BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of	DECISION
District Business Conduct Committee For District No. 8, Complainant,	Complaint No. C8A960054
vs.	District No. 8
Respondent Firm 1, Respondent 2, Respondent 3, and Respondent 4, Respondents.	Dated: April 28, 1999

Allegation that broker/dealer and associated persons acted unethically by participating in various optional purchase and dividend reinvestment plans through a series of related partnerships thereby exceeding the plans' investment limits dismissed on basis that plans' prospectuses did not specifically ban such conduct.

Pursuant to Procedural Rule 9310, Respondent Firm 1 (or "the Firm"), Respondent 2, Respondent 3, and Respondent 4 have appealed a decision issued by the District Business Conduct Committee for District No. 8 ("DBCC"). After a review of the entire record in this matter, we reverse the DBCC's findings and sanctions and dismiss the complaint.

Background. Respondent Firm 1 became a member of the NASD on January 10, 1994. Respondent Firm 1's main office was in City 1, and the Firm also maintained an account processing center ("Processing Center") in City 2. The Firm was also a member of the City 1 Stock Exchange. Respondent 2, the President of Respondent Firm 1, Respondent 3, a Vice-President of Respondent Firm 1, and Respondent 4, a Vice-President of Respondent Firm 1, owned 60 percent, 15 percent, and 25 percent of Respondent Firm 1, respectively. Respondent 2, Respondent 3, and Respondent 4 were also the Firm's Directors.[1]

[1] Respondent 2 entered the securities industry in August 1983 as a general securities representative, general securities principal, and registered options principal Company 4, a former NASD member.

The only business of the Firm was to purchase common stock in various dividend reinvestment and optional cash stock purchase plans ("the Plans") through a series of general partnerships (the "Partnerships") created by Respondent Firm 1 for the sole purpose of investing in these Plans and then arbitraging the stock.[2] The Partnerships were booked on the Firm's records as Respondent Firm 1 proprietary accounts. The Firm and its principals, Respondent 2, Respondent 3, and Respondent 4, were the general partners. Respondent Firm 1 owned 80 percent, Respondent 2 owned 12 percent, Respondent 4 owned five percent, and Respondent 3 owned three percent of each Partnership.

Respondent Firm 1 withdrew its NASD registration in June 1997.

Facts

This matter came to the attention of NASD Regulation staff as the result of an examination of the Firm that began in May of 1995. An exit conference was held in June of 1995, at which time staff determined to hold open the issue of the Firm's conduct in connection with the Plans. An investigation followed, which culminated in the instant complaint.

In or about January 1994, Respondent Firm 1, Respondent 2, Respondent 4, and Respondent 3 created approximately 463 Partnerships. All of the Partnerships were created on approximately the same day. Each Partnership was formed pursuant to an identical Partnership Agreement. The purpose of the Partnerships as described in the Partnership Agreements was generally to buy and sell shares of stock. Each Partnership had its own name, federal tax identification number, and separate books and records. Each Partnership filed a separate partnership tax return. The sole business of each Partnership was to become a shareholder of record in various issuers that offered Plans.

The following describes the procedures followed by Respondent Firm 1: Respondent 4 ran the City 2 Processing Center, which employed one unregistered clerk. Respondent 4 was responsible for naming and creating the Partnerships, obtaining a federal tax identification number for each Partnership, creating separate books and records, and filing separate tax returns for each Partnership. Respondent 4 also participated in selecting the Plans in which the Partnerships would participate. He also handled the paperwork for each Partnership's participation in the Plans.

The names of the Partnerships generally contained the designation "Co." and the name of some form of business or product, e.g., Company 1, Company 2, and Company 3. When Respondent 4 was asked on what basis he selected the Partnerships' names, he testified that the names were arbitrarily

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Respondent 3 never registered with Respondent Firm 1. From December 1992 to the present, Respondent 2 and Respondent 3 have been registered with another NASD member. Respondent 3 is also associated with another NASD member as its President. Respondent 4 entered the securities industry in August 1983 as a general securities representative and general securities principal of Company 4. He was associated with Respondent Firm 1 from June 1993 until Respondent Firm 1 terminated its NASD registration in July 1997, but he never became registered with the Firm.

