BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 3 Complainant, vs. Respondent 1 Respondent.	DECISION Complaint No. C3A970026 District No. 3 Dated: January 26, 1999

The National Adjudicatory Council ("NAC") of NASD Regulation, Inc. ("NASD Regulation") called this matter for review pursuant to NASD Procedural Rule 9312. After examining the entire record, we affirm the findings made by the District Business Conduct Committee for District No. 3 ("DBCC") that Respondent 1 violated Conduct Rules 2110 and 3010 by failing to supervise in a manner reasonably designed to achieve compliance with the broker/dealer registration provisions of the federal securities laws and failing to enforce the supervisory procedures of member firm, Firm A, in a manner reasonably designed to achieve compliance with the NASD rules pertaining to private securities transactions. We impose a censure, a $5,000 fine, and $954.60 in costs for the DBCC hearing.[1]

Background

Respondent 1 first entered the securities industry in July 1966 as a registered representative of a former member firm. He joined Firm A in March 1977 and remains registered with the Firm as a general securities principal.

[1] The NAC called this matter for review to examine the DBCC's findings and sanctions, in particular to consider the implication that a firm can contract away its obligation to supervise and book private securities transactions merely because it designates a registered representative as an "independent contractor." The NAC also questioned whether the DBCC decision provided a sufficient rationale for imposing sanctions that are below the range recommended in the relevant NASD Sanction Guideline for supervisory violations, discussed infra.

Procedural and Factual History

This matter arose as a result of a routine examination of Firm A, a registered broker/dealer. During the examination, NASD Regulation district staff observed that a registered representative of the Firm, ("Registered Rep"),[2] operated out of a "satellite" office away from the main office and engaged in certain municipal finance activities under the name of Firm B, which is not registered as a municipal securities broker/dealer with the Securities and Exchange Commission ("Commission").[3] After further investigation, district staff determined that Firm B, acting through the Registered Rep, might have functioned as a municipal securities broker regarding four municipal financings. Because the Registered Rep's participation in these securities transactions occurred away from Firm A, district staff discerned that the transactions could be viewed as "private securities transactions" as contemplated by NASD Conduct Rule 3040. Moreover, because the Registered Rep had not provided Firm A with prior written notice of his participation in those transactions, district staff determined that the Registered Rep might have violated Rule 3040. Faced with this information, the Registered Rep submitted a Letter of Acceptance, Waiver and Consent ("AWC") to NASD Regulation to resolve the matter as to him. NASD Regulation accepted the AWC.

As a result of the investigation into the Registered Rep's activities, district staff also determined that Respondent 1, who was designated as the Registered Rep's supervisor, might have failed to perform certain supervisory responsibilities. On March 20, 1997, the DBCC filed a single-cause complaint against Respondent 1 alleging that he had violated Conduct Rules 2110 and 3010 by failing to supervise the Registered Rep in a manner reasonably designed to achieve compliance with the broker/dealer registration provisions of the federal securities laws and to enforce the Firm's supervisory procedures in a manner reasonably designed to achieve compliance with the NASD rules pertaining to private securities transactions.

Respondent 1 filed an answer to the complaint in which he stated that the Registered Rep's association with Firm A "was limited to the status of an Independent Contractor whose activities could include consulting and acting as placement agent for municipal bond issuers and therefore [he felt the Registered Rep] acted as a consultant and a placement agent." Respondent 1 also stated that it was his belief that, as an independent contractor, the Registered Rep had given proper information about and notice of his dealings, and had proper supervision as a consultant and placement agent in the transactions in question. According to Respondent 1, the placement activities in which the Registered

---

[2] Although the Registered Rep is not the subject of the current matter, the activities he engaged in are discussed herein because they provide the underlying basis for the action brought against Respondent 1.

[3] The Registered Rep owned and operated Firm B as a sole proprietorship. Firm B was located in the same geographic region as Firm A. Firm B was not, however, located at the same address as that of Firm A.

Rep had engaged were specifically included in writing in an agreement the Registered Rep had entered into with the Firm.

