BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of	
Department of Enforcement,	DECISION
Complainant,	Complaint No. C01040001
vs.	Dated: September 6, 2005
Respondent Firm	
and	
Respondent	
Respondents.	

Respondents participated in three contingency offerings where the seller failed to establish a proper escrow account at a bank; participated in one contingency offering where the seller did not send investors timely reconfirmation offers when it extended the closing date for the offering; and failed to establish, maintain, and enforce written supervisory procedures covering contingency offerings. Held, findings and sanctions affirmed.

Appearances

For the Complainant: Counsel 1 and Counsel 2

For the Respondents: Respondent Counsel

DECISION

Pursuant to NASD Procedural Rule 9311(a), Respondent Firm (and its president, the Respondent, appealed a decision of an NASD Hearing Panel (the "Hearing Panel"), in which the Hearing Panel imposed a fine of $7,500, jointly and severally, on the Respondent Firm and the Respondent (together, the "Respondents"). The Respondents admitted to violations of SEC Rules 15c2-4 and 10b-9 under the Securities Exchange Act of 1934 (the "Exchange Act"), which govern contingency offerings, and to violations stemming from these SEC rule violations of NASD conduct rules regarding adequate supervisory procedures. The sole issue on appeal is

whether the sanctions imposed by the Hearing Panel are appropriate. After a review of the entire record, we affirm the sanctions imposed by the Hearing Panel.

I. Procedural History

NASD's Department of Enforcement ("Enforcement") filed a three-cause complaint against the Respondents concerning their involvement in three contingency offerings.[1] Cause one of the complaint alleged violations of Exchange Act Rule 15c2-4 and NASD Conduct Rule 2110 by the Respondent Firm and NASD Conduct Rule 2110 by the Respondent for participating in three contingency offerings in which the issuer failed to use an appropriate escrow agent.[2] Cause two of the complaint alleged violations of Exchange Act Rule 10b-9 and NASD Rule 2110 by the Respondents for participating in a contingency offering where the prospectus terms did not comply with Rule 10b-9 and where the offering's expiration date was extended without sending reconfirmation offers to existing investors. Cause three of the complaint alleged violations of NASD Conduct Rules 3010 and 2110 by the Respondents for failing to establish, maintain, and enforce written procedures to ensure that the Respondent Firm complied with Rules 10b-9 and 15c2-4. The Respondents filed a joint answer in which they admitted all of the allegations in the complaint except for one factual statement.[3]

A hearing in this matter was held before the Hearing Panel. During the hearing, the Respondents confirmed that they were admitting to all of the violations as alleged in the complaint. Consequently, the hearing was limited to the issue of appropriate sanctions. The Hearing Panel's decision fined the Respondents, jointly and severally, $5,000 for the violations of Rules 15c2-4 and 10b-9 (and NASD Rule 2110) and $2,500 for the violation of NASD Rules 3010 and 2110. The Respondents filed a timely appeal, in which they argue that the sanctions imposed by the Hearing Panel are unwarranted given the mitigating factors present in the case and prior NASD case law.

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[1] A contingency offering, which can also be referred to as a minimum-maximum offering or a part-or-none offering, is an offering whereby the issuer is required to sell, and receive payment for, a certain minimum number of securities by a certain date. If the minimum is not sold, or payment is not received, by the specified date (and the offering is not properly extended), the existing investors receive a refund of their investment. *See generally* Louis Loss & Joel Seligman, *Securities Regulation* § 9-C-6 (3d ed. 2004).

[2] A violation of any Commission or NASD rule is itself also a violation of NASD Conduct Rule 2110. *See Stephen J. Gluckman*, Exchange Act Rel. No. 41628, 1999 SEC LEXIS 1395, at *22 (July 20, 1999). NASD Rule 115 extends NASD rule requirements to persons associated with a member.

[3] The Respondents denied that no reconfirmation offers were sent to the eight existing investors in the third offering and asserted that reconfirmation offers were, in fact, sent in or about February 2002. During the hearing, the parties agreed that the reconfirmation offers had been sent to investors. However, because the reconfirmation offers were sent after the expiration date set forth in the prospectus, the Respondents had still violated Rule 10b-9.

II. Facts

The facts of this case are not in dispute. Before the Hearing Panel, the Respondents admitted the allegations in the complaint, with the one exception noted above, and the violations of Rules 15c2-4 and 10b-9 and NASD Conduct Rules 3010 and 2110. Nonetheless, we review the facts in detail because we have considered them in deciding whether the sanctions imposed on the Respondents by the Hearing Panel are appropriate.

A. Respondents

1. The Respondent

The Respondent first entered the securities industry after graduating from college when he spent three years with the State 1 Secretary of State's office, ultimately holding the position of Chief of Market Surveillance. After serving for five years in an unregistered capacity with another NASD member, the Respondent joined Firm A, the predecessor to the Respondent Firm, as its president in 1987. The Respondent first became registered with NASD as a general securities principal and a general securities representative in 1987. The Respondent remains registered with NASD and still serves as president of the Respondent Firm.

2. The Respondent Firm

Firm A, a broker-dealer firm originally based in City 1, State 2, became a member of NASD in 1986. When the Respondent was hired as Firm A's president in 1987, Firm A had approximately 12 registered representatives. In 1989, the Respondent purchased Firm A, moved its headquarters to City 2, State 2, and changed its name to the Respondent Firm in the early 1990s.

The Respondent Firm currently has approximately four employees and 38 registered representatives. Over the years, the Respondent Firm has had as many as 55 registered representatives. The Respondent Firm deals primarily in mutual funds and managed accounts. It also engages in a limited variable products business and distributes some specialty products, including real estate partnerships. The Respondent estimated that approximately 10 percent of the Respondent Firm's business is in specialty products like those at issue in this case. The Respondent testified that he is responsible for, among other things, the due diligence for such products, and he estimated that he has reviewed more than 100 such programs during his career. The Respondent testified that he personally reviewed the three offerings at issue in this case and performed the due diligence on those three offerings on behalf of the Respondent Firm.