[2] Respondent Firm 1 maintained one customer account, that of its accountant.

selected, but that his main concern was to make the first 15 digits of each name sufficiently different so that there would be no back office problems, i.e., that a key punch operator would not mistakenly enter the incorrect Partnership name. He testified that the fact that the names appeared to indicate different types of businesses was not a consideration.

Respondent 4 researched the various Plans. Respondent 2 selected the Plans in which the Partnerships would invest and also determined how many Partnerships would participate in each Plan. After making these determinations, Respondent 2 would call the issuer and request that authorization cards be sent to the Processing Center. Respondent 4 testified that they usually arrived at the City 2 office in one envelope. Respondent 4 would fill out the cards, sign them, and return them to the issuer in one envelope. The return address on the envelope was Respondent Firm 1's City 2 Processing Center. The Partnerships then became shareholders of record in the selected companies.

Respondent 4 handled the Partnerships' purchases pursuant to the Plans. He prepared an instructional cover letter, a list of the Partnerships, and one check for all of the Partnerships. The list of shareholder/Partnerships was in alphabetical order, and also included each Partnership's account number, tax identification number, and amount of investment. The cover letter, the check, and the list all indicated Respondent Firm 1. When the time for investing in the Plan arrived, Respondent 4 would send the issuer an instructional cover letter, the list, and the check in the same envelope from the Processing Center via Federal Express.

Neither the cover letter nor the list indicated that the Partnerships were related accounts or Respondent Firm 1 proprietary accounts. Respondent 4 did not advise the companies that Respondent Firm 1 intended to arbitrage the stock that the Partnerships purchased through the Plans.

Respondent Firm 1 requested that the transfer agents deliver the stock to Respondent Firm 1, which Respondent Firm 1 deposited in its account at Corporation 1. Corporation 1 would then send the certificates back to the transfer agent (for cancellation and registration in "street name").

After the Partnerships made their purchases pursuant to the Plans, Respondent Firm 1 arbitraged the stock, i.e., Respondent Firm 1 would sell the stock in the open market at a profit, either because the Partnerships had purchased the stock at a discount or because the stock had been priced on an "average" price of the stock over a given period of time. Of the six Plans at issue, four offered stock at a discount, and two priced the stock on the basis of an average price.

During the relevant time, the Respondent Firm 1 Partnerships participated in six Plans, as described below. Prospectuses set forth the terms of the Plans, which differed somewhat as to the number of shares each shareholder was able to purchase in a prescribed period of time and the cost of the shares. Each of the Plans, however, limited the number of shares each shareholder could purchase within a given period of time.[3] Participants in the Plans did not pay any brokerage commissions or service charges in connection with their purchases. Only one Plan specifically referenced the issue of arbitrage. The following describes the terms of each Plan as set forth in the issuer's prospectus.

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[3] The prospectuses were silent on the issue of whether the Plan administrators had authority to waive the Plans' restrictions; however, at least two of the Plan administrators admitted that they had authority to waive these restrictions.

(1) Corporation 2: The Plan related to 329,097 authorized and unissued shares of common stock, and it permitted all holders of record of at least 20 shares to invest up to $2,000 per calendar month at 95 percent of the prevailing market price. Approximately 70 Partnerships became shareholders of record in Corporation 2 and participated in its Plan.

The Corporation 2 prospectus did not specifically address the issue of the establishment of multiple accounts or arbitrage, but the company reserved the right to exclude any participant from participating in the Plan and to decline to issue all or any portion of the shares for which payment was tendered if it appeared to the company that the participant's use of the Plan was "not in the best interests of the Company or its other shareholders."

