BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Ronald Pellegrino, Bellingham, Washington, Respondent.	DECISION Disciplinary Proceeding No. C3B050012 Dated: January 4, 2008

Registered principal failed to supervise registered representatives. Held, findings affirmed and sanctions modified.

Appearances

For the Complainant: Leo F. Orenstein, Esq., David Utevsky, Esq., Financial Industry Regulatory Authority, Department of Enforcement

For the Respondent: Pro se

Decision

Ronald Pellegrino ("Pellegrino") appeals from a July 28, 2006 decision of a FINRA[1] Hearing Panel. The Hearing Panel found that, from July 2001 to March 2003, Pellegrino inadequately supervised registered representatives of Metropolitan Investment Services, Inc. ("MIS" or "the Firm") when he: (1) failed to respond sufficiently to a red flag indicating possible misconduct by representatives in the sale of unsuitable proprietary investment products; and (2) unreasonably delegated responsibility for both compliance and supervision of more than 100 representatives to a single inexperienced individual, in violation of NASD Rules 3010(a) and 2110. For these violations, the Hearing Panel suspended Pellegrino for six months in all

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[1] As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this decision to FINRA shall include, by reference and where appropriate, references to NASD.

capacities. After a complete review of the record, we affirm the Hearing Panel's findings of violation. We find, however, that the sanctions imposed by the Hearing Panel are not appropriately targeted to address the misconduct at issue. We bar Pellegrino in all principal capacities, but we do not impose any additional suspension in other capacities.

I. Background

Pellegrino passed the general securities representative qualification examination in 1977 and the general securities principal examination in 1985. On July 5, 2001, Pellegrino joined MIS, a broker-dealer in Spokane, Washington, as its general manager and senior vice president. From July 12, 2001 until December 15, 2003, Pellegrino was registered with MIS as a general securities representative and a general securities principal, and from November 16, 2001 until December 15, 2003, as an options principal. Pellegrino is not currently registered with any member firms.

II. Facts

This case concerns whether Pellegrino, from October 2001 to March 2003, failed to supervise MIS representatives, who systematically made unsuitable recommendations to invest in, and misleading sales presentations concerning, securities offered by two affiliated companies, Metropolitan Mortgage & Securities Co., Inc. ("Metropolitan") and Summit Securities, Inc. ("Summit").

A. History of Metropolitan, Summit, and MIS

Metropolitan, based in Spokane, Washington, was incorporated in 1953 by C. Paul Sandifur, Sr., who served as the company's chief executive officer and chairman until the 1990s.[2] Metropolitan was engaged in the business of investing in "cash flowing" assets.[3] In 1990, Metropolitan incorporated Summit as a wholly owned subsidiary. Like Metropolitan, Summit also was in the business of investing in cash flow assets. By September 2002, Metropolitan held as much as $1.5 billion in assets and had become the "oldest and largest debenture company . . . in [the state of] Washington."

To finance its operations, Metropolitan and Summit sold debentures, debenture-like investment certificates, and, beginning in the mid-1990s, preferred stock. Prior to 1979,

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2 In 1972, Metropolitan acquired the Western United Life Assurance Company, an annuity and life insurance company. By 2001, Western United would grow to become Metropolitan's largest active subsidiary.

3 The "cash flowing" assets consisted of "obligations collateralized by real estate, structured settlements, annuities, lottery prizes and other investments . . ., and in securities, which consist primarily of U.S. Treasury and government agency obligations and investment grade bonds."

Metropolitan offered its proprietary products only to Washington state residents. In 1979, Metropolitan set up MIS to sell and distribute Metropolitan's proprietary products intrastate. MIS was initially a "SECO" (i.e., SEC-only) broker-dealer and became a FINRA member in 1983. MIS was the primary, if not sole, vehicle through which Metropolitan and Summit publicly offered their securities. Although MIS evolved to offer other general securities and mutual funds, the majority of MIS' revenues were derived from the ongoing retail sales of its affiliates' securities.

Between 1983 and 2000, MIS grew from employing 25-30 representatives to more than 200, located in as many as seven or eight states, but mostly in Washington. The "overwhelming majority" of the representatives were located not in MIS' Spokane offices but "off site." MIS remained closely aligned with, if not subservient to, Metropolitan and Summit. During the relevant period, C. Paul Sandifur, Jr. ("Sandifur"), the son of Metropolitan's founder, controlled all relevant entities. Specifically, Sandifur was the: (1) chief executive officer, president, and controlling shareholder of Metropolitan; (2) owner of National Summit Corp. ("National"), the parent company of Summit and MIS;[4] and (3) the president of MIS. MIS had one office of supervisory jurisdiction in Spokane, located in the same offices as Metropolitan and Summit. MIS and Metropolitan shared various departments, including human resources (which contained hiring and recruitment functions), legal, cashiering, information technology, and accounting. Metropolitan determined how many employees MIS employed, and required MIS to consult it before making policy changes.

B. Metropolitan and Summit Securities Were High Risk Products

During the relevant period, MIS representatives sold Metropolitan debentures, Summit investment certificates, and Metropolitan and Summit preferred stock. The Metropolitan debentures and Summit investment certificates paid interest rates that varied depending on the amount of the investment, the time to maturity, and the payment option selected.[5] Metropolitan and Summit also had several authorized series of preferred stock, which paid cumulative dividends that varied by series.

The Metropolitan and Summit securities were speculative products that involved a high degree of risk. Some of the risk derived from the nature of the instruments themselves. For example, the debentures and investment certificates: (1) represented "unsecured general obligations"; (2) were governed by indentures that did not restrict the issuer's ability to issue additional debentures or incur other debt, including debt that was senior in right of payment to the debentures, or require the issuer to maintain any specified financial ratios, minimum net worth, minimum working capital, or sinking fund; (3) were subordinated to all indebtedness and

[4] National acquired Summit in 1994, and Summit acquired MIS in 1995.

[5] For example, as of April 29, 2002, a $100 investment in Metropolitan Series III and III-A debentures paid interest at 8.375 percent over a 120-month period.

other liabilities and commitments of subsidiaries; and (4) were not guaranteed or insured by another entity or any governmental agency.

The Metropolitan and Summit securities also involved issuer-specific risk. In 1999, after 48 continuous years of profitability and never missing an interest or dividend payment, Metropolitan began to show troublesome signs. For the years ending September 30, 1999, 2000, 2001, and 2002, earnings were insufficient to meet fixed charges and preferred stock dividends by approximately $800,000, $17.4 million, $40.2 million, and $3.4 million, respectively. Metropolitan's balance sheet also reflected that it was highly leveraged. For example, as of June 30, 2001, Metropolitan's debt to equity ratio was 35 to 1.[6] Moreover, as shown on Metropolitan's statements of cash flows, Metropolitan's cash inflows were becoming increasingly dependent on investments in debentures and preferred stock. Likewise, Summit's financial position was not solid.[7]

The offering documents for Metropolitan and Summit securities contained financial statements that disclosed these issues as well as narrative sections that disclosed certain risks. For example, a prospectus for Metropolitan's debentures, dated May 11, 2001, listed the following risk factors, among others:

> **Our earnings have been insufficient to cover fixed charges and preferred stock dividends for the last two fiscal years, which, if continued, could result in our inability to pay you the full amounts you are entitled to on your debentures.**
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> . . . . [I]f the insufficiency in earnings continues, and if we are unable to sell a sufficient amount of debentures and preferred stock or obtain funds from other sources, we may not have sufficient funds to pay you the full amounts you are entitled to on your debentures.

This prospectus further explained that "[w]e will rely, in part, on our subsidiaries to make payments to us for us to make payments on the debentures," which in turn largely depended on obtaining permission from state insurance commissioners to make such payments. In addition, the prospectus explained that the debenture investment proceeds may be used to pay preferred stock dividends and principal and interest on the debentures. The offering materials also disclosed significant liquidity risks, including that the debentures were not liquid and that the

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6 Balance sheets reflect that the amount of Metropolitan's debentures rose from $198 million in September 1999 to $355 million in September 2002, which concerned Washington regulators enough to inform the SEC of this "dramatic[ ] increase[ ]."

7 For example, Summit reported that, for the fiscal year ending September 30, 2001, it suffered a net loss of nearly $2.5 million and that that was insufficient to cover its fixed charges, including preferred stock dividend requirements.

preferred stock lacked an active trading market.[8] Summit's offering documents disclosed risks that were similar to those contained in Metropolitan's offering materials.[9]

Although Pellegrino denies that he understood just how risky Metropolitan's and Summit's securities were, the record demonstrates that these investments were highly speculative. MIS gave express guidance to representatives that the affiliates' preferred stock should not be sold to those with either low risk tolerances or "preservation of capital" as their number one investment objective. Moreover, in investigative testimony, Pellegrino, Sandifur, and former MIS compliance officers Al Olsen ("Olsen") and Reuel Swanson ("Swanson"), all admitted that the affiliates' proprietary products were medium to high risk products. For example, Pellegrino conceded that the debentures were below investment grade and that, on a scale from 1 to 10, with 10 being the riskiest, the Metropolitan debentures were a "7" and the preferred stock was an "8." Sandifur conceded that "people [who] want a minimized risk probably shouldn't be investing significant amounts of their portfolio in Metropolitan's products."

