BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Market Regulation, Complainant, vs. Yankee Financial Group, Inc. Melville, NY and Richard F. Kresge Bay Shore, NY, Respondents.	DECISION Complaint No. CMS030182 Dated: August 4, 2006

Hearing Panel held that respondents: (1) were liable for firm representatives' fraudulent solicitations and unsuitable recommendations; (2) failed to supervise and implement a reasonable system of supervision; (3) failed to report customer complaints; and (4) failed to register a person who was functioning as a principal and a representative. Held, findings affirmed in part, modified in part; sanctions affirmed in part and modified in part.

Appearances

For the Complainant: Jeffrey K. Stith, Esq., Matthew Campbell, Esq., Department of Market Regulation, NASD

For the Respondents: Lawrence R. Gelber, Esq.

Decision

Pursuant to NASD Procedural Rule 9311(a), Yankee Financial Group, Inc. ("Yankee" or "the Firm") and Richard F. Kresge ("Kresge") appeal from a December 10, 2004 Hearing Panel decision. The Hearing Panel found that the Firm and Kresge: (1) were liable for fraudulent sales practices and unsuitable recommendations of the Firm's registered representatives; (2) failed to supervise the Firm's registered representatives; (3) failed to report customer complaints; and (4) failed to register an individual who worked as a principal and a representative of the Firm.

For these violations, the Hearing Panel expelled the Firm, barred Kresge as a principal and in any supervisory capacity, and ordered respondents to pay $3,866,426 in restitution. After a complete review of the record, we affirm in part and modify in part the Hearing Panel's findings of violations, and we affirm in part and modify in part the sanctions imposed.

I. Background

Kresge entered the securities industry in 1978. Since Yankee's formation in 1986, Kresge has been the Firm's president, chief executive officer, and 95 percent owner. During the relevant period of time, Kresge was registered with Yankee in several capacities, including general securities representative, general securities principal, and financial and operations principal. Kresge also served as the Firm's compliance officer, except from February 2002 through June 2002, when Joseph Korwasky ("Korwasky") held that position.

Yankee has been a registered broker-dealer since August 1986. During the relevant period, Yankee's main office was in Bay Shore, New York. Between 1986 and 2001, Yankee's business primarily involved municipal and government bonds and mutual funds. As described in more detail below, Yankee experienced a major change in the nature of its operations when it opened two new offices, one in Melville and the other in Brooklyn, New York, in 2001.

II. Facts

A. Yankee Opens an Office in Melville, New York

In early 2001, Yankee, acting through Kresge, reached an agreement with Kenneth Gliwa ("Gliwa") and Robert Stelz ("Stelz"), principals of Glenn Michael Financial, Inc. ("Glenn Michael"), to buy Glenn Michael's branch office in Melville, New York. In March 2001, Yankee bought the Melville office, adding approximately 50 representatives to Yankee's existing 10 to 12 representatives. At that time, the Melville office's business consisted of municipal bonds, mutual funds, listed equities, and a small amount of penny stock business.

After the acquisition of the Melville office, Kresge continued to work in Bay Shore, and Gliwa and Stelz continued to work in Melville. Kresge remained Yankee's president, compliance officer, and 95 percent owner, and he visited the Melville office once every 10 to 14 days. Stelz became the manager of the Melville office. Gliwa, who was registered as a general securities representative, a general securities principal, and an equity trader, was assigned responsibility for the Firm's trading. Both Stelz and Gliwa continued to service their own customers.

B. Yankee Opens an Office in Brooklyn, New York

In or around August 2001, Gliwa informed Kresge about a client, Joseph Masone ("Masone"), who knew of some unhappy representatives looking to switch firms. A meeting was held to discuss adding these representatives at a location that was to be a new Yankee office. At the meeting, Masone introduced Kresge, Stelz, and Gliwa to Joseph Ferragamo ("Ferragamo"). Ferragamo explained that he was registered with Valley Forge Securities, Inc.

("Valley Forge"), provided a business card identifying himself as vice president of investments, and represented that he was the "owner" of a Valley Forge branch office in New York City that primarily worked with listed stocks. Ferragamo stated that he was the spokesperson for several brokers who wanted to leave Valley Forge and suggested that Gary Giordano ("Giordano") could serve as the branch manager of a new Yankee office. Kresge, Gliwa, and Stelz proceeded to interview Giordano.

At a meeting in September 2001, Kresge and Gliwa met with Ferragamo, Masone, and Michael Trotta ("Trotta"), the chief executive officer of Silver Star Foods ("Silver Star"). Kresge did not know Trotta, and no one asked why he was there. At or soon after this second meeting, an agreement was reached to open a Yankee office in Brooklyn. Kresge testified that Ferragamo financed the Brooklyn office and guaranteed the payment of its expenses. The terms also provided that Yankee would receive 15 percent of the Brooklyn office's commissions and a $25 per ticket charge. No records were created to document Ferragamo's financing role or the override arrangement.[1]

At Ferragamo's recommendation, Kresge hired Giordano to be the manager of the Brooklyn office. As manager, Giordano was responsible for handling the day-to-day office operations, hiring brokers subject to Kresge's approval, and supervising the office, which included signing off on new accounts, conducting suitability reviews, training representatives regarding sales practices, and monitoring transactions and "back office" functions. The Brooklyn office proceeded to hire David Anderson (a/k/a Vasily Kouznetsov) ("Anderson"), Eric Cenname ("Cenname"), Adam Klein ("Klein"), Lawrence Dugo ("Dugo"), and Cesar Ramos ("Ramos").[2] Around September 2001, Ferragamo asked Kresge not to register him with Yankee, first claiming that the new office had limited funds to do so, but then claiming that he wanted to avoid being held jointly and severally liable with his former firm in a "minor" NASD arbitration matter in which he was named. Kresge agreed not to register Ferragamo.

C. Fraudulent Sales and Unsuitable Recommendations

The Brooklyn office opened in October 2001. Immediately thereafter, hundreds of customer accounts were transferred to Yankee from Valley Forge and L.H. Ross. From October 2001 until April 2002, the Brooklyn representatives solicited members of the public to purchase large quantities of securities in three companies: Silver Star, Western Media Group, Corp.

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[1] In an investigative interview, Kresge testified that he expected Masone would be compensated for his role with a commission override. At the hearing, Kresge denied his prior testimony and testified that he expected Masone would only receive a finder's fee. By July 9, 2002, Kresge learned that Masone had a relationship with Silver Star and was an officer of a company that paid the lease for the Brooklyn office.

[2] Giordano had been associated with Weatherly Securities Corporation; Ferragamo, Klein, and Ramos with Valley Forge; Anderson and Cenname with L.H. Ross & Company ("L.H. Ross"); and Dugo with Salomon Grey Financial Corporation.

("Western Media"), and Golden Chief Resources, Inc. ("Golden Chief"). In total, approximately 147 Yankee customers invested $6.3 million in Silver Star, $1.6 million in Western Media, and $500,000 in Golden Chief. The financial statements of all three of these issuers contained going concern opinions. The record amply demonstrates that all three over-the-counter securities were highly speculative.

Ten Yankee customers testified how Brooklyn representatives, including Anderson, Cenname, and Dugo, solicited them to purchase these three securities. Finding the customers' testimony to be credible, the Hearing Panel found that the Brooklyn brokers solicited investments using material omissions and misrepresentations, with scienter, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-5, and NASD Conduct Rules 2120 and 2110. Specifically, the Hearing Panel found that Yankee representatives made no risk disclosures, "enthusiastically gave false information about the companies' prospects and stability at a time when those companies' losses were mounting and when their auditors placed 'going concern' qualifications on their financial statements," and "used . . . boiler-room type tactics such as creating a false sense of urgency to invest, claiming to be investing themselves or for family members, and making baseless price predictions."[3] The Hearing Panel further concluded that the Brooklyn brokers' recommendations of these securities to such customers were unsuitable, in violation of Conduct Rule 2310 and IM-2310-2. In so holding, the Panel found that the brokers ignored their customers' financial information and investment objectives, failed to assess their customers' risk tolerance, and lacked a reasonable basis for believing that these securities were suitable for their clients.[4] We affirm these findings.[5] In separate disciplinary proceedings, all of which were resolved either through default

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[3] For example, Anderson frequently urged WB, an 84-year old customer, to buy shares of Silver Star, Western Media, and Golden Chief, predicting that the price of each would dramatically increase, such as his claim that Golden Chief would rise from $.88 per share to as high as $8 to $15 per share. Cenname told customer JL, a 66-year old retiree, that he was involved in Silver Star, that he and his parents were investing in it, and that it was relatively safe. Up to four times per week, Cenname called JL and pressured him to invest, telling him "[g]et money any way you can, borrow it, do it anyway you can do, but you really ought to put a lot of money in it because I think it's going to go up a lot." Dugo "forceful[ly]" recommended Western Media and Silver Star to RP, predicting that the price of each would double or triple in the near future.

[4] As of March 31, 2004, the 10 customers who testified had incurred losses totaling $3,866,426, which reflected total realized and unrealized losses minus any restitution already received.

[5] Respondents do not challenge the Hearing Panel's findings that the Brooklyn representatives engaged in fraudulent conduct and made unsuitable recommendations, except to argue that it was unfair to make such findings without providing the representatives an opportunity to defend themselves. NASD proceeded separately against the Brooklyn representatives, all of whom were barred as a result of settlements or default judgments. In addition, respondents in fact had the opportunity to call the Brooklyn representatives as

[Footnote continued on next page]

decisions or settlements issued prior to the complaint at issue here, NASD barred Gliwa, Ferragamo, Anderson, Cenname, Klein, and Dugo from the securities industry.

D. Customer Complaints

Yankee received three customer complaints in the fourth quarter of 2001, seven complaints in the first quarter of 2002, and eight complaints in the second quarter of 2002. Eleven of these complaints concerned Anderson; one complaint concerned Dugo. None of these complaints was reported to NASD.

E. Yankee's Supervisory System for the Brooklyn Office

1. Supervisors and Compliance Officers

As explained above, Kresge purported to delegate primary supervisory responsibility over the Brooklyn office to Giordano. Kresge also purported to delegate to Gliwa, who remained in the Melville office, responsibility to supervise both Giordano's execution of his supervisory duties and Giordano's conduct with his own book of clients. Gliwa also remained responsible for supervising Yankee's order execution function, which now included trades called in to Melville from Brooklyn.[6] According to Kresge, Giordano was to "bother" Gliwa or Kresge only if there was a problem.

From October 2001 to December 2001, Kresge served as Yankee's compliance officer. During this period, Brooklyn brokers, through aggressive sales practices, sold nearly $3 million of Silver Star alone. Kresge testified that Gliwa was overwhelmed with work and had visited the Brooklyn office just two or three times.[7] Kresge realized that he needed to hire a compliance officer.

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witnesses at the hearing, but did not do so. We further address this argument below at Section IV.B.1.a.

[6] Although Gliwa denied having supervisory duties concerning the Brooklyn office, the Hearing Panel sided with Kresge's testimony on this issue. "Credibility determinations of an initial fact-finder, which are based on hearing the witnesses' testimony and observing their demeanor, are entitled to considerable weight and deference." *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *17 (Feb. 10, 2004). We find no reason to disturb this credibility determination nor any of the other credibility determinations described below.

[7] At the hearing, Kresge disagreed with his previous testimony that Gliwa was overwhelmed. The Hearing Panel, however, concluded that Kresge's earlier statements were credible. We see no reason to disturb this credibility determination. *Faber*, 2004 SEC LEXIS 277, at *17; *see also Bearcat, Inc.*, Exchange Act Rel. No. 49375, 2004 SEC LEXIS 527, at *14 (Mar. 8, 2004) (giving weight to investigative testimony over later, contradictory hearing testimony).

In December 2001, Kresge hired Korwasky to be Yankee's compliance officer. Korwasky started in January 2002 as an in-house consultant and, in mid-February 2002, became vice president of compliance. Kresge assigned Korwasky three priorities: preparing revised written supervisory procedures that reflected the addition of the Melville and Brooklyn offices, devising a continuing education program, and developing an understanding of the Brooklyn office. Dissatisfied with the unpleasant condition of his office in Melville, as well as his lack of access to the Firm's back office functions or the Central Registration Depository ("CRD®") system, Korwasky came to the office just once or twice a week and worked mainly from home. After Korwasky joined Yankee, Gliwa continued to have responsibilities to supervise the Brooklyn office.

2. Written Supervisory Procedures

In adding the Melville office, Kresge took an old supervisory procedures manual that the Melville office had been using and taped "Yankee" on the cover. Assuming that the Melville representatives already had copies, Kresge did not ask Gliwa to distribute the manual. When the Brooklyn office opened, Kresge did not provide Giordano with a compliance manual, assuming, apparently without asking, that Gliwa would. Neither the Melville nor the Brooklyn representatives received a copy of the supervisory procedures manual.

After being assigned to revise Yankee's supervisory procedures, Korwasky learned that the existing manual contained no references to Yankee, and he began developing a revised set of procedures "from square one." In March 2002, Korwasky finished a draft revised procedures manual. Although Kresge told Korwasky that the draft manual looked good, in his investigative testimony Kresge testified that he actually believed the manual was grossly deficient.[8] In April 2002, Korwasky made copies of his draft procedures and distributed them to "the people [he] was concerned with," including Giordano and Dugo, and to "key people" to distribute to the Melville representatives. Dissatisifed with Korwasky's draft manual, Kresge hired an outside firm in May 2002 to develop a new manual. As of September 2002, Yankee still had not put in place revised supervisory procedures.[9]

3. Supervision of the Brooklyn Office

Kresge viewed the Brooklyn office as an independent and separate entity. Tellingly, he claimed he had no awareness of what was occurring there. From October to December 2001, Kresge paid just three visits to that office, during which he did not review any files, talk to any

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[8] At the hearing, Kresge testified that he had changed his assessment and believed that the draft procedures were good.

[9] Kresge changed his story at the hearing, claiming that Korwasky's draft procedures were put "in force." We have no basis to change the Hearing Panel's finding crediting Kresge's earlier statement that Yankee had not implemented the revised procedures.

brokers, or discuss any customer complaints. Kresge did not know whether the Brooklyn brokers were trained on suitability or sales practices. In investigative testimony, Kresge testified that he never asked Gliwa how the Brooklyn office was doing "compliance wise" or what Gliwa looked at when he reviewed order tickets.[10] Kresge also believed that neither Gliwa nor Stelz had ever reviewed any Brooklyn customer accounts, with one exception.

When Korwasky joined Yankee, he asked Kresge to schedule a meeting with Brooklyn office personnel. Kresge told Korwasky that no one from the Melville office had ever visited the Brooklyn office. In February 2002, Kresge and Gliwa accompanied Korwasky to meet Ferragamo and Giordano.

Subsequently, Korwasky made several recommendations concerning the Brooklyn office and persons affiliated with it. First, Korwasky recommended, soon after joining Yankee and numerous times thereafter, that Kresge install a system in Brooklyn to monitor representatives' telephone conversations. Kresge never implemented this recommendation. Second, after growing concerned about Ferragamo's constant presence in the Brooklyn office and learning that Ferragamo funded it, Korwasky asked Kresge to ban Ferragamo until he was registered. In investigative testimony, Korwasky stated that Kresge agreed that Ferragamo should be registered, but did not know if Kresge ever followed that recommendation.[11] Third, Korwasky recommended, after learning in April 2002 that Dugo and others had begun working from an office on Staten Island, that Kresge shut it down. The Staten Island office ultimately was closed, and Dugo was instructed to report to the Brooklyn office, but he immediately resigned. Fourth, in May 2002, Korwasky recommended that Dugo and Anderson be subject to heightened supervision in response to customer complaints. Anderson agreed to be subject to heightened supervision, but Dugo resigned before such procedures became effective. Fifth, Korwasky recommended to Kresge that several "controls" be put in place, including the use of "active account letters," to ensure a customer's awareness of trading activity, and that the representatives' use of "scripts" and "rebuttal books" be immediately banned. Kowarsky's recommendations were "generally disregarded." Finally, Korwasky recommended that Kresge ban Masone from Yankee premises after Masone answered a phone call that Korwasky placed to Yankee. Kresge agreed to ban Masone, and Korwasky proceeded to bar Masone from Yankee offices. On June 27, 2002, Korwasky resigned after Gliwa and Giordano sought Korwasky's approval to open accounts for four customers whom Korwasky considered to be unsuitable.

After learning that Anderson had been the subject of yet more customer complaints, Kresge terminated Anderson on August 6, 2002. On September 3, 2002, Kresge informed

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[10] At the hearing, Kresge disputed his earlier testimony that he had not asked Gliwa how the Brooklyn office was doing compliance-wise. We have no basis to disturb the Hearing Panel's finding crediting Kresge's earlier testimony.

[11] At the hearing, Korwasky testified that, in April 2002, Kresge agreed to ban Ferragamo and "took action" to do so. We have no basis to disturb the Hearing Panel's finding crediting Korwasky's earlier investigative testimony.

Giordano that the Melville trading desk would only accept orders from Brooklyn for listed stocks. Shortly after Kresge provided investigative testimony to NASD, Kresge terminated Giordano and shut down the Brooklyn office.

III. Procedural History

On August 12, 2003, the Department of Market Regulation ("Market Regulation") filed a four-cause complaint against Yankee, Kresge, Giordano, and Korwasky. Cause one alleged that Yankee and Kresge were liable for fraudulent sales practices and unsuitable recommendations by Yankee's registered representatives, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and NASD Conduct Rules 2120, 2310, 2110, and IM-2310-2. Cause two alleged that Yankee, Kresge, Giordano, and Korwasky failed to supervise the Firm's representatives, establish a supervisory system, and establish written supervisory procedures, in violation of Conduct Rules 3010 and 2110. Cause three alleged that Yankee, Kresge, Giordano, and Korwasky failed to report customer complaints, in violation of Conduct Rules 3070(c) and 2110. Cause four alleged that Yankee, Kresge, and Korwasky failed to register Ferragamo, in violation of Membership and Registration Rules 1021(a), 1031(a), IM-1000-1, and IM-1000-3 and Conduct Rule 2110.

On December 10, 2004, the Hearing Panel found that Yankee and Kresge were responsible for all alleged violations. The Panel expelled Yankee, barred Kresge in any principal or supervisory capacity, and ordered Yankee and Kresge to pay $3,866,426 in restitution.[12] On January 5, 2005, Yankee and Kresge filed this appeal.

IV. Discussion

A. Failure to Supervise

The Hearing Panel found that Yankee and Kresge failed to establish a supervisory system and failed to supervise the Brooklyn office, in violation of Conduct Rules 3010 and 2110. We affirm the Hearing Panel's findings.

1. Respondents Failed to Establish a Reasonable System of Supervision

Conduct Rule 3010(a) provides that "[e]ach member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable NASD rules." The requirement to comply with this rule is not limited to the member firm itself. As president, Kresge was responsible for "compliance with all the requirements imposed on his firm unless and until he reasonably delegates particular functions to

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[12] The Hearing Panel found that Korwasky failed to report one customer complaint, dismissed all other allegations against him, and issued Korwasky a letter of caution. Giordano settled the complaint and was permanently barred from the securities industry.

another person in that firm, and neither knows nor has reason to know that such person's performance is deficient." *William H. Gerhauser, Sr*., 53 S.E.C. 933, 941 (1998); *see, e.g.*, *Dist. Bus. Conduct Comm. v. A.S. Goldmen & Co*., Complaint No. C10960208, 1999 NASD Discip. LEXIS 18, at *41-43 (NAC May 14, 1999) (holding president responsible for failing to establish adequate supervisory procedures), *aff'd*, Exchange Act Rel. No. 44328, 2001 SEC LEXIS 966 (May 21, 2001); *James H. Thornton*, 53 S.E.C 1210, 1215-16 (1999) (holding firm and president responsible for supervisory failures). There is no evidence that Kresge delegated ultimate responsibility to establish the Firm's reasonable system of supervision to anyone else.

In 2001, Yankee added two new locations,[13] a substantial number of new personnel, and, for the first time, the sale of speculative, unlisted, over-the-counter stocks. Respondents' failure to modify (or at least consider whether they needed to modify) Yankee's procedures in light of these dramatic changes was inconsistent with their obligations. *See NASD Notice to Members 99-45*, at 294 (June 1999) (listing such factors as among those that firms should consider when preparing a system of supervision); *see also La Jolla Capital Corp.*, 54 S.E.C. 275, 282 (1999) (stressing "the obvious need to keep [a] new office with . . . untried personnel under close surveillance"). Most significantly, Yankee's transformation from a firm that sold only bonds and mutual funds to one that also sold speculative, unlisted securities marked a fundamental shift in the risk profile of Yankee's business. Sales of such products involve heightened regulatory responsibilities and a corresponding need for heightened supervision. At the first sign that the Brooklyn representatives were selling such securities, Kresge should have known that the Firm's supervisory system was insufficient. As explained below, respondents failed to design a reasonable system of supervision that accounted for these major changes.

a. Respondents Failed to Designate the Brooklyn Office as an Office of Supervisory Jurisdiction

Respondents failed to designate the Brooklyn office as an Office of Supervisory Jurisdiction ("OSJ"), as required by Conduct Rule 3010(a)(3). Certain types of activities, set forth in Rule 3010(g)(1), "are sufficiently vested with regulatory significance that the locations where members conduct these types of activities require special recognition and attention." *NASD Notice to Members 99-45*, at 296. Some of these activities occurred in Brooklyn. Kresge testified that Giordano was reviewing and approving new accounts and customer orders. *See* Rule 3010(g)(1)(D), (E). The record also shows that Kresge was aware that Giordano supervised two brokers in the Staten Island executive suite. *See* Rule 3010(g)(1)(G) (defining an OSJ to include any office that has "responsibility for supervising the activities of persons associated with the member at one or more other branch offices"). Moreover, a member firm is required to designate offices as OSJs "as it determines to be necessary in order to supervise its registered representatives and associated persons." Rule 3010(a)(3). Among the relevant considerations is

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[13] Respondents argue that the Hearing Panel's decision inaccurately described the transaction by which the Melville office became part of Yankee as both a "merger" and an "acquisition." Even if one or both of these descriptions were somehow inaccurate, such an error is immaterial and harmless.

"whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers." Rule 3010(a)(3)(A). Given that the Brooklyn representatives engaged in retail sales of a new, and particularly risky, product line for Yankee, respondents were required to designate the Brooklyn office as an OSJ.

b. Respondents Failed to Make Reasonable Efforts to Determine That Supervisory Personnel Were Qualified

Conduct Rule 3010(a)(6) requires "[r]easonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities." Kresge did not make reasonable efforts to determine that Giordano was qualified to supervise the Brooklyn office. Ferragamo recommended Giordano for the position of Brooklyn branch manager. In considering Giordano, Kresge was required to determine that Giordano understood, and could effectively conduct, his required responsibilities. Kresge did interview Giordano and review his CRD record. Kresge also testified that he asked Giordano about his employment history. Had he conducted an effective investigation, Kresge would have learned that from November 1997 to September 2001, Giordano was employed by five different firms. Kresge generally agreed that a broker changing firms frequently in a relatively short period would be a "red flag of a potential compliance issue." Kresge checked to see if Giordano's firm was on NASD's Taping Rule list,[14] but Kresge admitted that he had never heard of the firms Giordano had worked for. Kresge also was not sure if he reviewed Giordano's examination history at the time. Asked whether he ever asked Giordano how long he had been a principal, Kresge evasively testified that he asked Giordano if he understood compliance procedures and how to carry them out.

Had Kresge conducted a reasonable due diligence investigation concerning Giordano's qualifications, he would have learned that Giordano passed his general securities representative and principal qualification examinations in December 1997 and March 2001, respectively, passing the latter just six months before he began managing the Brooklyn office. The fact that a person has passed the appropriate licensing examination "does not, in and of itself, qualify a supervisor." *NASD Notice to Members 99-45*, at 297. Moreover, Kresge's reliance on Giordano's self-description of his qualifications was not sufficient, since Kresge could "confirm the representations without having to undertake extreme or excessive efforts." *Id.* at 298. Kresge did not even ensure that Giordano received a copy of what was serving as Yankee's written supervisory procedures. Moreover, once the Brooklyn office opened, Kresge took no steps to monitor Giordano, except, as explained below, to assign a person (Gliwa) to monitor him who did not have the time and possibly the qualifications to do so effectively. Kresge admitted

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[14] Conduct Rule 3010(b)(2) (the "Taping Rule") requires broker-dealers that hire a certain percentage of their representatives from "Disciplined Firms," as defined in Rule 3010(b)(2)(J), to establish, maintain, and enforce special written procedures for supervising the telemarketing activities of its registered persons, including tape-recording all telephone conversations between the member's registered persons and both existing and potential customers. NASD maintains a list of Disciplined Firms as well as firms that are subject to the Taping Rule.

that he did not even know if the Brooklyn representatives had received any training concerning suitability or sales practices. As the Commission has held, "it is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention. . . . Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised." *La Jolla Capital*, 54 S.E.C. at 284.

Likewise, respondents failed to investigate reasonably whether Gliwa was qualified to serve as a supervisor for Giordano. While assigning someone to supervise Giordano was certainly the right idea, *see id.* at 283, "[a] member's obligation to determine whether a supervisor is properly qualified to fulfill his or her supervisory duties is an ongoing obligation." *NASD Notice to Members 99-45*, at 298. By December 2001, Kresge was aware that Gliwa was having difficulty fulfilling his supervisory duties. Kresge testified that, during the October 2001 to December 2001 period, Gliwa, who maintained his own book of clients, was "wearing seven or eight hats," was "overwhelmed with work," and visited the Brooklyn office only "two or three times." Kresge never discussed with Gliwa what he would look for when reviewing order tickets, was aware that Gliwa never conducted regular reviews of Brooklyn trades or customers accounts for suitability, and knew that, prior to NASD's investigation, Gliwa had never rejected any orders. At one point, Korwasky also informed Kresge that Gliwa was incompetent as a supervisor and "doesn't get it." But despite these warnings about Gliwa's qualifications, respondents never delivered a copy of the written supervisory procedures to Gliwa and kept him on as a supervisor of the Brooklyn office. We agree with the Hearing Panel, which found that "[b]ecause Kresge knew of Gliwa's supervisory deficiencies, [the] continued delegation to [Gliwa] of supervisory authority was not reasonable."

c. <u>Respondents Failed to Ascertain the Qualifications of the Brooklyn Representatives</u>

Conduct Rule 3010(e) provides that "[e]ach member shall have the responsibility and duty to ascertain *by investigation* the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with [NASD]." (Emphasis added.) NASD has indicated that, at a minimum, members must review an applicant's Uniform Application for Securities Industry Registration or Transfer ("Form U4") and Uniform Termination Notice for Securities Industry Registration ("Form U5"), review the applicant's CRD history, and contact the applicant's previous employers. *NASD Notice to Members 97-19*, at 157 (Apr. 1997). Firms also should consider using best hiring practices, including obtaining explanations regarding any customer complaints and regulatory actions to determine the merit, to the extent practicable, of each before hiring, and asking about any pending proceedings, customer complaints, regulatory investigations, or arbitrations not listed in CRD. *Id.* As indicated above, a firm's president is responsible for compliance with this requirement unless and until it is reasonably delegated.

Viewed under these standards, Kresge's efforts to investigate the Brooklyn brokers were woefully insufficient. Kresge claimed that he contacted NASD to ensure that adding these representatives would not result in changes to Yankee's restrictive agreement. Yet Kresge did

not contact the prospective representatives' employers. Kresge interviewed all of the representatives, except for Dugo, and asked the questions contained on Form U4, but nothing beyond that. Although Kresge reviewed the applicants' CRD records, all that mattered to him was whether they were registered as general securities representatives, had any disclosures, or worked for a firm that was on NASD's list of firms subject to the Taping Rule, which he explained was his "barometer of quality" for a firm. Kresge admitted that he was not concerned with the amount of the applicants' experience and did not check to see which, or how many, firms had employed the applicants. When reviewing Ferragamo's CRD record, Kresge did not check to determine the capacity in which Ferragamo was registered or to see what examinations he had passed. Moreover, Robert Montani ("Montani"), Valley Forge's compliance officer, testified that Kresge never inquired with him about Ferragamo or any other Valley Forge brokers.[15]

As a result, Kresge hired a number of brokers for the Brooklyn office with questionable histories. Kresge conceded that he was not aware that Klein, Cenname, Dugo, Anderson, and Ferragamo had previously switched firms numerous times within short periods. Moreover, those same individuals previously worked for firms that, as of September 2001, either were Disciplined Firms for purposes of the Taping Rule or subject to that rule, despite Kresge's claim that he checked to see if the brokers' previous firms were subject to the Taping Rule.[16] *See* Conduct Rule 3010(b)(2). Although Kresge allowed Ferragamo to work as an unregistered principal, Kresge failed to learn that Ferragamo had been registered only as a corporate securities representative, had never been registered as a general securities representative or principal, and twice failed the general securities representative examination. Had Kresge exerted minimal investigative efforts, he would have discovered this troubling information.

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[15] Kresge testified that, as part of his due diligence efforts, he contacted Montani to discuss Ferragamo. Citing an SEC press release and the web site of the United States Attorney's Office for the District of New Jersey, respondents argue that a civil injunctive action and a criminal indictment filed in February 2005 against Montani demonstrate that the Hearing Panel erred in crediting Montani's testimony over Kresge's testimony. Respondents have not moved to have this additional evidence admitted, so we do not consider it as part of the record. In any event, such events would not lead us to ignore the Hearing Panel's credibility determination. *See Faber*, 2004 SEC LEXIS 277, at *17-18 ("Credibility determinations of an initial fact-finder, which are based on hearing the witnesses' testimony and observing their demeanor, are entitled to considerable weight and deference."). In this regard, we note that Montani's testimony is largely consistent with Kresge's general failure to investigate the Brooklyn brokers or contact other employers. Although respondents also assert that a phone record demonstrates a call was placed to Montani, there is no indication that this evidence was admitted. Moreover, the phone bill indicates only that someone at Yankee placed a phone call to Valley Forge the month after the Brooklyn office opened and is not probative.

[16] At the hearing, Kresge even admitted that he recognized one of the firms for which Dugo had worked as a "bad firm."

Kresge also failed reasonably to investigate two areas of concern contained in Dugo's CRD report: (1) that Dugo was the subject of a pending arbitration action alleging a mishandling of an account; and (2) that Dugo pled guilty in 1984 to cocaine possession, a felony charge that was dismissed after his successful completion of a drug treatment program. Kresge neither asked Dugo to explain these disclosures, nor even met Dugo. Instead, Kresge testified that he discussed with Giordano a disclosure contained in Dugo's CRD report, and that Giordano convinced him to hire Dugo. Considering Kresge's substandard investigation into Giordano's qualifications, Kresge's sole reliance on him to ascertain whether Dugo was qualified was unreasonable.[17] Kresge also evidently did not learn that Ferragamo was the subject of two pending customer arbitration matters, which were not reported in CRD until November 2001 and August 2002, that claimed damages totaling $190,000 allegedly caused by unauthorized transactions, breaches of contract and fiduciary duty, negligence, and unsuitable recommendations.

The Hearing Panel made two errors in describing Kresge's efforts to investigate the Brooklyn representatives. First, the Hearing Panel erroneously faulted Kresge for never learning that, in late 2000, federal prosecutors issued an indictment alleging that Ferragamo's former Valley Forge office "was controlled by organized crime figures." There is no evidence in the record of such an indictment. Second, the Hearing Panel erred in finding that Kresge was unaware that Anderson was the subject of a customer-initiated NASD arbitration when Kresge hired him. The record does not demonstrate that such an arbitration was pending. Given the preponderance of the evidence demonstrating respondents' failure to investigate prospective employees, however, we find that such errors are not material.

d. Respondents Failed to Establish Reasonably Designed Procedures

Rule 3010(a) requires that each member establish and maintain a supervisory system "that is reasonably designed to achieve compliance with applicable securities laws." Although the Firm had written supervisory procedures, the procedures were not distributed to anyone in Melville or Brooklyn. A concomitant duty is that a firm should determine whether heightened supervisory procedures are necessary for any of its registered representatives "with a recent history of customer complaints, final disciplinary actions involving sales practice abuse or other customer harm, or adverse arbitration decisions." *NASD Notice to Members 97-19*, at 157. Respondents employed Dugo, who was the subject of a pending arbitration matter when he was hired and who had a prior felony conviction for a drug-related offense, and Anderson, who was the subject of numerous complaints lodged by Yankee customers as early as November 2001. Despite this, respondents failed to require heightened supervisory procedures for these two employees until April 2002, six months after the Brooklyn office opened. *See James H.*

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[17] Respondents argue it is "outrageous" to fault Kresge for not inquiring about Dugo's 1984 guilty plea because the charges were eventually dismissed and should not even appear in Dugo's CRD record. The fact remains, however, that the felony charge was not expunged from CRD, and there is no evidence in the record that a court of competent jurisdiction has ordered that it be expunged.

Thornton, 53 S.E.C. at 1215-16 (faulting firm and its president for failing to determine whether heightened supervisory procedures were needed for representative with a history of complaints and lawsuits); *Consolidated Inv. Servs., Inc.*, 52 S.E.C. 582, 587-89 (1996) (discussing obligation to ensure that heightened procedures are in place to supervise new brokers who are the subject of pending complaints).

For all of these reasons, we affirm the Hearing Panel's findings that respondents failed to establish and maintain a reasonable system of supervision, in violation of Conduct Rules 3010 and 2110.

2. Respondents Failed to Supervise the Brooklyn Office

Market Regulation further alleged, and the Hearing Panel found, that respondents failed to supervise the activities in the Brooklyn office. We affirm the Hearing Panel's findings.

As an initial matter, we find that Kresge was responsible at all times not only for establishing a supervisory system, but also for supervising the Brooklyn office. The Commission has "long maintained that 'final responsibility for supervision of the trading activities of a member firm of NASD rests with the firm's president, unless the president reasonably delegates the duties to someone else and has no reason to know that person is not properly performing the delegated duties.'" *Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558, at *43 n.45 (July 6, 2005) (*citing Michael T. Studer*, Exchange Act Rel. No. 50543 (Oct. 14, 2004), *aff'd*, *Studer v. SEC*, 148 Fed. Appx. 58 (2d Cir. 2005)). The record does not demonstrate that Kresge's purported delegations of supervisory authority were reasonable.

Although Kresge purported to put Giordano in charge of the Brooklyn office and Gliwa in charge of monitoring Giordano, based upon all of the circumstances, these were unreasonable delegations of supervisory authority. As explained in detail above, Kresge failed to conduct a reasonable investigation into Giordano's qualifications, leaving Kresge with no sufficient basis to conclude that Giordano was capable of supervising an entire office. Furthermore, Kresge knew that Gliwa's performance of his supervisory responsibilities was deficient. Moreover, after this supervisory scheme was established, ample red flags soon appeared, demonstrating that these supervisors were not fulfilling their responsibilities, as further explained below.

Respondents' hiring of Korwasky as compliance director did not entail a delegation of responsibility to supervise the Brooklyn office. Compliance officers do not become "supervisors" solely because they occupy the position of compliance officer. Instead, we look to whether Korwasky was given "the requisite degree of responsibility, ability or authority to affect the conduct of" the Brooklyn-based brokers. *John H. Gutfreund*, 51 S.E.C. 93, 113 & n.24 (1992) (settled case). Although the record demonstrates that Kresge assigned Korwasky some significant compliance-related tasks, there is no evidence that Korwasky was actually given a grant of supervisory authority over the Brooklyn representatives. On the contrary, the record demonstrates that Korwasky's authority was limited, considering that he repeatedly had to seek

Kresge's approval for his various recommendations concerning the Brooklyn office. Moreover, there is no evidence that Korwasky had the ability to hire or fire Brooklyn employees.[18]

Accordingly, Kresge retained responsibility for supervising the Brooklyn office at all times. Kresge was responsible for "reasonable supervision," a standard that "is determined based on the particular circumstances of each case." *Christopher J. Benz*, 52 S.E.C. 1280, 1284 (1997), *petition for review denied*, 168 F.3d 478 (3d Cir. 1998) (table). The SEC has held that "red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review." *Id.* at 1283 n.13 (quoting *Edwin Kantor*, 51 S.E.C. 440, 447 (1993)); *Houston A. Goddard*, 51 S.E.C. 668, 672-73 (1993).

Respondents argue that Kresge was ignorant of the problems in the Brooklyn office, asserting that Giordano and Gliwa deliberately concealed evidence of the sales practice problems. The record, however, demonstrates that Kresge knew, or should have known, of a number of red flags, but took no action. After the first meeting with Masone and Ferragamo, Stelz, the Melville office manager, was concerned enough to advise Kresge to check out Masone's background. Moreover, Ferragamo resisted being registered for reasons that ostensibly included a desire to avoid being held liable in an arbitration matter pending against him. Ferragamo described the brokers he wanted to bring with him to Yankee as disgruntled, and the brokers whom Kresge ultimately hired included persons who had moved frequently to and from disciplined firms, several persons with little relevant experience, and one person who was the subject of a pending arbitration.

The red flags continued after the Brooklyn office opened. Contrary to Ferragamo's representation that his business primarily involved listed stocks, the Brooklyn representatives immediately began selling speculative Over-the-Counter Bulletin Board® stocks. Kresge was aware of the large volume and speculative nature of Brooklyn's business, given that he reviewed commission runs and saw Brooklyn-generated order tickets, and that Yankee received significant commission overrides and ticket charges. Scott Gomolak, who worked at the trading desk, testified that he sought Kresge's approval for certain orders for Silver Star placed by Brooklyn brokers, and Kresge admitted seeing a ticket for a very large order of Silver Star. In fact, around November 2001, Stelz warned Kresge that the Brooklyn office's trading of "cheap stocks" needed to be monitored closely. Moreover, Yankee started receiving complaints concerning the Brooklyn brokers, some of which Kresge discussed with Korwasky, and Kresge himself fielded

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[18] Even if the assignments given to Korwasky could somehow be construed as a delegation of supervisory authority, it was not a reasonable delegation. Respondents failed to give Korwasky the support he would have needed to fulfill such a large responsibility. From the start, Korwasky was responsible for the project of completely revising Yankee's written supervisory procedures, by itself a large task that took months to complete. Kresge did not even introduce Korwasky to Brooklyn personnel until more than one month after he was hired. Respondents gave Korwasky such inadequate office space and resources that he often chose to work from home. Kresge even believed at the time that Korwasky was "useless," an allegation that Kresge retracted at the hearing.

complaints from Montani about Yankee brokers lying to Valley Forge customers. Korwasky was concerned enough that he recommended that Yankee install a system that would allow for tape recording of the Brooklyn brokers' telephone solicitations. Kresge knew of, and had approved, the Staten Island office. Kresge also was aware that Masone, who was not registered with Yankee, was frequently in the Melville office, used the telephones, and delivered documents between Melville and Brooklyn.

Faced with these red flags, Kresge should have been actively monitoring the activities in Brooklyn. Instead, Kresge paid little attention. Kresge visited the Brooklyn office just three times in the first three months of its operation. Kresge relied on various persons to supervise the Brooklyn office, including: (1) Giordano, who had little (if any) supervisory experience; (2) Gliwa, whom Kresge knew was seriously overworked; and eventually (3) Korwasky, to whom Kresge gave little support. Yet Kresge never asked Gliwa how the Brooklyn office was doing compliance-wise; did not know whether the Brooklyn brokers were trained on suitability or sales practices; knew that neither Gliwa nor Stelz had reviewed any customer accounts; never ensured that Korwasky's recommendation to tape record the Brooklyn brokers was implemented; and remained ignorant about how Giordano distributed the 85 percent share of Brooklyn's commissions or whether these payments were accurately reflected on the books and records of the broker-dealer. *Cf. A.S. Goldmen & Co*., 1999 NASD Discip. LEXIS 18, at *44 (holding that president failed to review the supervisory authority he delegated and assure that it was being exercised properly); *Benz*, 52 S.E.C. at 1282-83 (finding that branch manager who ignored red flag warnings concerning a representative's sales practice abuses failed to supervise); *Consolidated Inv.*, 52 S.E.C. at 589-90 (holding president liable for failing to supervise where there was no evidence that he took steps to determine a delegated supervisor's effectiveness); *SECO Sec., Inc*., 49 S.E.C. 873, 875-76 (1988) (holding that president of firm failed to supervise, where he did not visit new branch office during its initial months of operation, appointed a branch manager with little supervisory experience, and had no compliance-related discussions with the branch). Kresge claimed that he was not alarmed about the pending arbitration matter against Ferragamo and was evasive when asked whether he further investigated it.[19] And when Kresge saw the large order for Silver Star, his only concern was whether the client had money to cover the trade. *Cf. Kantor*, 51 S.E.C. at 443-44 (settlement order faulting supervisor for focusing on capital commitment and risk management issues, rather than compliance issues). Had respondents responded to the litany of red flags, they might have brought the improper sales activity to an end more quickly.

Respondents argue that Kresge responded to problems in the Brooklyn office, noting that, upon Korwasky's recommendations, Kresge: (1) ordered brokers working in an unofficial Staten

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19 Kresge admitted that, had he learned that there were *two* pending arbitration actions against Ferragamo, it "absolutely would have affected my decision to do business with him." Respondents contend that, because they were not requiring Ferragamo to register, they should not be faulted for failing to probe about the pending arbitration. As explained in Section IV.E below, however, respondents' failure to register Ferragamo, who worked as a principal of Yankee, was itself a violation of NASD rules.

Island office to return to Brooklyn; (2) required Dugo and Anderson to be placed on heightened supervision; and (3) barred Masone from Yankee offices.[20] Kresge also eventually fired Anderson and Giordano and closed the Brooklyn office. Kresge's actions, however, came after months of inaction in the face of red flags *and* after NASD began investigating the firm.[21] *See Thornton*, 53 S.E.C. at 1215 (finding failure to supervise where responses to signs of possible misconduct were inadequate and belated). Respondents also note that they hired Korwasky, who indeed made several appropriate recommendations concerning the Brooklyn office. As explained above, however, respondents never gave Korwasky supervisory authority or sufficient support to monitor the high pressure sales of risky, unlisted securities occurring in the Brooklyn office. Moreover, respondents did not follow a number of Korwasky's recommendations to monitor the office's operations.

The cases that respondents cite in support of their argument that they did not fail to supervise are distinguishable. For example, in *Arthur J. Huff*, 50 S.E.C. 524 (1991), the SEC dismissed allegations that a principal in a compliance department failed to supervise a representative who engaged in a massive securities fraud. When the principal joined the firm, he inherited responsibility to monitor the representative, whom the compliance department had already investigated to its satisfaction, and there were no new developments that raised questions. When a problem did surface, the principal conducted an investigation and recommended that the representative be fired. *Id.* at 528-29. The Commission also dismissed the allegations in *Louis R. Trujillo*, 49 S.E.C. 1106 (1989), that a supervisory employee had failed to supervise a representative who engaged in repeated violations of antifraud provisions. In *Trujillo*, the supervisor had limited authority to correct problems he detected. Despite that limited authority, the supervisor detected and reported numerous concerns about the problematic representative and ultimately went over his own supervisor's head when appropriate remedial action was not taken. *Id.* at 1110-11. In *Juan C. Schidlowski*, 48 S.E.C. 507 (1986), the Commission dismissed allegations that a president had failed to supervise activities that involved sales of securities before the effective date of registration. In that case, there was no indication that the president was aware of the irregularities or that the person in charge of the sales, also a high level manager, could not be trusted. *Id.* at 509. In contrast to *Huff*, *Trujillo*, and *Schidlowski*, Yankee and Kresge had ample authority to supervise the Brooklyn office, had plenty of reasons to be concerned about Giordano and Gliwa (e.g., the sales of low-priced securities, Gliwa's failure to visit the Brooklyn office, the complaints being raised about the Brooklyn brokers, Korwasky's numerous recommendations), took little action to detect problems, and did not respond appropriately if at all to the red flags and warning signs until months after the Brooklyn office opened.[22]

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[20] While respondents also argue that they followed Korwasky's recommendation to ban Ferragamo from the office, we affirm the Hearing Panel's finding that they did not.

[21] At the latest, Kresge was aware of NASD's investigation by April 1, 2002, when he received a copy of NASD's request dated March 25, 2002, sent to Gliwa pursuant to Rule 8210.

[22] As explained above, there is abundant evidence that the Brooklyn representatives engaged in fraudulent solicitations and made unsuitable recommendations. We nevertheless note

[Footnote continued on next page]

Accordingly, the preponderance of the evidence demonstrates that Yankee and Kresge failed to reasonably supervise the Brooklyn office, in violation of Conduct Rules 3010 and 2110.

B. Respondents' Liability for Yankee Representatives' Violations of Section 10(b) of the Exchange Act and Rule 10b-5 Thereunder

The Hearing Panel held that, pursuant to the principle of respondeat superior and as controlling persons, Yankee and Kresge were liable for the Brooklyn representatives' fraudulent solicitations, in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. We address these two theories of secondary liability separately.

1. Controlling Person Liability

The Hearing Panel held that Yankee and Kresge may be held responsible for the Brooklyn representatives' violations of Section 10(b), pursuant to the "controlling person" provisions set forth in Section 20(a) of the Exchange Act. We affirm the Hearing Panel's finding.

a. Prima Facie Case: Control and an Underlying Violation

To prove controlling person liability under Section 20(a), "'control' and an underlying violation of the securities laws by the controlled entity are required elements." *Initial Pub. Offering Sec. Litig*., 241 F. Supp. 2d 281, 392-93 (S.D.N.Y. 2003). The SEC has defined control as "the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." *SEC v. First Jersey Sec., Inc*., 101 F.3d 1450, 1472-73 (2d Cir. 1996) (*citing* 17 C.F.R. § 240.12b-2).

The record demonstrates a prima facie case of controlling person liability. First, both Yankee and Kresge were control persons. As a matter of law, a broker-dealer such as Yankee is a controlling person under Section 20(a) with respect to its registered representatives. *Hollinger v. Titan Capital Corp*., 914 F.2d 1564, 1573-74 (9th Cir. 1990) (en banc). As president of a broker-dealer who, by law, had ultimate responsibility for the Firm's compliance with all applicable regulatory requirements, Kresge also qualifies as a control person.[23] Second, there is

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that "[a] determination that a respondent has violated NASD's supervisory rule is not dependent on a finding of a violation by those subject to the respondent's supervision." *Prager*, 2005 SEC LEXIS 1558, at *47 (*citing NASD Notice to Members 98-96* (Dec. 1998)).

[23] Kresge's status as president of a broker-dealer—by itself—suffices to demonstrate that he was a control person at Yankee. Nevertheless, we note that other factors further reinforce Kresge's status as a control person. Kresge used his powers to direct the Brooklyn representatives. Specifically, Kresge hired and fired employees of the Brooklyn office, assigned Korwasky to develop procedures to govern it, restricted its activities, and eventually shut it

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abundant customer testimony and other documentary evidence supporting the Hearing Panel's finding that the controlled persons—the Brooklyn brokers—violated securities laws by fraudulently soliciting customers and making unsuitable recommendations.

Respondents did not challenge at the hearing that the Brooklyn representatives engaged in fraudulent conduct and made unsuitable recommendations. Nor do they now challenge the Hearing Panel's findings in this regard, except to argue that this proceeding is unfair because the Brooklyn representatives did not have an opportunity to defend themselves. "The Commission's interpretations of the Exchange Act's fairness language have focused on whether the [self regulatory organization] had followed its internal procedures and whether those procedures were fair." *Dep't of Enforcement v. J. Alexander Sec., Inc.*, Complaint No. CAF010021, 2004 NASD Discip. LEXIS 16, at *59-60 (NAC Aug. 16, 2004), *aff'd sub nom. Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558 (July 6, 2005). We see nothing unfair about the procedures followed here. Through the complaint, respondents were provided with notice of the allegations concerning the Brooklyn representatives. Over the course of a four-day hearing, respondents were afforded an ample opportunity to present documentary evidence and witness testimony concerning such allegations and to cross-examine Market Regulation's numerous customer witnesses. Nothing obligated Market Regulation to call the Brooklyn representatives as witnesses to satisfy its burden of proof that such representatives engaged in fraud and made unsuitable recommendations.[24] *Cf. Market Surveillance Comm. v. Benz*, Complaint No. CMS940056, 1996 NASD Discip. LEXIS 29, at *3, 7-15 (NBCC Mar. 15, 1996) (in a failure to supervise case, finding that the Market Surveillance Committee proved a representative's underlying violations without the representative's testimony), *aff'd*, *Christopher J. Benz*, 52 S.E.C. 1280 (1997), *petition for review denied*, 168 F.3d 478 (3d Cir. 1998) (Table).

Moreover, respondents had the opportunity to call the Brooklyn representatives as witnesses and request, pursuant to NASD Procedural Rule 9252, that NASD Procedural Rule 8210 be invoked to compel their testimony.[25] Respondents did not do so. Furthermore, while

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down. Moreover, Kresge was not only Yankee's president, but its chief executive officer and 95 percent owner. Such positions are strong evidence that Kresge possessed the power to control or direct Yankee and the Brooklyn office. *See Dietrich v. Bauer*, 76 F. Supp. 2d 312, 335 (S.D.N.Y. 1999) (control can be inferred from positions such as "owner" and "president").

[24] It has been stated that, in a Section 20(a) action, it is not necessary to proceed against the "principal perpetrator" or even identify the primary violator in the complaint. *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1170 n.47 (D.C. Cir. 1978) (*citing*, *inter alia*, *Kemmerer v. Weaver*, 445 F.2d 76, 78-79 (7th Cir. 1971)); *McCarthy v. Barnett Bank*, 750 F. Supp. 1119, 1126-27 (M.D. Fla. 1990); *see also* 9 Louis Loss & Joel Seligman, *Securities Regulation* 4465 (3d ed. rev. 2004) ("[i]t is not necessary to join the allegedly controlled person").

[25] In pertinent part, Procedural Rule 8210(a) authorizes an adjudicator or NASD staff to require a "person subject to [NASD's] jurisdiction" to provide testimony. NASD retains jurisdiction over, among others, a "person whose registration has been revoked or canceled" for

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respondents never conceded that the Brooklyn representatives engaged in violative conduct, respondents did not argue that Market Regulation's proof of such underlying violations was insufficient.[26] Given these circumstances, we reject respondents' argument that there was anything unfair about making findings concerning the Brooklyn representatives' conduct.[27]

With respect to Market Regulation's prima facie case of controlling person liability, there is a significant conflict concerning whether Section 20(a) also has a scienter element.[28] Under the majority view, Section 20(a) does not contain a scienter element; under the minority view, it does. *Initial Pub. Offering*, 241 F. Supp. 2d at 393 n.120 (explaining that the Fifth, Seventh, Eighth, Ninth, Tenth, and Eleventh Circuits "have all rejected a scienter requirement, holding that good faith may be asserted as an affirmative defense," while the Third and Fourth Circuits have adopted the minority view). In yet a third approach, the Second Circuit, which "has yet to definitely answer this question," has held that Section 20(a) requires a showing that "the controlling person was in some meaningful sense a culpable participant in the primary violation."[29] *Id.* at 393 (*citing Boguslavsky v. Kaplan*, 59 F.3d 715, 720 (2d Cir. 1988)) (internal

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"two years after the effective date of revocation or cancellation of registration." NASD By-Laws, Art. V, § 4(a)(ii). Within the previous two years of the April 2004 hearing, NASD had barred the Brooklyn representatives involved in this case, including Ferragamo, Anderson, Cenname, Klein, Dugo, and Giordano, either through settlements or default decisions. At a prehearing conference, respondents' counsel made statements demonstrating his awareness of the rights afforded under Rule 9252.

[26] To the extent that respondents' fairness argument is made on behalf of the Brooklyn representatives, respondents have no standing to raise such complaint. Our findings concerning the Brooklyn representatives apply only to Yankee and Kresge as the named parties. The Brooklyn representatives were barred in separate cases, either through settlements or default decisions.

[27] We also find no evidence supporting respondents' argument that the Hearing Panel was biased. In any event, our de novo review of this matter cures the alleged prejudice or unfair treatment, if any, that may have existed below. *Thomas C. Kocherhans*, 52 S.E.C. 528, 533 (1995).

[28] "The courts have concluded that scienter includes recklessness" and have defined recklessness as "an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Faber*, 2004 SEC LEXIS 277, at *19 n.18 (holding respondent liable for violations of Section 10(b), Rule 10b-5, and NASD Rules 2120 and 2110) (*quoting Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1063 (9th Cir. 2000), *and Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)).

[29] The Second Circuit has not defined "culpable participation," which has led to an intra-circuit split concerning its meaning. Some district courts have equated "culpable participation"

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quotation marks omitted). Respondents argue that the "culpable participation" requirement applies in this case.[30]

We agree with the majority view and, therefore, hold that Market Regulation need not demonstrate scienter or culpable participation to prove controlling person liability. However, even if scienter or culpable participation were required, the record establishes those elements. As explained in detail in Part IV.A above, respondents played an active role in hiring the branch manager and the representatives for the Brooklyn office that Kresge expected to be "aggressive," yet recklessly turned a blind eye to their questionable employment histories and troublesome disclosures, despite having a duty to inquire. Moreover, respondents were aware of other red flags,[31] yet recklessly failed to carry out their duty to supervise the Brooklyn representatives.[32]

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with scienter. 241 F. Supp. 2d at 394-95. Other district courts have found that "although the meaning of 'culpable participation' is unclear, there is strong reason to believe that it is not the same as scienter." *Id.* at 395. One court speculated that it is "more closely analogous to the (criminal) concept of actus reus, i.e., culpable conduct, than it is to mens rea, i.e., culpable state of mind." *Id.* at 394 n.123.

[30] Respondents erroneously maintain that controlling person liability also requires a showing that the control person induced the underlying violations. As explained below, *respondents* bear the burden of proving as part of an affirmative defense that they did not induce the violations.

[31] *E.g*., the lack of record-keeping concerning the distribution of payments to the Brooklyn office; the role and unregistered status of Ferragamo and Masone; the receipt of customer complaints; the sale of large volumes of speculative securities; and the emergence of the rogue Staten Island office.

[32] *See Carpenter v. Harris-Upham & Co.,* 594 F.2d 388, 394-395 (4th Cir. 1979) (holding that controlling person liability contains a state of mind requirement and examining whether broker-dealer was accountable as a controlling person by considering, among other things, whether broker-dealer failed to adequately supervise); *Alstom SA Sec. Litig*., Civ. 406 F. Supp. 2d 433, 491-92 (S.D.N.Y. 2005) (in a Section 20(a) action, holding that the culpable participation element requires that plaintiffs plead facts giving rise to a strong inference that the controlling person "acted with recklessness," or, in other words, "that the controlling person knew or should have known that the primary violator was engaging in fraudulent conduct, *or that the controlling person failed to review or check information that he or she had a duty to monitor*, or that the controlling person ignored obvious signs of fraud") (emphasis added); *Dietrich v. Bauer*, 126 F. Supp. 2d 759, 765 (S.D.N.Y. 2001) (in case involving sole owner of a broker-dealer, holding that culpable participation is shown by "willful blindness," or "where the control person knew or should have known that primary violator, over whom the person had control, was engaged in fraudulent conduct, but . . . did not take steps to prevent the primary violation") (internal quotation marks and citation omitted).

In addition, respondents did not enforce a reasonable and proper system of supervision and internal control over the Brooklyn representatives.

b. Affirmative Defenses

Because Market Regulation has demonstrated the prima facie elements of controlling person liability, under Section 20(a) the burden shifts to respondents to demonstrate that they acted in good faith and did not directly or indirectly induce the act or acts constituting the violation. *First Jersey Sec*., 101 F.3d at 1473; *Hollinger*, 914 F.2d at 1575. To establish good faith, the controlling person must "prove that he exercised due care in his supervision of the violator's activities in that he 'maintained and enforced a reasonable and proper system of supervision and internal controls.'" *First Jersey Sec*., 101 F.3d at 1473 (*citing Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980)); *Hollinger*, 914 F.2d at 1576; *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1120 (5th Cir. 1980). As explained in detail above in Part IV.A, respondents failed to show that they maintained and enforced a reasonable system of supervision over the Brooklyn office. Accordingly, we hold respondents responsible, pursuant to the controlling persons provisions of the Exchange Act, for the fraudulent solicitations carried out by the Firm's representatives.

2. Respondeat Superior

The Hearing Panel held Yankee and Kresge accountable for Yankee representatives' violations of Section 10(b) and Rule 10b-5 under the theory of respondeat superior. We affirm as to Yankee, but dismiss as to Kresge.

Respondeat superior is a principle of secondary liability. Under respondeat superior, an employer is liable for the acts of his employees committed while acting in the scope of their employment or for a misleading statement made by an employee or other agent who has actual or apparent authority. *Hollinger*, 914 F.2d at 1577 n.28 (*citing Restatement (Second) of Agency* §§ 219, 257, 261 (1958)); *see Michael T. Studer*, Exchange Act Rel. No. 50543A, 2004 SEC LEXIS 2828, at *22 (Nov. 30, 2004) (stating that respondeat superior "holds an employer liable for the wrongs committed by its employee"). Respondeat superior is a form of strict liability. *Hollinger*, 914 F.2d at 1582 (Hall, J., dissenting).

a. Respondeat Superior Liability Is a Viable Theory of Secondary Liability for Section 10(b)/Rule 10b-5 Violations

In 1994, the Supreme Court decided *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164, holding that a private plaintiff may not maintain under Section 10(b) a suit alleging aiding and abetting liability. *Id*. at 191. In so holding, the Court noted that "the language of Section 10(b) does not in terms mention aiding and abetting." *Id*. at 175. The dissenting opinion warned that the majority's holding "casts serious doubt, both for private and SEC actions, on *other* forms of secondary liability that . . . have long been recognized by the SEC and the courts but are not expressly spelled out in the securities statutes," including respondeat superior. *Id*. at 200 & n.12 (Stevens, J., dissenting). Notwithstanding *Central Bank*,

and as discussed below, respondeat superior liability is a viable theory of secondary liability under Section 10(b) of the Exchange Act.

Prior to *Central Bank*, most circuit courts of appeals had fully recognized respondeat superior liability under Section 10(b). Marc I. Steinberg & Ralph C. Ferrara, *Securities Practice: Federal and State Enforcement* § 4:37 (Sept. 2005) (citing pre-*Central Bank* cases and stating that "a majority of courts, including the Second, Fifth, Sixth, Seventh, and Ninth Circuits, apply the strict liability doctrine of respondeat superior to hold principals liable under the securities laws for the misconduct of their employees") (footnotes omitted).[33] The Commission, too, had long recognized the doctrine of respondeat superior in enforcement or disciplinary actions. *See Cady, Roberts & Co*., 40 S.E.C. 907, 911-12 (1961) (finding firm to have violated antifraud provisions of the securities laws solely on the basis of agency principles); *see also Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 362 (6th Cir. 1970) (holding that broker-dealer violated antifraud provisions due to misrepresentations of sales manager and various salespersons, affirming expulsion of broker-dealer from NASD membership, and stating that "[i]t has long been the position of the Commission that a broker-dealer may be sanctioned for the willful violations of its agents under the doctrine of *respondeat superior*"). In addition, in pre-*Central Bank* disciplinary proceedings, NASD disciplined broker-dealers for the acts of their representatives. *E.g*., *Dist. Bus. Conduct Comm. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Complaint No. LA-4154, 1989 NASD Dicip. LEXIS 33 (NASD Bd. of Governors Apr. 26, 1989) (disciplining brokerage firm for acts of representatives and noting that "a firm acts through its employees and is accountable for its employees' actions").

In the wake of *Central Bank*, however, courts began to debate whether respondeat superior remained a viable theory of secondary liability under Section 10(b). Most courts that have addressed the issue have held that respondeat superior remains applicable in actions brought under Section 10(b), while other courts have reached a contrary conclusion.[34] It appears

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[33] It is generally established that secondary liability may exist by virtue of respondeat superior, independent of the controlling person provisions, Section 20(a) of the Exchange Act and Section 15 of the Securities Act. *E.g., In re Villa*, 261 F.3d 1148, 1152 (11th Cir. 2001); *Marbury Mgmt.*, 629 F.2d at 716. The Third Circuit has held that respondeat superior should not be widely expanded in securities law but should be available against broker-dealers and accounting firms in view of the public trust of the firms involved and their duty to supervise. *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 182-83 (3d Cir. 1981).

[34] For post-*Central Bank* cases upholding or continuing to apply respondeat superior, see, for example: *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 100-01 (2d Cir. 2001); *Jairett v. First Montauk Sec. Corp*., 153 F. Supp. 2d 562, 570-74 (E.D. Pa. 2001); *Rivera v. Clark Melvin Sec. Corp*., 59 F. Supp. 2d 280, 295-96 (D.P.R. 1999), *complaint dismissed in part on other grounds*, 59 F. Supp. 2d 297 (D.P.R. 1999); *Vento & Co. of New York, LLC v. Metromedia Fiber Network, Inc.*, No. 97 Civ. 7751, 1999 U.S. Dist. LEXIS 3020, at *32-37 (S.D.N.Y. Mar. 17, 1999); *Levine v. Metal Recovery Tech., Inc*., 182 F.R.D. 112, 115 (D. Del. 1998); *Seolas v. Bilzerian*, 951 F. Supp. 978, 981-84 (D. Utah 1997); *Denten v. Merrill Lynch, Pierce, Fenner & Smith*, 887 F. Supp. 176 (N.D. Ill. 1995); *see also AT&T v. Winback &*

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that the Commission has sided with those courts that recognize the validity of respondeat superior after *Central Bank*.[35] Our post-*Central Bank* decisions have also recognized that a firm can be held to have violated securities laws through the acts of its officers or employees acting within the scope of their employment.[36] We continue to agree with the reasoning of those courts that recognize respondeat superior liability under Section 10(b) and Rule 10b-5. Therefore, we will continue to concur with the SEC and apply the doctrine of respondeat superior in NASD disciplinary proceedings.[37]

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Conserve Program, 42 F.3d 1421, 1429-32 (3d Cir. 1994) (discussing effect of *Central Bank* on the scope of liability under the Lanham Act). For cases holding the opposite, see, for example: *In re Fidelity/Micron Sec. Litig*., 964 F. Supp. 539, 544 & n.10 (D. Mass. 1997); *In re Prudential Ins. Co*., 975 F. Supp. 584, 612-13 (D.N.J. 1996), *rev'd on other grounds*, 133 F.3d 225 (3d Cir. 1998).

[35] *E.g.*, *Raymond James Fin. Servs., Inc.*, Initial Dec. Rel. No. 296, 2005 SEC LEXIS 2368 (Sept. 15, 2005) (upholding respondeat superior after *Central Bank* and pointing out that "corporations, including broker-dealers, have frequently been held liable for the actions of lower-level employees"), *notice of final decision*, Exchange Act Rel. No. 52810, 2005 SEC LEXIS 2995 (Nov. 21, 2005); *Bearcat,* 2004 SEC LEXIS 527, at *19 n.22 (firm violated Rule 10b-5 through acts of employees and disciplined for such violation, citing *Piper Cap. Mgmt., Inc.*, Exchange Act Rel. No. 48409, 2003 SEC LEXIS 2047 (Aug. 26, 2003), and *Rent-Way Sec. Litig*., 209 F. Supp. 2d 493, 522 (W.D. Pa. 2002), for the proposition that "fraud of an officer or employee is imputable to corporation when committed within scope of employment and for corporation's benefit"); *Castle Sec. Corp*., 53 S.E.C. 406, 411-12 (1998) (holding member firm liable for manipulation and markup violations committed by employee who "took actions on the broker-dealer's behalf"), *appeal dismissed*, No. 98-4232 (2d Cir. Nov. 13, 1998).

[36] *E.g.*, *Dep't of Enforcement v. U.S. Rica Fin., Inc.*, Complaint No. C01000003, 2003 NASD Discip. LEXIS 24, at *11-25, 55 (NAC Sept. 9, 2003) (brokerage firm violated Rule 10b-5 through acts of firm's president; brokerage firm expelled from membership); *Dep't of Enforcement v. Fiero*, Complaint No. CAF980002, 2002 NASD Discip. LEXIS 16, at *33-68, 111-12 (NAC Oct. 28, 2002) (attributing violations of SEC and NASD rules by firm president to brokerage firm and expelling brokerage firm from membership).

[37] Respondents argue that respondeat superior is directed at allocating economic loss, not "imposing regulatory discipline." As explained above, however, both the Commission and NASD have recognized respondeat superior in enforcement actions, both before and after *Central Bank*. The cases cited by respondents, none of which involve enforcement actions, are inapposite. *See Taber v. Maine*, 67 F.3d 1029, 1032 (2d Cir. 1995) (involving civil action for damages under the Federal Tort Claims Act); *Horn v. Duke Homes*, 755 F.2d 599, 601 (7th Cir. 1985) (involving private action under Title VII of the Civil Rights Act of 1964); *Jennings v. Davis*, 476 F.2d 1271, 1273 (8th Cir. 1973) (action for actual and punitive damages under 42 U.S.C. § 1983). Respondents also argue that the Exchange Act "does not authorize NASD to impose any liability on the basis of the common law." There is ample precedent, however, for

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b. Yankee Is Responsible for the Conduct of Its Brooklyn-Based Representatives

Respondents argue that the Brooklyn representatives were "independent contractors" and that, therefore, Yankee is not responsible for their misconduct under respondeat superior principles. We disagree.

The notion that a broker-dealer might escape responsibility for the actions of its registered representatives by virtue of such representatives' so-called status as "independent contractors" is antithetical to the whole purpose of the broker-dealer registration and supervision requirements. Through their duty to supervise, broker-dealers are required to control the activities of their registered representatives and other associated persons. Conduct Rule 3010. Through Section 15(a)(1) of the Exchange Act, natural persons who want to engage in a securities business must either register as a broker-dealer or associate with a broker-dealer that is registered. This scheme essentially mandates that natural persons engaged in a securities business be associated with a registered broker-dealer that is required to supervise them and that is accountable for failing to do so. *See* Membership and Registration Rule 1014(a)(9) and (10); Rule 3010. There is no third, "independent contractor" option that allows either the broker-dealer or its registered representatives to circumvent or negate the registered broker-dealer's supervisory duties or its obligation to control its representatives. Indeed, the Commission has stated in a Section 21(a) settlement order that it "does not recognize the concept of 'independent contractors' for purposes of the Exchange Act." *William V. Giordano*, Exchange Act Rel. No. 36742, 1996 SEC LEXIS 71, at *11 (Jan. 19, 1996).[38] Accordingly, we reject respondents' post-

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the proposition that a broker-dealer may be sanctioned in an SEC or NASD enforcement action for violations of the Exchange Act by its employees. The violation is of the Exchange Act rather than common law, and the doctrine of respondeat superior merely establishes that the broker-dealer may be held legally responsible for violations of the Exchange Act committed by its employees. Citing *General Bond & Share Co. v. SEC*, 39 F.3d 1451 (10th Cir. 1994), respondents also erroneously contend that a holding that respondeat superior liability exists under Section 10(b) would involve a change in NASD rules requiring fair notice and comment before enforcement. NASD has not changed its rules but rather is applying a legal principle that both it and the Commission have recognized for decades.

[38] *See also Gordon S. Macklin*, SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,303 (pub. avail. June 19, 1982) (indicating that broker-dealers "may not shift their obligation to control or supervise the activities of their independent contractor salespersons who are associated persons"); *NASD Notice to Members 86-65*, 1986 NASD LEXIS 386, at *2 (Sept. 1986) ("Irrespective of an individual's location or compensation arrangements, all associated persons are considered to be employees of the firm with which they are registered for purposes of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the member.").

hoc effort to avoid responsibility for the Brooklyn representatives on grounds they were "independent contractors."[39]

We also find that the Brooklyn-based representatives were acting within the scope of their employment when they solicited customers to invest in Silver Star, Golden Chief, and Western Media. Selling securities was what Yankee hired the representatives to do. Moreover, such sales were effected to serve Yankee, which profited from the activities, and took place at Yankee facilities. Accordingly, we hold Yankee responsible for the misconduct of the Brooklyn-based brokers under the doctrine of respondeat superior.

c. Market Regulation Did Not Allege That Kresge Was Liable Pursuant to Respondeat Superior

We dismiss the Hearing Panel's findings that Kresge also may be subject to discipline pursuant to respondeat superior. In its complaint, Market Regulation alleged that only Yankee was liable under this doctrine. *Cf. A.S. Goldmen & Co.*, 1999 NASD Discip. LEXIS 18, at *12 n.8 (declining to reach issue not alleged in complaint).

C. Respondents' Liability for the Yankee Representatives' Violations of NASD Conduct Rules

The Hearing Panel found that Yankee and Kresge were liable for the Brooklyn representatives' violations of NASD's suitability and antifraud rules, and, as a result, violated the high standards of commercial honor and just and equitable principles of trade required of NASD members and their associated persons.[40] We affirm the Hearing Panel's decision to hold Yankee

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[39] Apart from the legal conclusion that the Exchange Act does not recognize the status of "independent contractor," the Brooklyn-based representatives did not possess those characteristics ordinarily associated with independent contractors. The securities-related services provided by the Brooklyn brokers were part of Yankee's regular business. Indeed, the fact that Yankee registered the Brooklyn brokers necessarily means that Yankee viewed the Brooklyn representatives as "engaged in [its] investment banking or securities business." Membership and Registration Rule 1031. The Brooklyn-based brokers were registered as representatives of Yankee and held themselves out to the public as representatives of Yankee, and Yankee allowed them to do so. Also, Yankee was required to supervise these brokers, and Yankee and Kresge did purport to supervise these brokers, however deficient this supervision may have been in this particular case.

[40] Conduct Rule 2120 provides that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance." Conduct Rule 2310 requires that a member, "[i]n recommending to a customer the purchase, sale or exchange of any security, . . . shall have reasonable grounds for believing that the recommendation is suitable for such customer." Conduct Rule 2110 requires that a "member, in the conduct of his business, shall observe high standards of commercial honor

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responsible for these violations. As the Commission has held, "[i]t is well-established that a firm may be held accountable for the misconduct of its associated persons because it is through such persons that a firm acts." *SIG Specialists, Inc*., Exchange Act Rel. No. 51867, 2005 SEC LEXIS 1428, at *31 (June 17, 2005); *Prime Investors, Inc*., 53 S.E.C. 1, 5-6 (1997).[41] Accordingly, we affirm the Hearing Panel's decision that Yankee is liable for the Brooklyn representatives' violations of NASD's antifraud, suitability, and fair dealing rules.

We also affirm the Hearing Panel's decision to hold Kresge accountable for the Brooklyn brokers' violations of NASD's suitability and antifraud rules. Our finding in this regard is separate and apart from our finding above that Kresge failed to supervise, in violation of Conduct Rule 3040. Kresge was president of his firm and accordingly had an overarching responsibility for his firm's regulatory obligations. It is axiomatic that "the president of a brokerage firm is responsible for his firm's compliance with all applicable requirements unless and until he reasonably delegates a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his or her duties." *Kirk A. Knapp*, 51 S.E.C. 115, 126 n.50 (1992); *see also Gerhauser*, 53 S.E.C. at 940-41 (holding that president was responsible for net capital violations, because even though he may have effectively delegated responsibility to comply with net capital requirements to the firm's FINOP, he provided incorrect information relevant to the firm's net capital calculation to the FINOP and incurred responsibility for the net capital violations).

NASD's antifraud and suitability rules are *member firm* requirements. *See* Conduct Rule 2120 (requiring a "member" to refrain from using manipulative, deceptive, or fraudulent devices); Conduct Rule 2310 (requiring "a member" to comply with suitability requirements). We, therefore, find that it is consistent with *Knapp* to hold Kresge personally responsible for the

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and just and equitable principles of trade." NASD Rule 115 extends the requirements of NASD rules to persons associated with a member.

[41] Respondents argue that holding Yankee vicariously liable for their representatives' violations renders NASD Conduct Rule 3010, which requires firms to establish a system to supervise representatives, meaningless. The Commission, however, has rejected such an argument. In *SIG Specialists*, an NYSE member firm was censured and fined for NYSE rule violations committed by a specialist of the firm. The firm argued that failure to supervise was the only basis upon which a member firm could be disciplined for violations by an associated person. Rejecting that argument, the Commission cited *Armstrong, Jones & Co.*, 421 F.2d at 362, for the proposition that "[t]he fact that Congress enacted an additional provision giving the Commission the power to sanction firms for inadequate supervision does not limit the Commission's power to discipline a [firm] for its employees' acts." *SIG Specialists*, 2005 SEC LEXIS 1428, at *31-32 & nn. 34-35 (internal quotation marks omitted); *see also* Steinberg & Ferrara, *supra*, at § 4:37 (explaining that respondeat superior applies in SEC administrative enforcement proceedings initiated against broker-dealers, despite Sections 15(b)(4)(E) and 20(a) of the Exchange Act, which impose the duty to supervise and controlling person liability).

Yankee representatives' violations of NASD's antifraud and suitability rules, especially given the reckless manner in which he carried out his responsibilities in connection with the Brooklyn office. Kresge played an active role in creating the environment for violative activities by the Brooklyn-based representatives, turning a blind eye to the questionable qualifications and histories of the participants involved despite having a duty to ascertain their qualifications, and failing to put in place a reasonable system of supervision. Kresge also recklessly ignored the numerous red flags that predictably followed. Given the extent to which Kresge abdicated his responsibilities as president when approving the composition of the Brooklyn office and its putative supervisors, it was an extreme departure from the standards of care for Kresge simply to walk away almost as if this situation were someone else's problem. Moreover, had he been fulfilling his supervisory responsibilities, Kresge would have had ample and clear reasons to know that the Brooklyn-based brokers were not complying with applicable antifraud and suitability rules, especially considering the reckless way in which he staffed the Brooklyn office.

Accordingly, we affirm the Hearing Panel's decision to hold Yankee and Kresge liable for the Brooklyn representatives' violations of Conduct Rules 2120, 2310, and IM-2310-2.[42]

D. <u>Reporting Violations</u>

The Hearing Panel found that respondents failed to report to NASD 18 written customer complaints, in violation of Conduct Rules 3070(c) and 2110. We modify the Hearing Panel's findings.

Conduct Rule 3070(c) requires member firms to report to NASD on a quarterly basis statistical and summary information regarding customer complaints. "Complaint" includes "any written grievance by a customer involving the member or person associated with a member." Conduct Rule 3070(c). A firm's president is responsible for the firm's compliance with Rule 3070 unless and until he reasonably delegates responsibility for that obligation and neither knows nor has reason to know that such person's performance is deficient. *Dep't of Enforcement v. Fox & Co. Invs., Inc.*, Complaint No. C3A030017, 2005 NASD Discip. LEXIS 5, at *36 (NAC Feb. 24, 2005) (holding that a firm president violated Rule 3070(a)), *aff'd*, Exchange Act Rel. No. 52697, 2005 SEC LEXIS 2822 (Oct. 28, 2005).

During the fourth quarter of 2001 and the second quarter of 2002, Kresge, as president and compliance officer, was directly responsible for reporting customer complaints to NASD, and the Firm failed to report 11 customer complaints.[43] Respondents argue that Kresge had no

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[42] In light of this finding, we do not address in this case whether a president of a broker-dealer may be held responsible pursuant to Section 20(a) of the Exchange Act for firm representatives' violations of NASD rules alone.

[43] Kresge delegated the task of reporting customer complaints to Korwasky, beginning with those complaints received during the first quarter of 2002. Korwasky resigned from Yankee in June 2002. As a result, Kresge was again responsible for filing the report of customer complaints received during the second quarter of 2002.

knowledge of any complaints because Giordano "deliberately hid" them from Kresge. The preponderance of the evidence, however, suggests otherwise. Kresge admitted that he was aware of complaints about Dugo and Anderson made in the second quarter of 2002. While Korwasky was receiving complaints in "piecemeal" fashion, he nevertheless testified that he had received complaints concerning Dugo and Anderson in the first quarter of 2002, and shared information about them with Kresge, and that Kresge had forwarded complaints he had received to Korwasky, including complaints about Anderson.[44] Accordingly, we affirm the Hearing Panel's finding that respondents failed to report the 11 customer complaints received during the fourth quarter of 2001 and the second quarter of 2002.

During the first quarter of 2002, Kresge delegated the task of reporting customer complaints to Korwasky, and the Firm failed to report seven customer complaints. The record demonstrates that Korwasky was responsible for failing to report at least three complaints.[45] While the Firm is responsible for such failures, under these circumstances Kresge is not. There is nothing to suggest that Kresge's delegation of this responsibility to Korwasky was unreasonable. Moreover, considering the short period of time involved, and the fact that there is no evidence that Kresge was, or should have been, aware that Korwasky's execution of this responsibility was deficient, Kresge did not fail to carry out his responsibility.

Accordingly, we find that Yankee failed to report 14 customer complaints and that Kresge was responsible for Yankee's failure to report 11 customer complaints, in violation of Conduct Rules 3070(c) and 2110.

E. Failure to Register Ferragamo

The Hearing Panel found that respondents failed to register Ferragamo as a principal and a representative, in violation of Membership and Registration Rules 1021(a) and 1031(a), IM-1000-1 and IM-1000-3 and Conduct Rule 2110. We affirm the Hearing Panel's findings.

Rule 1031(a) provides that "[a]ll persons engaged or to be engaged in the investment banking or securities business of a member who are to function as representatives shall be

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[44] In any event, before Kresge can be heard to complain that he did not receive such complaints, he first must demonstrate that written supervisory procedures required all customer complaints to be forwarded to him. Kresge failed to make any such showing.

[45] The complaint alleged that Korwasky failed to report just three customer complaints. Finding that Korwasky had personal knowledge of only one complaint, the Hearing Panel held him responsible for failing to report just that single complaint. The record, however, demonstrates that Korwasky had received copies of several customer complaints. For example, Korwasky admitted that he was aware of several complaints involving Dugo and Anderson, and the record demonstrates that Korwasky was aware of the three complaints he allegedly failed to report. Accordingly, for purposes of assessing respondents' liability, we modify the Hearing Panel's finding and find that Korwasky failed to report *three* customer complaints.

registered as such with NASD." Similarly, Rule 1021(a) requires all "principals" to be registered. Rule 1021(b) defines the term principal to include all sole proprietors, officers, partners, managers of OSJs, and directors of corporations who are "actively engaged in the management of the member's investment banking or securities business." Investment banking or securities business includes the functions of supervision, solicitation, conduct of business in securities or the training of persons associated with a member for any of these functions. Rules 1021(b), 1031(b). Membership and Registration IM-1000-3 provides that "[t]he failure of any member to register an employee, who should be so registered, as a Registered Representative may be deemed to be conduct inconsistent with just and equitable principles of trade."

Under these standards, respondents should have registered Ferragamo as a representative and a principal. Ferragamo played key roles in the hiring of Giordano and the Brooklyn brokers. Ferragamo was present whenever there were discussions concerning the Brooklyn office, including meetings to discuss Gliwa's supervisory role. In fact, Ferragamo was constantly in the Brooklyn office and even was present when Korwasky visited the Staten Island office. Ferragamo also played a role in managing the mechanics of the securities business. For example, Ferragamo informed Kresge that he intended to direct certain orders taken by the Brooklyn office to third party broker-dealers. Ferragamo also provided the financial support for the office, including paying bills. *See Vladislav S. Zubkis*, 53 S.E.C. 794, 799-800 (1998) (holding that a person controlled a firm and was an "associated person" based in part on his payment of firm expenses such as rent, telephone charges, and compensation of brokers). Moreover, Ferragamo acted as a manager of an office that should have been designated as an OSJ. Rule 1021(b).

Kresge argues that he should not be held responsible because he was told that Ferragamo would not engage in a securities business. It is unclear, however, what Kresge thought Ferragamo was doing in Yankee's offices on a regular basis if not engaging in a securities business. Indeed, Kresge seemed simply to turn a blind eye to this entire issue, despite Korwasky's urging that Ferragamo be banned from the office. For the reasons explained above, we affirm the Hearing Panel's findings that Yankee and Kresge failed to register Ferragamo as a representative and a principal of Yankee.[46]

V. Procedural Argument

On appeal, respondents argue that counsel for Market Regulation falsely represented to the Hearing Panel and the NAC that a purported arbitration matter was pending against Anderson when Kresge hired him in 2001. Respondents contend that, for this reason, the Hearing Panel's decision should be vacated. We disagree.[47]

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[46] Yankee also failed to disclose in a February 2002 amendment to its Uniform Application for Broker-Dealer Registration ("Form BD"), as required, that Ferragamo was partially financing the operations of Yankee, in violation of Membership and Registration IM-1000-1.

[47] Respondents raised these issues in letters filed on appeal. Treating respondents' letters as a motion, the NAC Subcommittee denied respondents' motion on the grounds that it failed to

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At the evidentiary hearing, Market Regulation asked Kresge if he was aware that Anderson was the subject of an arbitration claim that was "apparently" issued in September of 2001. Kresge replied that he was not aware of such an arbitration. Citing this testimony, the Hearing Panel found that Kresge, at the time he hired Anderson, was "unaware" that Anderson "was the subject of one customer arbitration claim for unauthorized trading." In holding respondents accountable for failing to maintain an adequate supervisory system, the Hearing Panel also stated that Kresge "never asked about pending or reported arbitrations involving the brokers."

On appeal, respondents assert that Market Regulation had no factual foundation for asking Kresge about a pending arbitration matter against Anderson. Essentially, respondents argue that a CRD report for Anderson, which Market Regulation submitted into evidence, demonstrates that there was no arbitration matter pending against Anderson in September 2001. Claiming that Market Regulation knew that there was no such arbitration, respondents argue that the Hearing Panel's findings on this issue were procured by "fraud" and that the entire decision should be vacated. In response, Market Regulation argues that the Anderson CRD report does show that an arbitration matter was pending against him in September 2001.

We find that the Hearing Panel erred in finding that there was a pending arbitration matter against Anderson that Kresge failed to discover. Anderson's CRD report, read in its entirety shows that, although a customer made a "complaint" about Anderson in 2001, such customer did not file an arbitration claim against Anderson until 2003. Our review is de novo, however, and, on the basis of the entire record, we find that this error changes neither our conclusion that Kresge failed to supervise nor any of our other findings. *Frank J. Custable*, 51 S.E.C. 855, 862 (1993).

Moreover, there is no evidence to suggest that Market Regulation knowingly misrepresented facts about the purported arbitration. We therefore find no fraud perpetrated by Market Regulation. Accordingly, we have considered and reject respondents' procedural argument.

VI. Sanctions

Like the Hearing Panel, we aggregate respondents' misconduct for purposes of imposing sanctions, because such misconduct emanated from a single, underlying problem: respondents' addition of, and failure to monitor, the Brooklyn office. Based upon our assessment of the

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request specific relief. Subsequently, respondents filed additional letters that amounted to a motion for reconsideration. We grant respondents' motion for reconsideration and address the outstanding motion in this decision.

principal considerations in the NASD Sanction Guidelines ("Guidelines") (2001 ed.),[48] we agree that the violative conduct was egregious and involved systematic supervision failures, and that substantial sanctions are appropriate.

Here, the fraudulent solicitations, unsuitable recommendations, and supervisory failures occurred over a six-month period, involved solicitations of numerous customers, and led directly to at least $3.6 million in customer losses. *See* Guidelines at 9-10 (Principal Consideration Nos. 8, 9, 11). In addition, respondents' conduct resulted in the potential for their monetary gain, through the receipt of ticket charges and commission overrides from Brooklyn-generated business. *See id*. (Principal Consideration No. 17). Moreover, respondents' failure to supervise the Brooklyn office was, at the least, reckless. *See id.* (Principal Consideration No. 13). Despite the presence of numerous red flags, Kresge paid minimal attention to his responsibility to investigate the qualifications of those he hired, ignored signs that should have resulted in additional supervisory scrutiny, and failed to implement an adequate supervisory system. *See id.* at 108 (Supervision, Principal Consideration Nos. 1, 3). Moreover, respondents intentionally allowed Ferragamo to avoid registration.[49]

We agree with the Hearing Panel's decision to expel Yankee. The Hearing Panel's decision to bar Kresge only in all principal and supervisory capacities, however, is not commensurate with the seriousness of Kresge's violations. Accordingly, we expel Yankee and we bar Kresge in all capacities. Such sanctions are consistent with the Guidelines.

We also agree with the Hearing Panel that restitution is appropriate here. Restitution is "a traditional remedy used to restore the status quo where otherwise a wrongdoer would unjustly benefit or his victim would unjustly suffer loss." *David J. Dambro*, 51 S.E.C. 513, 518 (1993); *Toney L. Reed*, 51 S.E.C. 1009, 1013 (1994) (restitution is "founded on the principle that a wrongdoer shall not be unjustly enriched by his wrongdoing, or that the wrongdoer should restore his victim to the status quo ante"). As the Guidelines direct, "[a]djudicators may order restitution when an identifiable person, member firm, or other party has suffered a quantifiable loss as a result of a respondent's misconduct, particularly where a respondent has benefitted from the misconduct." Guidelines at 6 (General Principles Applicable To All Sanction Determinations); *see also Reed*, 51 S.E.C. at 1013 (Commission expressing the "desire to see that monetary amounts assessed by the NASD be turned over to wronged customers where they

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[48] *See* Guidelines at 9-10 (Principal Considerations In Determining Sanctions), 96 (Misrepresentations Or Material Omissions Of Fact), 99 (Suitability – Unsuitable Recommendations) 108 (Supervision – Failure To Supervise), 82 (Reportable Events Under Conduct Rule 3070 – Failing To Report), 52 (Registration Violations).

[49] Respondents argue that NASD permitted the Brooklyn representatives to become associated with Yankee and should have warned Yankee about them. As the Commission has held, however, NASD's approval of an association "does not relieve [respondents] of their supervisory responsibilities." *Thornton*, 53 S.E.C. at 1216 & n.10 (*citing Custable*, 51 S.E.C. at 860 n.14).

are identifiable"). At times, the appropriate amount of restitution "may exceed the amount by which the wrongdoer was unjustly enriched, if equity would demand that the wrongdoer, rather than the customer, bear the loss." *Reed*, 51 S.E.C. at 1013-14 & n.22 (*citing Restatement of Restitution* § 1 cmt. e (1937)).

As our past cases demonstrate, we have ordered respondents to pay restitution to customers in cases involving fraudulent solicitations,[50] unsuitable recommendations,[51] and supervisory violations.[52] As between respondents and the 10 customer witnesses who were placed in unsuitable investments and defrauded, equity requires respondents to bear the burden of the loss and "to return the customer[s] to the position occupied prior to the improper recommendation." *Dambro*, 51 S.E.C. at 518.

The Hearing Panel ordered respondents, jointly and severally, to pay $3,866,426 in restitution to the 10 customer witnesses, plus interest. This amount reflected the total losses as of the date of the hearing, realized and unrealized, that the customers incurred through investing in Silver Star, Golden Chief, and Western Media, minus any restitution already received. We affirm that part of the restitution amount that included the 10 customers' realized losses, as well as the customers' unrealized losses in Silver Star and Golden Chief. As of March 31, 2004, approximately four weeks before the hearing, Silver Star was trading at $.01/share and Golden Chief was trading at $.0001/share. Because these securities were worthless, it was appropriate to order restitution of the customers' unrealized losses. *See, e.g.*, *Faber*, 2004 SEC LEXIS 277, at *13 (ordering restitution of unrealized losses in "nearly worthless" stock).

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[50] *See Dep't of Enforcement v. Kapara*, Complaint No. C10030110, 2005 NASD Discip. LEXIS 41, at *36 (NAC May 25, 2005) (ordering a general securities representative to pay $780,000 in restitution to two customers to whom he sold securities through material misrepresentations and explaining that a representative's "deception makes restitution an appropriate sanction").

[51] *See Faber*, 2004 SEC LEXIS 277, at *28 (affirming NASD's findings that a general securities principal sold a speculative security to two customers through the use of fraudulent solicitations and, as to one of those customers, unsuitable recommendations and affirming order that Faber pay $82,220 in restitution).

[52] *See Dist. Bus. Conduct Comm. v. Inv. Mgmt. & Research, Inc.*, Complaint No. C3B940028, 1997 NASD Discip. LEXIS 43 (NBCC July 25, 1997) (ordering a firm to pay restitution for failing to supervise a branch manager who made 115 unsuitable recommendations to customers to switch mutual funds), *aff'd and sanctions modified on other grounds sub nom. Kenneth Krull*, 53 S.E.C. 1101 (1998).

We modify that part of the restitution award, however, that included GA's and DW's[53] unrealized losses in Western Media as of March 31, 2004. As of that date, GA's unrealized losses in Western Media were $230,400, and DW's unrealized losses were $42,000. At that time, Western Media was trading at $.56/share and was not a worthless security. The record is silent as to whether, since the hearing, GA and DW have sold any of the Western Media shares they held as of March 31, 2004 or, if they continue to hold any such shares, the current value of their holdings. As a result, it is not clear if the Hearing Panel's order will, in fact, return these two customers to the status quo ante. Therefore, if GA and DW have sold all or part of the shares of Western Media they held as of March 31, 2004, the amount of restitution should reflect GA's and DW's realized losses. If GA and DW continue to hold any of the shares of Western Media that they held as of March 31, 2004, the amount of restitution should include any unrealized losses in their holdings in Western Media as of the effective date of this order. *Cf. Dambro*, 51 S.E.C. at 519 (utilizing a similar approach for calculating restitution); *Kapara*, 2005 NASD Discip. LEXIS 41, at *36-37 ("As a condition of restitution, the person entitled to restitution must return or offer to return that which he received as part of the transaction, or its value, unless such thing has, among other facts, been continuously worthless *or consists of money that can be credited if restitution is granted*.") (emphasis added).

VII. Conclusion

We affirm the Hearing Panel's decision that Yankee and Kresge: (1) are responsible for the Brooklyn brokers' fraudulent solicitations and unsuitable recommendations, in violation of Section 10(b) of the Exchange Act, Exchange Act Rule 10b-5, and Conduct Rules 2120, 2310, 2110 and IM-2310-2; (2) failed to supervise and establish a supervisory system, in violation of Conduct Rules 3010 and 2110; and (3) failed to register Ferragamo as a principal and representative, in violation of Membership and Registration Rules 1021(a), 1031(a), IM-1000-3 and Conduct Rule 2110. We also find that Yankee failed to report 14 customer complaints and that Kresge failed to report 11 customer complaints, in violation of Rules 3070(c) and 2110, modifying the Hearing Panel's finding.

For these violations, we bar Kresge in all capacities, and we expel Yankee. The bar and expulsion imposed herein are effective upon service of this decision.

We also order Kresge and Yankee, jointly and severally, to pay restitution, plus interest, as follows: (1) $1,050,575 to customer JC; (2) $1,191,691 to customer WB; (3) $42,240 to customer GR; (4) $224,354 to customer JL; (5) $236,985 to customer JH; (6) $7,377 to customer RP; (7) $14,400 to customer GW; (8) $58,704 to customer AW; (9) $20,100 to customer DW, plus the realized and/or unrealized losses in the 50,000 shares of Western Media that DW held as of March 31, 2004, calculated as of the effective date of this order; and (10) $763,700 to customer GA, plus the amount of realized and/or unrealized losses in the 240,000 shares of Western Media that GA held as of March 31, 2004, calculated as of the effective date of this

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[53] The calculations concerning DW include the losses incurred in the accounts of his three children.

order.[54] Finally, we affirm the imposition of $7,820.22 in costs, and we further assess respondents costs on appeal of $1,699.39.[55]

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney, Senior Vice President
and Corporate Secretary

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[54] Interest shall be paid from May 1, 2002, at the rate established for the underpayment of income taxes in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a). With respect to all customers except GA and DW: Respondents shall submit to Market Regulation proof of payment within 30 days of the effective date of this decision. With respect to customers GA and DW: Within 30 days of the date of this order, respondents are required to pay GA $763,700 and DW $20,100, their realized losses, and shall submit to Market Regulation proof of payment. Within 60 days of the date of this order, Market Regulation shall inform respondents by letter the amounts that respondents owe in restitution to customers DW and GA for the 50,000 and 240,000 shares of Western Media that DW and GA, respectively, continued to hold as of March 31, 2004, which Market Regulation shall calculate in a manner consistent with this order. Within 30 days of the date of Market Regulation's letter, respondents shall submit to Market Regulation additional proof of payment.

Where customers cannot be located, unpaid restitution should be paid to the appropriate escheat, unclaimed-property, or abandoned property fund for the states of the customers' last known residences.

[55] We have considered and reject without discussion all other arguments advanced by respondents.