

BEFORE THE BOARD OF GOVERNORS

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

In the Matter of

District Business Conduct Committee
For District No. 1,

Complainant,

vs.

Respondent Firm 1

and

Respondent 2

Respondents.

DECISION

Complaint No. C01970028

District No. 1

Dated: August 20, 1999

Member firm, through registered principal, (1) failed to complete a needs analysis and implement a training plan for the Firm Element of the continuing education program within the required time period, and (2) failed to have proper written supervisory procedures. Held, DBCC's findings and sanctions are affirmed.

Respondents Firm1 and Respondent 2 appealed the 1998 decision of the District Business Conduct Committee for District No. 1 ("DBCC") pursuant to Procedural Rule 9310. After a review of the entire record, the National Adjudicatory Council ("NAC") of NASD Regulation, Inc. ("NASD Regulation") considered this matter pursuant to Rule 9349(a).

The NASD, Inc. Board ("Board") called this matter for review pursuant to NASD Procedural Rule 9351(a). On review, we find that there was sufficient evidence to support the findings that Respondent Firm 1, acting through Respondent 2, failed to have proper written supervisory procedures governing compliance with the NASD's continuing education program requirements and failed to complete a needs analysis and implement a training plan for the Firm Element of the Continuing Education Program within the required time period. Accordingly, we

affirm the DBCC's findings and order that Respondents 1 and 2 be censured, fined \$5,000 jointly and severally, and required to pay the costs associated with the proceedings.

Background

Respondent 2 first entered the securities business in 1969 with Firm A. He has been co-managing partner and Chief Operations Officer of Respondent Firm 1 since 1981. Respondent 2 owns 49 percent of Respondent Firm 1, and his co-managing partner owns the other 51 percent. Respondent 2 is registered as a general securities principal. Respondent Firm 1 has been a member firm of the NASD since 1981. Neither Respondent 2 nor Respondent Firm 1 has any disciplinary history.

Facts

Respondent Firm 1, a discount commission broker, employs six registered persons. Approximately 65 percent of Respondent Firm 1's business is in equities, 30 percent is in options, and five percent is in mutual funds.¹ Approximately 24 percent of Respondent Firm 1's revenue is derived from institutional trades, and the remaining 75 percent is derived from retail trades.

Establishment of the Continuing Education Program Requirements. In August 1994, the NASD issued Special Notice to Members 94-59 ("August 1994 Notice"), which requested comments from members on a proposed rule that would require firms to institute a mandatory continuing education program. The August 1994 Notice explained that the rule would require all firms to provide two types of continuing education programs: one that would address a "Regulatory Element" and another that would address a "Firm Element."² The August 1994 Notice explained that each firm would conduct its own needs analysis and would create its own Firm Element program that would be tailored to the unique needs of the firm.

¹ Respondent Firm 1 participates in selling groups for new equity issues, mostly for preferred stocks.

² The Regulatory Element is designed to impart information that is broadly applicable to all registered persons. It requires all registered persons to participate in a computer-based training session within 120 days of their second, fifth, and tenth registration anniversary dates. The Firm Element has a different objective: to address issues specific to each particular firm. Each firm must therefore design its Firm Element to address the unique aspects of its business. Thus, the Firm Element requires firms to keep employees up to date on job-, and product-related subjects through a formal ongoing training program.

The NASD subsequently issued Special Notice to Members 95-13 in March 1995 ("March 1995 Notice"), announcing that the Securities and Exchange Commission ("SEC") had approved the continuing education rule proposal and that all member firms were required to complete the needs analysis and training plan of the new Securities Industry Continuing Education Program ("CEP") no later than July 1, 1995, and were required to implement the plan no later than January 1, 1996. The cover letter to the March 1995 Notice explained that there would be a series of regional conferences to help member firms understand and prepare for the new requirements.

Examinations of Respondent Firm 1. An SEC Examiner, conducted a routine examination of Respondent Firm 1 in late 1995. The Examiner sent Respondent Firm 1 a letter explaining certain deficiencies that he found during the examination.³ Among the deficiencies the Examiner noted was Respondent Firm 1's failure "to have completed an analysis of training needs as well as a written training plan prior to July 1, 1995" and a failure to implement the Firm Element of the CEP "no later than January 1, 1996." The letter requested that Respondent Firm 1 respond no later than February 9, 1996 by "setting forth the steps taken to correct the practices and procedures noted herein, and to ensure that they will not recur."

