

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of the Association of

X

as an

Equity Trader

with

The Sponsoring Firm

Redacted Decision

Notice Pursuant to
Rule 19h-1
Securities Exchange Act
of 1934

Decision No. SD00011

This matter involves the proposed association of X¹, a person subject to a statutory disqualification, as an equity trader with a member firm ("the Sponsoring Firm" or "the Firm"). A hearing in this matter was held in May 2000, before a subcommittee of the Statutory Disqualification Committee of NASD Regulation, Inc. ("NASD Regulation") ("Subcommittee"). X appeared and was accompanied by his proposed supervisor ("Proposed Supervisor"), the head of the Sponsoring Firm's over-the-counter ("OTC") trading desk, and the Firm's Director of Compliance.

X is subject to a statutory disqualification as the result of his 1992 guilty plea to charges of criminal sale of a controlled substance (one-half ounce of cocaine). The conviction was a second-degree felony. X was sentenced to lifetime probation. In 1997, X was granted an early discharge from probation.² X's statutory disqualification expires in March 2002.

NASD Prior Approvals

X has twice before been approved by the NASD to associate with a member firm as a statutorily disqualified person. Pursuant to an SEC Rule 19h-1 notice ("1997 Notice"), the NASD

¹ The names of the Statutorily Disqualified individual, the Sponsoring Firm, the Proposed Supervisor, and other information deemed reasonably necessary to maintain confidentiality have been redacted.

² [Footnote redacted.]

approved X's association with Firm A as a registered representative. The Securities and Exchange Commission ("SEC") confirmed that approval later in 1997.³ By the terms of the 1997 Notice, X was permitted to function only as an apprentice trader and was subject to the following supervisory conditions:⁴ (1) he was required to be located in close physical proximity to his supervisor; (2) he was not allowed to service retail accounts or provide investment advice; (3) his employment was restricted to that of a "runner" (taking orders from other broker-dealers⁵ and delivering them to the appropriate trader, retrieving faxes and performing other administrative tasks); (4) he was not authorized to commit any of the Sponsoring Firm A's capital; and (5) all of his incoming and outgoing correspondence was required to be reviewed and approved by his supervisor.

X was registered with Firm A for three months in 1997. Thereafter, X became associated with the Sponsoring Firm as an apprentice trader, despite the fact that the Firm had not sought prior approval to employ a statutorily disqualified individual, as required by NASD and New York Stock Exchange ("NYSE") rules.⁶ Disciplinary proceedings were initiated against both the Sponsoring Firm and X by NASD Regulation. The Sponsoring Firm entered into a Letter of Acceptance, Waiver and Consent ("AWC") that was accepted by NASD Regulation's National Adjudicatory Council ("NAC") in 1999. The Sponsoring Firm consented to findings of violations of Article III, Section 3 of NASD's By-Laws and Conduct Rule 2110 and to sanctions of a censure and fine in the amount of \$50,000. A Letter of Caution ("LOC") was issued to X in 1999.

The Sponsoring Firm explained in its Statement of Corrective Action and Mitigating Circumstances ("Mitigation Statement"), which was attached to the 1999 AWC, that both the Firm and its outside counsel had spoken by telephone with an NASD Regulation Compliance & Disqualification Specialist about X's association with the Firm and that, based on those conversations, the Sponsoring

³ Notice Pursuant to Rule 19h-1 of Securities Exchange Act of 1934 (SD-1348).

⁴ The 1997 Notice provided that X's association would involve a two-stage process that would necessitate the filing of another application to seek X's registration as an equity trader.

⁵ The Sponsoring Firm has clarified that the Notice should have stated that X would be taking orders from other "brokers," rather than from other "broker-dealers."