The DBCC held a hearing on the matter. District staff introduced the testimony of a Senior Compliance Examiner with NASD Regulation who conducted both the initial examination and the investigation regarding this matter. District staff also entered into the record a series of documents provided by the Registered Rep, including various engagement letters, offering circulars, confirmations of purchase, closing memoranda, correspondence with purchasers, and settlement accountings related to the four municipal securities offerings in which Firm B was alleged to have functioned in an unregistered capacity. District staff also entered into evidence relevant portions of the Firm's written supervisory procedures related to private securities transactions, as well as documentation indicating that Respondent 1 was the Registered Rep's designated supervisor.

Respondent 1 did not introduce any documentary evidence or testimony, other than his own, at the DBCC hearing. Respondent 1 stated that he was generally aware of the Registered Rep's municipal finance activities, although the communications between them were verbal only and did not include much in the way of detail. Respondent 1 also explained that he relied upon the Registered Rep's many years in the securities industry without incident, his vast experience in the municipal finance area and his general integrity in concluding that it was appropriate to permit the Registered Rep to function independently through Firm B. Respondent 1 asserted that he believed that the Registered Rep had been acting as a "placement agent" of exempt securities, not as a broker/dealer. Finally, Respondent 1 represented that he, along with the Firm's compliance officer, had expended considerable effort to avoid similar problems in the future and that the Registered Rep's municipal securities activities would be conducted through Firm A going forward.

In 1997, the DBCC issued a decision. The DBCC found that Respondent 1 had violated Conduct Rules 2110 and 3010 by failing to fulfil his supervisory responsibilities. In arriving at this conclusion, the DBCC rejected Respondent 1's contentions that the Registered Rep had acted merely as a "placement agent" of exempt securities and that it was appropriate to permit the Registered Rep to function independently through Firm B. The DBCC ordered that Respondent 1 be censured and fined $2,500. The DBCC also imposed hearing costs of $954.60.

The parties were informed that the case had been called for review. Respondent 1 responded by letter, stating that he accepted the sanctions imposed by the DBCC. He also stated that he did not intend to take any further action regarding these proceedings. District staff filed a brief statement, commenting that, because Respondent 1's correspondence did not raise any issues concerning the propriety of the findings and sanctions, district staff rested on the analysis set forth in the DBCC's decision. The parties, however, were given the opportunity to provide oral argument. The district staff appeared at the hearing and requested that the NAC uphold the DBCC's findings. District staff also asserted that the sanctions imposed by the DBCC should be either upheld or increased. Respondent 1 did not participate in the hearing.

Discussion

Respondent 1 has not appealed, and does not contest during this call-for-review proceeding, the DBCC's findings of violation. Nonetheless, we have reviewed the entire record and determine that such findings are supported by a preponderance of the evidence. The underlying activities that serve as the predicate for the violations relevant to this case and Respondent 1's failure to supervise will be discussed separately below.

Underlying Violations. As part of its holding that Respondent 1 violated Conduct Rules 2110 and 3010 by failing adequately to supervise the Registered Rep, the DBCC found that Firm B, through the Registered Rep, improperly engaged in the business of effecting municipal securities transactions without being registered as a municipal securities broker/dealer. We concur with this finding. The record indicates that, although the Registered Rep was a registered representative with Firm A, he did not limit his activities to executing securities transactions as an associated person of the Firm. He also effected municipal securities through Firm B, which acted as a broker, although it was not registered as such with the Commission.

Section 15B(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78o-4(a)(1), requires municipal securities broker/dealers to register with the Commission if they use the United States mail, telephones, or other instrumentality of interstate commerce to trade municipal securities, even if they transact only intrastate business. The Exchange Act defines the term "municipal securities broker" as a "broker engaged in the business of effecting transactions in municipal securities for the account of others." Section 3(a)(31) of the Exchange Act, 15 U.S.C. §78c(a)(31). The phrase "engaged in the business of effecting transactions in municipal securities" used in the above definition has not been the subject of extensive judicial or Commission interpretation. In Benjamin and Lang, Inc., SEC No-Action Letter, 1978 WL 13780 (Aug. 1, 1978), however, the Commission explained that, "if the Firm acted as an agent for the issuer in soliciting purchasers for a sale of municipal securities on a negotiated basis, as opposed to acting as a consultant to the issuer . . . , the Firm would be considered to be effecting transactions in securities," which would require the Firm to be registered with the Commission as a broker.