B. The Offerings

The violations at issue here arise out of three separate real estate investment syndications that were sponsored by the same real estate company, Firm B, and that used the same entity as the escrow agent, Firm C. First, we will briefly set forth the relevant facts regarding Firm B and Firm C. Then, we will address the specific facts surrounding each of the three offerings.

1. Firm B

Firm B, which is located in State 2, identifies real estate properties that it believes will appreciate in value and, for each property, creates a limited liability company ("LLC") to acquire, and in some cases develop, the property. The Firm B-sponsored LLCs then offer membership interests to State 2 residents through selling agreements entered into with broker-dealers such as the Respondent Firm.[4] Firm B is unaffiliated with the Respondents.

The Respondent testified that he has been involved with Firm B and DS, Firm B's president, since the early 1980s and reviewed Firm B programs extensively in the mid-1980s. The Respondent testified further that PM, a State 2-based corporate attorney, was responsible for drafting the Firm B documents at issue in this case and that PM had worked with Firm B since the 1980s. The Respondent stated that, in the early 1980s, all partnerships or specialty products went through a legal review done by the Respondent Firm's attorney at the time, Employee 1.[5] Through this process, Employee 1 reviewed the work that PM did for Firm B, and the Respondent did not recall Employee 1 ever noting significant errors with PM's work. The Respondent did not ask Employee 1, or any other attorney, to review the Firm B documents for the three offerings at issue in this case because, by the time of the offerings, he had developed trust in PM's work.

2. Firm C

Firm C is a company that provides back office and other administrative services, including acting as an escrow agent, to its customers. Firm C was established and is run by a former Firm B employee. However, it is independent of Firm B. Firm C is not a "bank," as that term is defined in Section 3(a)(6) of the Exchange Act. Firm C acted as the escrow agent for all three offerings at issue in this case until it was replaced during the third offering by a bank.

3. LLC 1

LLC 1 was formed by Firm B to acquire and develop a 17.51-acre property with the proceeds from an offering of its membership interests, pursuant to a prospectus dated April 15, 2000. Under the terms of the part-or-none offering, LLC 1 could offer up to 3,209 membership interests at a price of $1,000 per interest. The minimum investment in LLC 1 was $25,000, or 25 membership interests. For each individual membership interest sold, LLC 1 would retain $915, and the remaining $85 would be paid out in commissions to participating dealers. According to

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[4] The three Firm B offerings at issue were not registered with the Securities and Exchange Commission. Each offering relied on the intrastate exemption from registration in Section 3(a)(11) of the Securities Act of 1933.

[5] The Respondent's testimony is unclear on this point. The Respondent did not join the Respondent Firm until 1987; thus, it is unclear whether the Respondent was aware of Employee 1's review of PM's work done prior to the time the Respondent joined the Respondent Firm or whether the Respondent's estimation of the time period was an error.

the prospectus, the offering expired on August 31, 2000, "unless extended, in the sole discretion of [LLC 1]." If LLC 1 failed to raise at least $2,000,000 by the expiration date, the proceeds received at that time would be returned to the investors along with any accrued interest.

The Respondent Firm was a participating dealer in the LLC 1 offering, pursuant to a May 2000 selling agreement signed by the Respondent on behalf of the Respondent Firm. The selling agreement acknowledged that "[a]ll funds shall be placed in an escrow with Firm C, a State 2 corporation . . . , and a minimum of two million dollars ($2,000,000) is necessary to be raised, prior to making proceeds from the Offering available to the [LLC 1]." The escrow agreement between Firm C and LLC 1 required Firm C to establish an interest-bearing escrow account with Bank 1. The escrow agreement also stated that participating brokers, such as the Respondent Firm, would instruct subscribers to make checks for subscriptions of LLC 1 membership interests payable to the order of "[LLC 1] Escrow." Any checks made payable to any other party would be returned to the participating brokers. While the Respondent testified that he believed he had seen an escrow agreement with Bank 1, he did not produce one, and the record contains no such agreement.

The Respondent Firm, which participated in the offering on a "best efforts" basis, sold membership interests of LLC 1 to 21 investors for a total of $952,750, on which the Respondent Firm earned commissions and due diligence fees totaling $85,747.50, pursuant to the selling agreement.[6] The LLC 1 offering closed successfully on August 11, 2000, when LLC 1 surpassed $2,000,000 in proceeds.

4. LLC 2

LLC 2 was formed to acquire a 63-acre property with the proceeds from an offering of its membership interests, pursuant to a prospectus dated May 7, 2001. Under the terms of the part-or-none offering, LLC 2 could offer up to 1,800 membership interests at a price of $1,000 per interest. The minimum investment in LLC 2 was $25,000, or 25 membership interests. For each individual membership interest sold, LLC 2 would retain $915, and the remaining $85 would be paid out in commissions to participating dealers. According to the prospectus, the offering expired on September 30, 2001, "unless extended, in the sole discretion of [LLC 2]." If LLC 2 failed to raise at least $1,450,000 by the expiration date, the proceeds received at that time would be returned to the investors along with any accrued interest.

The Respondent Firm was a participating dealer in the LLC 2 offering pursuant to a June 19, 2001 selling agreement signed by the Respondent on behalf of the Respondent Firm. The selling agreement acknowledged that "[a]ll funds shall be placed in an escrow account with Firm C, a State 2 corporation . . . , and a minimum of one million four hundred fifty thousand dollars ($1,450,000) is necessary to be raised, prior to making proceeds from the Offering available to

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[6] In addition to the 8.5 percent commission, the Respondent Firm received a 0.5 percent due diligence fee for the membership interests it sold in each of the three offerings. Of the 8.5 percent commission, between 70 and 90 percent was paid out to the individual representative who made the sale, and the Respondent Firm retained the remaining 10 to 30 percent.

