

BEFORE THE NATIONAL ADJUDICATORY COUNCIL
NASD REGULATION, INC.

In the Matter of

Market Regulation Committee,

Complainant,

vs.

Respondent 1

and

Respondent Firm 2,

Respondents.

DECISION

Complaint No. CMS950041

Market Regulation Committee

Dated: February 7, 2000

This matter comes before us after a remand issued by the Securities and Exchange Commission ("Commission").

Procedural History

In a decision, the National Business Conduct Committee ("NBCC"), our predecessor, found that Respondent 1 and Respondent Firm 2 (or "the Firm") had engaged in a course of conduct that had the intended effect of overstating the Firm's capital to Firm A (Respondent Firm 2's clearing firm), the NASD, and the Securities and Exchange Commission ("Commission"). The NBCC concluded that by selling Company 1 common stock out of Respondent Firm 2's proprietary inventory account (the "Respondent Firm 2 Inventory Account") to two accounts personally owned by Respondent 1 and then back again to the Respondent Firm 2 account five different times, the respondents had, in effect, "parked" the stock in order to avoid losses in the Respondent Firm 2 account. The respondents appealed to the Commission.

In a decision dated (date omitted), the Commission sustained the NASD's findings and sanctions. The respondents appealed to the United States Court of Appeals for the Ninth Circuit ("the Court"). The Court dismissed all but one of the findings and remanded the case to the Commission for further consideration. The Commission, in turn, remanded the case to the NASD to determine whether the remaining finding should be sustained or dismissed.

Facts

There are three securities accounts at issue: The Respondent Firm 2 Inventory Account, Respondent 1's personal trading account at Respondent Firm 2, and Respondent 1's individual retirement account ("IRA"). Respondent 1 was the sole beneficial owner of his personal accounts and exercised total control over the trading in each of these accounts. The Respondent Firm 2 Inventory Account was a Respondent Firm 2 corporate account. Respondent 1 was the only person authorized to effect transactions in the three accounts. During the review period, Respondent Firm 2 had either a \$30,000 or \$50,000 net capital requirement, and the Firm was also required by its clearing firm, Firm A, to maintain a minimum net capital of \$100,000.

The pertinent facts are essentially undisputed. Respondent Firm 2 and Respondent 1 engaged in the series of transactions between the Respondent Firm 2 Inventory Account and Respondent Firm 2's personal account in order to maintain Respondent Firm 2's net capital at a level of \$100,000. The following transactions were at issue:

<u>SET 1</u>	12/30/91	Respondent 1's IRA bought 14,500 @ 6 1/8 from the Respondent Firm 2 Inventory Account
	1/2/92	Respondent 1's IRA sold 10,000 @ 6 1/2 to the Respondent Firm 2 Inventory Account
	1/2/92	Respondent 1's IRA sold 4,500 @ 6 1/2 to the Respondent Firm 2 Inventory Account
<u>SET 2</u>	3/13/92	Respondent 1's Personal Account bought 79,000 @ 7 1/8 from the Respondent Firm 2 Inventory Account
	3/16/92	Respondent 1's Personal Account sold 79,000 @ 3 to the Respondent Firm 2 Inventory Account
<u>SET 3</u>	3/16/92	Respondent 1's IRA bought 75,000 @ 3 from the Respondent Firm 2 Inventory Account
	3/17/92	Respondent 1's IRA sold 40,000 @ 3 5/8 to the Respondent Firm 2 Inventory Account
	3/18/92	Respondent 1's IRA sold 5,000 @ 3 1/2 to the Respondent Firm 2 Inventory Account
	3/19/92	Respondent 1's IRA sold 30,000 @ 3 3/8 to the Respondent Firm 2 Inventory Account
<u>SET 4</u>	12/7/93	Respondent 1's IRA bought 35,825 @ 4 1/4 from the Respondent Firm 2 Inventory Account
	12/15/93	Respondent 1's IRA sold 36,581 @ 2 3/4 to the Respondent Firm 2 Inventory Account

<u>SET 5</u>	12/14/93	Respondent 1's IRA sold 20,000 @ 3 to the Respondent Firm 2 Inventory Account
	12/17/93	Respondent 1's IRA bought 20,000 @ 3 3/8 from the Respondent Firm 2 Inventory Account

The Court dismissed Sets 2 through 5 on the ground that these transactions did not constitute "parking," and it remanded Set 1, the transactions that occurred on December 30, 1991 and January 2, 1992, to the Commission to determine whether the evidence justified a finding that "parking" had occurred as to those transactions. The Commission remanded the matter to the NASD for further consideration and the issuance of a decision responsive to the Court's concerns.

Discussion

Based on the Court's rationale for dismissing four of the five sets of transactions at issue, we dismiss the remaining set -- the December 30, 1991 - January 2, 1992 (Set 1) series of trades. The Court stated that securities "parking" is, at a minimum, comprised of the following elements:

- a pre-arrangement to sell and then buy back securities (to conceal true ownership);
- on the same, or substantially the same, terms (thus keeping the market risk entirely on the seller);
- for a bad faith purpose, accomplished through a sham transaction in which nominal title is transferred to the purported buyer while the economic incidents of ownership are left with the purported seller.

