

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

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In the Matter of	:	
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Department of Enforcement,	:	Complaint No. CAF000029
	:	
Complainant,	:	Dated: March 21, 2002
	:	
vs.	:	
	:	
Respondent 1,	:	
	:	
	:	
	:	
Respondent.	:	
_____	:	

**Unregistered, statutorily disqualified person worked for an entity that trained individuals for day trading and shared office space with a member firm. Held, respondent, a branch manager, did not violate NASD Rules by failing to supervise the individual and failing to require the individual to register, because evidence did not demonstrate that the individual was an associated person of a member firm and was required to be registered with the NASD.**

NASD Regulation's Department of Enforcement ("Enforcement") has appealed a 2001 NASD Regulation Hearing Panel decision pursuant to NASD Procedural Rule 9311. After a review of the entire record in this matter, we uphold the Hearing Panel's dismissal of all allegations against Respondent 1.

Procedural History

Enforcement commenced its investigation of Firm A, the member firm with which Respondent 1 was associated, to examine Firm A's office-sharing arrangements with Training Company 1. Training Company 1 was not registered as a broker-dealer and was engaged in the business of training individuals for day trading. Enforcement filed the complaint in this matter against Respondent 1, Firm A, Employee 1, owner and president of Firm A, and Training Company Employee 1, an unregistered, statutorily disqualified individual who worked for Training Company 1. Firm A, Employee 1, and Training Company Employee 1 settled the allegations against them before the Hearing Panel hearing. Thus, the Hearing Panel's decision pertained only to Respondent 1.

## Background

Firm A has been an NASD member firm since 1996. Respondent 1 was registered with Firm A as a general securities principal and representative. Respondent 1 was the branch manager of Firm A's Location A branch office ("Location A Office"), which Firm A shared with Training Company 1.

In 1998, Respondent 1 responded to Training Company 1's advertisement for a compliance officer. At the time, Training Company 1 had applied for NASD membership and was attempting to acquire a registered broker-dealer. If it became a broker-dealer, Training Company 1 planned to offer its customers day-trading services. Respondent 1 worked as Training Company 1's "compliance officer" from 1998 through 1999, while Training Company 1's broker-dealer application was pending with the NASD. The NASD never approved Training Company 1's application, and Training Company 1 withdrew the application in 1999.<sup>1</sup>

## Facts

In 1998, in anticipation of becoming an NASD member, Training Company 1 leased the Location A Office, acquired computer equipment for day trading, installed the equipment into the Location A Office, and connected the computer equipment to the clearing firm of the broker-dealer that it planned to acquire. Training Company 1 also had begun advertising for day-trading customers and had attracted some customers.

Also in 1998, a Training Company 1 principal contacted Employee 1 and proposed that Firm A open a branch office in the Location A Office until Training Company 1's NASD membership was approved.<sup>2</sup> Training Company 1 represented to Employee 1 that it already employed a registered principal (Respondent 1) whom Firm A could employ to operate a branch office in Location A. Employee 1 contacted Respondent 1 directly. Respondent 1 agreed to

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<sup>1</sup> During the relevant period, Training Company 1 also employed Training Company Employee 1 to train individuals for day trading. Respondent 1 was not responsible as a Training Company 1 employee for supervising Training Company Employee 1.

<sup>2</sup> Training Company 1 never intended for Firm A's branch office to remain in the Location A Office on a long-term basis. Rather, Training Company 1 intended for it to provide day-trading facilities to potential customers of Training Company 1 while Training Company 1's NASD membership application remained pending. Training Company 1 expected that once its membership application was approved, the Firm A branch would close, and Firm A's customers would transfer their accounts to Training Company 1.

serve as Firm A's branch manager and sole registered employee in the Location A Office. Firm A opened a branch office in the Location A Office in 1999.<sup>3</sup>

The sign on the building outside the entrance to the Location A Office contained the name Training Company 1. The sign inside the entrance to the building and immediately outside the interior entrance to the Location A Office contained both Firm A's and Training Company 1's names.

Firm A's customers used the computer equipment<sup>4</sup> that Training Company 1 previously had installed and connected to the clearing firm.<sup>5</sup> There were no physical barriers in the Location A Office that separated Training Company 1's workspace from that of Firm A.<sup>6</sup>

Enforcement relied on evidence from three of the 11 customers who had accounts at Firm A's Location A Office during its approximately three months of operation. Only one customer, RB, testified before the Hearing Panel. RB responded to a Training Company 1 advertisement for day-trading training many months before Firm A opened its branch office. In 1998, he began spending time in Training Company 1's office, practicing day trading on Training Company 1's computers under Training Company Employee 1's instructions. When Firm A opened a branch office in the Location A Office, RB opened an account with Firm A.