C. The Underlying Violations and Resulting Customer Losses

1. MIS Representatives Made Unsuitable Recommendations to Customers Who Had Low Risk Tolerances and Capital Preservation Objectives

Considering these risks, MIS representatives lacked a reasonable basis for believing that significant investments in MIS' affiliates' products were suitable for customers with a low tolerance for risk. Despite this, between October 2001 and March 2003, twenty MIS representatives made at least 57 sales to 36 customers who invested more than 20 percent of their net worth in the proprietary products and who also indicated on their MIS subscription agreements that they had a low risk tolerance or "preservation of capital" as their sole investment objective ("the Schedule A transactions"). In addition, 29 MIS representatives made at least 108 sales to 99 customers who invested more than 20 percent of their net worth in the proprietary products and who listed preservation of capital as their number one investment objective ("the Schedule B transactions"). Many of the investors were elderly, many were retired, and many were taking income from their investments. The 165 transactions on Schedules A and B, which totaled $4,177,803, primarily involved purchases of debentures and investment certificates, although 12 transactions involved preferred stock.[10] Accordingly, the record demonstrates that

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[8] For years, Metropolitan preferred stock could be sold through MIS' "secondary desk," and the amount of time that took could be up to 60 days.

[9] Although the offering documents disclosed many risks, it was not until a March 27, 2003 registration statement for Metropolitan debentures that Metropolitan expressly disclosed that an investment "involves a significant degree of risk."

[10] The Schedule A and Schedule B transactions included only customers for which FINRA staff had obtained subscription agreements. MIS' records indicated that numerous additional

[Footnote continued on next page]

the MIS representatives made at least 165 unsuitable recommendations, in violation of NASD Rules 2310 and 2110.[11] *Cf. Dane S. Faber*, Exchange Act Rel. No. 49266, 2004 SEC LEXIS 277, at *26 (Feb. 10, 2004) ("We have repeatedly held that high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk."); *Gordon Scott Venters*, 51 S.E.C. 292, 293-94 (1993) (holding that recommendation for elderly widow with $35,000 in net worth to invest $2,300 in speculative stock was unsuitable).

2. MIS Representatives Used Misleading Sales Presentations, Advertisements, and Sales Literature

Pellegrino conceded that "some [MIS] registered representatives did not present the [Metropolitan and Summit] securities in a 'fair and balanced' manner." Indeed, MIS customers recounted, in numerous letters to FINRA, that MIS representatives made misleading statements about the risks involved in the affiliate products, including representations that the investments were "safe."[12] Considering that the prospectuses disclosed a litany of risks, these misleading statements were at least negligent and violated NASD Rule 2110.[13] The parties also stipulated

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customers with the same characteristics as the customers on Schedules A and B also purchased the proprietary products in hundreds of additional transactions totaling at least $17 million.

[11] NASD Rule 2310(a) provides that "[i]n recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." Unlike the Hearing Panel, we do not find that the MIS representatives violated NASD IM-2310-2 because the complaint did not allege any such violation.

[12] Likewise, former MIS representative Kim Cowdell ("Cowdell") testified that, due to inadequate training, he misrepresented the proprietary products to customers as safe, conservative investments.

[13] NASD Rule 2110 requires a member, in the conduct of his business, to "observe high standards of commercial honor and just and equitable principles of trade." Negligent misrepresentations violate NASD Rule 2110. *See Dep't of Enforcement v. Reynolds*, Complaint No. CAF990018, 2001 NASD Discip. LEXIS 17, at *44, *47 (NASD NAC June 25, 2001). As an aside, we note that the fact that the complaint specifically pled only that the MIS representatives' misleading sales presentations constituted fraud does not preclude our finding that they constituted negligent misrepresentations. The importance of the misleading sales presentations in this proceeding is not whether they were fraudulent or merely negligent, but the fact that they were being made. The complaint alleged that the sales presentations were occurring and that they violated NASD Rule 2110. For these reasons, we think that Pellegrino had sufficient notice to understand the allegations pertaining to the sales presentations and an adequate opportunity to plan a defense. *Cf. Dist. Bus. Conduct Comm. v. Euripidies*, Complaint

[Footnote continued on next page]

that certain MIS registered representatives used misleading advertisements and sales literature to sell the proprietary products. Specifically, in 14 advertisements, published mostly in August and September 2001, MIS registered representatives compared the rates on proprietary products to "bank rates," without explaining the difference between bank products and the Metropolitan proprietary products.[14] Furthermore, in sales literature and a number of letters to investors, MIS registered representatives emphasized that the proprietary products involved "no market volatility," "stability in a volatile market," and that Metropolitan had "an unblemished 48 year history of never having missed an interest or principal payment," without addressing the serious risks in the products. These advertisements and letters, which contained materially misleading information and materially misleading comparisons to bank accounts, violated NASD Rules 2210(d)(1)(A) and (B), 2210(d)(2)(M) (NASD Manual 2001 ed.), and 2110.[15]

3. Metropolitan, Summit, and MIS File for Bankruptcy, and MIS Customers <u>Incur Substantial Losses</u>

On October 22, 2003, FINRA accepted from MIS a Letter of Acceptance, Waiver and Consent ("AWC") that, among other sanctions, blocked MIS from selling any affiliate's securities until MIS certified that it had reviewed and revised its supervisory system relating to sales of such products. Soon afterward, the Metropolitan enterprise crumbled. On December 15, 2003, MIS ceased operations. In press releases dated December 26, 2003, Metropolitan and Summit announced that interest and principal payments on debentures, notes, and investment certificates would be suspended; that they planned to delist certain series of preferred stock from the American Stock Exchange; and that their auditor, Ernst & Young, believed that losses in excess of those previously reported on the issuers' Forms 10-Q had been incurred. On February 4, 2004, Metropolitan and Summit filed petitions for reorganization under Chapter 11 of the U.S. Bankruptcy Code, and MIS filed a voluntary bankruptcy petition under Chapter 7. Swanson predicted that debenture holders ultimately would receive approximately 30 percent of their investments back, and that preferred stockholders would lose their entire investments.

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No. C9B950014, 1997 NASD Discip. LEXIS 45, at *8-11 (NASD NBCC July 28, 1997) (finding that respondent had notice of allegations that he violated the suitability rule where the complaint charged only a violation of NASD Rule 2110 and described the violative conduct).

[14] For example, several advertisements for Metropolitan debentures stated, in bold print, "Tired of Low Bank Rates? Compare Ours" or "Bank Rates Have You Depressed? Compare Our Rates!"

[15] During the relevant period, NASD Rule 2210(d)(1)(A), (d)(1)(B), and (d)(2)(M) prohibited, among other things: communications with the public that omitted material facts or included misleading, unwarranted, or exaggerated statements; and advertisements and sales literature that made misleading comparisons.

D. Supervision

The allegations in the complaint include both that Pellegrino failed to establish and maintain an adequate system of supervision, and that he failed to adequately respond to red flag warnings of violations. We first describe the supervisory system in place during the relevant period, and then turn to the red flags that were present.

1. Supervisory System

Pellegrino testified that MIS president Sandifur had "overall responsibility" for MIS' compliance system. Pellegrino reported to Sandifur, whom the record demonstrates had a significant impact on MIS' day-to-day operations. Nevertheless, the MIS supervisory manual expressly delegated to Pellegrino, among other duties, the responsibility to "review[ ] the firm's overall supervisory system."

When Pellegrino joined MIS on July 5, 2001, the management team consisted of Swanson, Olsen, and Diane Edwards ("Edwards"). Swanson was a longstanding, dual employee of both Metropolitan and MIS. Swanson joined Metropolitan in 1960 in an accounting capacity, became a Metropolitan director in 1969, served as treasurer from 1972 to 1975, and became corporate secretary in 1976, a position in which he still served. At MIS, Swanson was serving as secretary and treasurer, financial and operations principal ("FINOP"), and chief compliance officer, a position he had held since 1997. Swanson joined MIS in 1979, and had been registered as a general securities representative, general securities principal, and FINOP since 1983. Swanson received his general securities representative, general securities principal, and FINOP licenses in 1983 via waiver. Swanson testified that MIS was the only broker-dealer at which he had ever worked and that, during the relevant period, he spent only half of his time on his compliance role at MIS, usually reviewing subscription agreements.

Olsen was an assistant vice president at MIS, and the principal responsible for supervising the more than 200 dispersed registered representatives, a role for which he had never been trained.[16] Olsen also had a variety of other responsibilities, including overseeing information systems issues, assisting Swanson with certain compliance functions, such as reviewing advertising and subscription agreements, assisting with updating compliance manuals, and servicing his own customers. Olsen first entered the securities industry when he joined MIS in 1996 as a systems analyst, which entailed responsibilities for improving internal communications with the information technology department. Olsen became registered as a general securities representative in November 1996 and a general securities principal in April 1997, among other capacities. Prior to joining MIS, Olsen spent 26 years in the U.S. Air Force in aircraft maintenance, and obtained undergraduate and MBA degrees from Eastern Washington University in 1996 and 1997.

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16 Olsen testified that he taught himself how to perform his supervisory responsibilities, claiming that he "read as much as I could from the NASD," and "talked to the NASD local people."

Edwards was an MIS assistant vice president and operations manager. Edwards entered the securities industry in 1996, when she joined MIS. Edwards became registered as a general securities representative in 1998 and a general securities principal in June 1999. Edwards testified that her training was "on the job." Edwards testified that the general securities principals in the operations department she managed were responsible for approving subscription agreements, although other principals would help out during busy times. Edwards testified that she also had responsibilities in hiring, updating sections of the compliance and supervisory manuals, and other administrative and compliance responsibilities.

Such was the state of the supervisory system when Pellegrino joined MIS. After he joined, Pellegrino realized that Swanson was the chief compliance officer "in name only," became concerned with the conflicts that Swanson had as a dual employee, and attempted to remove Swanson from the compliance officer position. Pellegrino testified that, in August 2001, he requested Sandifur's permission to appoint Olsen as the chief compliance officer, but that Sandifur refused because Swanson "has been around forever." Pellegrino further testified that, in February 2002, Sandifur refused Pellegrino's renewed request.

