

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of the Association of

X

as a

General Securities Representative

with

The Sponsoring Firm

Redacted Decision

Notice Pursuant to
Section 19(d)
Securities Exchange Act
of 1934

Decision No. SD04012

Date: 2004

On September 10, 2003, the Sponsoring Firm¹ ("the Firm") completed a Membership Continuance Application ("MC-400" or "the Application") seeking to permit X, a person subject to a statutory disqualification, to associate with the Sponsoring Firm as a general securities representative. In February 2004, a subcommittee ("Hearing Panel") of NASD's Statutory Disqualification Committee held a hearing on the matter. X appeared, accompanied by his counsel. X was also accompanied by his proposed branch manager, his Proposed Supervisor. LL appeared on behalf of NASD's Department of Member Regulation ("Member Regulation").

A. X's Statutorily Disqualifying Event

X is subject to a statutory disqualification as a result of his November 1996 conviction in State 1 for operating a motor vehicle while under the influence of alcohol ("DUI"), a felony because X had a previous misdemeanor DUI conviction. X was fined \$1,500, placed on probation for five years, assigned 140 hours of community service, and had his driver's license revoked for one year. X was discharged from probation in May 1999.

Following his 1996 felony conviction, X's employer, Firm 1 filed an application to continue X's association with that firm. In an October 1997 decision, the National Adjudicatory Council ("NAC") issued a decision (Notice Pursuant to SEC Rule 19h-1) approving the

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.

application. On the basis of that decision, and the SEC's subsequent review, X remained associated with Firm 1.

B. Background Information

1. X

X was first registered in the securities industry in October 1994 as a general securities representative (Series 7). He also qualified as a uniform securities agent (Series 63) in October 1994; a general securities sales supervisor (Options Module - Series 9) in May 2001; and a general securities sales supervisor (General Module - Series 10) in March 2002. X was employed with Firm 1 from July 1994 to November 2001. In 2001, Firm 1 changed its name to Firm 2, where X remained employed until November 2002. In 2002, Firm 2 underwent a reorganization and became Firm 3, a member of the New York Stock Exchange ("NYSE"). As a result, X was deemed to be employed by a different firm, and Firm 3 was required to file an application on X's behalf. In January 2003, Firm 3 submitted an application to the NYSE to employ X in the capacity of a general securities representative. The firm withdrew the application in July 2003.² The Sponsoring Firm submitted this Application in September 2003.

As described below, X was the subject of eight customer complaints between 1997 and 2003. The first two complaints were made in March 1997. One customer alleged misrepresentation and failure to follow instructions, seeking compensatory damages of \$46,000. The complaint was settled in November 1997 for \$30,000. A second customer sought \$80,000 in compensatory damages for alleged unauthorized trading and poor performance on the part of X. The matter was settled for \$40,000. The third complaint was received in February 1999. The customer alleged churning, unsuitability, misrepresentation, domination and control, and failure to supervise and sought \$1,780,000 in compensatory damages. The matter went to arbitration, and the customer was awarded \$372,921. X was held jointly and severally liable for \$250,000 in damages.

The fourth and fifth complaints were received in October 1999. One complaint alleged unauthorized trading, unsuitability, misrepresentation, and excessive trading; those customers were awarded \$267,205 in arbitration. The other complaint, alleging unauthorized trading, unsuitability, excessive trading, and misrepresentation was settled for \$170,000. The parties agreed that the complaint against X would be expunged, but no order of expungement has been filed. The sixth complaint, alleging breach of fiduciary duty, negligence, misrepresentation, and excessive trading, was received in August 2002. The customer alleged \$90,000 in compensatory damages, and the matter is currently pending before NASD Dispute Resolution.

² X explained at the hearing that he asked Firm 3 to withdraw the application because seven months had elapsed with the NYSE having taken no action on the application. X stated that he decided instead to work for a firm that would file an application through NASD.

The seventh complaint was received in September 2002. The customer alleged breach of fiduciary duty, negligence, misrepresentation, and excessive trading. The customer alleged compensatory damages of \$65,000. The matter is also pending before NASD Dispute Resolution. The eighth complaint, alleging excessive commissions, was filed in September 2003. The customer alleged \$70,000 in compensatory damages. X settled the complaint for \$5,000.

2. The Firm

The Sponsoring Firm has been a member of NASD since 1994. The Firm has five offices of supervisory jurisdiction ("OSJs") and 10 branch offices. The Firm employs 20 registered principals, 67 registered representatives, and 116 employees. The Firm represented in its Application that it is a "securities/broker-dealer" firm. The Sponsoring Firm's Form BD indicates that the Firm is engaged in: selling corporate debt securities; retailing corporate equity securities over-the-counter; retailing mutual funds; acting as a non-exchange member arranging for transactions in listed securities by an exchange member; acting as a put and call broker or dealer or options writer; selling private placement securities; trading securities for its own account, and being an underwriter or selling group participant for corporate securities other than mutual funds.

