

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of
the Association of
X
with
The Sponsoring Firm
as a
General Securities Principal

Redacted Decision

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

Decision No. SD03004

Dated: 2003

On January 18, 2002, the Sponsoring Firm¹ ("the Firm") submitted a Membership Continuance Application ("MC-400" or "the Application") requesting permission for the Firm to continue its NASD membership if it permitted X, a person subject to a statutory disqualification, to be associated with it as a general securities principal. In April 2003, a Hearing Panel of the Statutory Disqualification Committee of NASD held a hearing on the matter. X appeared, accompanied by his Proposed Supervisor, the Firm's President and CEO. PL appeared on behalf of the Department of Member Regulation ("Member Regulation") of NASD.

A. The Statutorily Disqualifying Events

X is subject to a statutory disqualification as a result of two regulatory actions:

(1) In November 1995, X consented to an Agreed Injunction and Final Judgment ("the 1995 Injunction") issued by State 1. The State 1 court enjoined X from selling certain specified collateralized mortgage obligations ("CMO") mortgage-backed derivative securities for three years; enjoined him for an additional year from selling certain specified CMO mortgage-backed derivative securities to public funds, individuals, or charitable, retirement or eleemosynary

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.

institutions; and enjoined him from violating any provision of the State 1 Security Act or the rules promulgated thereunder.

The underlying conduct occurred between March 1989 and March 1993, during which time X was President, Chairman of the Board, and a registered general securities principal of Firm 1. X was also the founder and majority shareholder of Firm 2, the parent and sole owner of Firm 1. The violative conduct involved the fraudulent offer and sale of approximately \$100 million of mortgage-backed derivative products, including Interest Only strips ("IOs"), Inverse IOs, and Inverse Floater CMOs, by five Firm 1 registered representatives and other Firm 1 employees to public customers. The public customers included municipalities and state educational institutions, whose investment objectives stressed safety of principal, liquidity, market stability, short maturities and low risk.²

(2) The Commission subsequently brought an administrative action against X and Firm 1. In a September 1997 Order, the Commission found that from at least March 1989 through March 1993, three of Firm 1's registered representatives (other than X) and two other Firm 1 employees willfully violated Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder in connection with the offer and sale of certain high-risk CMOs to public clients. The Commission also found that one of the Firm 1 registered representatives and two other employees charged an undisclosed markup of more than 10 percent above market value in an adjusted trade. In addition, the Commission found that one of the employees involved in this conduct was statutorily disqualified because the Commission had barred him from being associated with any registered broker or dealer with the right to reapply after one year. Notwithstanding the pendency of this bar, this individual became Sales Manager of Firm 1, was promoted to the position of Executive Vice President and Managing Director of Firm 1, and was the person chiefly responsible for supervising Firm 1 registered representatives.

The Commission further found that Firm 1 and X failed reasonably to supervise Firm 1 representatives and other employees who were subject to their supervision. Among other things, the Commission found that Firm 1's written supervisory procedures were inadequate, and that X had appointed the statutorily disqualified individual to act as the person chiefly responsible for supervising registered representatives. The Commission found that Firm 1 and X knew that this person was statutorily disqualified, but that they had allowed him to act in this capacity "with nearly unfettered discretion," notwithstanding their representation to NASD that the statutorily disqualified person would have no supervisory duties and would be adequately supervised.

² As a result of the same conduct, in 1995, X and Employee 1 agreed to an NASD Letter of Acceptance, Waiver and Consent ("AWC"), in which Firm 1 was censured and fined \$400,000, \$25,000 of which was joint and several with X and \$25,000 of which was joint and several with Employee 1. Additionally, X was suspended from selling derivative products to public fund customers for two years. He also entered into an undertaking to follow Firm 1's written compliance and supervisory procedures regarding the recommendation and sale of such securities and the supervision of such activities.