Respondent 2 responded to the SEC examiner's letter on February 9, 1996. With regard to the CEP requirement, Respondent 2 noted that the SEC examiner had completed his examination prior to the January 1, 1996 deadline for implementation of the program. Respondent 2 wrote:

Since your examiner was here, however, we have completed our training plan. We are implementing it by holding a meeting of our registered personnel, in conjunction with our annual compliance meeting (NASD Rules of Fair Practice, Article III, Section 27), to participate in the Firm Element requirement of the continuing education program. We have chosen to adopt as the Firm Element the general outline prepared by the Securities Industry Association for the Regulatory Element, specifically addressing:

- The general objectives of the training program;
- The knowledge and skills to be imparted by the program;
- Which persons the program should cover;
- The delivery mechanism;

³ The SEC examiner sent a copy of the deficiency letter to the Director of NASD Regulation District No. 1.

- The time schedule for delivery; and
- Appropriate feedback.

Respondent 2 enclosed a "copy" of Respondent Firm 1's training plan, which was merely a photocopy of the Regulatory Element outline (the "Photocopied Outline") from the March 1995 Notice. There is no evidence that Respondent 2 ever received a response from the SEC.⁴

About a year later, in March 1997, NASD Regulation conducted its own examination of Respondent Firm 1.⁵ On May 13, 1997, Respondent 2 received a fax from the NASD Regulation District No. 1 Examiner regarding a net capital problem that had been discovered as a result of the examination. Approximately seven weeks later, the Regional Counsel for NASD Regulation District No. 1, wrote to Respondent 2 informing that "the staff plans to present the apparent continuing education deficiencies uncovered during the above-referenced examination of [Respondent Firm 1] to an examination subcommittee of the District Business Conduct Committee in the near future."⁶ The letter asserted that these deficiencies could constitute violations of Conduct Rule 3010 and Membership and Registration Rule 1120. The Regional Counsel offered Respondent 2 the opportunity to respond to District No. 1 before the issuance of any formal complaint against Respondent Firm 1 and Respondent 2.

In his July 10, 1997 response, Respondent 2 complained that two examinations had been performed: one by the SEC in late 1995, after which the SEC addressed the CEP problem, and another by NASD Regulation in 1997, after which Respondent Firm 1 was notified only of a net capital rule problem. Respondent 2 wrote that it was not until "a few weeks ago" that a District No. 1 Supervisor called and told Respondent 2 that she had

⁴ Later that year, in August 1996, Notice to Members 96-55 ("August 1996 Notice") announced that NASD Regulation would provide software to members in order to help them comply with the continuing education requirements.

⁵ In January 1997, a of District No. 1 Supervisor sent Respondent 2 a letter notifying him that Respondent Firm 1's FOCUS report had been late.

⁶ The Regional Counsel explained in his letter to Respondent 2 that "the firm failed to complete an adequate needs analysis and [failed to] ensure that all covered persons received the firm element training" and that "[i]n addition, the training program did not meet the minimum standards, in that the questions did not cover the following matters concerning securities products, services and strategies offered by the firm: (1) general investment features and associated risk factors, (2) suitability and sales practices considerations and (3) applicable regulatory requirements."

discovered some problems with Respondent Firm 1's continuing education program. Respondent 2 asserted that he asked the the Supervisor to write and inform him of the deficiencies.⁷ He claimed that the Supervisor agreed to explain the deficiencies in a letter, but that the she never sent him anything. Respondent 2 wrote in his letter: "[if] the Supervisor (or other NASD Regulation staff) provides us with information about any deficiencies, we will take corrective action."

Respondent 2 insisted that the Firm Element portion of the CEP that had been originally proposed was appropriate for his business and did in fact cover the topics that the Regional Counsel said it had failed to cover. Respondent 2 also defended the appropriateness of using a photocopy of the Regulatory Element outline as Respondent Firm 1's Firm Element plan. He also stated that on April 22, 1997, Respondent Firm 1 held a meeting during which the Firm Element training program was completed by the Firm's registered persons. He enclosed a document that purported to show that Respondent Firm 1's registered persons had completed the program, and he claimed that he had not provided it to NASD Regulation earlier because no one had asked him for it.

⁷ Respondent 2 wrote in his July 10, 1997 letter to the Regional Counsel that he "asked [the supervisor] to specify in a letter exactly what [the deficiencies] were and [that] we would take immediate corrective action. . . ." At the November 23, 1998 hearing (the "NAC Hearing") held before a subcommittee of the National Adjudicatory Council ("NAC"), however, Respondent 2 claimed and the District 1 Supervisor confirmed that she volunteered to write a letter explaining the deficiencies and that he never asked her to do so.