On July 11, 2002, however, Pellegrino informed Washington's Department of Financial Institutions ("WDFI"), in response to a letter in which it expressed serious concern with Swanson's performance, that Swanson's role as chief compliance officer "has been in transition to . . . Olsen for many months." On July 29, 2002, WDFI requested that MIS continue transfering the compliance officer position to Olsen, out of concerns with Swanson's dual employee status and his approval of correspondence containing "problematic misstatements" concerning Metropolitan products. Pursuant to these instructions, in August 2002, Pellegrino appointed Olsen as MIS' chief compliance officer. Pellegrino prevented Olsen from continuing to service his own customers, but he did not relieve Olsen of his responsibility to supervise MIS representatives.[17]

2. <u>Red Flags of Abusive Sales Practices</u>

The record demonstrates that there were a number of signs that, during Pellegrino's tenure, should have caused him to be concerned about potential sales practice abuses at MIS.

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[17] Shortly after this appointment, Olsen expressed concerns about his dual role. In November 2002, Olsen forwarded to Pellegrino an on-line discussion thread in which one participant expressed a concern about a conflict between the compliance officer and representative supervisor roles, and a second participant warned against serving in both capacities. Pellegrino's response was, "[n]ot sure I see the clear lines of similarity." Olsen left MIS in July 2003.

a. The Financial Condition of the Issuers

Pellegrino was aware of Metropolitan's and Summit's financial troubles. Pellegrino admitted that, prior to joining MIS, he reviewed the issuers' offering materials, became aware of the recent losses and of Metropolitan's highly leveraged business, and was concerned with the financial statements.[18] After he joined MIS, Pellegrino remained cognizant of Metropolitan's precarious financial condition, and Pellegrino admitted that he knew that the proprietary products were below investment grade and risky.[19]

b. MIS' Customers

Many of MIS' customers who invested in the Metropolitan and Summit securities had a low tolerance for risk or "preservation of capital" as their sole or primary investment objective. Pellegrino had access to this information, which FINRA easily obtained through a query of MIS' customer database. The makeup of MIS' customers and Pellegrino's awareness of the risk level of the proprietary products alone should have been cause for concern that MIS representatives were making unsuitable recommendations.

In addition, Pellegrino admitted that he became aware during his first six months at MIS, based on discussions with customers, that customers "might not fully appreciate the risk of the investment[s]." Pellegrino conceded that this was something he felt needed to be addressed.

This was further reinforced when, in the summer and fall of 2002, Public Opinion Strategies ("Public Opinion"), a pollster that Pellegrino retained to research impressions of Metropolitan, presented findings that most MIS customers thought they were obtaining low risk products through MIS and did not understand how risky the proprietary products were. Specifically, Public Opinion conducted four focus group sessions, two with customers and two with non-customers, and sent out a survey to 150 MIS customers who had reinvested in Metropolitan debentures. In August 2002, Public Opinion presented findings from its focus group sessions—all of which Pellegrino attended—that MIS customers: (1) believed that Metropolitan was a "conservative," "stable," "reliable," and "solid" company; (2) believed that the proprietary products were not high risk, were distinct from common stocks, and provided a "consistent rate of return (yields between 6-14%) and "regular payments" like "clockwork"; and

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18 Pellegrino testified, "When I first took a look at the prospectuses that [Metropolitan] sent to me I thought, What? Are you kidding? It was all red ink . . . . [I] saw the losses."

19 Metropolitan did not obtain ratings for its proprietary products. Pellegrino testified that, based on his "reverse-engineer[ing]" of the yield recommended by the qualified independent underwriter ("QIU") retained by MIS, he believed that the debentures "equated out to a BB basic rating." Pellegrino elaborated that the debentures were "medium to high risk"—not "deep-distress junk," but not "investment-grade either"—and he conceded that his conclusion had not taken the liquidity risk into account. Pellegrino conceded that he considered the preferred stock to be "high risk."

(3) had a "very low" level of awareness of the proprietary products and placed substantial trust in MIS' representatives.[20] In December 2002, Public Opinion reported findings from its survey that: (1) MIS customers "see little risk" in the Metropolitan debentures; (2) 70 percent of reinvestors believed that the debentures "were relatively risk free"; and (3) 94 percent of reinvestors believed that Metropolitan and Summit were "financially strong." Pellegrino conceded that the Public Opinion findings told him that "the average Metro[politan] investors . . . wanted a low-risk investment." Sandifur testified at an investigative interview that the Public Opinion findings would have been a "red flag."

Many MIS customers repeatedly reinvested in the affiliate products, which also should have prompted heightened attention to whether they understood the risks involved, especially considering the issuers' deteriorating financial condition. Some MIS clients had been investing in such products since the 1950s, others "for a decade or more," and others were "second, third generation clients." Karen Arsenault ("Arsenault"), MIS' compliance officer after the relevant period, testified that "I don't think [the customers] knew or cared what [type of investment] they had because it paid them their money, and that's all they seemed to care about."

c. MIS' Focus on Concentration Levels

Another factor that was cause for heightened attention was that the established process through which MIS representatives assessed the suitability of the proprietary products for customers primarily focused on concentration levels. Before selling an affiliate's securities, MIS representatives and principals adhered to "Suitability Guidelines" ("Suitability Guidelines"), which prevented a customer from having more than 20 percent of his net worth invested in an affiliate's preferred stock, 30 percent in a single affiliated issuer, or 40 percent in combined investments across multiple affiliated issuers (i.e., the "20-30-40" concentration ratio). For preferred stock purchases, the Suitability Guidelines also set forth minimum net worth and income "eligibility" standards and specified that preferred stock was not permitted for "low risk tolerance portfolios."

Thus, despite the fact that MIS required customers to disclose a variety of information in subscription agreements, such as estimated liquid net worth, investment experience, risk tolerance, and investment objectives, the Suitability Guidelines essentially distilled the suitability determination—especially for debentures and investment certificates—to whether customers' holdings in proprietary products exceeded certain concentration levels. MIS' practice began in 1991, and, as Olsen explained, it had become engrained by the time Pellegrino joined MIS:

> [F]rom my very first day through every general manager . . . we were told that in order for an investor to invest in a debenture . . . they must . . . meet concentration levels. Risk wasn't really an

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[20] In marked contrast, Pellegrino testified that non-customers "reacted really strongly negatively to the prospectus," a difference that in itself was a red flag that MIS representatives were not disclosing the risks of the affiliate products.

> issue because low risk investors could invest in this. If it was preferred stock they had to be medium risk and again those concentration levels . . . , but I was told, we were all told for the whole time I was there, years and years I was there, that this was a specific process, this was a specific criteria that had been approved by the NASD for these products. You can invest . . . [in] Metro bonds [as a] low risk [investor] as long as [you] meet the concentration levels. And same things with preferred stock.[21]

d. Inexperience of MIS Staff

Another potential cause for concern was the fact that many MIS representatives and principals had no other securities experience other than at MIS. In fact, many MIS registered representatives were from families that had multiple generations who had worked for Metropolitan or MIS. Olsen articulated why the representatives' inexperience, coupled with MIS' focus on concentration levels, was a dangerous combination:

> What we are supposed to do in a broker-dealer is our first priority in life is that investor . . . . For forty or fifty . . . years that broker-dealer was set up not to do that. . . . The first priority was generating sales. This was a structure that had been in place for decades. . . .
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> * * *
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> [Y]ou read the books from Paul Sandifur's father that they went out and sold these bonds to farmers . . . . [T]hey were known as the bond boys. . . . At that point there was, my understanding from reading, there was no suitability. If your reflection showed in the mirror you were suitable. Everybody ought to own Metropolitan bonds. . . . [T]hese rep[resentatives] didn't know anything. They were truck drivers and all kind of things, no experience of coming in . . . . Everybody that came through the door whether they were reps from those fifty years up through staff members we came in

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21 The Suitability Guidelines, which MIS first implemented as a result of recommendations that FINRA made in 1991 and which evolved over subsequent years, made their first appearance at MIS as early as June 1993. In summer 2002, MIS' implementation of the Suitability Guidelines attracted WDFI's attention, albeit in a different respect than what is at issue in this proceeding. On June 24, 2002, WDFI informed Pellegrino of its concern that MIS was approving transactions after MIS representatives orally reported changes in customers' net worth that permitted such transactions to clear the MIS Suitability Guidelines. As explained below in Part IV.B.2.c, WDFI mandated that MIS obtain written verification of any net worth changes.

> with no experience and we learned . . . this is how the process works.

Pellegrino admitted that he recognized that many of MIS' representatives had no prior securities experience and that MIS had "no understanding of what a [broker-dealer] . . . was supposed to do in dealing with customers." In his appeal brief, Pellegrino also asserts that he appreciated that, because of the representatives' long history with Metropolitan, they harbored "strong support" for the issuers.

e. MIS' Revenues Primarily Derived from Affiliate Products

MIS' affiliation with the issuers whose securities produced the bulk of MIS' revenues was another obvious concern. Pellegrino testified that, when he joined MIS, there were numerous conflicts. One such conflict concerned Swanson, who was serving both as Metropolitan's director and secretary, and as MIS' FINOP and chief compliance officer. Pellegrino witnessed those conflicts from his initial interactions with MIS, which included initial interviews with numerous Metropolitan officers and employees. In a nod to the effect of such conflicts, Pellegrino testified that "[i]t was expected that everyone would sell bonds at Metropolitan."