⁶ The NYSE, as the Designated Examining Authority for the Sponsoring Firm, became aware of X's association with the Firm and notified the Firm in December 1997 that because X was a statutorily disqualified individual, he could not remain on the Firm's premises. Although the Sponsoring Firm had filed a Form MC-400 with respect to X's association in December 1997, which was prior to the NYSE notice, the Firm was in violation of NASD and NYSE rules because it had allowed X to associate with the Firm prior to obtaining the requisite approvals. According to the Sponsoring Firm's 1997 Form MC-400, X joined the Firm after having become acquainted with the Firm's chairman and chief executive officer, during X's tenure at Firm A.

Firm had understood (incorrectly) that X could associate with the Firm in a clerical position prior to the NASD's approval of his association.⁷

NASD Regulation's Department of Member Regulation ("Member Regulation") approved X's association with the Sponsoring Firm as an apprentice trader under the same terms and conditions as outlined above, pursuant to SEC Rule 19h-1(a)(3)(ii). Following this approval, X re-associated with the Sponsoring Firm.

X's Business Activities as Proposed by the Sponsoring Firm

The Sponsoring Firm has requested approval for X to be employed as an equity trader on the Firm's OTC trading desk in the Firm's main office. The Sponsoring Firm proposes that X receive, process and execute agency orders transmitted by various Firm brokers and branch offices via telephone or facsimile, distribute the orders to traders, and report back to the branches after execution. X will not have access to customer funds or securities, he will not handle proprietary trades for the Sponsoring Firm, nor will he be involved in market-making. The Sponsoring Firm plans to compensate X with a base salary plus a discretionary bonus.

Background of the Sponsoring Firm

The Sponsoring Firm has been a member of the NASD since 1936 and has been in the securities business for 123 years. The Sponsoring Firm has four Offices of Supervisory Jurisdiction and four Branch Offices. It is a full-service investment bank engaged in the retail brokerage business. The Sponsoring Firm employs 49 registered principals and 224 registered representatives.

The following is a summary of the Sponsoring Firm's disciplinary history for the past 10 years, excluding the Firm's 1997 AWC for employing X, as described above:

The Sponsoring Firm entered into an AWC with NASD Regulation in 2000 regarding alleged violations of NASD and SEC firm quote rules, as well as allegedly inadequate written supervisory procedures to govern compliance with those rules. The AWC is pending approval by the NAC. The Sponsoring Firm consented to a censure and a fine in the amount of \$8,000.

In 1999, NASD Regulation accepted an AWC, finding that the Sponsoring Firm had violated NASD Systems and Programs, Rule 6130(d), an Automated Confirmation Transaction Service ("ACT") rule. The Sponsoring Firm failed promptly to update its quotations on limit orders, and

⁷ The Sponsoring Firm explained in its Mitigation Statement that it has adopted the following policy to ensure that this problem does not arise again: If the Sponsoring Firm hires a statutorily disqualified person, that person will be prohibited from being on the Firm's premises until the Firm obtains the appropriate regulatory approval.

inaccurately reported short sales to ACT without including the ".S" modifier. The Sponsoring Firm consented to a \$2,000 fine.

In 1997, the Sponsoring Firm consented to a \$125,000 fine and a censure by the Chicago Board of Options Exchange ("CBOE") for violations of CBOE Rules in connection with the supervision of a former employee who had perpetrated a fraud against the Sponsoring Firm.⁸ In addition to the fine and censure, the Sponsoring Firm agreed, among other things, to establish a procedure whereby supervisors would be made aware of active account reports for employees' personal accounts under certain circumstances.

The NASD accepted an AWC in 1994, which resulted in a censure and \$7,500 fine. The Sponsoring Firm was found to have acted in contravention of the Board of Governors' free-riding and withholding interpretation, now IM-2110-1. The Sponsoring Firm, through two of its associated persons: sold new issues, which traded at an immediate premium in the secondary market, to restricted persons; and sold new issues, which traded at an immediate premium in the secondary market, to four accounts of investment partnerships and/or corporations without first obtaining information about the names and business connections, and to nine accounts of domestic and foreign banks and other broker-dealers without first obtaining the required representations.