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<sup>3</sup> Firm A's Location A branch office remained open until 1999, when Respondent 1 resigned. While open, the Firm A Location A Office operated as a day-trading facility, and had only 11 customer accounts during the entire period.

<sup>4</sup> Respondent 1 had little knowledge of the day-trading programs installed on the Firm A computers. He relied on Training Company 1 employees, Training Company Employee 2 and Training Company Employee 3, for technology assistance.

<sup>5</sup> The clearing firm that Training Company 1 intended to use once its registration was complete was also Firm A's clearing firm. Respondent 1 testified that, since Firm A paid for the services of the clearing firm, he ran the Location A Office for Firm A at a deficit. Respondent 1 himself never received any money from Firm A. During the period at issue, he was paid only as an employee of Training Company 1.

<sup>6</sup> The Location A Office had a central trading room that housed several computer terminals. The evidence is conflicting as to whether certain of the terminals were used only for live trading while others were reserved for "paper trading" (i.e., demonstration trading with programs that simulated live day trading) or whether all of the computers were used for both live and paper trading. The Location A Office also had several offices with doors and a conference room. Respondent 1 testified that the conference room was reserved for Training Company 1 use and identified one office as belonging to Training Company 1, but both Training Company 1 and Firm A had access to the trading room.

RB completed all of the paperwork for the new account through and discussed suitability issues with Respondent 1. He day traded in the account for approximately two weeks, executing approximately 16 trades in 12 days. RB lost a significant amount of money and closed the account after Respondent 1 approached him and suggested that perhaps he should reconsider his suitability for day trading. RB never discussed suitability or details regarding opening a Firm A Account with Training Company Employee 1.

RB testified that he had believed that his account was with Training Company 1, not Firm A. The account opening documents, however, clearly indicated that his account was with Firm A. Training Company 1 was not mentioned on the documents. RB also stated that Respondent 1 did not say or do anything to lead him to believe that his account was with Training Company 1, and that he may have simply misunderstood.

RB testified that once he began live trading, for the first day or two, Training Company Employee 1 sat behind him for less than one hour. RB had never day traded before. He testified that Training Company Employee 1 did not tell him what to do with respect to buying or selling, but that Training Company Employee 1 was there for moral support, since Training Company Employee 1 had trained him. RB testified that he could not remember any specific instances in which he asked Training Company Employee 1 questions about trading strategy or in which he requested investment advice. RB testified that, while he was live trading, Training Company Employee 1 generally discussed stocks that fit into the trading patterns that Training Company Employee 1 had taught him, but that he (RB) alone made all of his own trading decisions. RB also recalled that Training Company Employee 2 and Training Company Employee 3 were available to provide technical computer support, but he could not recall requesting or receiving assistance from either of them.

The other two Firm A customers with whom Enforcement spoke, VT and JB, did not testify at the Hearing Panel hearing. The record suggests that Enforcement intended to present the telephonic testimony of VT at the Hearing Panel hearing, but that when Enforcement attempted to contact VT to testify, he was not available at the number that he had provided to Enforcement. In lieu of VT's testimony, the Hearing Panel accepted into evidence VT's signed declaration. Enforcement represented that JB refused to testify at the Hearing Panel hearing and offered portions of transcripts of two investigative interviews of JB.

VT's statement indicated that he and JB attended a day-trading course in 1999. Training Company Employee 1 conducted the seminar and invited all attendees to visit Training Company 1's Location A Office to paper trade or open live trading accounts. VT's statement also indicated that he attended a two-week training program with Training Company Employee 1 in the Location A Office and that Training Company Employee 1 stated that anyone who opened an account would not be required to pay for the training. VT's statement indicated that Training Company Employee 1 referred him to Respondent 1 to open an account with Firm A, which he believed to be the clearing firm for Training Company 1. VT's statement indicated that while VT traded live and paper traded, "Training Company Employee 1 helped [him] and other traders

quite a bit," and he "observed Training Company Employee 1 giving advice and helping traders."<sup>7</sup>

During investigative interviews in 1999, JB testified similarly to VT as to how he (JB) became acquainted with Training Company Employee 1 and Training Company 1. JB testified on that Training Company Employee 1 was present while JB engaged in paper trading and that Training Company Employee 1 sometimes alerted traders to stocks that followed particular trends or fit the day-trading criteria that Training Company Employee 1 had taught them. Enforcement interviewed JB a second time and asked him whether Training Company Employee 1 had engaged in similar conduct during JB's live trading sessions. JB stated that Training Company Employee 1 "wouldn't tell [the traders] which [stocks] to play, but he would say, watch this stock, (sic) it follows the pattern." JB also testified that he and other traders alerted each other to watch certain stocks when they saw a trading pattern that fit the day-trading criteria.<sup>8</sup>

Respondent 1 testified that Training Company Employee 1 referred only two customers (JB and VT) to Firm A. Respondent 1 testified that he never observed Training Company Employee 1 engage in inappropriate contact with Firm A customers. He stated that Training Company Employee 1's activities in the Location A Office generally were limited to preparing materials on day trading and interacting with individuals who were paper trading. Training Company Employee 1 testified before NASD staff in an on-the-record interview that he had few interactions with Firm A customers and that he had no interactions with live traders. Training Company Employee 1 did not receive referral fees or any other type of compensation from Firm A. Furthermore, Training Company Employee 1's business card that he presented to potential customers indicated that he was affiliated with Training Company 1 only, not Firm A.