In an effort to allow Respondent 2 every opportunity to introduce any potentially relevant information in support of his case, the NAC Hearing Subcommittee ("NAC Hearing Subcommittee") granted Respondent 2 motion to call the NASD District 1 Supervisor as a witness at the NAC Hearing. She testified that she had phoned Respondent 2 in May 1997 to allow him the opportunity to explain the deficiencies in Respondent Firm 1's continuing education program. She stated that they "argued for maybe half an hour or 45 minutes" about the deficiencies, including whether or not the Photocopied Outline was actually a photocopy. She stated that she did tell Respondent 2 that she would write him a letter explaining the deficiencies, but that she was later told by her supervisor not to do so because it would be pointless in light of the difficulty she had communicating with him. We affirm the NAC Hearing Subcommittee's determination to allow Respondent 2 to call the Supervisor as a witness, although we found that the Supervisor's testimony did not support Respondent 2's argument.

DBCC Proceedings

The DBCC filed its complaint in July 1997 and asserted that from January 1996 through March 1997 (the "Relevant Period"), Respondent Firm 1, acting through Respondent 2: (1) failed to establish written supervisory procedures governing the establishment of the CEP, in violation of Conduct Rules 2110 and 3010 and (2) failed to complete and implement a needs analysis and training plan on an annual basis for the Firm Element of the CEP, in violation of Membership and Registration Rule 1120. On August 15, 1997, Respondent 2 filed an answer in which he denied the allegations of the complaint and challenged the complaint's validity, asserting that the mistaken characterization of Respondent Firm 1 in the caption as " Inc." instead of "Co." (its proper name) rendered the complaint legally defective. In 1997, the DBCC filed an amended complaint which was identical to the original complaint in all respects except that it designated Respondent Firm 1 as "Company."⁸

One week before the DBCC hearing, Respondent 2 notified the DBCC hearing subcommittee ("DBCC Hearing Subcommittee") of his intention to call The District No. 1 regional counsel and supervisor as witnesses. The Regional Counsel moved the subcommittee for an order excluding his and the supervisor's testimony. The DBCC Hearing Subcommittee granted the Regional Counsel's motion to exclude the testimony, and the hearing went forward on March 24, 1998.

At the hearing, the Regional Counsel argued that the case against Respondent Firm 1 was simple:

[R]ather than sitting down and analyzing the business of the firm, and coming up with an analysis of the needs and requirements of the firm, and implementing a training plan relating to those [sic] individualized needs analysis, Respondent 2 simply copied an outline from the regulatory element . . . and said, okay, this is our – this fulfills our firm element.

The Regional Counsel argued that Respondent Firm 1 had violated Membership and Registration Rule 1120 relating to the CEP requirements because "you cannot comply with the requirements of the firm element by simply copying an outline relating to the regulatory element and saying this is our firm element." The Regional Counsel also argued that Respondent Firm 1 did not have proper written supervisory procedures that both provided a process by which

⁸ Respondent 2 filed an answer in response which reincorporated his earlier answer and claimed that the DBCC was again incorrect. According to Respondent 2, the official name of Respondent Firm 1 is " Co." and not "Company."

Respondent Firm 1 would ensure compliance with the CEP requirements and identified the individual(s) responsible for ensuring such compliance.

In response, Respondent 2 argued that Respondent Firm 1 did not have a proper Firm Element training plan in place at the time the DBCC filed its complaint because he did not understand his responsibilities under the rules until September 1997, several months after the DBCC filed its complaint. Respondent 2 claimed that he first understood the deficiencies in Respondent Firm 1's Firm Element training plan when he read the September 1997 Notice to Members 97-66 ("September 1997 Notice"), which included examples of other firms' Firm Element training plans. He also claimed that Respondent Firm 1 had a method for keeping track of which brokers had taken and passed the Regulatory Element of the CEP and that it was obvious that he was the supervisor in charge of compliance with the CEP requirements.⁹

In a decision issued in 1998, the DBCC rejected Respondent 2's arguments and concluded that Respondent Firm 1, acting through Respondent 2, had violated Conduct Rules 2110 and 3010 by failing to identify: (1) the steps that Respondent Firm 1 would take to ensure that its registered persons complied with the CEP requirements; and (2) the general securities principal who would be responsible for ensuring compliance with the CEP requirements. The DBCC also found that Respondent Firm 1, acting through Respondent 2, had failed to complete and implement a needs analysis and training plan, in violation of Membership and Registration Rule 1120. Accordingly, the DBCC censured Respondent Firm 1 and Respondent 2 and fined them \$5,000, jointly and severally.