Indeed, within weeks of starting at MIS, Pellegrino experienced firsthand how these conflicts interfered with compliance efforts. Pellegrino testified that his initial impression was that MIS was "a very disorganized, dysfunctional firm with some rogue reps, ineffective self-serving management prone to show favoritism, and running a business way too complex for the ability of managers and staff," and that no training program was in place. But despite having been told by Sandifur that he would have "many months to clean up the operations and compliance functions," Sandifur instructed Pellegrino in his second month at MIS to switch gears and develop a "production plan." That Sandifur curtailed Pellegrino's initial compliance efforts should have further heightened Pellegrino's concerns.

3. Pellegrino's Focus on Sales

During the relevant period, Pellegrino took certain supervisory steps that included training initiatives, staffing changes, and procedures changes. As we discuss below in Part IV.D, however, Pellegrino prolonged a direct response to the red flags present. For example, Pellegrino admitted in investigative testimony that he did not, in light of the Public Opinion findings, direct an investigation to see whether customers who reinvested had been misled by their brokers.

Instead, despite the red flags, Pellegrino's primary focus was boosting sales, which exacerbated the problems. When Pellegrino joined, he announced a goal to produce $10 million per month in sales of proprietary products and to retain 80 percent of the funds already invested in maturing debentures. In October 2001, Pellegrino initiated a weekly newsletter that featured articles on sales strategies and scripts for selling Metropolitan proprietary products.[22] In January 2002, he hired Bruce Bushman ("Bushman") as MIS' national sales manger. Pellegrino used sales contests, such as a January 2002 contest to win a Hawaii vacation for the most sales of Metropolitan Series E-7 preferred stock. Pellegrino posted sales goals—dictated by Sandifur—for raising "new money" (i.e., new subscriptions, not renewals), the daily sales numbers, and a "top-ten" list of producers.

Some of Pellegrino's sales initiatives reinforced MIS' practice of using concentration levels as the primary measure of suitability. Specifically, Pellegrino instituted changes that helped representatives learn how much more in affiliate products a customer could purchase yet still satisfy the Suitability Guidelines, including "buying power reports" and changes to MIS systems that automatically calculated concentration levels. Pellegrino also adopted the use of an "EZ" subscription agreement, intended to speed up the renewal process, that did not require a customer to identify risk tolerance or investment objectives.

In addition, Pellegrino approached the issuers' financial problems as a barrier to sales, rather than as information that he should ensure that MIS representatives were fully disclosing to customers. For example, in a March 29, 2002 e-mail to a Metropolitan officer concerning the topic for an upcoming "Back to Basics" training lunch, Pellegrino wrote:

> [T]he reps have to deal with a prospectus that is downright ugly in the amount and detail of risk disclosures. . . . very difficult to overcome potential investor objections. Our direction has been to focus the reps on the turnaround of the company . . . . several quarters of no red ink, management strategy beginning to work & have effect, and . . . the deals . . . [that] can . . . increase profitability . . . that's how we use the money MIS raises. . . .
>
> That's the theme.

Likewise, a few weeks later, Pellegrino wrote in an e-mail to Metropolitan's chief financial officer—using what Pellegrino characterized as a "bad choice" of words—"we need to build our 'spin' for the FY Q2 loss."

Notwithstanding that several former MIS employees testified that they felt no pressure to increase sales, Pellegrino's sales push paid off. In each year between 2000 and 2002, MIS increased the amount of new investments. For 2002, this "net new money" increased by approximately 30 percent, from nearly $500 million invested in 2001 to more than $700 million

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22 For example, one sales script instructed representatives to explain to customers that the debentures "have no market volatility." Another script implied that debentures earned guaranteed rates.

in 2002.[23] As Olsen characterized it, "Ron [Pellegrino] was phenomenally successful" in that "what used to be raised in one year now was being raised in a month."

III. Procedural History

On May 12, 2005, the Department of Enforcement ("Enforcement") filed a one-count complaint against Pellegrino. The complaint alleged that: (1) from at least October 2001 to March 2003, MIS representatives engaged in fraudulent sales practices, made unsuitable recommendations, and used misleading advertising and sales literature; (2) that Pellegrino failed to establish a supervisory system that was reasonably designed to achieve compliance with NASD rules, including adequate written supervisory procedures; and (3) that he failed to respond adequately to multiple red flags of misconduct. Pellegrino filed an answer denying these allegations. On August 29, 2005, Pellegrino filed a petition for bankruptcy under Chapter 7 of the U.S. Bankruptcy Code, which automatically stayed this disciplinary proceeding, and on September 15, 2005, the bankruptcy court terminated the stay.

The Hearing Panel conducted a six-day hearing, and it issued its decision on July 28, 2006. With respect to the underlying violations, the Hearing Panel found that, from July 2001 to March 2003, MIS representatives: (1) made at least 165 unsuitable recommendations to invest in Metropolitan and Summit proprietary products, in violation of NASD Rule 2310 and IM-2310-2; (2) used 14 misleading advertisements and "a number" of misleading pieces of sales literature, in violation of NASD Rules 2210(d)(1)(A) and (B), 2210(d)(2)(M) (NASD Manual, 2001 ed.), and 2110; and (3) used misleading sales presentations, in violation of NASD Rule 2110.[24] As for Pellegrino's conduct, the Hearing Panel found that Pellegrino failed to supervise, in violation of NASD Rule 3010 and 2110. It found that although "the written supervisory procedures as amended by [Pellegrino] were adequate," Pellegrino failed to establish an adequate supervisory system because he unreasonably delegated both compliance and supervision responsibilities to Olsen. The Panel also found that "the continuing favorable response of the customer focus groups to the proprietary products, in contrast to the response of the non-customer focus groups, was a red flag," and that Pellegrino, prior to January 2003, failed to "directly address[ ] the continuing view of the MIS representatives that the proprietary products were low risk."

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[23] Edwards testified that the increase in sales may have included "millions" raised through an initial public offering of Western United Holding preferred stock, which was not at issue in this proceeding.

[24] The Hearing Panel found that Enforcement failed to prove, however, that MIS representatives made fraudulent sales presentations, because it had not demonstrated that such representatives acted with scienter. Although the Hearing Panel did not expressly find that MIS representatives' sales presentations violated NASD Rule 2110, the Hearing Panel implicitly made that finding, stating that "MIS representatives' sales presentations recommended the proprietary products as low risk products, which was misleading." *See Reynolds*, 2001 NASD Discip. LEXIS 17, at *44, *47 (finding that negligent misrepresentations violate NASD Rule 2110). We find that it is not necessary for us to reach the question of whether the Hearing Panel correctly dismissed the allegations that the sales presentations were fraudulent.

Turning to sanctions, the Hearing Panel noted that there were several aggravating factors, including the extent of the underlying misconduct, the customer harm, and the customers' unsophisticated nature, but also found "significant mitigation." The Hearing Panel noted that Pellegrino realized that "there were a number of supervisory issues that needed to be resolved," but that he had "entered a bad situation at MIS" and "did not immediately realize the extent of the problems." It further found that Pellegrino "worked quickly to resolve what he viewed as the most glaring problems" and engaged in some efforts to "improve and implement compliance at MIS."[25] The Hearing Panel concluded that while Pellegrino "did not respond sufficiently to the red flag," he "did not deliberately ignore an indication of misconduct, which had existed for a long period of time prior to his arrival." For these reasons, the Hearing Panel suspended Pellegrino for six months in all capacities. Noting that the bankruptcy court presiding over Pellegrino's personal bankruptcy action "forbade this proceeding to impose monetary sanctions," the Hearing Panel did not impose monetary sanctions. This appeal followed.[26]

IV. Discussion

We affirm the Hearing Panel's findings that Pellegrino failed to maintain an adequate supervisory system and failed to adequately supervise, in violation of NASD Rules 3010(a) and 2110. As explained below, however, our grounds for these findings are significantly broader than the Hearing Panel's grounds.

A. Pellegrino Failed to Maintain an Adequate Supervisory System

NASD Rule 3010(a) provides that "[e]ach member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." NASD Rule 3010(a) requires a member's supervisory system to include certain elements, such as providing for: "(2) [t]he designation . . . of appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages;" "(5) [t]he assignment of each registered person to an appropriately registered representative(s) and/or

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25 The Hearing Panel cited Pellegrino's actions of "increasing the number of compliance . . . and operations personnel," "instituting programs to insure the accuracy of information on the subscription agreements," "instituting programs to increase MIS representatives' knowledge of the issuers' financials and the proprietary products," and "overseeing the improvements incorporated into the compliance and supervisory manuals."

26 MIS, Sandifur, Swanson, and Olsen all submitted AWCs, in which, without admitting or denying the allegations, they consented to findings of violations, including supervisory violations, in connection with MIS' sales of its affiliates' securities. MIS was fined $500,000 and ordered to pay $2.8 million in restitution. Sandifur was barred. Swanson was barred and fined $5,000. Olsen was suspended for one year in a principal capacity and was fined $5,000.

principal(s) who shall be responsible for supervising that person's activities"; and "(6) [r]easonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities." NASD Rule 3010(a)(2), (5), and (6). "Whether a particular supervisory system or set of written procedures is in fact 'reasonably designed to achieve compliance' depends on the facts and circumstances of each case." *Richard F. Kresge*, Exchange Act Rel. No. 55988, 2007 SEC LEXIS 1407, at *27 (June 29, 2007) (quoting *La Jolla Capital Corp*., 54 S.E.C. 275, 281 & n.15 (1999)).

MIS' supervisory procedures assigned to Pellegrino, the general manager, the responsibility "for reviewing the firm's overall supervisory system." Pellegrino was permitted to delegate all or some of his compliance responsibilities to others. Nevertheless, he remained responsible for those requirements "unless and until he . . . reasonably delegate[d] a particular function to another person in the firm, and neither kn[ew] nor ha[d] reason to know that such person [was] not properly performing his or her duties." *Id.* at *29.