Additionally, in interpreting the Exchange Act's definition of "securities broker," which uses the same language as that found in the definition of "municipal securities broker," the courts and the Commission have stated that "regularity of participation" in securities transactions is the primary indicium of whether an entity is "engaged in the business of effecting transactions." See SEC v. Hansen, No. 83-Civ.-3692, 1984 U.S. Dist. LEXIS 17835, at *25-26 (S.D.N.Y. Apr. 6, 1984); SEC v. National Executive Planners, Ltd., 503 F. Supp. 1066, 1073 (M.D.N.C. 1980); Massachusetts Financial Servs., Inc. v. Securities Investor Protection Corp., 411 F. Supp. 411, 415 (D. Mass.), aff'd, 545 F.2d 754 (1st Cir. 1976), cert. denied, 431 U.S. 904 (1977); see also In re Charles A. Roth, 50 S.E.C. 1147, 1152 (1992), aff'd, 22 F.3d 1108 (D.C. Cir.) (table format), cert. denied, 513 U.S. 1015 (1994). Other important factors include whether the entity received compensation tied directly to transactions in securities, engaged in negotiations between the issuer and the investor, made valuations as to the merits of the investment or gave advice, and was an active rather than passive finder of investors. See Hansen,

supra, at *26; Davenport Management, Inc., SEC No-Action Letter, 1993 WL 120436 (Apr. 13, 1993).

Here, the evidence shows that Firm B, through the Registered Rep, engaged in the business of effecting transactions in municipal securities. Firm B solicited potential purchasers, made recommendations of the municipal securities to the purchasers, provided confirmation of the transactions to the purchasers, and represented itself as the issuers' agent throughout the four offerings, which occurred over a two-year period. In addition, Firm B and the Registered Rep were compensated for their services from the proceeds of the sales of the municipal securities. Firm B, through the Registered Rep, also routinely communicated with the issuers and purchasers by using the United States mail and the telephone. Finally, there is no dispute that Firm B was not registered as a municipal securities broker with the Commission. Based on these facts, we find that Firm B, acting through the Registered Rep, engaged in the business of effecting transactions without being registered as a broker, contrary to the requirements of Section 15B of the Exchange Act. See Charles A. Roth, supra, at 1152; Davenport Management, Inc., supra; Benjamin and Lang , Inc., supra.

The DBCC also observed that the Registered Rep acted at variance with Conduct Rule 3040 when he participated in these municipal securities transactions without providing Firm A prior written notification. That rule prohibits any person associated with a member firm from participating in any manner in a private securities transaction outside the regular course of his or her employment unless that person provides prior written notice to the member. As the Commission has emphasized, the reach of Rule 3040 is "very broad." In re Ronald J. Gogul, Exchange Act Rel. No. 35824, at 5 (June 8, 1995). The rule covers "an associated person who not only makes a sale but who participates 'in any manner' in the transaction." Id.

The municipal securities transactions at issue in this case[4] were not within the course and scope of the Registered Rep's employment with Firm A. They were not recorded on Firm A's books and records. Firm A's name did not appear on any of the correspondence or offering documents as the entity that was providing the placement services. Moreover, there is no dispute that the Registered Rep failed to provide prior written notification of these transactions to Firm A. In light of these facts, we find that the Registered Rep acted in contravention of Rule 3040. See Charles A. Roth, supra, at 1150-52.

Supervision. Having reviewed the predicate violations, we turn now to the allegations of the complaint, which concern Respondent 1's failure to supervise the Registered Rep. As an initial matter, we note that it is undisputed that Respondent 1 was the Registered Rep's designated supervisor. In addition, the Registered Rep has asserted, and Respondent 1 does not dispute, that Respondent 1 was aware of his municipal finance activities (and even assisted him to a degree),[5] although the communications between them were all verbal and generally lacked specificity.