A Corporation 2 representative testified that Corporation 2 did permit related accounts to participate, so long as there was no record of arbitraging, which Corporation 2 defined as establishing multiple accounts and liquidating the positions in those accounts more than twice a year. The representative testified that when she saw on the company's shareholder list 75 accounts in alphabetical order - A to H - purchasing 20 shares each, she was concerned that someone was attempting to evade the $2,000 per shareholder limit. Upon further investigation, she determined that the Partnerships intended to arbitrage, but she did not have sufficient time to stop payment on the Respondent Firm 1 check. She testified that when she learned that 75 additional accounts were being opened by shareholders whose names were in alphabetical order from H to M, she sent a letter in September 1994 to the Respondent Firm 1 Processing Center stating that the Partnerships were no longer eligible for participation in the Corporation 2 Plan, and that Corporation 2 would no longer accept checks from the Partnerships. The letter stated that the arbitraging activity was contrary to the purpose of the Plan, which was to encourage long-term investment.

(2) Corporation 3: The Plan related to 750,000 authorized and unissued shares of common stock, and it permitted all shareholders of record to invest a maximum of $3,500 per quarter. The purchase price of the stock was the average of the closing sale prices of the common stock as reported by the Nasdaq National Market for the three consecutive trading days immediately preceding the date of purchase. The prospectus contained no restrictions regarding related accounts or arbitrage. One hundred Partnerships became shareholders of record in Corporation 3 and participated in its Plan.

A representative of Corporation 3 testified that his company acted as its own transfer agent, and that he learned from shareholder service employees that Corporation 3 had received a single check for $350,000 dated August 31, 1994 to open 100 accounts (in alphabetical order) with one share in each account. Corporation 3 employees also noticed that many of the tax ID numbers were in sequential order. Respondent Firm 1 did not advise Corporation 3 that the accounts were related. The representative testified that the company's initial reaction to the size of the check was quite positive. He stated that it appeared that the check could have come from a money manager. The representative testified that he had attempted to find the Partnerships in the telephone book in order to determine whether the Partnerships were actual businesses in the State, but he could not find any listings.

The Corporation 3 representative testified that after the Partnerships directed the company immediately to certificate their shares and send them out, he questioned whether the accounts were involved in a money laundering scheme or attempting to arbitrage the stock purchased in the Plan. The representative called Respondent 2. As a result of that conversation, he determined that the accounts were under common control, and he advised Respondent 2 that Corporation 3 would refuse to accept additional checks from Respondent Firm 1. Shortly thereafter, Respondent Firm 1 closed out its accounts. The representative indicated that he would not have accepted the first check from Respondent Firm 1 had he known that Respondent Firm 1 had intended to arbitrage the stock.

(3) Corporation 4: According to Corporation 4's prospectus, all shareholders of record could make optional cash purchases of common stock of not less than $1,000 or more than $20,000 per year at a five percent discount from market price. The prospectus did not affirmatively prohibit arbitrage. One hundred and seventy-six Partnerships became shareholders of record in Corporation 4 and participated in its Plan.

An Corporation 4 representative testified that as part of his investigation of a significant volume of purchases, Corporation 4's transfer agent produced a listing of Plan participants and their individual share holdings. The Corporation 4 representative noted that the addresses of a number of accounts were the same and that the transfer agent had permitted the Partnerships to participate in the Plan without regard to whether they were engaged "in a coordinated effort to take advantage of the plan or to take advantage of the shareholders of the company." As a result, Corporation 4 replaced its transfer agent and suspended the Plan. On April 16, 1996, Corporation 4 wrote to Respondent Firm 1 stating that the company had determined not to accept the funds that Respondent Firm 1 had proposed to invest for the month of March 1996.

(4) Corporation 5: The Plan related to eight million shares of common stock, which could be purchased by shareholders of record at a three-percent discount from market value. The prospectus specified a $5,000 limit per quarter. The prospectus stated that the Plan was primarily for the benefit of long-term investors, but that the company could also waive the Plan's limitations to raise additional capital. The prospectus stated:

> The intended purpose of the Plan is meant to preclude any person, organization, or other entity from establishing a series of related accounts for the purpose of conducting arbitrage operations and/or exceeding the optional cash payment limit.

One hundred and seventy-five Partnerships became shareholders of record in Corporation 5 and participated in its Plan.