When Pellegrino joined MIS in July 2001, the supervisory system was already inadequate. Swanson was serving as MIS' FINOP and compliance officer, which included correspondence review responsibilities,[27] and Olsen was serving as the lone supervisor of MIS' representatives. Neither of these delegations was reasonable. Swanson had a conflict of interest, due to his dual role working for both Metropolitan, for which he was spending the majority of his time, and MIS. As for Olsen, he was fulfilling several roles at MIS, including responsibilities for the demanding job of supervising MIS' 200 geographically dispersed representatives and for overseeing systems-related issues. Olsen was an inexperienced supervisor, whose only securities-related positions were at MIS and who never received training on how to supervise. Olsen admitted that he "had great difficulty" supervising all of the representatives and concerns that he "was exceeding [his] capability."

Although Pellegrino inherited this supervisory system, he did not take appropriate steps to correct it within a reasonable time. Pellegrino realized that Swanson should not have been serving as compliance officer, that the dispersement of the representatives "presented a supervisory challenge," and that the supervisory system "needed improvement." One year into Pellegrino's tenure, however, Swanson and Olsen remained in these roles, and Pellegrino even attempted to convince WDFI to permit Swanson to retain certain correspondence review tasks, *despite* WDFI's discovery that Swanson had approved several types of correspondence "containing problematic statements." Once WDFI insisted that MIS replace Swanson, Pellegrino proceeded in August 2002 to implement a new supervisory system that relied too heavily on Olsen. Specifically, Pellegrino appointed Olsen to be MIS' compliance officer, without relieving him of the already difficult—if not unmanageable—task of supervising MIS' representatives. *Cf. Kresge*, 2007 SEC LEXIS 1407, at *29-33 (finding that president made unreasonable delegations of supervisory authority, where such supervisors had limited experience, lack of training, and were "overwhelmed" with work).

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27 All of the misleading correspondence was sent when Swanson was compliance officer.

Pellegrino disputes that appointing Olsen as the compliance officer was unreasonable. He argues that a video of Olsen making a presentation at MIS' September 2002 compliance meeting demonstrates that he was skilled.[28] Pellegrino also notes that Olsen had a lengthy military career before joining MIS, was "detail oriented," and was "better . . . than Swanson." While the totality of the record, including the video, demonstrates that Olsen appeared to be a compliance-minded individual, we nevertheless find that Pellegrino's reliance on an inexperienced, untrained person to fill several demanding supervisory roles was not reasonable, especially considering the ongoing red flags of sales practice abuses that were occurring on Olsen's watch as the representatives' supervisor. Indeed, however good Olsen's intentions may have been, his testimony revealed that he was among the many MIS employees who did not understand that the Suitability Guidelines were an insufficient measure of suitability.[29]

Even if Olsen and Swanson were highly qualified and capable, "[i]t 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." *Kresge*, 2007 SEC LEXIS 1407, at *35-36 (citing cases). Pellegrino did not effectively discharge this duty. There were ample indications that Olsen's supervisory efforts were not preventing system-wide unsuitable recommendations and misleading sales presentations, and that Swanson's efforts were not preventing the use of misleading correspondence. While Pellegrino offered evidence of a number of supervisory steps he himself initiated, and added staff to the compliance department, he did not explain what he did to ensure that Olsen and Swanson were appropriately supervising to detect sales practice violations. That Pellegrino finally took the step of appointing Arsenault, a former FINRA employee, to be MIS' compliance officer does not excuse the fact that Pellegrino allowed an inadequate supervisory system to exist at MIS for nearly two years, when sales practice abuses were rampant.

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[28] On appeal, Pellegrino moved to introduce this video into evidence. The National Adjudicatory Council Subcommittee empanelled to consider this proceeding recommended that the video be admitted into evidence. We accept the Subcommittee's recommendation. NASD Rule 9346 requires that a proponent of additional evidence demonstrate that there was good cause for failing to introduce the evidence at the hearing below and that the evidence is material. We think Pellegrino has met both requirements. Based on our review of the record, it appears that the video is not in evidence because Pellegrino, who is pro se, did not understand how to proceed when the Hearing Officer reserved judgment on his initial attempt at a prehearing conference to introduce the video. In addition, as a video of Olsen's presentation at the September 2002 compliance meeting, the video has some relevance.

[29] Pellegrino argues that no rule prevented appointing the same person to supervise representatives and serve as compliance officer. NASD Rule 3010, however, requires that the supervisory system be reasonably designed to ensure compliance, which in this case required that Pellegrino not appoint Olsen to both positions.

Pellegrino argues that Sandifur prevented him from taking many supervisory steps, including efforts to remove Swanson. As long as Pellegrino remained MIS' general manager, however, he remained responsible for performing all duties that were assigned to him. *See George Lockwood Freeland*, 51 S.E.C. 389, 392 (1993); *Kirk Montgomery*, 55 S.E.C. 485, 496 (2001) ("[I]ndividuals identified as having particular supervisory duties in a firm's written procedures are responsible for discharging those duties."). If Sandifur was not cooperative, Pellegrino was "required to insist on . . . cooperation and compliance with applicable requirements or to resign." *Freeland*, 51 S.E.C. at 392 (rejecting the argument that firm owner's lack of cooperation excused principal's violations); *see John H. Gutfreund*, 51 S.E.C. 93, 112-114 (1992) (finding that, when management fails to take appropriate action, a supervisor "should consider what additional steps are appropriate to address the matter," including "disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities").[30]

Accordingly, we find that Pellegrino failed to establish and maintain an adequate supervisory system, in violation of NASD Rules 3010 and 2110.

B. Pellegrino Failed to Reasonably Supervise

Our discussion of whether Pellegrino failed to reasonably supervise is in two parts. First, we address whether Pellegrino knew or should have known of red flags of sales practice abuses. We find that he was aware of the red flags. Second, we examine whether Pellegrino failed to adequately respond to those red flags. We find that Pellegrino's response to these red flags was insufficient.

1. Red Flags Existed

A supervisor is 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 "[r]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review." *Id.* at 1283 n.13 (quoting cases); *see also Michael T. Studer*, Exchange Act Rel. No. 50543A, 2004 SEC LEXIS 2828, at *23 (Nov. 30, 2004), *appeal filed*, No. 04-6646-ag (2d Cir. Dec. 22, 2004). A failure to supervise is a violation of NASD Rules 3010(a) and 2110.[31]

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[30] Notwithstanding our findings above, we find that Pellegrino's delegation to Olsen of the responsibility to review MIS' advertising was reasonable. Considering that Olsen ultimately took steps to halt the misleading advertisements, and the relatively small number of violative ads that were published after Pellegrino's initial few months with MIS, the record does not show that Pellegrino should have known that Olsen was not reasonably exercising his authority to review advertising.

[31] In addition, "the Commission has determined that a violation of another NASD rule, in this case [NASD] Rule 3010, constitutes a violation of [NASD] Rule 2110." *Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558, at *2 n.3 (July 6, 2005).

As explained in detail above, numerous red flags existed that sales practice abuses were taking place and that heightened supervisory attention was warranted. Perhaps most significantly, Pellegrino was aware that MIS was selling its affiliates' risky securities and that most MIS customers did not understand how risky those securities were. Moreover, Pellegrino should have been aware that numerous MIS customers with low tolerance for risk were investing in Metropolitan and Summit proprietary products, *including* the preferred stock that MIS' Suitability Guidelines instructed should not be sold to such customers. *Cf. George J. Kolar*, 55 S.E.C. 1009, 1016 (2002) ("Decisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations.").

On appeal, Pellegrino claims that Ernst & Young, MIS' independent auditor, and Roth Capital Partners, LLC ("Roth"), MIS' QIU, led him to believe that the Metropolitan and Summit securities were not as risky as they actually were. Pellegrino claims that he believed that the issuers were "stable" because the offering documents showed that their assets were "of high quality," "fairly valued," and exceeded liabilities, and that Metropolitan returned to profitability for the quarter ending September 30, 2002. As for Roth's work product, Pellegrino argues that, as required by NASD Rule 2720, the offering prices for the preferred stock were no higher than, and the yields on the debt offerings were no lower than, those that Roth recommended.[32] Pellegrino argues that he was entitled to act in reliance on the auditor's and QIU's due diligence efforts, even if they were—in Pellegrino's words—"substandard" or the result of being misled by the issuers.[33] Similarly, Pellegrino tries to pin blame for the abusive sales practices on FINRA staff, which he asserts informed him that the securities "were risky" but failed to provide him "hard documentation," and WDFI, which he asserts failed to apprise him of their documented concerns with the issuers.

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[32] NASD Rule 2720 requires, in pertinent part, that, for sales of affiliates' securities like MIS' sales of Metropolitan and Summit securities, "the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established at a price no higher or yield no lower than that recommended by a [QIU]." NASD Rule 2720(c)(3)(A); *see also* NASD Rule 2720(b)(15) (QIU definition). Between 1998 and 2003, Roth acted as the QIU in approximately 18 separate offerings made by Metropolitan, Summit, and their affiliates.

[33] Pellegrino argues that Ernst & Young's and Roth's work product left him unaware that Metropolitan's and Summit's "asset values were inflated" or that "losses were masked in questionable loan transactions." In this regard, in January 2004, Ernst & Young resigned as Metropolitan's auditor and withdrew its independent auditor reports for the three prior years, saying it "could not rely on the representations of management." Previously, on June 17, 2003, after learning of FINRA's investigation and a decision by Metropolitan and Summit to raise the yield on certain debt securities, Roth discontinued its role as QIU for the offerings.