---

4 There is no dispute that the transactions at issue involved municipal securities.

5 For instance, the Registered Rep stated,

Respondent 1 stated that he relied on the verbal information that the Registered Rep provided him, as well as the Registered Rep's many years in the business without incident, the Registered Rep's experience in the municipal finance area, and his general integrity in concluding that it was appropriate to permit the Registered Rep to function independently through Firm B.[6] He also stated that he believed that the Registered Rep had been acting as a "placement agent" of exempt securities, not as a broker/dealer, and that the Firm's independent contractor agreement permitted the Registered Rep to engage in this business away from Firm A. We hold that Respondent 1's explanations for failing to supervise the Registered Rep more closely after becoming aware of the municipal finance activities provide him with no defense to this action.

Conduct Rule 3010 requires a member to establish, maintain, and enforce a supervisory system with written procedures. Each registered representative must be adequately monitored by a supervisor. See In re Christopher J. Benz, Exchange Act Rel. No. 38440, at 4 (Mar. 26, 1997), aff'd, 1998 U.S. App. LEXIS 29728 (3d Cir. Oct. 6, 1998). This is true, moreover, regardless of whether the registered representative is working out of a firm's main office, a branch office, or is operating as an

---

> Many of the leads as to potential bond financings were given to us by [Respondent 1] derived from his bond trading activities. . . . Similarly, in every instance involving an actual or potential bond issue transaction the resources of Respondent 1 were volunteered and called upon to provide computerized debt service schedules. In the pricing of a new issue, either prior to obtaining a commitment for the issuer and/or at the time the issue was ready for placement, [Respondent 1] was always called upon to give [Firm B] the benefit of his current market knowledge of interest rate levels and yield scales applicable to the particular type of issue.

[6] The Firm's written procedures relating to private securities transactions essentially tracked Rule 3040's requirements that written notice must be sent to and the activity approved by the Firm prior to any such transactions. When asked during the investigation why these procedures were not followed and enforced with respect to the Registered Rep's municipal finance business, Respondent 1 responded that he did not require written notice and approval because he had been apprised of the activity verbally. When asked specifically how he supervised the private securities transactions, Respondent 1 stated that "[The Registered Rep] has vast knowledge and experience in this area. In areas of the transactions in which [the Registered Rep] thought it appropriate, he and I discussed matters in great detail." Finally, when asked how he satisfied himself, as the Registered Rep's supervisor, that the Registered Rep's activities were in compliance with the broker/dealer registration provisions of the Exchange Act, Respondent 1 replied that "[b]ecause of the verbal communications between the parties and due to the respect and confidence that I have for [the Registered Rep], his experience, knowledge and integrity, I assumed that [the Registered Rep] was in compliance with all applicable rules and regulations, including Section 15 of the 1934 Act and NASD Conduct Rule 3040."

"independent contractor" from a "non-branch" office. See In re Bradford John Titus, Exchange Act Rel. No. 38029, at 3 & n.6 (Dec. 9, 1996). See also NASD Notice to Members No. 86-65 (Sept. 12, 1986). Indeed, the Commission has "long stressed the importance of proper supervision over off-site representatives." Bradford John Titus, supra, at 7; see also In re Royal Alliance Assocs., Inc., Exchange Act Rel. No. 38174 (Jan. 15, 1997).

Additionally, because a firm can act only through individuals, it is the obligation of those persons with supervisory responsibilities to ensure that supervision is adequate. See In re Stuart K. Patrick, 51 S.E.C. 419, 421 (1993), aff'd, 19 F.3d 66 (2d Cir.), cert. denied, 513 U.S. 807 (1994); see also Christopher J. Benz, supra, at 4-7; In re Koch capital, Inc., 51 S.E.C. 241, 247-48 (1992); NASD Rule 115(a). In this regard, the Commission has held that, when faced with indicators of irregularities or misconduct (many times referred to as "red flags"), a "supervisor cannot discharge his or her supervisory obligations simply by relying on the unverified representations of employees." In re Michael H. Hume, Exchange Act Rel. No. 35608, at 7 (Apr. 17, 1995); see also In re Shearson Lehman Hutton Inc., 49 S.E.C. 1119, 1123 (1989) (same). In view of these general principles, it is clear that Respondent 1 did not properly discharge his supervisory obligations.

