

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of
the Association of

X

as an

Investment Company and Variable Contracts
Products Representative

with

The Sponsoring Firm

REDACTED DECISION

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

Decision No. SD03001

On November 21, 2001, the Sponsoring Firm¹ (or "the Firm") submitted a Membership Continuance Application ("MC-400" or "the Application") to permit X, a person subject to a statutory disqualification, to associate with the Firm as an investment company and variable contracts products representative. In January 2003, a Hearing Panel of the Statutory Disqualification Committee of NASD held a hearing on the matter. X appeared, accompanied by the Proposed Supervisor, his attorney, and various witnesses that testified on X's behalf. PL appeared on behalf of the Department of Member Regulation ("Member Regulation") of NASD.

A. The Statutorily Disqualifying Event

In 1999, X pled guilty in a United States District Court to a charge of tax fraud (a felony). Specifically, X admitted that he knowingly and willfully attempted to evade a substantial part of the income tax due to the United States by signing and causing to be filed a fraudulent individual tax return for the year 1991. The return, which was not filed until 1995, declared that X had received taxable income for the calendar year 1991 in the amount of \$74,655, and that the amount of tax due was \$13,150. X failed to provide accurate information to his accountants regarding additional income that he received in 1991. The return did not include approximately \$32,676 in taxable income, which X

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.

received from his insurance brokerage business.² X pled guilty to evading approximately \$4,759 in taxes, in violation of 26 U.S.C. § 7201 (1999).

As a result of X's guilty plea, he was placed on probation for a term of five years. In addition to the standard conditions of probation, X was fined \$4,000, confined to his residence for a period of six months, and ordered to perform 500 hours of community service. During the six month confinement, X was required to be at his residence at all times except for approved absences for gainful employment, community service, religious services, medical care, educational or training programs and at other such times as were specially authorized by the U.S. Probation Office. After X completed his six months of house arrest and his community service requirements, and paid his fine, he moved for early termination of his probation. By order dated 2002, a United States District Court granted X's request for early termination, effective in 2002.³

B. Background Information

1. X

X has been employed in the securities industry since 1981 as an investment company products/variable contracts representative. He has not been associated with an NASD member since 1999.

X does not have any previous regulatory history, and the record does not contain any evidence of customer complaints against him.

2. The Firm

The Sponsoring Firm has been a member of NASD since 1966. The Sponsoring Firm's principal place of business is in State 1. The Sponsoring Firm has one office of supervisory jurisdiction ("OSJ") and three branch offices. The Firm employs three non-registered associated persons, 13 registered representatives, and one registered principal.

During the last 10 years, the Sponsoring Firm has received two Letters of Caution ("LOC"), one in 1994, and the other in 2000. In addition, NASD held a compliance conference with the Sponsoring Firm in 1999 to discuss certain identified deficiencies.

² During the hearing, the certified public accountant hired by X after he learned that he was the subject of a criminal investigation for tax evasion, testified that X had reported income from various insurance companies and other companies on approximately 20 Internal Revenue Service ("IRS") Forms 1099. X failed to report \$32,676 in income shown on two additional Forms 1099. The circumstances surrounding X's failure to report the additional income are more fully discussed below on page 5.

³ X's probation was scheduled to terminate on or about 2004.

In 1994, NASD issued an LOC to the Sponsoring Firm. NASD found that the Firm had violated certain registration requirements. NASD also found that the Firm had charged an administration fee on all no-load mutual fund purchases for a particular period, in violation of Conduct Rule 2430. The Firm responded to the LOC and advised NASD that the deficiencies had been corrected, and that it had refunded fees to customers who were improperly charged.

In 1999, NASD held a compliance conference with the Firm to discuss deficiencies related to the Firm's compliance under the firm element of the continuing education requirement and deficiencies related to the Firm's annual compliance meeting. The Firm responded to the meeting with a letter in 1999 that addressed the deficiencies.