These arguments are not only misguided,[34] they are belied by Pellegrino's own testimony. Pellegrino conceded that he believed the affiliate products were medium to high risk products.[35] And regardless of whether the auditor and the QIU accurately presented the issuers' financial situation or the degree of risk involved with their securities, the offering documents disclosed a litany of risks that made it perfectly clear that the proprietary products were not suitable for investors with a low tolerance for risk. Pellegrino points to no actions of Ernst & Young or Roth that led him to believe otherwise.[36]

Pellegrino also argues that the Public Opinion findings did not apprise him that MIS customers did not appreciate the risks of the Metropolitan and Summit products. Pellegrino asserts that he attended the Public Opinion focus group sessions and that several participants "demonstrated their appreciation of the risks associated" with the affiliate products. Public Opinion's *overall* findings, however, were that the majority of MIS' customers had the false

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[34] The SEC has "repeatedly pointed out that a broker-dealer cannot shift its responsibility for compliance with applicable requirements" to regulators. *Quest Capital Strategies, Inc*., 55 S.E.C. 362, 377-78 (2001).

[35] Pellegrino testified that Sandifur rejected his recommendations to retain S&P or Moody's to rate the Metropolitan debentures. Although a rating would have provided a more reliable indicator of how risky the proprietary products were, Pellegrino did not need a rating to understand that they were not suitable for investors with low risk tolerances. Indeed, Pellegrino continues to assert on appeal that he believed the affiliate products were of a "BB" rating. As defined by Standard & Poor's:

> Obligations rated 'BB' . . . are regarded as having significant speculative characteristics. . . . An obligation rated 'BB' is less vulnerable to non payment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or other economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.

Standard & Poor's Ratings Definitions, *available at* www.2.standardpoors.com/portal/site/sp/en/us/page.article/2,1,1,4,1148445953418.html (last visited Sept. 12, 2007).

[36] Pellegrino also notes that Robert Stephenson, who worked for Roth to develop pricing opinions on a number of the Metropolitan offerings, provided investigative testimony that, at the time of an April 2002 Metropolitan offering, he was of the opinion that Metropolitan "would generate enough cash flow from operations to cover" fixed charges and preferred stock dividends. There is no evidence, however, that Pellegrino acted in reliance on Stephenson's personal opinion and, in fact, there is evidence that Stephenson rarely spoke with Pellegrino. In any event, Stephenson testified that he never informed Pellegrino that the securities were low risk.

impression that Metropolitan and Summit products were low risk products. Thus, the fact that some of MIS' customers may have had a more accurate understanding of their investments than others did not transform the Public Opinion findings into something that Pellegrino could ignore.

Pellegrino contends that he did not appreciate the potential problems with MIS' Suitability Guidelines and their emphasis on concentration levels. In this regard, he notes that MIS initially adopted the Suitability Guidelines in 1991 pursuant to FINRA's request, and that WDFI reaffirmed the importance of those guidelines as late as the summer of 2002. And citing *James B. Chase*, Exchange Act Rel. No. 47476, 2003 SEC LEXIS 566 (Mar. 10, 2003), Pellegrino also argues that preventing excessive concentrations of the proprietary products was appropriate. These arguments are not persuasive. Despite the interactions between regulators and MIS over the years concerning MIS' Suitability Guidelines, regulators never informed MIS or Pellegrino that such guidelines were to serve as the sole measure of whether recommendations were suitable. While *Chase* certainly counsels that an excessive concentration in a security for persons of limited means and net worth is not suitable, nothing in *Chase* suggests that concentration levels are the sole or primary factor of a suitability determination. *Id*. at *17 (noting that the test for suitability is whether a recommendation is "consistent with [a customer's] financial situation and needs").

Accordingly, we find that Pellegrino was aware of numerous red flags of irregularities. We now turn to whether he adequately responded to such warnings.

2. Pellegrino Failed to Employ Reasonable Supervision

The red flags required that Pellegrino conduct an appropriate inquiry and follow up with reasonable supervisory steps in response to any problems detected. Pellegrino contends that he implemented numerous supervisory steps, including training initiatives, staffing and recruitment changes, and amendments to procedures. We find, however, that Pellegrino's efforts were insufficient. As explained below, the supervisory steps either failed to directly address the red flags of unsuitable sales and misleading sales presentations, served to exacerbate the problems, or occurred far too late.[37]

a. Training Initiatives

Pellegrino acknowledged that the MIS representatives' "lack of financial knowledge" was a "red flag" that he took steps to address, and he points to several training programs that he employed. For example, Pellegrino testified that he initiated regular conference calls with the issuers, timed to coincide with the release of their Forms 10-Q and 10-K, to educate MIS' representatives about those issuers' proprietary products. Pellegrino also initiated in early 2002 a

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[37] As an initial matter, we note that this proceeding does not present the issue of whether a compliance officer had supervisory responsibilities. Pellegrino's supervisory responsibilities derived from his position as general manager and the responsibilities he had for the Firm's overall supervisory system.

monthly two-day training session called "Back to Basics" for both new and existing representatives, which he testified focused on how to read and understand the issuers' financial statements. Pellegrino testified that, as a result of these efforts, "[a]ll of the prospectus risk factors became much more meaningful" to the MIS representatives.

Had the training sessions actually focused on educating MIS representatives about the risks of the proprietary products, the need to disclose that risk to customers, and how to properly evaluate a customer's suitability, we would give Pellegrino more credit. The record demonstrates, however, that the training programs were geared more towards helping the representatives increase sales than comply with regulatory requirements. The person responsible for putting together the "Back to Basics" training was Bushman, MIS' national *sales* manager. Those sessions primarily focused on sales training, and included just a small segment devoted to compliance training. Likewise, Pellegrino employed the issuer's employees to make the financial presentations in the conference calls, not MIS compliance personnel. Moreover, numerous former MIS representatives, including Edwards, Ryan Saccamanno ("Saccamanno"), Kim Cowdell ("Cowdell"), Chris Sullivan ("Sullivan"), Ted Metoyer ("Metoyer"), and Ross Bruner ("Bruner"), testified that the training sessions focused on casting Metropolitan and Summit in positive lights and downplaying—or not even addressing—the risks, such as emphasizing Metropolitan's 48 years of profit and characterizing its recent losses as "behind them," and how to do that when dealing with customers. For example, as Edwards testified:

> We were constantly being informed of the issuer's position. They had these avenues of revenue coming in, and we were going to look better and maybe next quarter . . . we would be showing some profit, and there was a lot of positive rah-rah at Metro. It was a very positive feel at Metro. Our financials are rough right now, but we are going to look really a lot better.

Some of the representatives also testified that the training sessions did not touch upon how to evaluate the risk level of the proprietary products or the customers' characteristics, such as the amount and nature of their other investments, for suitability purposes.

Pellegrino points to MIS' September 26, 2002 compliance meeting as an example of how he and Olsen emphasized the need for "balanced presentations" and properly trained representatives about how to evaluate suitability. That meeting, however, stands as a perfect example of how Pellegrino's training efforts actually reinforced the MIS representatives' misunderstanding that the affiliates' securities were suitable for low risk portfolios and that suitability determinations only entailed checking for concentration levels. Despite Public Opinion's focus group findings that MIS customers misunderstood that their investments were conservative and safe, Pellegrino permitted Public Opinion to present at that meeting the focus group findings in positive terms. Public Opinion's presentation conveyed that, "[f]ortunately, it's clear that customers do not see Metropolitan . . . or its investment products as high risk," and recommended that "Metropolitan should position itself as fulfilling the 'conservative' part of the investment portfolio." In addition, Edwards testified that, although the September 2002 meeting included a section on compliance, no one ever communicated to her that the process of relying on the concentration standards to determine suitability had changed. Likewise, that September

2002 meeting introduced technology changes that allowed representatives to automatically calculate concentration ratios, reinforcing the message that concentration was the key measure of suitability.

The result was that MIS representatives were essentially trained to believe that the debentures were low risk securities, suitable for everyone with sufficient net worth. Edwards testified that "[m]y distinct impression of [Metropolitan], the entire time I was there, was that it was a conservative company, safe, and that's what we all believed." Swanson testified that he was not concerned that the securities were risky "because of [Metropolitan's] ability to recapture [losses] in the sale of . . . assets that it already held and its change in concentration on commercial loans," and thought that both the debentures, and possibly the preferred stock, were suitable for low risk investors. Saccamanno testified that he sold the affiliate products "with confidence" based on what he learned in the training sessions. Consistent with such beliefs, many MIS employees, including Swanson, Metoyer, Saccomanno, and Cowdell, continued to invest in Metropolitan and Summit securities.

In his brief, Pellegrino asserts that, apart from any formal training sessions, he employed a "day to day emphasis . . . on reps to disclose all prospectus risk factors in full." Pellegrino points to no corroborative evidence of this "day to day emphasis." In fact, it was not until late in the review period that MIS began to conduct training sessions that meaningfully conveyed the riskiness of its affiliates' securities. Sullivan testified that in late 2002, more of the risk factors were incorporated into the training sessions. At the October 2003 annual MIS meeting, Arsenault, who was MIS' compliance officer at that time, described Metropolitan's debentures as "junk bonds" and explained that a customer should invest no more than five percent of his net worth in such products. According to Saccamanno, this was the first time he had ever heard an MIS manager describe the Metropolitan debentures in such a fashion.