The record shows that Respondent 1 had sufficient information to raise concern over whether the Registered Rep's municipal finance activities were in compliance with the Exchange Act and the NASD rules. See In re Shearson Lehman Brothers, Inc., 49 S.E.C. 619, 627 n.24 (1986) (stating that it is imperative that the system of internal controls be adequate and effective and that "those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention."); In re Reynolds & Co., 39 S.E.C. 902, 916 (1960) (same).[7] As noted above, Respondent 1 was verbally made aware of the Registered Rep's municipal finance operations and yet he did not endeavor to learn the specifics of or review any materials related to such activities. Had he done so, Respondent 1 would have discovered that Firm B, acting through the Registered Rep, served as more than merely a finder or consultant, and that Firm B had to be registered as a municipal securities broker.[8] Instead, Respondent 1 simply relied on the Registered Rep's characterization of his role in these activities and on the Registered Rep's integrity. Adequate supervision, however, cannot begin and end with unverified assumptions. See Michael H. Hume, supra, at 7; Shearson Lehman Hutton Inc., supra, at 1123; In re Prudential-Bache Secs., Inc., 48 S.E.C. 372, 396 (1986). Respondent 1's failure to take a more active

---

[7] Cf. In re Castle Secs. Corp., Exchange Act Rel. No. 39999, at 4 (May 18, 1998) (rejecting claim that there were insufficient indications that heightened supervision was required; relying, in part, on the fact that the registered representative was given the unusual authority to set prices for certain stocks away from the firm's trading desk and noting that in a past case, the Commission required heightened supervision when a firm gave a branch office permission to make a market in a stock) (citing In re Universal Heritage Investment Corp., 47 S.E.C. 839, 845 (1982)).

[8] As discussed above, Firm B's engagement documents, offering circulars, correspondence with purchasers, and confirmation and closing memoranda indicate that Firm B was effecting transactions in municipal securities.

supervisory role after learning of the activity in question was antagonistic to his duty to supervise the Registered Rep in a manner reasonably calculated to ensure compliance with the registration requirements of the Exchange Act, in violation of Conduct Rules 2110 and 3010.

Respondent 1 also violated Conduct Rules 2110 and 3010 by failing to supervise the Registered Rep with respect to private securities transactions, which are governed by Conduct Rule 3040, discussed above. Although he knew that the Registered Rep received compensation for participating in municipal securities transactions, Respondent 1 did not require prior written notice disclosing the terms of that participation, did not provide the Firm's written approval to the Registered Rep and did not record the transactions on the Firm's records. These transactions should have been handled in accordance with Conduct Rule 3040 and the Firm's written procedures, but they were not. Respondent 1 thus abdicated his supervisory obligations under these circumstances in violation of Conduct Rules 2110 and 3010.[9]

At various points in the record, Respondent 1 intimates that his supervisory responsibilities were somehow lessened because the Registered Rep and Firm A had entered into an agreement whereby the Registered Rep was designated as an independent contractor.[10] Respondent 1's implicit assertions regarding the law in this area are incorrect. In In re William V. Giordano, Exchange Act Rel. No. 36742 (Jan. 19, 1996), the Commission flatly rejected such a contention and stated:

> The Commission does not recognize the concept of "independent contractors" for purposes of the Exchange Act, even if an arrangement with an associated person satisfies the criteria for "independent contractor" status for other purposes. To the extent that a firm forms a relationship with an independent contractor, that firm would be responsible for either (1) ensuring that the independent contractor was registered as a broker-dealer or (2) assuming the supervisory responsibilities attendant to a relationship with an associated person.