The Corporation 5 representative responsible for administering its Plan became aware of the Respondent Firm 1 accounts when he reviewed a transfer sheet that showed 300 to 350 new shareholders having a common address and each owning a single share of stock. He suspected that someone was setting up related accounts, so he wrote to Respondent Firm 1 in July 1994. In that letter, he advised Respondent Firm 1 that he had reviewed information provided to him by Corporation 5's transfer agent and had determined that Respondent Firm 1 had established multiple accounts. He stated that in view of the language in the prospectus regarding related accounts, Corporation 5 would not accept voluntary cash payments in excess of $5,000 in any calendar quarter from multiple accounts which were set up in variations of the same name or which, irrespective of form, were established for the purpose of evading the $5,000 limitation.

Upon receipt of the letter, Respondent 2 called the representative. The two discussed the letter and the provisions of the Plan, and Respondent 2 assured the representative that the accounts were not the same entity. They did not discuss whether the accounts would subsequently arbitrage the stock. The representative testified that he did not ask Respondent 2 whether the entities were all owned by the same people or were set up to evade or avoid Plan limits or whether Respondent Firm 1 planned to arbitrage the stock that the Partnerships would purchase through the Plan. The Corporation 5 representative determined to permit 175 Partnerships to participate in the Plan at $5,000 per quarter ($875,000).

(5) Corporation 6: Three million shares of common stock were registered under the Plan. The purpose of the Plan was to provide recordholders of the company's common stock with a simple and convenient method of making voluntary cash payments to buy additional shares of common stock without payment of any brokerage commission or service charge. Shareholders of record could invest not less than $25 or more than $5,000 per month. The price of the stock was based on an average of the high and low sales prices of the stock. The prospectus did not reference related accounts or arbitrage.

Because Corporation 6 refused to provide any information to NASD Regulation staff, the DBCC dismissed the allegations as to that Plan.

(6) Corporation 7: The Plan involved 300,000 authorized and unissued common shares, which shareholders of record could purchase at a five-percent discount from market value. Each shareholder could invest not less than $10 or more than $5,000 per quarter. The prospectus stated that the purpose of the Plan was to provide eligible holders with a systematic, economic, and convenient method of making optional cash payments to buy newly-issued common stock without payment of any brokerage commission or service charge, and at a five-percent discount. The prospectus did not reference related accounts or arbitrage. Approximately 200 Partnerships became shareholders in Corporation 7 and participated in its Plan.

A Corporation 7 representative testified that she was notified by the plan's transfer agent that someone had set up 200 accounts and intended to invest the maximum amount allowed per quarter on the next investment date. The representative testified that she did not believe that the Respondent Firm 1 accounts were consistent with the purpose of Corporation 7's Plan, but that the terms of the Corporation 7 Plan did not prohibit related accounts from participating.[4] The Respondent Firm 1 accounts invested $945,000 on December 30, 1994, $1 million on October 31, $71,000 in February 1995, and approximately $1.7 million in March 1995. In 1995, Corporation 7 changed its Plan to place a $5,000 maximum on related accounts. After the Plan was changed, Corporation 7 returned an Respondent Firm 1 check and refused Respondent Firm 1's request for an exception.

[4] Based on this testimony, the DBCC dismissed the allegations relating to Corporation 7.

Discussion

After a thorough review of the record, including submissions on appeal, we reverse the DBCC's findings and dismiss the complaint and sanctions.[5]

The sole allegation of the complaint is that the respondents' conduct was inconsistent with the NASD's high standards of commercial honor and just and equitable principles of trade because the Partnerships' collective purchases in the Plans at issue exceeded the limits in the Plans that the issuers placed on each purchaser. We have concluded that the respondents, whose participation in the Plans was governed by the terms contained in the issuers' prospectuses, did not act outside of the terms of the Plans and, therefore, did not engage in violative conduct.