Accordingly, the training did not adequately respond to the red flags. *Cf. Consolid. Inv. Servs., Inc.*, 52 S.E.C. 582, 587 (1996) (rejecting the argument that a firm had adequately supervised where the supervisory tool it used was an "inadequate substitute" for meaningful supervision).

b. <u>Staffing and Recruitment</u>

Pellegrino also employed a number of staffing and recruitment initiatives that he claims demonstrate his supervision was adequate. We find, however, that such efforts were not directly employed to counter the red flags of sales practice abuses.

For example, the record demonstrates that Pellegrino instituted the so-called "7-7-0" standards for hiring new employees: (1) seven years' experience, which Pellegrino testified would "give [him] some comfort that they were well-versed"; (2) a Series 7 license, "preferably with broad experience; and (3) zero compliance problems. This was not a meaningful supervisory step because the true problems rested with MIS' then-existing staff and, as explained above, Pellegrino's efforts to train them fell short. Moreover, it is unclear what effect, if any, Pellegrino's new hiring standards had on MIS' existing workforce. During the relevant period, MIS was downsizing, not hiring, as the number of MIS representatives shrunk from 200 to between 120 and 150.[38] Moreover, Pellegrino testified that he had difficulty recruiting "talent[ed]" people.

Pellegrino also testified that he hired Bruce Bushman, Jim Bell, Erin Davis, and Jeanette Martin to work in the compliance department. Here too, the record suggests that this was not a meaningful supervisory step. None of these four persons had previous compliance experience. In addition, there is limited evidence concerning what these new employees actually did to detect and deter the sales abuses. Bushman's title was national sales manager, so it is unclear what, if any, compliance duties he had except for the "Back to Basics" training, which was actually geared towards sales. But regardless of what these employees did for the compliance department, their being hired did not curtail the sales practice violations. For example, Bell conducted branch office audits, and Martin assisted with a customer audit initiative, but there is no indication that these activities caused them to detect, or alert Pellegrino to, any red flags of sales practice problems. *Cf. Montgomery*, 55 S.E.C. at 504 (evaluating whether branch audits were an effective supervisory tool or simply a "pro forma exercise"); *La Jolla Capital Corp.*, 54 S.E.C. at 283 (noting that the assignment of a compliance officer to audit a firm's newly opened branch office was not meaningful supervision, where the assignment occurred months after the office opened and the record did not show how the compliance officer focused his supervision).

Accordingly, the staffing and recruitment efforts were not an adequate response to the red flags of irregularities.

c. <u>Changes to Compliance Manuals and Procedures</u>

Pellegrino also argues that a number of changes he effected to MIS' compliance manual and MIS' procedures showed that he adequately supervised the Firm's representatives. We disagree.

MIS had both a compliance manual, which was distributed to MIS representatives, and a supervisory manual. Prior to, and during, the relevant time period, the MIS compliance manual contained sections addressing suitability. The June 1999, June 2000, and August 2002 compliance manuals all stated that "when making recommendations to clients, Representatives shall have [a] reasonable basis to believe that such recommendations are suitable, that they are in accordance with the client's stated investment objectives, accepted risk level, and disclosed personal information and investment experience." The compliance manuals also explained that "those securities that suit the objective of capital preservation are, generally speaking, of the lowest risk." The September 2001, October 2002, and December 2002 supervisory manuals also contained similar suitability guidance, with additional language explaining that it applied to sales

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38 Pellegrino casts the downsizing as another one of the supervisory steps he took, but the record suggests that this was done for business reasons, rather than in response to red flags. In any event, the downsizing, which still left Olsen with the task of supervising between 120 and 150 representatives by himself, left in place a supervisory system that remained not reasonably designed to achieve compliance.

of the affiliate products, and required that MIS maintain records of the basis of suitability determinations. MIS also conveyed, through newsletters and the Suitability Guidelines, that "preferred stock" was not suitable for customers with "low risk tolerance."

Contrary to Pellegrino's contention, the procedures that Pellegrino inherited were problematic. The manuals' sections on suitability read well when viewed in isolation, but they were undermined by the Suitability Guidelines, which primarily framed the suitability determination in terms of measuring concentrations. Moreover, although the Suitability Guidelines correctly informed MIS representatives that the affiliated companies' preferred stock was not suitable for customers with low risk tolerances or objectives to preserve capital, by limiting that directive just to preferred stock and stating that there were no financial eligibility requirements for debenture purchases, the guidelines created the misimpression that significant concentrations of debentures were suitable for low risk investors. Further compounding this problem was that there was no mention of the debentures in a section that addressed where different types of investments fell on the risk spectrum, despite the fact that the debentures made up the majority of what MIS sold.

While we do not fault Pellegrino for the procedures as they existed when he joined MIS, he failed to correct them within a reasonable time. Pellegrino also implemented changes, like the "buying power reports" and "EZ" resubscription agreement, that reinforced the wrong message that the concentration standards were the primary consideration when evaluating suitability. In fact, it was not until late January 2003—18 months after he joined MIS—that Pellegrino improved MIS' procedures in ways that appropriately responded to the red flags. Pellegrino incorporated into MIS' January 31, 2003 Compliance Manual the "Fair and Balanced Presentation standard," which emphasized the need for sales presentations that would not "favor the positive attributes of a proposed investment over the potential negative attributes," "discuss[ ] only the payment history and length of time in business of an issuer," or "tell[ ] the investor to look at the prospectus themselves for the risk factors." Pellegrino further amended that manual by adding amended Suitability Guidelines that stated that *none* of the affiliate products were suitable for investors with low risk tolerances. We think that these were appropriate amendments, and indeed only seven of the 165 unsuitable transactions at issue occurred after the new compliance manual was issued. Nevertheless, Pellegrino waited to make such changes until after the red flags of sales practice abuses had been present for months and after a FINRA investigation into MIS' sales practices had commenced. *Cf. Kresge*, 2007 SEC LEXIS 1407, at *37 (finding that president failed to supervise where supervisory actions "occurred months after the misconduct at issue already had transpired and after NASD had begun its investigation"). Moreover, even after Pellegrino implemented these changes, the amended procedures still did not specifically address the significant risk factors in play. We therefore reverse the Hearing Panel's findings that Pellegrino implemented appropriate written supervisory procedures.

Pellegrino also points to a series of additional procedures he adopted. Pellegrino started a customer internal audit ("CIA") program that prevented representatives from changing customer financial information on customer account documentation to meet concentration standards without direct customer acknowledgement. The CIA program also required an MIS sales or operations principal to contact customers where a prospective investment would exceed a "10-15-20" concentration ratio (i.e., ratios equal to half of those specified in MIS' Suitability

Guidelines) and then "make a firm recommendation [to Olsen] of whether [the] trade is in fact suitable or unsuitable."[39] While these measures may have been sufficient to ensure that customers' investments in affiliate products did not exceed the stated concentration levels, they were neither designed nor implemented to ensure that MIS representatives took into account all relevant suitability factors, and not simply the concentration levels. The fact that MIS representatives continued to sell affiliate products to customers with low risk tolerances and capital preservation objectives shows that these procedures were ineffective.[40] *Cf. Kolar*, 55 S.E.C. at 1020 (rejecting the argument that implementation of various supervisory procedures was reasonable supervision, where such procedures were "inapplicable to the situation" that respondent confronted).

Pellegrino testified that the CIA program also included sending letters to customers who had purchased affiliate products asking whether they had received a prospectus and whether they understood the risk involved in the investment. Even if this procedure was implemented, it would not have been adequate to detect the sales practice abuses. Simply asking whether the customers understood the risks of the affiliate securities did not probe the customers' understandings of the risks, or detect for unsuitable recommendations.[41] *Cf. Quest Capital Strategies, Inc.*, 55 S.E.C. at 373 (internal quotation marks omitted) (finding that supervisory step of contacting customers was inadequate where such contact did not account for the fact that "customers . . . may fail to realize that they have been mistreated"). Indeed, the inadequacy of the program was further demonstrated by the fact that the sale of unsuitable securities continued unabated.

Accordingly, we find that the procedures that Pellegrino adopted did not adequately respond to the red flags.

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39 Pellegrino testified that part of the CIA program included a "second principal review," which required a second principal to contact the customer if the first contact left ambiguities about the customer's information.

40 Moreover, to some extent Pellegrino was directed by Washington state regulators to employ these particular supervisory steps, which belies any claim that Pellegrino was actively trying to respond to red flags.

41 "The test for whether . . . recommended investments [are] suitable is not whether [the customer] acquiesced in them, but whether . . . recommendations . . . were consistent with [the customer's] financial situation and needs." *Jack H. Stein*, Exchange Act Rel. No. 47335, 2003 SEC LEXIS 338, at *14 (Feb. 10, 2003); *see also Chase*, 2003 SEC LEXIS 566, at *18 (holding that "[m]ere disclosure of risks is not enough" and that registered representatives must be satisfied that a customer fully understands and "is . . . able . . . to take those risks").

d. Firing the Great Northern Registered Representatives

In Pellegrino's first month as general manager, Olsen and Edwards informed Pellegrino that a group of approximately 20 representatives referred to as the "Great Northern organization" were engaging in sales practice abuses when selling the Metropolitan and Summit proprietary products. After investigating the group and learning that the Great Northern representatives were informing customers that the affiliated issuers' preferred stock was "like a money market fund" and a "guaranteed investment" that could be sold back after a 60-day period, Pellegrino recommended to Sandifur that MIS terminate the group, and Sandifur agreed. Pellegrino claimed that, at the time, the Great Northern group was responsible for 23 percent of MIS' sales of proprietary products.