Id. See also Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1574 (9th Cir. 1990) (en banc) (rejecting contention that a distinction may be made under the Exchange Act between registered

---

[9] Even assuming, arguendo, that CIC, acting through the Registered Rep, was serving only as a finder or consultant, Rule 3040 still would have required the Registered Rep to provide the Firm with prior written notification of his activities. See, e.g., In re Charles E. French, Exchange Act Rel. No. 37409 (July 8, 1996); Ronald J. Gogul, supra, at 5-6; In re Gilbert M. Hair, 51 S.E.C. 374, 378 (1993); In re Charles A. Roth, 50 S.E.C. 1147, 1150 (1992); In re Terry Don Wamganz, 48 S.E.C. 257, 258-59 (1985).

[10] As discussed above, Respondent 1 stated in his answer to the complaint that "[the Registered Rep's] affiliation with [Firm A] was limited to the status of an Independent Contractor whose activities could include consulting and acting as placement agent for municipal bond issuers and therefore we feel he acted as a consultant and a placement agent."

representatives who are employees or agents and those who might meet the definition of independent contractors), cert. denied, 499 U.S. 976 (1991); Bradford John Titus, supra, at 3 & n.6 (noting that regardless of the title given and the physical location of the person to be supervised, all associated persons are subject to the same level of compliance supervision).

Based on the foregoing discussion, we find that Respondent 1 violated Conduct Rules 2110 and 3010 by failing to supervise in a manner reasonably designed to achieve compliance with the broker/dealer registration provisions of the federal securities laws and failing to enforce the supervisory procedures of member firm Firm A in a manner reasonably designed to achieve compliance with the NASD rules and the Firm's written procedures pertaining to private securities transactions.

Sanctions

Both the Commission and NASD Regulation have long stressed the importance of supervision of off-site representatives. The supervision requirements contained in Rule 3010 provide necessary safeguards against misconduct. The relevant NASD Sanction Guideline for supervision violations recommends imposing a fine of $5,000 to $25,000 and suspending the responsible individual for 10 to 30 business days. See NASD Sanction Guidelines (1996 ed.) at 53. The Guideline also lists principal considerations in determining sanctions, including: (1) prior or other similar misconduct; (2) extent of supervisor's periodic review and follow-up; (3) "red flag" warnings that should have alerted the firm and/or principal to intensify supervision, such as disciplinary history of the supervised person; (4) extent of any inadequacy in the actual supervision of the employee; (5) absence of any reasonable explanation for supervisory failure; (6) extent of employee misconduct; (7) demonstrated new corrective measures or controls to prevent recurrence; and (8) other mitigating or aggravating factors.

In this case, Respondent 1 failed properly to discharge his supervisory responsibilities over an off-site representative. We determine that the appropriate remedial sanctions under the facts of this case are a censure and $5,000 fine. In arriving at the fine, which is at the low end of the range recommended in the Guideline, we have taken into consideration certain mitigating factors. Respondent 1 has been working in the securities industry since 1966 without any prior supervisory-related disciplinary history. The registered representative he failed adequately to supervise has worked in the securities industry for more than 40 years without any prior disciplinary history. The underlying violations that served as the basis for this action, moreover, did not involve any abusive sales practices or customer losses. Finally, Respondent 1 fully cooperated during this investigation, has taken steps to strengthen the Firm's supervisory system, and aims to prevent the recurrence of the kind of violations that took place in this case.

While these facts militate against imposing a fine greater than $5,000, we do not find that such facts warrant imposing a fine below the range recommended in the Sanction Guideline, as did the DBCC.[11] We note, however, that the mitigating factors do support divergence from the Sanction

[11] The DBCC imposed a $2,500 fine.

Guideline with regard to the non-monetary sanctions recommended therein. As a result, we have not imposed any suspension, notwithstanding the Sanction Guideline's suggestion that the responsible individual should be suspended for 10 to 30 business days.

Accordingly, we impose a censure, a $5,000 fine, and $954.60 in costs for the DBCC hearing.[12]

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary

[12] 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, any member who fails to pay any fine, costs, of other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.