The Court found no evidence that any these factors were present in the four sets of transactions (Sets 2 through 5) that it dismissed. Specifically, the Court found that:

- There was no particular pattern that suggested a prearranged "bad-faith buy-back scheme." The trades occurred anywhere between one and seven days apart in response to a volatile market in Company 1 stock.
- None of the transactions took place on the same, or substantially the same, terms. The price differential between sale and repurchase in each transaction set varied from 3/8 to 4 1/8 (an 11 percent to 58 percent spread), and each account appeared to bear a market risk with every executed trade.
- There was no evidence of bad faith. All of the trades were reported to Nasdaq and Firm A as required, were fully paid with real funds, were executed mid-month, well in advance of Respondent 1's month-end net capital computation deadline, and were executed at the prevailing market price.

Thus, the essence of the Court's decision is that the trades were not sham trades. Rather, they were genuine, bona fide trades that involved actual transfer of ownership at market prices and in which the buyer actually bore the "economic consequences of ownership."

The fact that Respondent 1 executed these trades to protect the Firm's capital position was not determinative, especially since these trades did not occur at month-end when firms make a net capital calculation for reporting purposes. The Court noted that "avoiding a required haircut through a securities transaction is an innocuous fact that does nothing, in itself, to demonstrate the existence of a 'parking' scheme" and that an NASD firm may legitimately attempt to avoid a haircut by selling stock in a legitimate transaction. Avoidance of a required haircut becomes illegitimate, the Court stated, only where the avoidance of a required haircut is accomplished by a "sham trade" or some form of "contrived transaction" that is designed to camouflage temporarily the true ownership of the stock.

The Court stated that the evidence surrounding the transactions in Set 1 (December 30, 1991 -- January 2, 1992) "[came] closest to providing substantial evidence for a finding of 'parking.'" The Court considered that Respondent 1 admitted that the December 30 "transaction was made in order to keep my net capital above the \$100,000 guideline set by my clearing broker," and that "the purpose of [the January 2] transaction was merely to return shares to the [Respondent Firm 2] inventory account, after other securities had been sold by the [Respondent Firm 2] inventory account in sufficient amount to assure compliance with the [Firm A] agreement."

The Court stated that the administrative record would have to be reviewed to determine whether that set of trades, "when viewed in isolation, amounted to a sham designed to conceal the true ownership of the [Company 1] shares and thereby to avoid impermissibly a required net capital deduction." The Court added that, "[i]f supported by substantial evidence, such a conclusion would substantiate a finding of 'parking'" The NASD would, therefore, be required to prove that there was a: (1) pre-arrangement to sell and then buy back the securities; (2) on the same, or substantially the same, terms; (3) for a bad-faith purpose.

Noting that the Set 1 transaction occurred over month-end, just prior to Respondent Firm 2's net capital computation deadline, the Court stated that this transaction, "may suggest the presence of a bad-faith scheme in which [Respondent 1] had prearranged (in his own mind) for the Inventory Account to repurchase the [Company 1] shares after only temporarily leaving them in the IRA at month-end for purposes of [Respondent Firm 2's] net capital computation." If true, the Court stated, this would demonstrate the presence of a pre-arrangement to sell and buy back securities for a bad-faith purpose. The Court further considered that the fact that the December 30 sale price and the January 1992 purchase price (albeit the then-prevailing market prices) differed by only six percent could support a finding that the trades took place on substantially the same terms, and could thereby satisfy the third prong of the Court's definition of "parking."

The Court noted, however, that the Commission had not undertaken any explicit inquiry of the existence of a pre-arrangement, and had simply presumed that Respondent 1's control of all three accounts made a pre-arrangement unnecessary. The Court stated that because it held that a finding of

"parking" required the presence of a pre-arrangement to sell and then buy back securities, "the Commission erred in failing to make a finding on this question." Thus, the Court concluded, the Commission on remand would need "to review carefully the administrative record to determine whether [Set 1], when viewed in isolation, amounted to a sham designed to conceal the true ownership of the [Company 1] shares and thereby to avoid impermissibly a required net capital deduction."

After reviewing the record on remand from the Commission, we find that the record does not contain sufficient evidence to conclude that the transactions in Set 1, when viewed in isolation, were a sham designed to conceal the true ownership of the Company 1 shares and thereby to avoid impermissibly a required net capital deduction. Respondent 1 sold 14,5000 shares of Company 1 stock out of the Respondent Firm 2 Inventory Account to his IRA account on December 30, 1991, so that the Firm would not breach its agreement with Firm A to maintain \$100,000 in net capital. There is, however, no proof that Respondent 1 planned that the Respondent Firm 2 Inventory Account would repurchase the Company 1 stock. Respondent 1 testified: "No, I did not prearrange with myself to sell the stock back at essentially the same terms." He stated that the purpose of the January purchase "was merely to return shares to the [Respondent Firm 2] inventory account, after other securities had been sold by the [Respondent Firm 2] inventory in sufficient amount to assure compliance with the [Firm A] agreement."

Moreover, Set 1 bears the same indicia of bona fide transactions as do the transactions that the Court dismissed. Although, as the Court noted, the price differential was small, six percent, compared to the price differential in the other sets of transactions, it reflected the prevailing market prices and the fact that actual market risk was assumed. Further, there is no evidence in the record to contradict the conclusion that true ownership of the Company 1 stock did pass to Respondent 1's IRA account.

Based on the foregoing, we dismiss the complaint's allegations regarding the transactions referred to herein as Set 1 (occurring on December 30, 1991 and January 2, 1992).

On Behalf of the National Adjudicatory Council,

Joan C. Conley,
Senior Vice President and Corporate Secretary