In no case did any individual Partnership/shareholder purchase stock in a Plan above the limit specified by the issuer in its prospectus for each shareholder of record. As to each Plan at issue, however, the cumulative partnership purchases, if considered to be executed by one purchaser, exceeded the limits placed on Plan purchases by the issuer. The Corporation 2, Corporation 4, Corporation 3, Corporation 7, and Corporation 6 prospectuses did not, however, specifically prohibit participation by related accounts and did not specifically prohibit arbitrage of the common stock purchased pursuant to their Plans. When the Plan administrators for Corporation 2 and Corporation 3 reviewed the documentation provided by Respondent Firm 1 and concluded that Respondent Firm 1 was opening multiple accounts for the purpose of arbitraging the stock acquired under the Plans, they exercised their authority under the Plans and notified Respondent Firm 1 that they were prohibiting further Partnership participation.[6]

Although representatives of Corporation 4, Corporation 2, Corporation 3, and Corporation 7 testified that arbitraging the stock purchased by a series of related accounts was not consistent with the purpose of their Plans, i.e., to encourage long-term investors to increase their holdings in the companies, their Plans did not specifically prohibit such conduct. Further, although representatives of Corporation 4, Corporation 2, and Corporation 3 testified that arbitrage was detrimental to their companies, they provided no evidence of specific harm.

Corporation 5 had the only Plan at issue that specifically addressed multiple accounts and

[5] The DBCC imposed the following sanctions: Respondent Firm 1, Respondent 4, and Respondent 3 were censured, jointly and severally fined $170,000 (comprising disgorgement of $120,000 earned by the Partnerships in the Plans plus a $50,000 fine), and jointly and severally assessed $6,884.50 in costs. Respondent 2, Respondent 4, and Respondent 3 were also suspended in all capacities for 90 days and required to requalify by examination within 90 days in any capacity in which they wished to function, or cease to function in such capacity.

[6] Corporation 7 and Corporation 4 subsequently determined that their Plans should no longer permit participation by a series of related accounts, and they changed the terms of their Plans. The new Corporation 7 Plan gave Corporation 7 the authority to impose a $5,000 limitation on related accounts. Corporation 4 suspended its Plan and then reinstituted it without the discount feature, with the intent to discourage arbitrage.

arbitrage. The Corporation 5 prospectus stated that the terms of the Plan were "meant to preclude" the establishment of a series of related accounts for the purpose of conducting arbitrage and/or exceeding the optional cash payment limit. Although we question whether Respondent Firm 1 acted in good faith when it attempted to open multiple accounts for the purpose of arbitraging the stock, we have determined not to affirm the DBCC's finding of violation as to Corporation 5 on the basis that Corporation 5 made a business decision to permit 175 Partnerships to participate in its Plan.

When Corporation 5 determined that Respondent Firm 1 was attempting to establish a series of related accounts, its Plan administrator sent Respondent Firm 1 a letter referencing the intended purpose of the Plan and stating that Corporation 5 would not accept cash payments in excess of $5,000 in any calendar year from Respondent Firm 1 on the basis that Respondent Firm 1 appeared to control the accounts. After a telephone conversation with Respondent 2, however, Corporation 5 changed its mind and permitted 175 Partnerships to participate, thereby waiving the $5,000 limitation.

We find that it is irrelevant to our determination whether arbitrage was specifically mentioned in this conversation or whether the Corporation 5 representative knew or did not know that the Partnerships were related accounts. Corporation 5 had previously permitted broker/dealers to participate in its Plan and to arbitrage the stock. Thus, we believe that it was Corporation 5's responsibility to ascertain from Respondent Firm 1 whatever facts that the company deemed relevant. It is sufficient for our purposes that, after initially deciding to prohibit Respondent Firm 1's participation, Corporation 5 made a business decision to permit 175 Partnerships to invest in its Plan.

In reaching our decision, we have considered all of the arguments of the parties, and we have rejected them or sustained them to the extent that they are inconsistent or in accord with the views expressed herein. As stated above, participation in each of the Plans was governed by the terms set forth in each issuer's prospectus. The Corporation 2, Corporation 4, Corporation 3, and Corporation 7 prospectuses did not prohibit participation by a series of related accounts, and although Corporation 5 initially determined to prohibit Respondent Firm 1's participation in its Plan, the company later waived the $5,000 limitation set forth in its prospectus and allowed 175 Partnerships to participate. Because we have found that Respondent Firm 1's participation in each of the Plans at issue was not inconsistent with the Plans' requirements, we reverse the DBCC's findings and sanctions and dismiss the complaint.

On Behalf of the National Adjudicatory Council,

Joan C. Conley
Senior Vice President and Corporate Secretary