The Sponsoring Firm settled administrative proceedings with the SEC in 1993 resulting in a cease and desist order. The Sponsoring Firm was found to have purchased from and sold to the public approximately 66,000 shares of common stock worth about \$40,000 without having a registration statement filed or in effect, and without an exemption.

The NASD accepted an AWC in 1993 finding that the Sponsoring Firm had updated quotations in the OTC Bulletin Board system outside of the allowable time. The Sponsoring Firm consented to a \$250 fine.

Finally, within the past 10 years, the Sponsoring Firm has entered into settlement agreements with six states as a result of registration violations.

⁸ The Sponsoring Firm failed reasonably to supervise a former associated person who worked as a trader's assistant on the Firm's proprietary trading desk. The trader's assistant caused numerous losing option trades that he originally effected for his personal trading account and/or the accounts of other Sponsoring Firm employees to be assigned to the Firm's proprietary accounts, and converted the Firm's funds to his own use by causing certain profitable option trades that he originally effected for the Firm's proprietary accounts to be assigned to his personal trading account.

Background of Proposed Supervisor

X's proposed supervisor has been employed in the securities industry since 1988. The Proposed Supervisor became associated with the Sponsoring Firm in April 2000. He became registered as a general securities principal in 1999 and became head of the Sponsoring Firm's OTC trading desk in 2000. The Proposed Supervisor has no disciplinary history.

Member Regulation's Recommendation

Member Regulation recommends that X's association with the Sponsoring Firm be approved.

Discussion

After careful review of the entire record in this matter, we conclude that the Sponsoring Firm's application to employ X as an equity trader should be approved. We are mindful of the fact that X committed a serious offense, but we find that he has rehabilitated himself over the past eight years since his conviction involving the sale of a controlled substance. X was 23 years old and had been out of college for one year at the time of his offense. He has been registered as an apprentice trader with the Sponsoring Firm since 1999 and has not engaged in any intervening misconduct.⁹

With respect to the prior disciplinary incident involving X's association with the Sponsoring Firm prior to NASD's approval, we agree with Membership Regulation's determination that the following mitigating factors deserve consideration: First, the Sponsoring Firm apparently was confused, based on conversations that it and outside counsel had with an NASD Regulation Compliance and Disqualification Specialist, about whether X could associate in a clerical capacity prior to obtaining approval. Second, the Sponsoring Firm subsequently instituted a policy providing that if the Sponsoring Firm hires a statutorily disqualified person, that person will be prohibited from being on the Sponsoring Firm's premises until the necessary approvals are obtained from the appropriate regulatory agencies. Third, the Sponsoring Firm has already been sanctioned for its mistake in an NASD disciplinary proceeding.

As to the Sponsoring Firm's disciplinary history, we concur with Member Regulation that the number of disciplinary incidents involving the Sponsoring Firm is not out of the ordinary for a large firm. We also have considered that only two of the Sponsoring Firm's disciplinary incidents occurred in the past four years. Further, we agree with Member Regulation's determination that none of the Sponsoring Firm's past disciplinary events appear to bear directly on the Sponsoring Firm's ability to supervise X effectively. As noted by Member Regulation, the pending AWC (involving violations of firm quote rules) does not involve a claim that the Sponsoring Firm failed to supervise its employees, although it does involve alleged deficiencies in the supervisory procedures governing compliance with the SEC's

⁹ X passed the Series 55 (equity trader qualification examination) on April 17, 2000.

firm quote rules. The Sponsoring Firm has revised its written supervisory procedures to correct the deficiencies noted. Additionally, with respect to the Sponsoring Firm's 1997 settlement with the CBOE, we note that the incident involved a rogue broker who took steps to conceal his unlawful activity from the Firm, and that the Firm, in response to the CBOE's investigation, implemented adequate procedures.