Respondent 1 also testified that he contacted the Central Registration Depository ("CRD") to review Training Company Employee 1's history. CRD did not report that Training Company Employee 1 was statutorily disqualified.

### Discussion

Based on the record before us, we affirm the Hearing Panel's dismissal of the allegations against Respondent 1. We find that the evidence does not prove the allegation that Training Company Employee 1 was acting as an associated person of Firm A or that Respondent 1 failed adequately to supervise the Location A Office.

Enforcement alleged in cause one that Respondent 1 allowed Training Company Employee 1 to function as an associated person of Firm A in a capacity requiring registration,

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<sup>7</sup> VT traded at Firm A for seven days before closing his account. He traded for fewer than two hours per day and executed less than 50 trades while his account was open.

<sup>8</sup> JB traded at Firm A for one week before closing his account. JB traded for less than two hours per day and executed fewer than 60 trades during the life of the account.

even though Training Company Employee 1 was statutorily disqualified. NASD Membership and Registration Rule 1031 states that all persons engaged or to be engaged in the investment banking or securities business of a member who are to function as representatives shall be registered as such with the NASD. Rule 1031 defines "representatives" as associated persons who are engaged in the investment banking or securities business for a member, including the functions of supervision, solicitation, or training. Thus, we must determine whether the evidence before us supports the conclusion that Training Company Employee 1 acted as an associated person of Firm A. We conclude that the evidence is insufficient to support such a finding.

Article I, Section (dd) of the NASD By-Laws defines "associated person" as a natural person: (1) who is registered or has applied for registration;<sup>9</sup> or (2) who is engaged in the investment banking or securities business and is directly or indirectly controlling or controlled by a member, whether or not such person is registered. An individual need not be an employee of a broker-dealer in order to be considered an "associated person." Van Alstyne, Noel & Co., 43 S.E.C. 1080 (1969). A person may be an associated person if he performs the usual and customary functions of an employee of a broker-dealer. Id.

Enforcement contends that Training Company Employee 1 communicated with members of the public to determine their interest in investing, recruited members of the public as Firm A customers, and discussed investment strategies with active day traders. We concur that these factors, if established, could provide a sufficient basis for concluding that an individual is an associated person of a broker-dealer. See SEC v. Telsey, [1990-91] Fed. Sec. L. Rep. (CCH) p. 95,871 (S.D.N.Y. 1991). We do not find, however, that the evidence in this case is sufficient for us to make these factual findings.

Training Company Employee 1 represented himself to the public as being affiliated with Training Company 1, not Firm A. Although individuals who participated in Training Company Employee 1's training seminars may have opened accounts at Firm A, the evidence does not demonstrate that Training Company Employee 1 actively solicited customers for Firm A, that Respondent 1 or Firm A expected him to do so, or that Training Company Employee 1 earned or expected to earn compensation from Firm A for doing so. RB testified generally about statements that Training Company Employee 1 might have made while RB was live trading, but RB's testimony in this regard was vague. He was unable to recollect specific instances of discussing investments or securities with Training Company Employee 1. RB also testified that, once he determined to open an account, all of his interactions were with Respondent 1, not Training Company Employee 1. JB's testimony, while somewhat more specific than RB's, was less reliable, because he was unwilling to testify at the Hearing Panel hearing and was not available for cross examination by Respondent 1 or for Hearing Panel questioning.<sup>10</sup> We also

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<sup>9</sup> There is no dispute that Training Company Employee 1 was not registered with Firm A and had not applied for registration.

<sup>10</sup> The Hearing Panel indicated that, in determining whether to rely on JB's investigative testimony, it would consider the fact that he refused to testify before the Hearing Panel and that

have placed little weight on VT's statement,<sup>11</sup> because after originally agreeing to testify, he failed, without explanation, to testify at the Hearing Panel hearing and therefore was not subject to cross-examination. Respondent 1's testimony, which was corroborated by Training Company Employee 1's on-the-record testimony, indicated that, while in the Location A Office, Training Company Employee 1 primarily prepared day-trading training materials and trained individuals engaged in paper trading. The Hearing Panel heard Respondent 1's testimony, observed his demeanor, and found him to be credible. Credibility determinations of an initial fact finder are entitled to considerable weight and deference. Jonathan Garrett Ornstein, 51 S.E.C. 135 (1992). We find no reason to discredit Respondent 1's testimony.<sup>12</sup>