[LLC 2]." The escrow agreement between Firm C and LLC 2 required Firm C to establish an interest-bearing escrow account with Bank 1. The escrow agreement also stated that participating brokers, such as the Respondent Firm, would instruct subscribers to make checks for subscriptions of LLC 2 membership interests payable to the order of "[LLC 2] Escrow." Any checks made payable to any other party would be returned to the participating brokers. While the Respondent testified that he believed he had seen an escrow agreement with Bank 1, he did not produce one, and the record contains no such agreement.

The Respondent Firm, which participated in the offering on a "best efforts" basis, sold LLC 2 membership interests to 10 investors for a total of $355,000, on which the Respondent Firm earned commissions and due diligence fees totaling $31,950, pursuant to the selling agreement. The LLC 2 offering closed successfully in August 2001, when LLC 2 surpassed $1,450,000 in proceeds.

5. LLC 3

LLC 3 was formed to acquire a 200-acre property of vacant and undeveloped real estate with the proceeds from an offering of its membership interests, pursuant to a prospectus dated August 21, 2001. Under the terms of the part-or-none offering, LLC 3 could offer up to 3,000 membership interests at a price of $1,000 per interest. The minimum investment in LLC 3 was $25,000, and for each interest sold, LLC 3 would retain $915, and the remaining $85 would be paid out in commissions to participating dealers. According to the prospectus, the offering expired on December 31, 2001, "unless extended, in the sole discretion of [LLC 3]." If LLC 3 failed to raise at least $2,500,000 by the expiration date, the proceeds received at that time would be returned to the investors along with any accrued interest.

The Respondent Firm was a participating dealer in the LLC 3 offering pursuant to an October 2001 selling agreement signed by the Respondent for the Respondent Firm. The selling agreement acknowledged that "[a]ll funds shall be placed in an escrow with Firm C, a State 2 corporation . . . , and a minimum of two thousand five hundred (2,500) Membership Interests is necessary to be raised, prior to making proceeds from the Offering available to [LLC 3]." The record does not contain an escrow agreement between Firm C and LLC 3. Enforcement alleged in the complaint, and the Respondents admitted, that investor funds were transmitted to an escrow account at a bank that was controlled by Firm C as the escrow agent pursuant to an agreement between Firm C and LLC 3. There is nothing in the record that indicates the escrow arrangement established in connection with the LLC 3 offering differed in any substantive way from those in the previous offerings sponsored by Firm B, and the Respondent testified that there was an escrow agreement between LLC 3 and Firm C that was substantially the same as the escrow agreements for the other two offerings. While the Respondent testified that he believed he had seen an escrow agreement with Bank 1, he did not produce it.[7]

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[7] On or about February 2002, after NASD questioned the escrow arrangement, LLC 3 established another escrow account with Bank 2, which is a "bank" as defined in Section 3(a)(6) of the Exchange Act. The record includes the February 2002 escrow agreement between LLC 3 and Bank 2.

Unlike the two offerings described above, the LLC 3 offering did not close by its specified expiration date of December 31, 2001. The Respondent testified that in or around December 2001, he received a telephone call from Firm B's wholesaler who informed the Respondent that, while investors had subscribed for more than 2,500 interests, not all of the investors could meet the payment deadline of December 31, 2001. The Respondent testified that he reminded the wholesaler that, if the offering were extended, Firm B must amend the offering materials and send a reconfirmation letter to existing investors. In response, the wholesaler represented to the Respondent that PM was "on it." LLC 3 then amended the offering terms in two ways: it extended the offering until February 2002 and reduced the minimum amount required to be raised from $2,500,000 to $2,350,000. In February 2002, Firm B mailed a reconfirmation letter to those investors who had already purchased interests informing them of these changes. Each of the eight investors who invested in LLC 3 through the Respondent Firm before the initial expiration date agreed to the changes and returned the reconfirmation offer.[8] The LLC 3 offering closed in February 2002, when LLC 3 surpassed $2,350,000 in proceeds.

The Respondent Firm, which participated in the offering on a "best efforts" basis, sold units of LLC 3 to 15 investors for a total of $800,875, on which the Respondent Firm earned commissions and due diligence fees totaling $72,078.75, pursuant to the selling agreement.

III. Discussion

As noted above, the Respondents have admitted the violations. Nonetheless it is essential to understand the nature of the violations as a predicate to determining appropriate sanctions. Consequently, we briefly set forth the violations before analyzing the determination of sanctions.

A. Exchange Act Rule 15c2-4

Rule 15c2-4 provides that a broker or dealer who participates in a contingency offering on a best-efforts basis and accepts the sale price of a security before all of the represented contingencies are met must either deposit the investors' funds into a "separate bank account, as agent or trustee for the persons who have the beneficial interests therein" or transmit the investors' funds "to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred." Exchange Act Rule 15c2-4. If a broker or dealer fails to handle the investor funds in the prescribed manner, the broker or dealer has committed a fraudulent, deceptive, or manipulative act or practice under Section 15(c) of the Exchange Act.[9] *Id.*; *see Gerace*, 2001 NASD Discip. LEXIS 5, at *8-9.

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[8] Ultimately, 15 Respondent Firm customers invested in LLC 3. Eight customers had invested before the initial December 31, 2001 expiration date.