In addition, the Sponsoring Firm's compliance director, testified that he had joined the Firm in 2000 and that the Firm had recently undergone a general change in management in an effort to raise the Firm's standards in the area of compliance. Moreover, the Director of Compliance advised the Subcommittee that he had been responsible for supervising X during X's employment at Firm A.¹⁰ The Director of Compliance described himself as a "visible" and "proactive" compliance director. He has no disciplinary history. Additionally, X's proposed supervisor has 12 years of industry experience and has no disciplinary history.

The Sponsoring Firm has agreed to the following supervisory plan for X:

- (1) The supervisory procedures of the Sponsoring Firm will be amended to establish clearly that the Proposed Supervisor is X's responsible supervisor.
- (2) X will conduct securities business on behalf of the Sponsoring Firm only from the office where the Proposed Supervisor is physically located, at a desk near the Proposed Supervisor's.
- (3) X will act as an agency trader on the Sponsoring Firm's OTC desk, receiving and processing agency orders transmitted by various Sponsoring Firm brokers and branch offices either electronically or via telephone or facsimile, distributing the orders to market-making firms, and reporting back to the brokers and/or branches after execution.
- (4) X will not have access to customer funds or securities, he will not handle proprietary trades for the Sponsoring Firm, nor will he be involved in market-making.
- (5) X will not be responsible for servicing accounts of or providing investment advice to the Sponsoring Firm's customers.
- (6) The Proposed Supervisor will review all of X's trades on a daily basis.

¹⁰ The Director of Compliance confirmed in a letter to NASD Regulation dated May 2000 that he was responsible for supervising X during X's employment at Firm A. Moreover, the 1997 Notice listed the Director of Compliance as the individual responsible for supervising X at Firm A.

- (7) All of X's outgoing correspondence will be approved by the Proposed Supervisor prior to being sent. The Proposed Supervisor will review all incoming correspondence. The Proposed Supervisor will maintain copies of all outgoing and incoming correspondence with his initials, thereby evidencing his review and approval.
- (8) The Proposed Supervisor will meet with X on a quarterly basis to review his transactions. The Sponsoring Firm shall keep a log of these meetings.
- (9) All complaints pertaining to X, whether verbal or written, will be immediately referred to the Proposed Supervisor for review, and then to the Director of Compliance. The Proposed Supervisor will prepare a memorandum to the file as to what measures he took to investigate the merits of the complaint (e.g., contact with the customer) and the resolution of the matter. Documents pertaining to these complaints should be kept segregated for ease of review.
- (10) The Proposed Supervisor must certify semi-annually in writing (June 30th and December 31st) to the Director of Compliance that the Sponsoring Firm is in compliance with all of the above conditions of heightened supervision to be accorded X.
- (11) For the duration of X's statutory disqualification, the Sponsoring Firm must obtain prior approval from Member Regulation if it wishes to change X's responsible supervisor to another person.

In addition, the Sponsoring Firm will not be required to file another Form MC-400 application for approval of continuance in membership in the NASD if it later decides to expand X's duties commensurate with registration as a general securities representative and/or equity trader.

The NASD certifies that: (1) X meets all applicable requirements for the proposed employment (including having passed the Series 55 (equity trader exam)); (2) the Sponsoring Firm employs no other individuals who are subject to a statutory disqualification; and (3) X and the Proposed Supervisor have represented that no familial relationship exists between them. In addition to being an NASD member, the Sponsoring Firm is a member of the following other self-regulatory organizations ("SROs"): The American Stock Exchange, The CBOE, The New York Stock Exchange, and the Pacific Stock Exchange. Each SRO has advised NASD Regulation that it concurs with our determination to provide this notification to the SEC.

Accordingly, the application of X to become associated as an equity trader with the Sponsoring Firm will become effective within 30 days of the SEC's receipt of this decision, unless otherwise notified by the Securities and Exchange Commission.

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Senior Vice President and
Corporate Secretary