In addition, the Commission found that X was aware during the relevant period that Firm 1 registered representatives were offering and selling IOs, Inverse IOs and Inverse Floaters to public clients with conservative objectives. The Order stated that X had been warned on several occasions by other Firm 1 employees that the mortgage derivative securities being sold to public clients appeared to be inconsistent with their investment policies and objectives, and that there were unusually high concentrations of high-risk CMOs in these accounts. The Order stated that X was also aware that one of the registered representatives had had repeated disagreements with one of Firm 1's department heads about how to present the characteristics of mortgage derivative securities in written documents, and that serious questions had been raised about whether an adjusted trade that occurred in March 1994 comported with the federal securities laws.

The Commission suspended X from association with any broker, dealer, municipal securities dealer, investment adviser or investment company for 12 months (from October 1997 to October 1998); barred him from association in a supervisory capacity with any broker, dealer, investment company, investment adviser or municipal securities with a right to reapply after three years (from October 1997 to October 2000); and ordered him to pay a \$50,000 fine.

B. Background Information

1. X

X qualified as a general securities representative (Series 7) in November 1978 and July 1984; a general securities principal (Series 24) in January 1985 and July 2002; and a uniform securities agent (Series 63) in March 2000.

X was registered with Firm 1 and Firm 2 from October 1979 to October 1997. X became employed by the Sponsoring Firm in July 1996, when the Sponsoring Firm hired the bulk of Firm 1's employees and purchased Firm 1 assets. X was employed by the Sponsoring Firm until September 1997, at which time the Commission suspended him for 12 months in any capacity. Following the conclusion of the suspension, the Sponsoring Firm again employed X (in a non-supervisory capacity) in October 1998.

As a result of the 1995 Injunction (and prior to the Commission's September 1, 1997 Order barring X as a supervisor for three years with a right to re-apply), Firm 1 and its parent corporation, Firm 2, submitted an MC-400 Membership Continuance Application seeking approval for X to continue association as a general securities principal and control person with those firms. At a hearing held in April 1996, X indicated that he was currently in merger negotiations with the Sponsoring Firm to purchase certain assets of Firm 1 and Firm 2, pursuant to which Firm 1 would withdraw its membership in NASD within six months of the merger and cease conducting a securities business, and Firm 2 would be sold to outside persons. Once the merger was complete, all Firm 1 and Firm 2 accounts would be transferred to the Sponsoring Firm. X sought to continue his association as a general securities principal and control person with Firm 1 and Firm 2, and he simultaneously sought approval as a registered representative and limited control person with the Sponsoring Firm.

NASD approved X's association with Firm 1 and Firm 2 in a Rule 19h-1 Notice filed with the Commission in July 1996. NASD permitted X to remain as President and general securities principal of Firm 1 and Firm 2 for approximately six months, after which Firm 1 intended to file a Uniform Request for Broker-Dealer Withdrawal ("Form BDW"). NASD prohibited X from participating in the sale of derivative products, and his activities were limited to those of a "pool assembler," i.e., creating pools of government guaranteed securities to sell to public investors.

Pursuant to an SEC Rule 19h-1 Notification filed by NASD with the Commission in April 1999, X was permitted to associate with the Sponsoring Firm as a general securities representative under the Proposed Supervisor's supervision, pursuant to the same terms and conditions under which X had been permitted to associate with Firm 1. This form of approval was appropriate pursuant to SEC Rule 19h-1(a)(3)(ii), since X had been previously approved to associate with a broker-dealer, and NASD found, after reasonable inquiry, that the terms and conditions of the proposed employment were similar in all material respects to those previously approved. The only difference was that X had purchased the interests of some former partners, thereby increasing his ownership in the Sponsoring Firm, and he requested approval of this change. The Commission acknowledged receipt of the Notification in May 1999.

No customer complaints were filed against X following the 1995 Injunction, and the record shows no other regulatory or disciplinary actions taken against him.

2. The Firm

The Sponsoring Firm became an NASD member in January 1991. The Sponsoring Firm has one office of supervisory jurisdiction ("OSJ") and three branch offices, and it employs 98 persons, 18 of whom are registered principals and 72 of whom are registered representatives. The Sponsoring Firm is a limited partnership. X owns, indirectly through Firm 3, a corporation controlled by X, less than 10 percent of the Sponsoring Firm's controlling general partner, Firm 4. Through Firm 3 and certain trusts, X owns approximately 35 percent of the Sponsoring Firm's non-voting limited partnership units.³ The Sponsoring Firm conducts a municipal finance practice and additionally engages in the sales and trading of taxable and municipal fixed income securities and government guaranteed loans and pools in transactions with municipal customers.