In 2000, NASD issued an LOC to the Sponsoring Firm, alleging that the Firm had violated Municipal Securities Rulemaking Board ("MSRB") Rule G-2 by accepting two transactions in municipal securities while failing to have a registered municipal securities principal. The Firm promptly advised NASD that it had sent a memorandum to all registered representatives and order processing personnel that the Firm would process no transactions in municipal securities until a municipal securities principal became associated with the Firm.

C. X's Proposed Business Activities and Supervision

The Sponsoring Firm proposes to employ X as an investment company products/variable contracts representative who will sell mutual funds, 401(k) plans, and retirement programs. X will be compensated with an annual salary plus a quarterly bonus.⁴

The Firm proposes that the Firm's president and owner be responsible for supervising X in an off-site location. X will be working out of a branch office in State 1 Office 2. The Sponsoring Firm's president will supervise X from the Sponsoring Firm's home office in State 1 Office 1. The State 1 Office 1 office, which is an OSJ, is roughly 15 minutes by car from the State 1 Office 2 office. The Proposed Supervisor has experience supervising other registered representatives, and he currently supervises between five to 10 other registered representatives from the State 1 Office 1 office.

The Proposed Supervisor has over 32 years of experience working for the Sponsoring Firm, and he is the Firm's sole owner. The Proposed Supervisor has been registered with NASD since 1968, and he is currently registered as a general securities representative and a general securities principal. We are not aware of any regulatory actions taken against the Proposed Supervisor in any capacity.

⁴ X will receive 80% of the net commissions received by the Firm for the sale of the mutual funds.

D. Member Regulation Recommendation

Member Regulation recommends that X not be permitted to associate with the Sponsoring Firm. Member Regulation does not believe that X's association is in the public interest for the following reasons: (1) the nature of the disqualifying event (criminal conviction for tax evasion) and the fact that the conviction is relatively recent; (2) the fact that X was only recently released from probation (in 2002); and (3) the lack of daily on-site supervision.

Member Regulation believes that the proposed supervisory structure would be unacceptable even if X reported to the same office as the Proposed Supervisor because the nature of X's work takes him out of the office every day to visit with clients, where he would be unsupervised. Member Regulation is particularly concerned about the lack of daily supervision, given that, according to the conviction documents that are included in the record, X "concealed the true income from his accountants by failing to provide accurate information and documentation regarding the income he had received."

E. Discussion

After carefully reviewing the entire record in this matter, we approve the Firm's Application to employ X as an investment company and variable contracts products representative.

In reviewing this Application, we have considered whether the felony at issue, examined in light of the circumstances related to the felony and other relevant facts and circumstances, creates an unreasonable risk of harm to investors.⁵ We conclude that it does not. We note that X has accepted full responsibility for failing timely to file his 1991 tax return and for not reporting income in connection with that return. We will first examine X's personal circumstances leading up to his conviction and then consider the steps that he has taken to rehabilitate himself since his conviction.

X began having financial difficulties beginning in 1988 when he and his two brothers purchased a commercial property for \$325,000. X used \$100,000 of his own funds to improve the property, which consisted of a grocery store and apartment building that X's grandparents had owned since the 1950's. X has represented that, when it became apparent that the property would not be a profitable investment, he agreed to refinance the property for \$260,000 in 1989 to alleviate the financial burden on his two

⁵ See Frank Kufrovich, Exchange Act Rel. No. 45437, 2002 SEC LEXIS 357, at *16 (Feb. 13, 2002) (upholding NASD's denial of a statutory disqualification applicant who had committed non-securities related felonies "based upon the totality of the circumstances" and NASD's explanation of the bases for its conclusion that the applicant would present an unreasonable risk of harm to the market or investors).

brothers. The property continued to sustain large losses through the early 1990's, and X eventually lost the property in a sheriff's sale in 1995.