[9] Unlike Section 10(b) of the Exchange Act, a violation of Section 15(c)(2) does not require a finding of scienter. *See Dep't of Enforcement v. Gerace*, Complaint No. C02990022, 2001 NASD Discip. LEXIS 5, at *11 (NAC May 16, 2001); *Mkt. Regulation Comm. v. J.C.*

[Footnote continued on next page]

Rule 15c2-4 "imposes an obligation on the broker-dealer to ensure that funds received by him are not dissipated in any fashion–including by disbursement to the issuer–unless the contingency has been fully satisfied." Exchange Act Rel. No. 11532, 1975 SEC LEXIS 1229, at *5 (July 11, 1975). Thus, the rule is intended to insulate the proceeds of a contingency offering from possible unlawful activity by broker-dealers participating in the offering and to ensure that the issuer will receive the full proceeds (less commissions) promptly if the contingency occurs or that the investors will receive a prompt reimbursement of all invested funds if the contingency does not occur. *See id.*; *Robert Tretiak*, Exchange Act Rel. No. 47534, 2003 SEC LEXIS 653, at *32 (Mar. 19, 2003); *NASD Notice to Members 84-7*, at 1 (Jan. 1984).

Both the Commission and NASD have long made clear that Rule 15c2-4 requires that an escrow agent be a bank.[10] As the Respondents have admitted, all three of the offerings of Firm B discussed above were conducted in violation of Rule 15c2-4 because the escrow agent for the offerings was Firm C, which is not a bank. Thus, while the investors' money was held in an account at a bank, it was Firm C that acted as the escrow agent.[11] By participating in these offerings, the Respondent Firm violated Rule 15c2-4 and NASD Conduct Rule 2110. As the person responsible for the Respondent Firm's violations, the Respondent violated NASD Conduct Rule 2110. *See Tretiak*, 2003 SEC LEXIS 653, at *32 ("We agree with the NASD that Tretiak caused this violation [of Rule 15c2-4] and, accordingly, engaged in conduct inconsistent with just and equitable principles of trade in violation of NASD Rule 2110."); *Gerace*, 2001

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Bradford & Co., Complaint No. CMS960194, 1999 NASD Discip. LEXIS 25, at *13 (NAC June 10, 1999).

[10] *See NASD Notice to Members 98-4*, at 19 (Jan. 1998) (attaching a copy of *NASD Notice to Members 84-7* and noting that "[i]n particular, members should note the position of the SEC in . . . Question 10, that no person other than a bank may act as an escrow agent"); *NASD Notice to Members 87-61* (Sept. 1987) ("[Rule 15c2-4] requires that when an escrow account is used for distributions conducted on a contingency basis (e.g., best-efforts all-or-none or part-or-none offerings), the escrow agent must be a commercial bank that is unaffiliated with either the issuer or the underwriter."); *NASD Notice to Members 84-7*, at 6 (Jan. 1984) ("**Question**: May some person other than a bank (e.g., an attorney for the broker-dealer) act as an escrow agent within the meaning of [Rule 15c2-4]? **Answer**: No, the escrow agent must be a bank that is unaffiliated with either the issuer or the broker-dealer."); *see also Michael A. Traiger*, 48 S.E.C. 930, 931 (1988) (stating that Rule 15c2-4 "specifies that, until the contingency is satisfied, a broker-dealer participating in the offering may not accept funds from investors unless it (1) promptly deposits the funds in a separate bank account, as agent or trustee for the subscribers, or (2) promptly transmits the funds to a bank which has agreed in writing to act as escrow agent").

[11] The record contains monthly bank statements from each of the offerings that demonstrate that, in fact, no funds were released from the Bank 1 accounts before the minimum offering amount was reached. The only exception to that is when the amount in the Bank 1 account for LLC 3 was wired to Bank 2 after that escrow account was established.

NASD Discip. LEXIS 5, at *9 (finding that "Gerace was responsible for the Firm's violation of Exchange Act Rule 15c2-4 and Conduct Rule 2110").[12]

B. Exchange Act Rule 10b-9

Rule 10b-9 prohibits any person from representing that a security is being offered on an "all-or-none" or "part-or-none" basis unless the amount due from the investor will be refunded if either the specified number of units of the security are not sold or the seller does not receive the specified amount due by a specific date.[13] The purpose of Rule 10b-9 is to "ensure that those who invest in a venture under the condition that it will not go forward unless adequately capitalized are not at risk of losing their investment if that condition is not met." *Nat'l P'ship Invs. Corp.*, Exchange Act Rel. No. 38773, 1997 SEC LEXIS 1347, at *9 (June 25, 1997). Violations of Rules 15c2-4 and 10b-9 are "serious breaches of the duty owed by issuers, underwriters, and broker-dealers to the investing public." Exchange Act Rel. No. 11532, 1975 SEC LEXIS 1229, at *7; *Gerace*, 2001 NASD Discip. LEXIS 5, at *15-16. The Commission staff has provided its view that an all-or-none or part-or-none offering may be extended beyond the specified expiration date set forth in the offering materials without violating Rule 10b-9 only if: (1) prior to the specified expiration date, a reconfirmation offer is made to all subscribers that discloses the extension of the offering and any other material information necessary to update previous disclosures; (2) the reconfirmation offer is written such that if a subscriber does not affirmatively elect to continue the investment, his funds are returned; and (3) the reconfirmation is made far enough in advance of the specified expiration date so that any subscriber who elects not to continue his investment can have his funds returned promptly. *See* Securities Act Rel. No. 6455, 1983 SEC LEXIS 2288, at *58-59 (Mar. 3, 1983). A violation of Rule 10b-9 is considered a manipulative or deceptive device or contrivance for purposes of Section 10(b) of the Exchange Act. *See* Rule 10b-9(a).

Enforcement alleged, and the Respondents admitted, that the terms and extension of the LLC 3 offering violated Rule 10b-9.

C. NASD Conduct Rule 3010

The Respondents also concede violating NASD Conduct Rule 3010, which requires a member to establish, maintain, and enforce written supervisory procedures to supervise the types

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[12] Because Enforcement did not allege that the Respondent violated Rule 15c2-4, we need not decide whether, and if so under what circumstances, an individual can violate Rule 15c2-4. *Cf. Tretiak*, 2001 NASD Discip. LEXIS 1, at *48 & n.20, *aff'd*, 2003 SEC LEXIS 653 ("Although we do not necessarily adopt the Hearing Panel's conclusion that we can find that an individual has violated Rule 15c2-4 only if he is alleged to have aided and abetted a firm's violation, for purposes of this case, we affirm the Hearing Panel's finding of a violation of [NASD] Rule 2110.").

[13] Like Rule 15c2-4, Rule 10b-9 applies only to best efforts underwritings. *See* Rule 10b-9(b).

of business in which it engages. The Respondent Firm had no procedures in place that addressed its participation in part-or-none offerings to ensure its compliance with Rules 10b-9 and 15c2-4. While the Respondents kept a lengthy reference manual on general due diligence obligations, it contains no text regarding contingency offerings. Such general reference materials are not sufficient written supervisory procedures, particularly given the specific requirements imposed by Rules 10b-9 and 15c2-4 and the relative frequency with which the Respondent Firm participated in such offerings.[14] Moreover, such general reference material was not "tailored specifically to [the Firm's] business," nor did it "clearly identify who has supervisory responsibilities" within the Firm, as is required by Rule 3010. *See NASD Notice to Members 99-45*, at 294 (June 1999).

D. Sanctions

Given the agreement on the underlying facts and the Respondents' admission to the violations, the contested aspect of this case concerns sanctions and, more specifically, the appropriate weight to be given to the various factors set forth in the NASD Sanction Guidelines (the "Guidelines"). The Guidelines provide for monetary sanctions of $1,000 to $10,000 for violations of Rule 15c2-4, $5,000 to $50,000 for violations of Rule 10b-9, and $1,000 to $25,000 for violations of Rule 3010.

The Hearing Panel aggregated the violations of Rule 15c2-4 and Rule 10b-9 and imposed a fine of $5,000, jointly and severally, on the Respondents for those violations. The Hearing Panel imposed a fine of $2,500, jointly and severally, for the violation of Rule 3010. These sanctions are at the low end of the Guidelines. While we agree with the Respondents that there are mitigating factors that should be considered, the limited sanctions imposed by the Hearing Panel already reflect the panel's consideration of those mitigating factors.[15] Consequently, we affirm the sanctions imposed by the Hearing Panel.

As is always the case when determining appropriate sanctions, we must consider (1) the General Principles Applicable to All Sanction Determinations ("General Principles"), (2) the

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[14] The only pertinent aspect of the manual is a copy of a 1987 NASD Compliance Checklist. Under the heading "Underwriting and Related Activities," the checklist includes "Escrow funds in contingency offerings, whether public or private, to comply with SEC Rule 15c2-4." The checklist did not advance in any material way the objective of compliance with Rules 10b-9 and 15c2-4.

[15] The Respondents urge us to limit the sanctions to non-public remedies and argue that the Respondents' CRD® records should be expunged. Expungement is an extraordinary remedy that is generally available under federal and state laws only under very limited circumstances. *See generally NASD Notice to Members 01-65* (Oct. 2001) (requesting comment on when to allow expungement of customer dispute information and generally discussing expungement of CRD® records); *see also NASD Notice to Members 04-16* (Mar. 2004). In a situation where respondents have admitted to multiple violations of the federal securities laws, Commission rules, and NASD Conduct Rules, expungement is inappropriate.

Principal Considerations in Determining Sanctions ("Principal Considerations"), and (3) the specific principal considerations for the violations at issue: in this case, for violations of Rules 15c2-4 and 10b-9 ("Escrow Considerations") and Rule 3010 ("Rule 3010 Considerations"). The Guidelines do not purport to be an exhaustive list of factors, and adjudicators must also consider any other relevant matters that may arise in a particular case that, in their judgment, cause mitigation or aggravation of the violation. *See* Guidelines (2001 ed.) at 9 (noting that the list of Principal Considerations "is illustrative, not exhaustive; as appropriate, Adjudicators should consider case-specific factors in addition to those listed . . . in the [G]uidelines"). We turn now to a discussion of several of these factors.

1. Aberrant Conduct

The Respondents' violative conduct in this matter does not appear to reflect the usual manner in which they conduct their business. *See* Guidelines (2001 ed.) at 10 (Principal Consideration No. 16). For example, the record demonstrates that, following the NASD investigation and allegations, the Respondents have instituted formal policies and procedures for contingency offerings. In addition, the Respondents point to the Respondent's conduct in a recent offering in which the Respondent noticed during his due diligence review that the escrow account for the proposed offering was defective. The Respondent discussed the problem with the issuer, who amended the offering to conform to the Commission's requirements. We agree with the Respondents that the violations appear to be aberrant.[16]

2. Exposure of Customer Funds to Risk or Loss

One of the Escrow Considerations is the "[e]xtent to which customer funds were exposed to risk or loss."[17] Guidelines (2001 ed.) at 28 (Escrow Violations – Prohibited Representations In Contingency Offerings; Transmission Or Maintenance Of Customer Funds In Underwritings).

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16 The Respondents also point to General Principle No. 1, which provides that disciplinary sanctions are intended to be remedial rather than punitive, and argue that this recent conduct demonstrates that there is no need for formal discipline. *See NASD Notice to Members 04-17* (Mar. 2004). However, the Respondents' partial quotation of that General Principle ignores the fact that the principle states that "[t]he overall purposes of NASD's disciplinary process and NASD's responsibility in imposing sanctions are to remediate misconduct by preventing the recurrence of misconduct, improving overall standards in the industry, and protecting the investing public." *Id.* (emphasis added). Thus, while it is true that sanctions are intended to remediate misconduct rather than to punish, sanctions also have other purposes that must be considered. Certainly, imposing sanctions for rule violations serves both to prevent the recurrence of misconduct by imposing a cost when rules have been violated and to improve overall business standards in the securities industry.

17 Similarly, Principal Consideration No. 11 notes that adjudicators should consider "[w]ith respect to other parties, including the investing public . . . (a) whether the respondent's misconduct resulted directly or indirectly in injury to such other parties; and (b) the nature and extent of the injury."

Here, all of the funds were ultimately placed into a bank account pursuant to a written escrow agreement between the issuer and Firm C. However, Firm C was not a proper escrow agent under Rule 15c2-4. In addition, investors were required to make their checks payable only to the account. We find that, under these circumstances, there was not a significant risk of loss. In addition, the record does not indicate that any investor lost money as a result of the Respondents' conduct.

3. Reliance on Third-Party Counsel

Principal Consideration No. 7 instructs adjudicators to consider "[w]hether the respondent demonstrated reasonable reliance on competent legal or accounting advice." Guidelines (2001 ed.) at 9 (Principal Consideration No. 7). Here, the Respondents do not argue–nor could they argue–that their reliance on counsel is a defense to the allegations.[18] They do, however, assert that the Respondent's reliance on Firm B's representation that PM, an attorney whom the Respondent knew and trusted, was involved in drafting the documents and in advising Firm B on the offerings should mitigate sanctions.

In the past, we have stated that a respondent's reasonable reliance on an attorney other than its own may, in appropriate circumstances, have some mitigative effect. *See, e.g.*, *Gerace*, 2001 NASD Discip. LEXIS 5, at *20; *Dist. Bus. Conduct Comm. v. Progressive Asset Mgmt., Inc.*, Complaint No. C01930037, 1995 NASD Discip. LEXIS 41, at *19 (NBCC Dec. 7, 1995). In *Gerace*, for example, after being warned by an employee that an escrow account may not comply with the applicable Commission rules for contingency offerings, the respondent spoke with the issuer's counsel who informed the respondent that, in his opinion, the offering complied with the relevant rules. *Gerace*, 2001 NASD Discip. LEXIS 5, at *6-7. The respondent made no further inquiry. *Id.* The National Adjudicatory Council (the "NAC") noted that it "considered whether [the respondent] demonstrated reasonable reliance on competent legal advice" as a mitigating factor. *Id.* at *20. However, the NAC concluded that "[a]lthough we accept that [the respondent] believed that [the issuer's] lawyer was competent, we find that the attorney's representation of the issuer, and not [the broker-dealer], and the warning that an employee of [the respondent's] own Firm gave him regarding an escrow account, negate any mitigation that we would have given to [the respondent] for relying on the attorney's advice." *Id.*

In general, Principal Consideration No. 7 allows adjudicators to consider, as a mitigating factor, reasonable reliance on counsel, even if the attorney is representing a third party. Thus, even if a respondent cannot meet the requirements necessary to invoke reliance on counsel as an

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[18] To establish an affirmative defense of reliance on counsel, a respondent is required to show: (1) a request for advice of counsel on the legality of a proposed action; (2) full disclosure of the relevant facts to counsel; (3) receipt of advice from counsel that the action to be taken will be legal; and (4) reliance in good faith on counsel's advice. *See William H. Gerhauser*, 53 S.E.C. 933, 943 n.26 (1998) (citations omitted); *Dist. Bus. Conduct Comm. v. Stout*, Complaint No. C02940038, 1995 NASD Discip. LEXIS 223, at *8 (NBCC Sept. 7, 1995). Here, the Respondents could not have relied in good faith on the legal advice because the lawyer was Firm B's counsel, not the Respondents'. *See Gerace*, 2001 NASD Discip. LEXIS 5, at *11 n.9.

affirmative defense, adjudicators may still consider reasonable reliance on counsel as a mitigating factor. Here, The Respondent did not retain an attorney to represent the Respondent Firm, and he never spoke directly with PM, even though he had some question in his mind regarding the appropriateness of the escrow arrangement under Rule 15c2-4.[19] The Respondent's reliance on Firm B's representation that PM, who was the issuer's counsel, approved of the arrangement was not sufficient to answer the Respondent's legitimate questions and could not have been reasonable reliance given the frequency and clarity of NASD and Commission statements regarding this precise issue. Thus, we find no mitigation in this case due to this factor.

With respect to the reconfirmation offer violation of Rule 10b-9, the reliance on counsel factor is inapposite. There was no legal issue to be resolved. The Respondent knew the requirements and relied solely on a factual representation that PM was "on it." He did not conduct any further inquiries to ensure that the requirement was followed.

4. Lack of Disciplinary History

General Principle No. 2 "addresses the concept of deterring future misconduct by imposing progressively escalating sanctions on respondents who have engaged in past misconduct." *NASD Notice to Members 03-65*, at 682 (Oct. 2003).[20] This principle is echoed in Principal Consideration No. 1, which lists as a consideration "[t]he respondent's relevant disciplinary history" and cites to General Principle No. 2. The Respondents rely on both provisions to argue that NASD is required to consider the Respondents' lack of a disciplinary history as a mitigating factor. In support of their argument, the Respondents point to the "plain language" of the provisions and cite one decision of the National Business Conduct Committee ("NBCC"), the predecessor to the NAC. *See Progressive Asset Mgmt., Inc.*, 1995 NASD Discip. LEXIS 41, at *19 (acknowledging "the respondents' lack of disciplinary history" in affirming "lenient sanctions").

While the Respondents accurately note that some of our older cases do consider a respondent's lack of disciplinary history as a mitigating factor in imposing sanctions, since our opinion in *Department of Enforcement v. Balbirer*, Complaint No. C07980011, 1999 NASD Discip. LEXIS 29 (NAC Oct. 18, 1999), more than five years ago, we have consistently taken

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[19] The Respondent's testimony regarding the issue is somewhat confusing. While he testified that he was unaware that applicable Commission rules required the escrow agent to be a bank, he testified at another point that he noticed that Firm C was not a bank and contacted Firm B to inquire about this issue.

[20] In their briefs, the Respondents rely on language from an earlier version of the Guidelines. General Principle Nos. 1, 2, and 3 have been amended since the last publication of the Guidelines in 2001. *See NASD Notice to Members 04-17* (Mar. 2004) (amending General Principle Nos. 1 and 3); *NASD Notice to Members 03-65* (Oct. 2003) (amending General Principle No. 2). The amendments do not affect the underlying arguments made by the Respondents, nor do they affect our decision.

the view that a respondent's lack of disciplinary history is not a mitigating factor.[21] In *Balbirer*, we noted that "[w]e are not compelled to reward a respondent because he has acted in the manner in which he agreed (and was required) to act when entering this industry as a registered person." *Balbirer*, 1999 NASD Discip. LEXIS 29, at *10-11; *see also Roethlisberger*, 2003 NASD Discip. LEXIS 48, at *19 ("Under NASD Rule 2110, registered individuals are required as part of the terms of their admission to the securities industry to observe high standards of conduct and should not be rewarded merely because they have acted in a manner consistent with those standards."). We continue to believe that a respondent's lack of disciplinary history is not a mitigating factor for purposes of determining appropriate sanctions for violations of NASD and Commission rules. Moreover, while some of the statements made in General Principle No. 2 can be read out of context to indicate that a lack of disciplinary history should be considered mitigating, reading the Principle as a whole leaves little doubt that its focus is on ensuring that adjudicators consider whether respondents with a relevant disciplinary history should receive more severe sanctions (i.e., that the existence of a disciplinary history is an aggravating factor).

In this case, moreover, the fact that the Respondent has a clean disciplinary record is counterbalanced by the fact that, over the course of those many years, he personally performed due diligence on over 100 similar offerings. With such experience, the Respondent must be held to account for the fact that he permitted the Respondent Firm to take part in three offerings that violated Commission rules. The Respondent cannot point to his years of experience with no disciplinary record and expect to receive credit while ignoring the fact that those same years of experience should have caused him to be keenly aware of the requirements for contingency offerings.

5. <u>Scienter</u>

Principal Consideration No. 13 provides that adjudicators should consider "[w]hether the respondent's misconduct was the result of an intentional act, recklessness, or negligence." The Respondents argue in their brief that the Hearing Panel's finding of recklessness was "just plain wrong" and that the Respondents were "at most negligent."[22] However, the Respondents have repeatedly admitted to the violations of Rule 10b-9, which requires either reckless or intentional misconduct. *See Robert Tretiak*, 2003 SEC LEXIS 653, at *29-30. The record contains no

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[21] *See, e.g.*, *Dep't of Enforcement v. Roethlisberger*, Complaint No. C8A020014, 2003 NASD Discip. LEXIS 48, at *19 (NAC Dec. 15, 2003) ("A lack of disciplinary history, however, should not be considered a mitigating factor."); *Dep't of Enforcement v. U.S. Rica Fin., Inc.*, Complaint No. C01000003, 2003 NASD Discip. LEXIS 24, at *44-45 (NAC Sept. 9, 2003); *Dep't of Enforcement v. Fergus*, Complaint No. C8A990025, 2001 NASD Discip. LEXIS 3, at *57-59 (NAC May 17, 2001).

[22] The Hearing Panel found that the Respondent's conduct in not seeking independent legal advice even though he had questions regarding the escrow arrangement was reckless. Thus, the Panel concluded that the violations of Rule 15c2-4 were due to reckless conduct. The Hearing Panel did not make an explicit finding that the Respondent's conduct involving the violations of Rule 10b-9 was reckless or intentional.

indication that the Respondent's conduct rose to the level of intentional misconduct or that he or the Respondent Firm intended to defraud customers. Thus, we find that the Respondents engaged in reckless conduct in violating Rule 10b-9.

With respect to the violations of Rule 15c2-4, the Respondent also acted recklessly. The Respondent testified that, in conducting his due diligence review of the Firm B offerings, he noticed that Firm C was not a bank and discussed the issue with Firm B's wholesaler, who informed him that PM had drafted the documents, reviewed the arrangement, and approved the offering. The Respondent did not speak to PM directly. In similar circumstances, we have found a respondent's conduct to be reckless when, with 18 years of securities experience, an individual failed to take additional steps, after consulting with the issuer's counsel, to ensure that contingency offerings met the appropriate regulatory requirements. *See Gerace*, 2001 NASD Discip. LEXIS 5, at *11, *19-20. We find that the Respondent's conduct was reckless, but does not rise to the level of intentional misconduct.

6. Other Cases

The Respondents go to great lengths to demonstrate that the sanctions imposed by the Hearing Panel in this case are inconsistent with, and higher than, sanctions imposed in other cases involving contingency offerings and violations of Rules 15c2-4 and 10b-9. Both NASD and the Commission have consistently maintained that appropriate sanctions depend on the particular facts and circumstances of each case and cannot be determined by comparison with action taken in other cases. *See David A. Gingras*, 50 S.E.C. 1286, 1293-94 (1992); *Donald W. Collins*, 46 S.E.C. 642, 647 (1976); *Dep't of Enforcement v. Hanson*, Complaint No. C8A000059, 2002 NASD Discip. LEXIS 5, at *12 (NAC Mar. 28, 2002). This case demonstrates very clearly why this position is appropriate.