Since 1995, the Sponsoring Firm has received three Letters of Caution ("LOCs"), been the subject of one Compliance Conference, entered into one AWC, and been the subject of one state disciplinary action. During this time, X was employed by the Sponsoring Firm as a registered representative trading government guaranteed pools, had no supervisory responsibility, and was not named in the following actions.

(1) 2003 LOC

³ X is the President of Firm 3, which owns a partnership interest in the Sponsoring Firm.

This LOC addressed the Sponsoring Firm's failure to comply with NASD Conduct Rule 3010(a), (b), and (c) with respect to certain of its written supervisory procedures. The LOC also alleged that the Sponsoring Firm failed to comply with NASD Rule 3011 and the USA Patriot Act. The LOC also alleged that the Sponsoring Firm did not fully comply with SEC Rule 17a-3(a)(7), and Municipal Securities Rulemaking Board Rule ("MSRB") G-8(vii) in connection with its failure to make certain order ticket entries. The Sponsoring Firm responded to the LOC by letter dated February 2003, in which it described the actions taken by the Firm to address the issues raised in the LOC. Member Regulation has represented that the deficiencies noted in the LOC have been properly addressed.

(2) 2002 LOC

This LOC alleged that the Firm violated Conduct Rule 2110, by permitting Employee 2, a statutorily disqualified person, to participate in an offer to sell securities, in violation of the conditions of a Rule 19h-1 Notice from NASD to the Commission that allowed Employee 2 to associate with the Sponsoring Firm. The LOC also alleged that the Firm violated Conduct Rule 3010(b)(1) between December 2000 and July 2001, by failing to produce records documenting that a supervisor had conducted the required weekly spotchecks of the Firm's order tickets to ensure that Employee 2 had not approved transactions in a supervisory capacity during the period, and by failing to enforce and document special supervisory procedures set forth in the Rule 19h-1 Notice with respect to Employee 2.

In its February 2002 response to the LOC, the Sponsoring Firm stated that Employee 2's activities did not involve the sale of securities. The Sponsoring Firm stated that Employee 2 had prepared a written proposal to a pension fund regarding the mechanism by which the Sponsoring Firm would assemble Small Business Administration ("SBA") pools and that the proposal did not identify specific securities or quote quantity, term, price, yield or delivery date. The Sponsoring Firm stated that had the proposal been accepted, another registered representative would have made offers to sell the securities in accordance with the accepted proposal. Member Regulation indicated that the problems addressed in the LOC had been properly addressed.

(3) 2000 LOC

This LOC alleged that the Sponsoring Firm's written supervisory procedures were deficient in that there was no evidence that a specific individual had been designated authority for obtaining and disseminating financial and other information to persons making recommendations of municipal securities. The LOC also alleged that the Firm failed to have one of its registered representatives complete his continuing education regulatory element within the prescribed time frame.

(4) June 1999 Compliance Conference

Following a routine examination, NASD staff scheduled a Compliance Conference with the Sponsoring Firm. The issues for discussion included, among other topics, a net capital

violation, recordkeeping violations, late registration fees, violations of MSRB rules, and customer complaint and settlement violations. By letter dated June 1999, the Sponsoring Firm responded, outlining the actions that it took with respect to the deficiencies that were noted.

(5) 1998 AWC

NASD found that the Sponsoring Firm violated Rule 2110 by failing to comply with MSRB recordkeeping rules. The Sponsoring Firm was censured and fined \$3,000.

(6) 1995 consent order settlement with the State 2 Securities Division

The Sponsoring Firm effected 11 transactions in a non-institutional account before being registered as a broker-dealer in State 2. The Firm was fined \$680 and ordered to notify its State 2 customers of possible rescission rights.