Discussion

After a thorough review of the record and the parties' arguments on appeal, we affirm the DBCC's finding that Respondent Firm 1, acting through Respondent 2, violated Conduct Rules 2110 and 3010 and Membership and Registration Rule 1120 by failing to establish written supervisory procedures governing the CEP requirements and by failing to develop and implement the Firm Element portion of the CEP requirement.

⁹ In addition to the substantive argument Respondent 2 made at the DBCC hearing, he also argued that the DBCC Hearing Subcommittee had denied him due process when it refused to allow him to call the Regional Counsel and Supervisor as witnesses. He further argued that he believed that certain documents had been altered or were incomplete, and that other documents had been suppressed. The DBCC rejected Respondent 2's arguments, and we find that the DBCC was correct in doing so. Respondent 2 did not offer any credible evidence to support his allegations.

Failure to Establish Written Supervisory Procedures. NASD Conduct Rule 3010(b)(1) requires each member to "establish, maintain, and enforce written procedures to supervise . . . the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of this Association." Membership and Registration Rule 1120(a)(1) states that "[n]o member shall permit any registered person to continue to . . . perform duties as a registered person unless such person has complied with the requirements of [the Regulatory Element of the Continuing Education Program.]"

In his appeal brief and at the NAC Hearing, Respondent 2 explained that Respondent Firm 1 kept track of its registered persons' compliance with the computer-based training program by keeping a file of Central Registration Depository ("CRD") advisory messages which named the registered persons at Respondent Firm 1 who had completed the program. Respondent 2 also argued that because of Respondent Firm 1's small size, he was readily aware of who had not completed the computer-based training program, and it was therefore unnecessary for Respondent Firm 1 to have written procedures to ensure completion and to monitor those individuals who failed to complete the program. Respondent 2 finally argued that in any event, Respondent Firm 1 did in fact have written procedures governing registered persons' compliance with the CEP. He referred to a document entitled "Supervisory Procedures," which stated that the compliance department "is responsible for all compliance and regulatory matters, including the Continuing Education Program." Respondent 2 and his partner, were listed as the supervisors responsible for compliance.

We find that Respondent Firm 1's written supervisory procedures were inadequate. First, as the regional attorney pointed out on appeal, Respondent 2 added the "Compliance" section to the document entitled "Supervisory Procedures" after the NASD Regulation examination in March 1997. Thus, during the Relevant Period, Respondent Firm 1's written supervisory procedures did not state who was in charge of compliance supervision, and they were therefore deficient in this regard. Furthermore, Rule 3010 specifically requires "written supervisory procedures." We also find that Respondent Firm 1 did not satisfy this requirement by merely collecting CRD notices that indicated who had and had not completed the Regulatory Element of the CEP. These procedures are mandated by NASD rules, which apply to all members of the Association, and firms are not permitted to decide to abide by some rules but not others that they believe are unnecessary. Respondent Firm 1's written supervisory procedures simply did not explain the method Respondent Firm 1 used to keep track of compliance with the CEP requirements. We therefore find that Respondent Firm 1, through Respondent 2, violated Conduct Rules 3010 and 2110.

Failure to Complete and Implement a Needs Analysis and Training Plan for the Firm Element of the CEP. Membership and Registration Rule 1120 explains the Association's requirements regarding continuing education. Rule 1120(b)(2) articulates the standards for the Firm Element of the CEP. It requires that a firm

annually evaluate and prioritize its training needs and develop a written training plan. The plan must take into consideration the member's size, organizational structure, and scope of business activities, as well as regulatory developments and the performance of covered registered persons in the Regulatory Element.

These standards were reprinted and explained in various Notices to Members before and during the Relevant Period.¹⁰

The record supports the DBCC's finding that during the Relevant Period, Respondent Firm 1 failed to complete the required needs analysis, failed to develop a written training plan that was uniquely tailored to the needs of Respondent Firm 1, and failed to implement such a plan. Respondent 2 did not dispute the District's charge that Respondent Firm 1 never performed the needs analysis required under Rule 1120. Furthermore, when the District asked Respondent 2 for a copy of Respondent Firm 1's Firm Element training plan, Respondent 2 merely photocopied and submitted the Regulatory Element outline, which was published in Notice to Members 95-13 and which relates to the standard computer training program that all registered persons must complete. This was not appropriate, as the Regulatory Element of the CEP covers different topics and serves different objectives than the Firm Element. See note 2, supra.