The Respondents selected four NBCC cases with more egregious facts to buttress their contention that the sanctions imposed by the Hearing Panel in this case were "inordinate" and that "informal discipline is the fair and proportional result here."[23] The Respondents overlook the facts that all of the cases they cite were subject to earlier versions of the Guidelines and that none involved violations of Rule 3010, which accounted for one-third of the total fine imposed on the Respondents.[24] Moreover, in making their argument, the Respondents failed to cite two of

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[23] Specifically, the Respondents relied on *Dist. Bus. Conduct Comm. v. Hartman Secs., Inc.*, Complaint No. C06950018, 1997 NASD Discip. LEXIS 11 (NBCC Mar. 12, 1997); *Dist. Bus. Conduct Comm. v. Mains*, Complaint No. C8A950016, 1997 NASD Discip. LEXIS 3 (NBCC Jan. 3, 1997); *Progressive Asset Mgmt., Inc.*, 1995 NASD Discip. LEXIS 41 (NBCC Dec. 7, 1995); and *Dist. Bus. Conduct Comm. v. Ford*, Complaint No. C05910106, 1993 NASD Discip. LEXIS 236 (NBCC June 10, 1993).

[24] The Guidelines published in May 1993 provided for minimum monetary sanctions of $2,500 and $1,000 (if the broker-dealer and issuer were not affiliates) or $5,000 and $2,500 (if the broker-dealer and issuer were affiliates) for violations of Rule 10b-9 and 15c2-4, respectively. *See* Guidelines (1993 ed.) at 17-18. The 1996 version of the Guidelines combined the violations and recommended minimum monetary sanctions of $1,000 if the broker-dealer and

[Footnote continued on next page]

our more recent cases involving contingency offerings where significantly higher sanctions were imposed. *See Robert Tretiak*, Complaint Nos. C02990042 and C02980085, 2001 NASD Discip. LEXIS 1, at *56 n.22, *aff'd*, Exchange Act Rel. No. 47534, 2003 SEC LEXIS 653 (Mar. 19, 2003) (imposing a $15,000 fine on the respondent and suspending him in all capacities for six months for violations of Rules 15c2-4 and 10b-9); *Gerace*, 2001 NASD Discip. LEXIS 5, at *21 (fining Gerace $10,000 and suspending him in all principal capacities for one year for violations of Rules 15c2-4 and 10b-9). While the conduct in both *Gerace* and *Tretiak* was also more egregious than that at issue here, the sanctions were also higher than those imposed by the Hearing Panel in this case; thus, it merely demonstrates the futility in attempting to compare cases and outcomes. Moreover, none of the cases stand for the proposition advanced by the Respondents that informal discipline is appropriate for multiple violations of Commission and NASD rules occurring over three separate offerings.

7. Lack of Procedures

Principal Consideration No. 5 states that adjudicators should consider "[w]hether, at the time of the violation, the respondent member firm had developed reasonable supervisory, operational, and/or technical procedures or controls that were properly implemented." Guidelines (2001 ed.) at 9 (Principal Consideration No. 5). The Rule 3010 Considerations also instruct adjudicators to consider whether the deficiencies in the procedures "allowed violative conduct to occur or to escape detection." Guidelines (2001 ed.) at 109 (Supervisory Procedures – Deficient Written Supervisory Procedures). The Respondents admit that the Respondent Firm had no specific procedures regarding participation in contingency offerings, even though a significant amount of its business was derived from participation in such offerings. The Respondents have indicated that they kept on hand a general text on due diligence, which they used as a reference from time to time as needed. However, the text does not include any specific procedures regarding contingency offerings.

8. Number, Size, and Character of the Transactions

Principal Consideration No. 18 instructs adjudicators to consider the "number, size, and character of the transactions at issue." Guidelines (2001 ed.) at 10 (Principal Consideration No. 18). The conduct at issue here took place over a 19-month period and involved three separate private offerings. As a result of participating in the three offerings, the Respondent Firm's customers invested more than $2 million in offerings that violated applicable Commission rules, and the Respondent Firm received almost $190,000 in commissions and due diligence fees.

9. Affirmance of Sanctions

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the issuer were not affiliates and $2,500 if the broker-dealer and the issuer were affiliates. *See* Guidelines (1996 ed.) at 19. The current Guidelines provide for minimum monetary sanctions of $1,000 for violations of Rule 15c2-4 and $5,000 for violations of Rule 10b-9.

The Hearing Panel found that there were no "significant aggravating circumstances" identified in the Escrow Considerations. We agree with this characterization. For example, the Escrow Considerations concerning improper release of escrow funds, affiliation of the issuer and the broker-dealer, and the use of non-bona fide sales, are not present here. Weighing all of the relevant factors, we agree with the Hearing Panel that sanctions on the lower end of the Guidelines are appropriate. We see no reason to upset the Panel's sanctions of total fines of $7,500, jointly and severally.

IV. Conclusion

We affirm the Hearing Panel's findings and sanctions.[25] The Respondents are fined $5,000, jointly and severally, for their violations of Exchange Act Rules 15c2-4 and 10b-9 and NASD Conduct Rule 2110 and $2,500, jointly and severally, for their violations of NASD Conduct Rules 3010 and 2110. We also affirm the Hearing Panel's imposition of costs in the amount of $1,690.14, including an administrative fee of $750 and hearing transcript costs of $940.14.[26]

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President
and Corporate Secretary

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[25] We also have considered and reject without discussion all other arguments advanced by the Respondents.

[26] Pursuant to NASD Procedural Rule 8320, any member that 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.