Statutory disqualification examinations that were conducted in 1997 for X and Employee 3 were Filed Without Action. Statutory disqualification examinations were also conducted in 1999, 2000, 2001, and 2002 for X, and each of these examinations were Filed Without Action. Employee 3 is no longer associated with the Sponsoring Firm.

The Sponsoring Firm employs one other statutorily disqualified individual, Employee 2, who was allowed to associate with the Sponsoring Firm pursuant to an SEC Rule 19h-1 Notice. The Sponsoring Firm is not a member of any other self-regulatory organization, and we are not aware of any other complaints, disciplinary proceedings, or arbitrations against the Firm.

C. X's Proposed Business Activities and Supervision

The Sponsoring Firm proposes to employ X as a general securities principal in the Firm's main office, where he will act as the principal responsible for all aspects of the Firm's activities in "Guaranteed Loans and Pools." X will receive a base salary, and he will be entitled to participate in a traders' bonus pool consistent with the manner of compensation of the Sponsoring Firm's other traders.

The Sponsoring Firm proposes that the President and CEO of the Firm, serve as X's responsible supervisor. The Proposed Supervisor has been in the securities industry since 1990. He qualified as a general securities principal (Series 24) in November 1990; a financial and operations principal (Series 27) in October 1991; a general securities representative (Series 7) in November 1994; a uniform securities agent (Series 63) in February 1995; and a municipal securities principal (Series 53) in November 1997.

Prior to associating with the Sponsoring Firm, the Proposed Supervisor was associated with another registered broker-dealer as Director, Chief Financial and Administrative Officer, and Secretary and Treasurer from 1989 to 1991. From 1983 to 1989, he was employed by a savings association in the capacity of Executive Vice President and Treasurer. From 1977 to 1983, the Proposed Supervisor was Director and Chief Financial Administrative Officer of

another registered broker-dealer. From 1968 to 1977, the Proposed Supervisor was employed by an accounting firm as a Senior Manager specializing in the audit of securities and regulated industry companies.

The Proposed Supervisor's Central Registration Depository ("CRD") report indicates that when he was Executive Vice President of the savings association, it was placed under supervisory control in 1988 and receivership in 1989, and taken over by the Federal Deposit Insurance Corporation ("FDIC"). The Proposed Supervisor represents that the savings association failed due to bad real estate loans and that there were no allegations, charges or disciplinary actions taken against him.

We are not aware of any other disciplinary or regulatory proceedings, complaints, or arbitrations against the Proposed Supervisor.

D. Member Regulation's Recommendation

Member Regulation recommends that X's proposed association with the Sponsoring Firm as a general securities principal be approved, subject to the supervisory terms and conditions set forth below.

E. Discussion

After carefully reviewing the entire record in this matter, we approve the Sponsoring Firm's Application for X to associate with the Firm as a general securities principal. In reaching this conclusion, we have considered that X is the subject of two disqualifying events: a 1995 permanent injunction from State 1 and a 1997 Commission bar from acting in a supervisory capacity with the right to re-apply after three years.⁴ NASD has previously considered the injunction and approved X's association with the Sponsoring Firm as a registered representative. The issue before us is whether X may associate with the Sponsoring Firm as a general securities principal following the conclusion of his three-year bar by the Commission in any supervisory capacity with a right to re-apply.

The Commission has enunciated the legal standard for NASD to follow when it evaluates an application to re-enter the securities industry involving an individual who previously has been barred by the Commission with a right to reapply. See Paul Edward Van Dusen, 47 S.E.C. 668 (1981) and Arthur H. Ross, 50 S.E.C. 1082 (1992). The Commission stated in those decisions that, following the expiration of the time that it has specified as the date after which an application for re-entry may be made, "the Commission upon a proper showing will generally act favorably upon the application." Van Dusen, 47 S.E.C. at 671. The Commission specified, however, that re-entry would not be "granted automatically" when an application is made after

⁴ In addition, the SEC suspended X for 12 months in any capacity. The suspension ended in 1998.

the specified period has expired. Rather, other factors must be "carefully weighed and considered" such as: (1) any intervening misconduct in which the individual has engaged; (2) the nature and disciplinary history of the prospective employer; and (3) the supervision to be accorded the application. Id. Thus, "in the absence of new information reflecting adversely on [an individual's] ability to function in his proposed employment in a manner consonant with the public interest," the Commission declared that it would be "inconsistent with the remedial purposes of the Exchange Act and unfair to exclude [the individual] any longer from the position he seeks." Id. at 671-672.

We have considered that X has not engaged in any intervening misconduct in the approximately five years since he re-entered the securities industry in October 1998. We have also considered that in 1996, NASD recommended, and the Commission approved, X's proposed association with Firm 1 as a general securities principal and control person of Firm 1 and his proposed association with the Sponsoring Firm as a registered representative, and that in 1999, NASD approved X's ownership interest in the Sponsoring Firm. During 1996 and following his one-year suspension, X has traded government guaranteed pools without incident. We have also considered that X has dealt and will continue to deal almost exclusively with the sale of government guaranteed pools to institutional customers, and that he will not be trading CMOs. As a supervisor, X will be supervising registered persons on the Firm's government loan trading desk. Further, the yearly statutory disqualification exams have been filed without action.

The Proposed Supervisor, who has been X's supervisor since 1999, has not been the subject of any disciplinary or regulatory proceedings. We have also considered the Sponsoring Firm's disciplinary history, which, in the last three years, has included one formal and three informal disciplinary actions. We are concerned about the number of deficiencies noted in these actions, but we are also satisfied that the Firm has satisfactorily responded to NASD regarding those deficiencies and has made the necessary corrections to its procedures.

After considering all of the facts, including X's disciplinary history and subsequent unblemished conduct in the securities industry, we conclude that X should be permitted to become registered with the Sponsoring Firm as a general securities principal, supervised by the Proposed Supervisor, and subject to the following additional supervisory conditions:

1. The Sponsoring Firm will rewrite its written supervisory procedures to establish clearly that the Proposed Supervisor is X's primary supervisor;
2. The Proposed Supervisor will continue to occupy an office adjacent to the Firm's trading floor where X will work, where the two will be in plain sight of each other. In addition, X will work out of an office near the Proposed Supervisor's office;
3. X's responsibilities will be limited to directing and supervising all aspects of the Firm's promotion of, purchase of, trading of, and sale of government guaranteed loans and pools; acting as a trader of these products; and, as a principal, supervising the government guaranteed loans and pools trading desk;

4. Employee 4, a Compliance Specialist with the Firm, or another similarly qualified registered representative designated by the Proposed Supervisor, will review X's supervisory and trading activity, including markups, as well as his correspondence and transactions on a daily basis. The designated representative will report this information to the Proposed Supervisor on a daily basis;
5. An exception report will be generated under the initials of "CLAP" and reviewed by Employee 4 or another similarly qualified registered representative daily, to determine that X has not transacted or conducted trades in CMOs. A summary of these reports, prepared by Employee 4 or another similarly qualified registered representative, will be provided to the Proposed Supervisor on a weekly basis;
6. X will not have any involvement in and/or supervision of the Firm's activities in the purchase, sale and trading of CMOs;
7. The Proposed Supervisor will conduct a compliance meeting with X at least once a month to discuss these terms and conditions. A record of these meetings will be kept in X's file;
8. The Firm must obtain prior approval from Member Regulation if it wishes to change X's responsible supervisor from the Proposed Supervisor to another person.

These are heightened supervisory terms and conditions that are only imposed on X and are not part of the Firm's standard supervisory program.

NASD certifies that: (1) X meets all applicable requirements for employment; (2) the Firm employs one other statutorily disqualified individual, Employee 2, who was allowed to associate with the Sponsoring Firm pursuant to an SEC Rule 19h-1 Notice; 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 a general securities principal with the Sponsoring Firm under the above-referenced supervisory plan will become effective upon the issuance of an order by the Commission that it will not institute proceedings pursuant to Section 15(b) of the Exchange Act and that it will not direct otherwise pursuant to Section 15A(g)(2) of the Exchange Act. This notice shall serve as an application for such an order.

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary