

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of the Association of

X

in a

Supervisory Capacity

with

The Sponsoring Firm

Redacted Decision

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

Decision No. SD04004

Date: 2004

On May 27, 2003, the Sponsoring Firm ¹("the Firm") submitted a Membership Continuance Application ("the Application") seeking to allow X to associate with the Sponsoring Firm in a supervisory capacity.² In November 2003, a subcommittee ("Hearing Panel") of NASD's Statutory Disqualification Committee held a hearing on the matter. X appeared, accompanied by: (1) his counsel, (2) his proposed supervisor, and (3) the Sponsoring Firm's General Counsel. PL appeared on behalf of NASD's Department of Member Regulation ("Member Regulation").

A. X's Statutorily Disqualifying Event

X became subject to a statutory disqualification because in February 2002, the Securities and Exchange Commission ("Commission") entered, and X consented to, an Order Instituting

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

² We note that the Sponsoring Firm's Application to allow X to associate with the Firm in a supervisory capacity still places certain limits on his supervisory responsibilities, including a prohibition that precludes him from supervising the Firm's registered representatives. We therefore view the Application as requesting that X be allowed to associate with the Sponsoring Firm in a limited supervisory capacity.

Public Proceedings, Making Findings and Imposing Remedial Sanctions ("Commission Order"). The Commission Order barred X from association with any broker-dealer in a supervisory capacity, but provided that he could reapply for association with the appropriate self-regulatory organization after one year and three months. X was also required to pay a \$15,000 fine.³ The Commission, however, allowed X to continue to be associated with the Sponsoring Firm as a supervised registered representative.

The Commission Order arose from the failure of the Sponsoring Firm and X to supervise brokers reasonably in the Firm's State 1 and State 2 offices. These brokers offered and sold over \$6.4 million in unregistered securities without the Sponsoring Firm's approval in violation of Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933 ("Securities Act") and Sections 10(b) and 15(a) of the Exchange Act and Rule 10b-5 thereunder. The brokers misappropriated most of the funds raised from the sale of the unregistered securities and converted a substantial portion of those funds for their own benefit. In addition, the brokers used these funds to make principal and interest payments to other investors who had invested in the securities at earlier points in time, as well as to investors who had lost money in prior investments with the brokers.

B. Background Information

1. X

(a) General Background

X has been in the securities industry since January 1986. He passed the: (1) Series 7 exam (general securities representative) in January 1986; (2) Series 63 exam (uniform securities agent state) in April 1986; (3) Series 24 exam (general securities principal) in May 1991 and December 1995⁴; (4) Series 27 exam (financial and operations principal) in May 1991; (5) Series 4 exam (registered options principal) in December 1993; and (6) Series 53 exam (municipal securities principal) in June 1995. He has been with the Sponsoring Firm from April 1991 to the present. X is the Sponsoring Firm's president and he currently owns 100 percent of the Sponsoring Firm.

(b) Regulatory History

³ The Commission Order also found that the Sponsoring Firm failed to establish written supervisory procedures, or a system for implementing such procedures, that were reasonably designed to prevent or detect violations of the federal securities laws in willful violation of Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 17a-3 and 17a-4 thereunder.

⁴ Pursuant to a Letter of Acceptance Waiver and Consent ("AWC") submitted to NASD, X was required to retake the Series 24 examination in 1995.

NASD's Central Registration Depository ("CRD[®]") records show that since the Commission Order was issued in February 2002, X has been named in an arbitration complaint filed by two clients of a Sponsoring Firm registered representative. The complaint alleged that trading activity in their account resulted in losses exceeding \$1.4 million.⁵

In addition to the arbitration claim, X's CRD record includes one complaint filed with NASD that occurred after the Commission Order was issued.⁶ In July 1998, a customer filed a complaint against X in his capacity as president of the Sponsoring Firm. The complaint alleged that X knew about and consented to the alleged selling of \$200,000 of unregistered securities that were sold away from the Firm by a terminated broker.⁷

X's CRD record also includes one disciplinary matter prior to the issuance of the Commission Order. In 1995, X submitted and NASD accepted an AWC for violations of Article II, Sections 1 and 27 of the Rules of Fair Practice (currently NASD Rules 2110 and 3010). As a result of the AWC, NASD fined X and the Sponsoring Firm \$5,000, jointly and severally, for failing to establish and enforce written supervisory procedures as well as establish an adequate supervisory system. In addition, NASD ordered X to requalify as a general securities principal.

1. The Firm

(a) General Background

The Sponsoring Firm became a member of NASD in February 1985. The Firm has one office of supervisory jurisdiction and 24 branch offices. The Sponsoring Firm employs 18 registered principals and 53 registered representatives. The Sponsoring Firm sells corporate debt securities, corporate equity securities, mutual funds, tax shelters, and limited partnerships in primary distributions. The Sponsoring Firm also sells variable life insurance and annuities. In addition, the Sponsoring Firm acts as a government securities dealer, a government securities broker, and a put-and-call broker/dealer/option writer.

⁵ At the hearing, Employee 1 indicated that this arbitration claim had been reduced to approximately \$480,000 and he submitted X's amended Uniform Application for Securities Industry Registration ("Form U4"). X's Form U4 states that an analysis of the clients' accounts revealed that after withdrawals by the clients, the account declined in value by less than \$200,000 after initial deposits of more than \$1.7 million. In addition, X's Form U4 states that X had no personal involvement or contact regarding the transaction activity of the account and was named only in his capacity as president of the Firm.

⁶ X was also named in three additional customer complaints in his capacity as president of the Sponsoring Firm, but he was subsequently dismissed from these actions.

⁷ This matter is still pending.

(b) Regulatory History

The Sponsoring Firm has been the subject of two regulatory actions. These actions include: (1) a March 2001 allegation leading to a \$30,000 disgorgement by the State 1 Securities Division, plus \$11,000 in interest, for the Sponsoring Firm's failure to supervise the actions of a State 1-based former registered representative who sold unregistered promissory notes without the Sponsoring Firm's knowledge and consent; and (2) a \$5,000 fine by NASD for the Sponsoring Firm's failure to establish and enforce appropriate supervisory procedures as well as an adequate supervisory system arising from an AWC submitted by the Sponsoring Firm in 1995.

In addition, the Sponsoring Firm has been involved in: (1) a \$65,091 payment in July 2000 to a customer as a result of an unauthorized wire transfer; (2) a \$45,000 reimbursement to a customer to settle an allegation of an unauthorized wire transfer arising from a November 1999 allegation; and (3) a \$250,000 finding of liability against the Sponsoring Firm for an alleged breach of fiduciary duty, failure to supervise and negligence in the sale of a private placement arising from a customer complaint filed in September 1998.

Finally, an NASD June 1999 routine examination of the Sponsoring Firm resulted in a compliance conference addressing the following issues: (1) during a period in March 1999, NASD staff noted that the Firm failed to include execution time on its order tickets; (2) the Firm failed to have evidence that it had entered into a network and brokerage affiliate agreement with Firm 1; and (3) the Firm violated its restriction agreement with NASD by participating as a selling group member in firm commitment underwritings on three separate occasions in 1999.⁸

C. X's Proposed Business Activities and Supervision

The Sponsoring Firm proposes to employ X as its president and chief executive officer. Under the Sponsoring Firm's plan, X would not directly supervise any of the Sponsoring Firm's registered representatives. X, however, would be involved in hiring decisions and would be responsible for setting company strategy and policy.

⁸ The record also shows that in April 1995, State 3 alleged that the Sponsoring Firm violated the State 3 Securities Code by failing to post a surety bond in lieu of its net capital requirement. According to the Sponsoring Firm, however, State 3 made this allegation based on a reporting error made by Firm 2, an insurance management company. In May 1995, Firm 2 sent the Sponsoring Firm a letter asking the Firm to disregard its notice of cancellation for the bond. In September 2001, the Sponsoring Firm submitted a letter informing NASD staff of the error and indicating that State 3 was unable to locate any documents relating to a pending action against the Sponsoring Firm. In addition, in February 2002, Firm 3 revoked the Firm's bond as a result of the occurrence of claims under that bond. The Firm, however, secured an alternative bond with the same coverage limits.

The Sponsoring Firm proposes that the Proposed Supervisor serve as X's direct supervisor. The Proposed Supervisor, who is the Firm's Chief Compliance Officer, has been in the securities industry for more than 30 years. In addition, the Proposed Supervisor has six years of experience on NASD's District Business Conduct Committee ("DBCC") for District 11.⁹ The Proposed Supervisor's resume indicates that he is a former Senior Vice President of Firm 4 and is currently registered as a Series 4, 7, 24, 27, 53, 55 and 63.

While serving as Firm 4's Senior Vice President, the Proposed Supervisor was named in: (1) a State 4 action alleging a failure to supervise that was ultimately dismissed against him with prejudice, and (2) an NASD arbitration claim that awarded \$700,000 to the complaining customer. The Proposed Supervisor's Form U4, however, states that he was named in the arbitration complaint as a controlling principal along with other firm principals and that he "had no oversight responsibilities for the alleged perpetrators." The Proposed Supervisor does not have any other informal or formal disciplinary history.

D. Member Regulation's Recommendation

Member Regulation recommends that the Application be denied. Member Regulation's recommendation was partially based on the fact that since the Commission Order was issued, X had been named in an arbitration complaint alleging over \$1.4 million in damages. Member Regulation concluded that this allegation reflected poorly on X's ability to supervise representatives and that allowing X to resume his supervisory responsibilities at the Sponsoring Firm would not serve the public interest. In addition, Member Regulation expressed concern as to whether any of the Firm's employees had enough experience to supervise X. Member Regulation also indicated that it would be difficult for even an experienced employee to supervise X in light of the fact that X still owns 100 percent of the Firm.

E. Discussion

After carefully reviewing the entire record in this matter, we approve the Sponsoring Firm's Application to employ X in a supervisory capacity. We approve the Application because of the significant steps that the Firm has taken to correct deficiencies in its supervisory system and protect investors from the problems that initially caused the Commission to bar X. In addition, we find that X has taken full responsibility for his prior misconduct and has made a serious commitment to protecting investors from any future harm.

1. The Firm Has Taken Significant Steps to Protect Investors from Future Harm

In its role as a regulator of the securities industry, NASD has a responsibility to evaluate applications to act in registered capacities by scrutinizing all of the facts and circumstances surrounding an applicant who comes before it seeking readmission. Even though the Commission has granted the person the right to seek readmission, it remains NASD's

⁹ The Proposed Supervisor served on the DBCC for District 11 from 1986 to 1992.

responsibility to evaluate whether the readmission of the applicant will be in the public interest and will be consistent with the protection of investors.

In this instance, X was found to have failed reasonably to supervise a group of brokers who engaged in a fraudulent scheme to steal millions of dollars from investors. The Commission Order noted that X's failures were the result of both the Firm's inadequate written supervisory procedures and the Firm's failure to establish a system to implement its supervisory procedures. Specifically, the Commission Order stated that the Sponsoring Firm's written procedures did not describe in adequate detail the roles or responsibilities of the Sponsoring Firm's principals, nor did they clearly allocate responsibility for specific supervisory duties to those principals. In addition, the Commission Order concluded that the Sponsoring Firm's written procedures failed to provide for a system of follow-up and review to ensure that supervision was being diligently exercised. For example, during the period when the violations occurred, the Sponsoring Firm had failed to track the Firm's correspondence, conduct scheduled inspections or maintain a complete blotter of its sales.

The Commission Order instructed the Sponsoring Firm to hire an independent consultant ("Consultant") to conduct a comprehensive review of the Sponsoring Firm's supervisory and compliance procedures and recommend a system to correct deficiencies in these procedures. The Commission Order also required the Consultant to identify a system for maintaining records that would verify the Sponsoring Firm's compliance with the Consultant's recommendations.

The Sponsoring Firm has presented evidence that the Firm has met its obligation to hire a Consultant and that the Sponsoring Firm has either substantially or fully complied with all of the Consultant's recommendations to cure the prior defects in the Firm's supervisory system. At the hearing, X also testified that the Sponsoring Firm has spent over \$90,000 to overhaul its supervisory system. In addition, the Proposed Supervisor, an individual with substantial industry experience, testified that he is convinced that the Sponsoring Firm will commit the resources necessary to ensure that an adequate supervisory system remains in place. Considering the substantial steps taken by the Sponsoring Firm to resolve the deficiencies in its supervisory procedures and protect investors from future harm, we believe that X should be allowed to associate with the Sponsoring Firm in a supervisory capacity.

We acknowledge Member Regulation's concern that the Sponsoring Firm's employees may not be able to supervise X adequately because he continues to own 100 percent of the Firm. However, X's proposed supervisor has had experience as a Senior Vice President at another small firm that gives him the ability to understand and identify potential problems relevant to a firm of the Sponsoring Firm's size. In addition, the Proposed Supervisor has more than 30 years of industry experience and has acknowledged that he understands the heightened responsibility associated with supervising an individual who is a 100 percent owner of the Firm. The Sponsoring Firm also appears to be well positioned to supervise X in that it has proposed a committee to support the Proposed Supervisor in his supervision of X and an extensive program to monitor X, with regular supervision by both the Proposed Supervisor and the committee. We conclude that the Sponsoring Firm's proposed supervision of X will be sufficient to allow X to associate with the Sponsoring Firm in a supervisory capacity.

2. X Has Taken Full Responsibility for His Prior Misconduct

We are also persuaded that allowing X to associate with the Sponsoring Firm in a supervisory capacity will not cause harm to the Firm's customers because X has taken full responsibility for his prior misconduct and appears to be committed to avoiding any future harm to investors. For example, the record indicates that X actively promoted and agreed to a multi-party settlement before a United States District Court. This settlement, agreed to in November 1999, provides for restitution to investors who were victimized because of the Sponsoring Firm's failure to supervise its brokers. The settlement is valued at \$3 million, of which X is responsible for approximately \$2.5 million.¹⁰

Moreover, X and the Sponsoring Firm have performed the tasks required by the Commission Order by hiring the Consultant and complying with the Consultant's recommendations for improving the Firm's supervisory system. In addition, X testified that he is aware of the damage that his prior misconduct inflicted on the aggrieved customers, as well as on both his and the Firm's reputation. X also acknowledged that although the Firm will remain tarnished by this misconduct, he is committed to taking the steps necessary to restore investors' confidence in the Firm. Consequently, we find that it is consistent with NASD's objective of investor protection to allow X to associate with the Sponsoring Firm in a supervisory capacity.

We order that the Sponsoring Firm implement a plan of supervision, the details of which are as follows:

1. X will not be assigned as a direct supervisor for any registered representatives.
2. X will not serve as Chief Compliance Officer of the Sponsoring Firm.
3. The Sponsoring Firm will rewrite its supervisory procedures to establish clearly that the Proposed Supervisor will be X's primary supervisor.
4. X will work out of an office at the same physical location as the Proposed Supervisor.
5. The Proposed Supervisor will conduct meetings with X on a monthly basis to review X's role in compliance and supervisory matters at the Firm.
6. The Proposed Supervisor will maintain a written record of these meetings and document all matters addressed.

¹⁰ The record indicates that the settlement involves yearly payments to plaintiffs over the next seven years and that one of the Sponsoring Firm's affiliates is also responsible for contributing to the \$2.5 million that X is obligated to pay under the settlement.

7. X and the Firm will establish a committee that will be responsible for a quarterly review of certain of the Firm's policies and procedures in areas identified in the Commission Order and listed below in items (a) through (f). The committee shall initially be composed of the Chief Operating Officer, Chief Financial Officer and General Counsel. The committee will maintain and preserve a written record of its review and, as necessary, make recommendations to X and the Proposed Supervisor to ensure that X and the Firm maintain adequate policies and procedures in the following areas:
 - a. Procedures regarding the Firm's investigation of the character, qualifications and experience of registered representatives seeking affiliation with the Sponsoring Firm.
 - b. Procedures and documentation requirements concerning the on-site inspections of the Sponsoring Firm's offices of supervisory jurisdiction, branch offices, and non-branch offices.
 - c. Procedures and their implementation with respect to review and approval or disapproval of outside business activities by the Firm's registered representatives.
 - d. Procedures concerning obtaining and reviewing correspondence of the Firm's registered representatives.
 - e. Procedures concerning the Firm's review of and response to customer complaints.
 - f. Procedures for maintaining a complete blotter of sales of mutual funds and direct participation programs.
8. The Proposed Supervisor shall meet with the committee on a quarterly basis to discuss his efforts to supervise X.
9. As necessary, the Proposed Supervisor shall seek the advice and counsel of the committee on any material issues or matters concerning compliance and supervision on which the Proposed Supervisor and X do not agree. If requested by the Proposed Supervisor, the committee will offer written advice or recommendations to him and X on such issues or matters.
10. The committee will conduct an annual review of the Firm's Written Supervisory Procedures Manual and Compliance Manual and, as necessary, provide updates or written comments on such manuals.

11. No member of the committee shall have been the subject of a disciplinary action by the Commission or NASD within the past 10 years.
12. Committee members may only be replaced, terminated or sanctioned by the majority vote of X, the Proposed Supervisor, and the Firm's Director of Supervision. The majority vote of these individuals shall also be required to replace a member of the committee or fill a vacancy on the committee. If there is a change in the membership of the committee, notification of such change shall be provided to Member Regulation not later than 10 business days after such change.
13. The Proposed Supervisor will review and have the power to veto any of X's decisions to hire or fire employees with supervisory responsibility or registered representatives.
14. The Sponsoring Firm must obtain prior approval from Member Regulation if it wishes to change X's primary supervisor from the Proposed Supervisor to another person.
15. The Sponsoring Firm must retain an independent consultant acceptable to Member Regulation for a period of two years to certify on an annual basis that the Sponsoring Firm is in compliance with the preceding plan of supervision.

We conclude that allowing X to re-enter the securities industry in a supervisory capacity at this time would not present an unreasonable risk of harm to the market or investors and would not be contrary to the public interest.¹¹ We therefore approve the Sponsoring Firm's Application to employ X in a supervisory capacity.

Accordingly, in conformity with the provisions of SEC Rule 19h-1, the association of X in a supervisory capacity, according to the terms and conditions set forth herein, will become effective upon the issuance of an order by the Commission that it will not institute proceedings pursuant to Exchange Act Section 15A(g)(2). NASD is also seeking relief under Exchange Act Section 19(h). This notice shall serve as an application for such an order.

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

¹¹ NASD certifies that X meets all applicable qualification requirements for the proposed employment.