Regulatory History

The Firm's 2000, 2001, and 2002 routine examinations each resulted in the issuance of one or more Letters of Caution ("LOCs"). A February 2002 LOC, based on findings noted during the 2000 routine examination, cited the Firm for failing to report customer complaints as required by NASD Rule 3070, having deficient written supervisory procedures, and allowing two associated persons to perform duties while their registrations were inactive due to their failure to complete continuing education requirements. The Firm's response indicated that it had taken steps to ensure future compliance.

The Sponsoring Firm received two LOCs in 2003 based on findings noted during the 2001 routine examination. An August 2003 LOC cited the Firm for failing accurately to report trades and failing accurately to prepare order tickets and confirmations. The Firm's response indicated that it had taken steps to ensure future compliance. An LOC issued in September 2003 cited the Firm for failing to disclose to customers the difference between the cost and reported price of eight sales in violation of SEC Rule 10b-10. The Firm was also cited for allowing an associated person to perform duties while his registration was inactive due to a failure to complete continuing education requirements, failing to conduct a needs analysis, and failing to prepare a continuing education plan for calendar years 2000 and 2001. The Firm's response indicated that it had taken steps to ensure future compliance.

The Sponsoring Firm received a second LOC in September 2003 based on findings noted during the 2002 routine examination. This LOC cited the Firm for failing to develop and implement an anti-money laundering compliance program. The LOC noted that the Firm's

procedures had been amended and no further action was required. The LOC also cited the Firm for failing to prepare accurate order tickets for four trades and 29 transaction reporting violations. The Firm's response was unavailable. The Sponsoring Firm also received an LOC in February 2003 for failing to respond to a breakpoint letter survey. The Firm was not required to respond to the LOC; however, it was required to submit the survey.

The findings from the Firm's 2003 routine examination are still under review, and the Firm's 2004 routine examination has not yet begun.

The Sponsoring Firm is currently the subject of three pending arbitrations, alleging a total of approximately \$830,000 in compensatory damages. Further, the Firm has been a party in 21 settled arbitrations. Of these, two claims were withdrawn, and one claim was denied. In addition, the Sponsoring Firm has been named in the following regulatory actions:

- In May 1999, the State 2 Securities Department alleged that the Firm had engaged in the offer and sale of unregistered securities in the form of promissory notes by an unregistered employee. The matter was resolved by stipulation and consent. A consent order of restitution in the amount of \$33,360 plus 10 per cent interest, a fine of \$2,500 and \$1,500 in costs was issued in October 1999.
- In January 2000, the State 2 Securities Department filed a temporary order of suspension against the Firm for its failure to pay a fine. Upon receipt of payment, the State vacated the temporary order of suspension without prejudice.
- In April 2000, NASD alleged that the Firm failed to enforce its supervisory procedures by not installing a recording system as required by NASD Rules. On appeal, the NAC determined that the violation was technical in nature and reduced the fine imposed by a Hearing Panel to \$10,000, jointly and severally. The NAC concluded that the Firm would not need to install a tape recording system.
- In January 2001, the State 3 Division of Securities sanctioned the Sponsoring Firm for denying the Division's auditors access to the Firm's books and records, while physically preventing auditors from entering the sales floor where the auditors witnessed books and records of the Firm being discarded and hidden. In February 2004, the State suspended the Firm for one year and subjected the Firm to six months' probation. In addition, the Firm was required to have a surprise audit at its expense.
- In February 2001, the State 4 Department of Banking & Finance alleged that the Firm failed to properly supervise and allowed unregistered activity and fined the Firm \$25,000. The State agreed to approve registration of the City 1 and City 2 offices, and the Sponsoring Firm agreed to withdraw its application for registration of the City 3 office.