X admits that he neglected his personal affairs during the period in which his financial situation deteriorated. This led to his failure to file his tax returns for the years 1991 through 1993 on a timely basis, and his failure properly to communicate with his tax advisors. He also admits that his 1991 tax return, which he did not file until 1995, did not report income documented by two Forms 1099. X also was delinquent in filing his 1992 and 1993 tax returns, as set forth in the Criminal Information. X became aware in 1995 of the IRS investigation related to his delinquent tax returns for the years 1991 through 1993.

In 1999, X entered into a plea agreement under which he agreed to plead guilty to count one of the Criminal Information, charging that he knowingly and willfully attempted to evade income tax due to the United States by causing a false and fraudulent 1991 individual tax return to be filed. According to the Criminal Information, X owed an additional tax of approximately \$4,759 as a result of having failed to include \$32,676 in taxable income in his 1991 tax forms. As part of the plea agreement, the government agreed to dismiss the charges of failure to file tax returns for tax years 1992 and 1993.

Thereafter, X hired new tax advisors and filed all delinquent tax returns with the IRS, amended his 1991 tax return to include the missing Form 1099 income of \$32,677, and made a settlement with the IRS to satisfy his tax obligations. X thus has fully satisfied his tax obligations. The IRS determined that X owed taxes in the amount of \$5,152 for tax year 1991, based on his amended 1991 return, because of various offsets and expenses.⁶

We are also mindful that the conviction occurred almost four years ago and that the court granted X's request for early termination of his probation as of 2002, finding that X had successfully completed the terms of his probation. X served his six-month house arrest, performed over 500 hours of community service, and paid a fine in the amount of \$4,000. Additionally, there has been no evidence of misconduct since the time

⁶ At the hearing, X's tax advisor informed the Hearing Panel that certain income was inaccurately reported in X's 1991 tax return as income from commissions when, in fact, it represented rental income that he had received. As a result, the amended 1991 tax return that the tax advisor prepared for X reclassified that amount as rental income.

The Hearing Panel noted that the corrected 1991 tax return resulted in less tax being paid by X than the amount that was included in the original 1991 filing. X's tax advisor testified that after including the \$32,676 commission income that X had omitted in his original 1991 tax return and after applying adjustments for rental income and expenses, X's taxes due for 1991 amounted to \$5,152, as compared to the \$17,909 in taxes that he initially owed for 1991.

of X's conviction. X has been gainfully employed since he left the securities industry in 1999 because of his status as a statutorily disqualified individual. He has been involved in marketing activities for X Associates, which is solely owned by X's brother and is not an NASD member, and he is presently working as the director of sales and marketing for a pharmacy benefit management company.

We also have considered the fact that the Sponsoring Firm has had no formal regulatory action taken against it since its inception in 1966. The Proposed Supervisor is a qualified and highly experienced general securities principal with no formal or informal disciplinary history, and we are persuaded that he will properly supervise X. Although the Firm has had a few LOCs in its regulatory history, we note that none of those actions alleged that the Firm had failed to supervise individuals, and we recognize that the Firm took prompt action to rectify its past deficiencies.

Additionally, the Sponsoring Firm agreed to certain additional supervisory procedures suggested by Member Regulation, including the requirement that the Sponsoring Firm's written supervisory procedures be amended to state that the Proposed Supervisor is the primary supervisor responsible for X. At the hearing in this matter, the Sponsoring Firm presented a draft of its revised written supervisory procedures that include the proposed heightened supervisory procedures applicable to X's supervision, the terms of which were agreed upon by the Sponsoring Firm and Member Regulation.

Moreover, the Hearing Panel was particularly impressed with the seriousness with which the Proposed Supervisor has approached his supervisory responsibilities concerning X.⁷ The Proposed Supervisor testified that he has known X for 10 years, and that he is willing to take on the additional supervisory responsibility that is necessary to supervise a statutorily disqualified individual. In addition, JT, who conducted business with X from 1995 through 1999 in his capacity as a salesman with Firm 1, accompanied X to the hearing and vouched for his integrity. Further, we believe that the record demonstrates that X is rehabilitated and that he will adhere to the heightened supervisory plan outlined below.⁸

With respect to Member Regulation's concern that the nature of X's business does not permit him to be supervised on a daily basis, we believe that the additional supervisory conditions that Member Regulation has negotiated with the Sponsoring Firm

⁷ The Proposed Supervisor stressed that he would be "totally involved" in the supervision of X.

⁸ The Hearing Panel questioned X extensively about the circumstances leading to his criminal conviction and about his efforts to rehabilitate himself. The Hearing Panel found X to be forthright and honest regarding the circumstances of his criminal conviction. The Hearing Panel also found that X takes full responsibility for his actions and recognizes that his future conduct must be scrupulously in compliance with applicable rules and regulations.

will subject X to sufficiently rigorous oversight. For example, under the supervisory conditions set forth below, X must submit to daily review of his sales contacts. Also, before any sales are placed for X, an employee of the Sponsoring Firm, acting on behalf of the Proposed Supervisor, will contact the client to verify the accuracy of the sale. In addition to the Firm's rigorous oversight, we approve offsite supervision in this instance because the nature of X's business takes him out of the office the majority of the time, X has been registered in the securities industry for 18 years with no regulatory history, and he has not engaged in fraudulent conduct that resulted in harm to customers. To address the fact that X primarily conducts business outside of the office, we have provided as heightened supervisory conditions that, at least once a month, the Proposed Supervisor will accompany X on his meetings with clients to verify that X has adhered to all standards and disciplines established by the Sponsoring Firm, and that, at least quarterly, the Proposed Supervisor will make unannounced visits to X's office. We have concluded that the agreed-upon supervisory conditions subject X to a high degree of accountability.

Member Regulation and the Sponsoring Firm have agreed to enhanced supervisory conditions numbers 1 through 8, and 10 through 12 below. We have included additional supervisory condition number 9 below:

1. The Proposed Supervisor shall be the primary supervisor responsible for X;
2. The written supervisory procedures for the Sponsoring Firm will be amended to state that the Proposed Supervisor is the primary supervisor responsible for X;
3. Each day, X will provide a list of all sales contacts, including the nature of the contacts;
4. Each day, the Proposed Supervisor will review X's written sales contacts as to the nature of the contact;
5. The Proposed Supervisor will review all written presentations and/or proposals;
6. Before any sales are placed for X, an employee of the Sponsoring Firm, acting on behalf of the Proposed Supervisor, will contact the client to verify the accuracy of the sale;
7. At least once a month, the Proposed Supervisor will accompany X on sales appointments to verify that he has adhered to all standards and disciplines established by the Sponsoring Firm;
8. Once a month, the Proposed Supervisor will meet with X to review his activity and review compliance procedures;

9. Once during a calendar quarter, the Proposed Supervisor will review X's activity by making unannounced visits to X's office;
10. Once a year, the Proposed Supervisor will present to X a written report as to his compliance with all necessary requirements in order for him to fulfill his obligations;
11. If at any time the Proposed Supervisor feels that X has not complied with these heightened supervisory terms and conditions, a written report will be submitted to him that requests his acknowledgement and understanding of the deficiencies and requires his signature and a plan as to how the deficiencies will be corrected. A copy of this signed report will be kept in X's file; and
12. The Proposed Supervisor must certify quarterly (March 31st, June 30th, September 30th, and December 31st) to the Compliance Department of the Sponsoring Firm that X and the Proposed Supervisor are in compliance with all of the above conditions of heightened supervision to be accorded X.

NASD certifies that: (1) X meets all applicable requirements for employment; (2) the Firm employs no other individuals who are subject to statutory disqualification; and (3) X and the Proposed Supervisor have represented that they are not related by blood or marriage.

Accordingly, in conformity with the provisions of SEC Rule 19h-1, the association of X as an investment company products/variable contracts representative with the Sponsoring Firm under the above referenced supervisory plan will become effective within 30 days of the Commission's receipt of this notice, unless otherwise notified by the Commission.

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary