inquiry, even without cost from his own Firm, and instead, proceeded to effect the Hess Notes transactions. Accordingly, we find that Merz did not act reasonably in allegedly relying on a "non-opinion letter" based on documentation that was not included in the actual Hess Notes transactions in question.

Turning to the Cooperative Notes, there is no evidence that Merz received reliable assurances from the Law Firm that the Cooperative Notes would be drafted in such a way as to ensure that they were not securities.[17] The concern of the producer members does not support Merz' argument that the Cooperative Notes were not securities because their concern was that the notes could not give an equity interest to the investors, which was prohibited by state charter for the Cooperative. In fact, the offering documents themselves represented, in the Credit Agreement, that the notes were restricted securities that were exempt from registration under the 1934 Act. Merz' admitted failure to read the Credit Agreement provides further support for our conclusion that he also did not act reasonably in proceeding with the Cooperative Notes transactions without further investigation, or inquiry of his Firm or regulatory authorities.[18]

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[17] The record contains some handwritten notes from a Law Firm attorney who attended the May 25th Meeting. These notes, however, appear to reflect a concern that Merz' compensation for the Cooperative deal should be reflected as "consulting fees" and "not as solicitation of securities."

[18] In SEC v. Jakubowski, CCH Fed. Sec. L. Rep. Para 90,252 [Current] (7th Cir. 1998), the Seventh Circuit stated that "for a lawyer to fail to read a document central to a business transaction is reckless indeed." Id. at p. 91,114. We believe the same is true of a person

We also do not credit Merz' argument or the DBCC's reasoning that Merz provided full disclosure to the investors in the Hess and Cooperative Notes. While there is no evidence that Merz intentionally misled the investors, the record shows that he did not provide them with full disclosure documents advising them of the risks of their investments. Further, with regard to the Hess Notes, Merz admitted that he did not inform the investors that Hess had refused to sign the collateral pledge agreement proposed by Merz.

We are also disturbed by Merz' asserted lack of understanding of NASD Conduct Rules. As we have noted, his alleged ignorance of the requirements is no excuse for his conduct.[19] Moreover, the record demonstrates that Aegon provided Merz with the appropriate manuals and annual questionnaires about his activities. Merz did not properly utilize the materials provided to him, and he failed to consult with the compliance department of his Firm, which might have prevented Merz from violating the rules. Merz' demonstrated lack of appreciation for rules and procedures and his evasiveness in responding to investigative inquiries in repeated attempts to conceal his misconduct lead us to conclude that he should be barred in all capacities.

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in Merz' position, who arranged the sale of the Cooperative Notes.

[19] At the review hearing, Merz argued that he has experienced great remorse about these events and has tried to convey his experience to his colleagues to prevent similar occurrences from happening to them. We uphold the NAC hearing subcommittee's acceptance of a letter on review, from Merz' current employer, that discusses Merz' actions in this regard. We do not, however, find that Merz' subsequent speech to his co-workers mitigates the serious misconduct in which we have found him to have engaged.

For the foregoing reasons, we affirm the DBCC's imposition of a censure; $110,000 fine; and $2,472.25 in costs. We allocate the fine per cause as follows: cause one - $86,000 in profits plus a $10,000 fine; cause two - $14,000 fine. We also impose on Merz a bar in all capacities.[20] The bar in all capacities is effective immediately upon the service of this decision.

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary

[20] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be revoked for non-payment.

EXHIBIT A

COMPLAINT C8A960094
Schedule A

SCHEDULE OF HESS PROMISSORY NOTES
SOLD WITH THE PARTICIPATION OF RESPONDENT MERZ

Date	Customer	Interest Rate	Amount
7/10/90	K.B.	20 percent	$ 10,000
7/10/90	D.H.	20 percent	$ 10,000
7/10/90	H.B.	20 percent	$ 85,000
7/10/90	J.H.	20 percent	$110,000
7/10/90	T.T.	20 percent	$ 10,000
7/10/90	M.W.	20 percent	$ 10,000
7/10/90	W.B.P.	20 percent	$ 25,000
7/10/90	P.W.	20 percent	$ 50,000
7/10/90	T.W.	20 percent	$100,000
7/10/90	V.B.	20 percent	$ 10,000
7/10/90	R.D.	20 percent	$ 50,000
7/10/90	J.G.	20 percent	$100,000
7/10/90	M.S.	20 percent	$ 10,000
7/10/90	K.T.	20 percent	$100,000
7/10/90	P. Inc. - V.H.C.	20 percent	$ 40,000
7/10/90	P.V.H.	20 percent	$ 50,000
		Total	$770,000

EXHIBIT B

COMPLAINT C8A960094
Schedule B

SCHEDULE OF COOPERATIVE PROMISSORY NOTES
SOLD WITH THE PARTICIPATION OF RESPONDENT MERZ

Date	Customer	Amount	Description
6/1/93	R.F.	$1,000,000	Promissory note dated 6/1/93
6/1/93	R.D.	$ 30,000	Promissory note dated 6/1/93
6/1/93	D.D.	$ 30,000	Promissory note dated 6/1/93