Enforcement also argued that the training offered by Training Company Employee 1 was critical to Firm A's broker-dealer function.<sup>13</sup> We do not agree. There is no evidence that Firm A or Respondent 1 encouraged or supported Training Company Employee 1's efforts to train Training Company 1 customers in day trading. This finding is further bolstered by the fact that few of Training Company Employee 1's trainees opened accounts with Firm A and that Training Company Employee 1 was responsible, if at all, for a very small minority of the customers who

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[con't]

neither the Hearing Panel nor Respondent 1 had an opportunity to cross examine him. We concur with the Hearing Panel's determination in this regard.

<sup>11</sup> The Hearing Panel indicated that it intended to give VT's declaration less weight than it would have given his testimony, since he inexplicably decided not to testify before the Hearing Panel. We concur with the Hearing Panel's determination in this regard and note that VT's inexplicable unavailability at the hearing requires us to give VT's declaration, important portions of which are in dispute, less weight than we have given other evidence, such as Respondent 1's testimony.

<sup>12</sup> Respondent 1 argued that, in order to obtain a clear picture of the workings of the Location A Office, the Hearing Panel should have heard from all of the customers who traded there. He noted that the three customers to whom Enforcement spoke were responsible for only 4.9 percent of the trades executed through the Location A Office. Enforcement confirmed that its investigators did not contact the other customers in the Location A Office. Although we disagree with Respondent 1 that the Hearing Panel needed to hear from all of the customers, we note that Respondent 1 testified that he never observed Training Company Employee 1 acting in a registered capacity. Respondent 1's testimony on this point is not directly contradicted by opposing live testimony.

<sup>13</sup> Respondent 1 prepared a newspaper article for Firm A that offered "free training." Respondent 1 testified that the "training" to which he referred was training on the use of the computer, not Training Company Employee 1's training on day-trading strategies.

actually opened accounts in Firm A's Location A Office.<sup>14</sup> In sum, when all of the facts establishing Training Company Employee 1's actions are viewed cumulatively, they cannot support the conclusion that he acted as an "associated person."

With respect to the allegations in cause two that Respondent 1 failed to supervise adequately the activities in the Location A Office, we again affirm the Hearing Panel's dismissal of the allegations of the complaint. Enforcement alleged in the complaint that Respondent 1 failed in his supervisory responsibilities by allowing "unregistered" and "unaccountable" persons (Training Company Employee 1, Training Company Employee 2 and Training Company Employee 3) to control the branch office and by failing to implement a supervisory system reasonably designed to prevent these activities.

We find that the evidence is insufficient to support a finding of supervisory violations. The record demonstrates that Training Company Employee 2 and Training Company Employee 3 provided only technical support for Firm A customers' use of office computers,<sup>15</sup> that Training Company Employee 1 talked to Firm A customers during live trading, and that at least three Firm A customers had taken day-trading classes from Training Company Employee 1. We do not find that this evidence is sufficient to find, as alleged in the complaint, that Respondent 1 failed in his supervisory responsibilities by allowing these individuals to "control" the branch office. Enforcement also argued that Respondent 1 generally failed to exert control over the Location A Office. In support of this argument, Enforcement noted that Respondent 1 did not hold a key to the Location A Office, that he relied on Training Company 1 staff to open the office every day, and that Firm A did not pay rent or utility bills for the office. Respondent 1 countered that, once open for business, he controlled the entrance to the office door, which generally remained locked, and that Firm A, not Training Company 1, paid for the services of the clearing firm. Although it may be unusual for a branch manager in a small office not to hold a key to the office door and for a firm not to pay rent for its office space, we do not find that this evidence, without more, is sufficient to sustain Enforcement's allegation that Respondent 1 failed properly to supervise the Location A Office. Furthermore, if we cannot find that Training Company Employee 1 was an associated person, we can hardly conclude that Respondent 1 had an obligation to supervise him.

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<sup>14</sup> Enforcement acknowledged that Firm A did not pay Training Company Employee 1, but contended that an individual need not receive remuneration from a broker-dealer in order to fall within the definition of associated person. We agree. We conclude, however, that the evidence as a whole is insufficient for us to find that there was another basis for concluding that Training Company Employee 1 was an associated person of Firm A.

<sup>15</sup> RB also testified that he remembered possibly receiving what he referred to as research reports from Training Company Employee 3 or Training Company Employee 2. His testimony in this area is vague and, in our view, not sufficient to substantiate a finding that Respondent 1 failed to supervise by allowing these two individuals to control the Location A Office.



Accordingly, the complaint is dismissed.<sup>16</sup>

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President and  
Corporate Secretary

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<sup>16</sup> 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.