- In November 2001, the State 5 Commissioner proposed an order to deny the Firm a dealer application based on allegations of boiler-room activities out of a State 1 branch office. The Commissioner also obtained information from State 3 examiners regarding the Firm's failure to provide documents upon State 3's request and a subsequent suspension order. The Firm agreed that it would not reapply to be registered as a dealer in State 5 for two years, starting in May 2002, unless State 3 vacated its suspension order and the Firm's registration in State 3 was reinstated and fully effective without any conditions or restrictions.
- In February 2002, State 6 alleged that the Firm concealed material information from, and made false or misleading statements to, agency staff during an investigation and examination by destroying an index card, replacing the card with another containing altered information and misrepresenting that the altered card was the original. It was also alleged that the Firm: engaged in dishonest or unethical practices by employing two cold callers who were not registered with NASD; violated various provisions of the State 6 Uniform Securities Act by employing unregistered agents and selling unregistered non-exempt securities to State 6 customers; and failed to enforce and maintain adequate supervisory procedures. Pursuant to a consent order, the Sponsoring Firm was fined \$12,500 and directed to file quarterly reports for two years concerning any securities-related complaints, actions or proceedings, including arbitrations that affected State 6 residents. The Firm was also ordered to reimburse the state up to \$2,500 for costs associated with one or more branch examinations conducted within 24 months.
- In October 2003, NASD filed a complaint alleging that the Sponsoring Firm participated in undertakings involving the purchase of securities from issuers or affiliates of issuers with a view to the distribution of an unregistered stock, thereby acting as an underwriter in violation of Section 5 of the Securities Act of 1933; acting through an individual, while acting as a distribution participant or an affiliated purchaser of such person, directly or indirectly, bid for, purchased, or attempted to induce persons to bid for or purchase a security that was the subject of distribution during its participation in the distribution; engaged in special selling efforts and methods to further the distribution of unregistered securities; acting through an individual, purchased shares from other broker dealers and other customers of the firm while participating in a distribution; knowingly or recklessly engaged in manipulative or deceptive devices or contrivances in connection with the purchase or sale of securities, and knowingly or recklessly effected transactions in, or induced the purchase or sale of, securities by means of manipulative, deceptive, or other fraudulent devices or contrivances; engaged in a series of wash sales to create the false appearance of trading volume and market interest, operating as a manipulation of the market in the stock; acting through individuals, operated a scheme to manipulate the market by engaging in sales to customers involving misrepresentations and omissions, unauthorized trades, and a series of failures to execute customer sale orders; and effected transactions as a principal and charged retail customers excessive markups. This action is currently pending.

The record shows no other complaints, disciplinary proceedings, or arbitrations against the Sponsoring Firm. The Firm does not employ any statutorily disqualified individuals and it is not a member of any other self-regulatory organization ("SRO").

C. X's Proposed Business Activities and Supervision

The Sponsoring Firm proposes that X will work out of an OSJ located in State 1. He will be employed as a registered representative and will be compensated on a commission basis. The Firm proposes that the Proposed Supervisor will be responsible for supervising X. The Proposed Supervisor is a registered principal who has been employed with the Firm since October 2003. The Proposed Supervisor is currently employed in the State 1 OSJ in a non-producing capacity. He does not currently supervise other registered representatives. The Sponsoring Firm proposes that the Proposed Supervisor will be located in the same office as X, approximately 10 feet away from X's work area and will supervise only X.

The Proposed Supervisor holds the following registrations: registered options principal (since September 1995); general securities representative (since October 1985); general securities principal (since July 1990); municipal securities principal (since April 1998); uniform securities agent (since November 1985); and investment advisors law exam (since July 1999). The Proposed Supervisor has been associated with nine different firms between 1988 and the present. The record shows no disciplinary or regulatory proceedings, complaints, or arbitrations against the Proposed Supervisor. X and the Proposed Supervisor are not related by blood or marriage.

The Sponsoring Firm proposes that the Proposed Supervisor will supervise X's activities as follows:

1. The Proposed Supervisor will, on a daily basis, review all orders entered by X on behalf of his clients and evidence this review by initialing the daily trade and/or commission runs.
2. The Proposed Supervisor will review and approve all of X's new account forms prior to opening the accounts. The Proposed Supervisor will evidence his review and approval by signing his name in the appropriate space on each new account application.
3. The Proposed Supervisor will review the trading in X's accounts on a monthly basis. He will review X's customer statements and the Active Account Report (which reflects customers serviced by X) and evidence his review by initialing those documents and detailing this review in the Monthly Supervision Report that he is required to file with the Firm's Compliance Department.
4. X will not be allowed to maintain discretionary accounts.

5. To ensure that he is in compliance, X will meet with the Proposed Supervisor on a monthly basis to conduct a comprehensive review of all trades, new accounts, customers, conversations and compliance-related issues.

D. Member Regulation Recommendation

Member Regulation recommends that this Application be denied. Member Regulation believes that X's eight customer complaints since 1997 raise regulatory concerns and notes that these customer complaints have occurred since the time he was approved for continued association as a registered representative with Firm 1 in 1997. Member Regulation believes that this record demonstrates that X is unable to act responsibly and is unlikely to abide by the terms and conditions of a heightened plan of supervision.

Member Regulation has also considered the Sponsoring Firm's disciplinary history, which includes regulatory actions initiated by NASD and state regulators. Member Regulation notes that, among other allegations, the Firm has been cited for deficient written supervisory procedures and inadequate supervision of its employees. Therefore, Member Regulation does not believe that the Firm can adequately supervise X. Additionally, Member Regulation stated that it is unwilling to support a heightened plan of supervision to be carried out by a Firm with a history of supervisory deficiencies. Further, the Firm has been, and remains, the subject of a significant number of arbitrations, most of which have resulted in substantial damages being awarded to the claimants. With respect to X's Proposed Supervisor, Member Regulation has considered the Proposed Supervisor's lack of disciplinary history, but has concluded that his regulatory record does not outweigh its other concerns.

On the basis of the foregoing, Member Regulation believes that permitting X to continue his employment in the securities industry creates an unreasonable risk of harm to the market or investors and is not in the public interest.

E. Discussion

After carefully reviewing the entire record in this matter, we deny the Sponsoring Firm's Application to employ X as a general securities representative. In reviewing this Application, we have considered whether X's association with the Sponsoring Firm, examined in light of all the relevant facts and circumstances, creates an unreasonable risk of harm to the market or investors. We deny the Application based on the following three significant problems. The Sponsoring Firm has a serious disciplinary history that includes supervisory failures. X has accepted no responsibility for serious sales practice complaints. The Firm's proposal to supervise X's activities is inadequate to promote compliance with securities industry rules. Therefore, we conclude that X's continued participation in the securities industry as an employee of the Sponsoring Firm would present an unreasonable risk of harm to the market or investors.

In reaching our conclusion, we have considered that X's felony conviction was non-securities and non-financial related. Nevertheless, X is subject to a statutory disqualification,

and we are required to determine whether X's association with the Sponsoring Firm would create an unreasonable risk of harm to the market or investors. We believe that it would. In X's favor is the fact that NASD examiners have conducted yearly statutory disqualification reviews of X and have filed satisfactory reports. In addition, since approval of his continued association with Firm 1 in 1997, X has no disciplinary history. On the other hand, X has amassed eight customer complaints in the years between his approval and this Application, resulting in payments to complaining customers of more than \$500,000.

These complaints alleged serious sales practice violations, including unauthorized trading, misrepresentation, fraud, and excessive trading. At the hearing, X accepted no responsibility for any conduct on his part that might have contributed to or prompted the allegations. He denied any wrongdoing and explained how each of these complaints against him was unfounded. While none of these customer complaints caused NASD or any other regulatory authority to take disciplinary action against X, we believe that the volume of complaints indicates a need for close supervision of X's sales activities.

X seeks to become associated with the Sponsoring Firm, a firm with a significant and serious disciplinary history and numerous customer complaints and arbitrations, as described on pages 4 through 6 of this Decision. The Sponsoring Firm has, among other things, been disciplined for supervisory failures, including both the failure to reasonably supervise and the failure to have adequate written procedures. In addition, the Firm has been sanctioned for employing unregistered agents and for failing to cooperate with state regulators on the Firm's premises. At the hearing, X's counsel gave the Firm's view of how and why the underlying events occurred; in each case the explanations were entirely exculpatory. Various regulators, however, have taken a different view and sanctioned the Sponsoring Firm for the alleged violations.

Given the Firm's regulatory history and history of customer arbitrations, we find that the supervisory plan described by the Firm is not adequate. We also find that the proposed supervisory plan is inadequate for X's needs, particularly given the nature of the Sponsoring Firm's business activities. The branch where X is employed has only been in operation for four months. Its four brokers have high production levels, mainly from transactional business generated through telemarketing activities. Further, the branch manager of the office, is a producing manager. He decides the commission rates for his brokers. Brokers select the securities they will sell from an the Sponsoring Firm focus list, but they are free to come up with their own solicitation ideas and research them on their own.

Although the Proposed Supervisor represented that he would approve every trade and new account and speak to X's clients to make sure they are being properly serviced, we conclude that X needs supervision more tailored to the nature of the business he proposes to conduct at the Sponsoring Firm. X would be employed in a small, entrepreneurial, high-producing office where the pressure to conform to the business model may increase the risk to X of customer dissatisfaction and future complaints. Given X's rejection of responsibility to any degree for his

past customer complaints, we find that there is a risk of harm to the public if we grant this Application.

Accordingly, we find that it is not in the public interest and that it creates an unreasonable risk of harm to the market or investors, to permit X to associate as a general securities representative with the Sponsoring Firm.

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President and
Corporate Secretary