Respondent 2's argument that he did not understand what was required for the Firm Element until he received the September 1997 Notice to Members 97-66 is unavailing. The

¹⁰ For instance, both the August 1994 Notice and the March 1995 Notice stated that at a minimum, the Firm Element had to "cover the following matters concerning securities products, services and strategies offered by the member: a. General investment features and associated risk factors; b. Suitability and sales practice considerations; c. Applicable regulatory requirements." These Notices to Members also made clear that the member had to "administer its continuing education programs in accordance with its annual evaluation and written plan and . . . maintain records documenting the content of the programs and completion of the programs by covered registered persons."

March 1995 Notice, which was issued more than two years before the September 1997 Notice, contained five pages of "Guidelines For Firm Element Training." These Firm Element Guidelines expressly stated that each firm was required to conduct an analysis of its overall business and had to develop a training plan that covered the following: "[d]escriptive information regarding the general investment features of the products, services, or strategies," "[b]asic techniques for pricing investment products, services, or strategies," "[a]ssociated risk factors such as business risk, interest rate risk, inflation risk, market risk, and political risk," "[f]eatures that may affect a product's liquidity, taxability, callability [sic], convertibility, and legality for certain classes of investors," "[s]uitability of the products, services, or strategies for different types of investors, considering their investment objectives and constraints, financial status, and level of sophistication," and "[a]pplicable regulatory requirements, including standards for communications with the public." Furthermore, the September 1997 Notice contained examples of Firm Element programs that other member firms had created and implemented. Respondent 2 did not dispute that Respondent Firm 1 had received all the relevant Notices to Members. Nor did Respondent 2 explain how these other firms were able to use the instructions and information made available by the Association to its members to create their Firm Element programs, while his firm was unable to do so. We therefore find that Respondent 2 had sufficient information available to him from which to develop a proper Firm Element training plan. He simply failed to do so.

We therefore affirm the DBCC's finding that Respondent Firm 1, acting through Respondent 2, violated Membership and Registration Rule 1120 by failing to conduct a needs analysis and implement a training plan for the Firm Element of the CEP.

Sanctions

We note that the 1996 edition of the NASD Sanction Guidelines ("Guidelines") for Conduct Rule 3010 violations recommends a monetary sanction of \$5,000 to \$25,000 and a suspension of the responsible individual in all capacities for 10 to 30 business days. The Guidelines for violations of Rule 1120 relating to the Firm Element recommend a monetary sanction of \$2,500 to \$20,000. In aggravated instances, the Guidelines recommend a five-day suspension. The Guidelines recommend limiting the sanction to a monetary penalty for those instances involving only one Rule 1120 violation of short duration or for inadvertent Rule 1120 violations.

On the basis of the foregoing, we impose a censure, a fine of \$5,000 on Respondent 2 and Respondent Firm 1, jointly and severally, and \$839.50 in costs, which will also be assessed jointly and severally.¹¹ We have taken into account the fact that the respondents do not have a prior disciplinary history. We reiterate, however, that the requirements were widely and appropriately publicized and that the respondents had notice of them. We note that the DBCC did not impose a fine for each violation, and that the fine it did impose is less than the combined minimum fines that the Guidelines recommend for each violation. Furthermore, the DBCC did not impose the other recommended sanctions, such as a 10- to 30-day suspension for the Rule 3010 violation and a five-day suspension for an aggravated Rule 1120 violation. Compare In re L.H. Alton & Co., Exchange Act Rel. No. 40886 (Jan. 6, 1999) (SEC affirmed imposition of combined minimum fines for continuing education and supervision violations and 30-day suspension for combination of violations, including continuing education and supervision violations). We nonetheless find that these sanctions are appropriately remedial under the circumstances. The Guidelines for Rule 1120 expressly state that only a monetary sanction should be imposed in the case of a single continuing education violation. Furthermore, the supervisory violation involved Respondent 2's failure to write down Respondent Firm 1's policy for ensuring compliance with the continuing education program requirements. We note that Respondent Firm 1 is comprised of several individuals, and therefore this lapse does not rise to the level of an egregious violation.

¹¹ The \$5,000 represents a \$2,500 fine for each cause. The sanctions are below the applicable Guidelines. See Guidelines (1996 ed.) at 52 (Supervision Violation) and 12 (Firm Element Violation).

Accordingly, Respondent 2 and Respondent Firm 1 are each censured, fined \$5,000, jointly and severally, and assessed costs, jointly and severally, of \$ 839.50 for the DBCC proceedings.¹²

On Behalf of the NASD Board of Governors,

Alden S. Adkins, Senior Vice President and General
Counsel

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, or 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.