We give Pellegrino credit for taking action to have the Great Northern group fired. Nevertheless, our examination of whether Pellegrino reasonably supervised looks to the totality of his actions over the relevant period. The fact remains that, when presented with red flags indicating that problematic sales practices were occurring throughout MIS, Pellegrino failed to act with the same level of diligence and directness that he did when reacting to the Great Northern situation.[42]

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We have considered the individual supervisory steps that Pellegrino took as well as the cumulative effect of those supervisory efforts. In light of the red flags that were present, Pellegrino's supervisory efforts were inadequate. While he implemented a variety of supervisory actions, those actions, whether viewed individually or collectively, failed to directly address the problems that were causing voluminous amounts of unsuitable recommendations and misleading sales presentations. Accordingly, we find that Pellegrino failed to supervise in violation of NASD Rules 3010(a) and 2110.

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[42] On appeal, Pellegrino moved to introduce evidence that he has cooperated during 2005 with federal government agencies, including a U.S. Attorney in Portland, Oregon, in connection with an investigation of an MIS representative. Pellegrino notes that the "Fair and Balanced Presentation" standard he authored was "[o]f particular interest" to the U.S. Attorney and argues that "if I had something to hide regarding my reorganization and enhancement of MIS and it's [sic] compliance program, I would not have cooperated without counsel and without a legal requirement to do so." We reject Pellegrino's motion because the proffered evidence is not material. The mere fact that Pellegrino cooperated to some extent with federal prosecutors has no bearing on whether he committed the violations at issue. Nor does it mitigate his conduct for sanctions purposes, given that his cooperation occurred well after his violations had been detected.

V. Sanctions

For Pellegrino's failure to supervise, the Hearing Panel suspended Pellegrino for six months in all capacities. We modify the sanctions to align Pellegrino's supervisory failures with sanctions that focus on limiting his ability to act as a principal in a supervisory capacity.

For failing to supervise, the FINRA Sanction Guidelines ("Guidelines") recommend, in egregious cases, suspending the responsible individual in any or all capacities for up to two years or imposing a bar.[43] The Guidelines also recommend the imposition of a fine between $5,000 to $50,000.[44] In assessing what sanction is appropriate, we consider the Principal Considerations in Determining Sanctions.

There are numerous aggravating factors, but we do not agree with the Hearing Panel that there is significant mitigation. The nature, extent, size, and character of the underlying misconduct are aggravating.[45] MIS representatives made at least 165 unsuitable recommendations to invest in the proprietary products over a period of more than 18 months. Many of the customers who invested were elderly, retired, and unsophisticated.[46] Directly or indirectly, Pellegrino's conduct resulted in injury to customers.[47] In the 165 transactions at issue, customers invested more than $4.1 million and, to the extent that such customers still held such products when the issuers declared bankruptcy, it was expected that debenture holders would receive only a third of their investments back, and that preferred stockholders would lose their entire investment.

It is also aggravating that Pellegrino ignored numerous red flag warnings of this activity over an extended period of time that should have resulted in additional supervisory scrutiny.[48] While Pellegrino may not have immediately recognized the extent of the problems, it did not take him long to see them. Before he started at MIS, Pellegrino read the prospectuses and knew that MIS' affiliates' securities were risky. Upon starting, his impression was that MIS was "chaotic" and rife with conflicts. Within the first six months of starting, Pellegrino knew that customers did not fully appreciate the extent of the risks involved with the proprietary products.

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43 *FINRA Sanction Guidelines*, at 108 (2006), http://www.finra.org/web/groups/enforcement/documents/enforcement/p011038.pdf [hereinafter *Guidelines*].

44 *Guidelines*, at 108.

45 *Guidelines*, at 108 (Principal Considerations in Determining Sanctions, No. 2).

46 *Id.*; *Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 19).

47 *Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 11).

48 *Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 9), 108 (Principal Considerations in Determining Sanctions, No. 1).

Over time, the red flags only became more evident, as more and more proprietary products were sold to customers with low tolerances for risk and the Public Opinion findings were presented.

The quality and degree of Pellegrino's implementation of MIS' supervisory procedures in the face of these red flags was poor.[49] Pellegrino's delegation to Olsen of supervisory responsibility was inadequate, and there is no evidence that Pellegrino was actively monitoring whether Olsen was properly implementing the supervisory procedures, which is perhaps best demonstrated by the large number of unsuitable recommendations that occurred during his tenure.[50] Indeed, Olsen's testimony reflected that he did not understand that the Suitability Guidelines should have served only as one component of a suitability determination.

Except for Pellegrino's firing of the Great Northern representatives—which we find mitigates his conduct to some extent—the supervisory steps Pellegrino took were often ineffective, undermined by his sales initiatives (commenced in the context of clear warning signs), implemented only after detection of wrongdoing by regulators, mandated by regulators,[51] or taken only after far too much damage had been done. For example, although Pellegrino ultimately authored the "Fair and Balanced" standard that was perhaps his most direct attempt at addressing the sales practice abuses, it took him 18 months and the pressure of a pending FINRA investigation to do so.[52] In addition, while Pellegrino removed Swanson and Olsen from the compliance officer position and required that certain investors be contacted before approving transactions in proprietary products, he did so only in response to, or after, FINRA's and WDFI's detection of problems. Although the Hearing Panel found it mitigating that Pellegrino had "entered into a bad situation," the fact remains that it was Pellegrino's responsibility to take reasonable steps to ensure MIS' compliance with regulatory requirements, no matter how difficult the circumstances. He failed, over an extended period of time and in the face of persistent red flags, to react in a way that corresponded to the irregularities that were present. And given how conspicuous the red flags were, we find that Pellegrino's failure to supervise was at least reckless.[53] It is also aggravating that Pellegrino has sought to shift the blame to others,

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49 *Guidelines*, at 108 (Principal Considerations in Determining Sanctions, No. 3).

50 MIS' procedures for supervising customer accounts required supervisors to "periodically examine customer accounts to detect and prevent irregularities or abuses" and to "monitor selected telephone conversations between registered representatives and existing and potential customers."

51 *Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 3).

52 Pellegrino received a written request for information from FINRA on January 6, 2003, a few weeks before he amended the compliance manual.

53 *Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 13).

including Sandifur, the issuers, Ernst & Young, Roth, FINRA, and WDFI, instead of accepting responsibility for his conduct.[54]

Pellegrino contends it is mitigating that he had to ensure MIS' compliance with many new regulations and participate in several FINRA examinations during the relevant period. The fact that Pellegrino's workload may have been heavy does not excuse or mitigate his misconduct. If he needed assistance, it was Pellegrino's responsibility to establish an adequate supervisory system that gave him that assistance. Instead, he made unreasonable delegations of supervisory authority to Swanson and Olsen. *Cf. Barry C. Wilson*, 52 S.E.C. 1070, 1073 (1996) (rejecting the argument that "excessive demands on [respondent's] time" due to FINRA examinations and compliance responsibilities excused failure to comply with FINRA requests). Pellegrino also argues that he rebuffed Sandifur's instructions to "sandbag" the restitution payments that MIS had consented to pay in an AWC. He did so, however, only after FINRA had detected wrongdoing at MIS, which does not give those actions any mitigating effect.[55]

After careful consideration of these circumstances, we find that barring Pellegrino in all principal capacities is needed to deter him from again engaging in supervisory violations. For the reasons explained above, Pellegrino's failure to supervise was egregious, and we do not think that merely suspending Pellegrino in a principal capacity for a limited duration of time would be sufficient to ensure that he fully understands the need to comply with the obligations and responsibilities that principals shoulder. In this regard, we note that Pellegrino not only failed to supervise, he focused on boosting sales in the face of numerous red flags of abusive sales practices. In short, to permit Pellegrino to be entrusted with supervisory responsibilities again would place customers at too great a risk.

We do not conclude, however, that suspending Pellegrino in non-principal capacities is needed to deter him from engaging in other types of violations. Although we find that Pellegrino's failure to supervise was a serious violation, it was a failure in his capacity as a supervisor, not as a general securities representative. Moreover, Pellegrino is a veteran of the industry, and his early and prompt firing of the Great Northern representatives is mitigating. Combined, these circumstances lead us to conclude that imposing an additional general suspension on Pellegrino would have limited additional remedial value.

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[54] *Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 2).

[55] *Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 4).

Therefore, to protect investors and remedy Pellegrino's misconduct, we bar Pellegrino from serving in a principal capacity.[56] We emphasize that we are tailoring our sanctions to address Pellegrino's egregious supervisory failures.[57]

There is no indication that the United States bankruptcy court presiding over Pellegrino's personal bankruptcy action lifted the automatic stay for an action to enforce a decision imposing monetary sanctions. *See* 11 U.S.C. § 362(b)(25)(B). Therefore, we shall not impose any monetary sanctions.

VI. Conclusion

We affirm the Hearing Panel's findings that Pellegrino failed to establish, maintain, and implement a supervisory system, in violation of NASD Rules 3010 and 2110. We modify the sanctions, however, and bar Pellegrino from serving in a principal capacity.[58]

On behalf of the National Adjudicatory Council,

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Marcia E. Asquith
Vice President and Deputy Corporate Secretary

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[56] Pellegrino argues that his unemployment warrants lower sanctions. Pellegrino's lengthy career in this industry, however, makes it likely he will try to reenter it. *Cf. Steven E. Muth*, Exchange Act Rel. No. 52551, 2005 SEC LEXIS 2488, at *79-80 (Oct. 3, 2005) (imposing a supervisory bar despite respondent's unemployment, where SEC "believe[d] it likely that [respondent] will seek reemployment in the securities industry"); *see also Herbert J. Burns*, 52 S.E.C. 823, 828 (1996) (rejecting the argument that unemployment was a reason to set aside sanctions).

[57] Our imposition of a principal bar in this proceeding does not mean, however, that broader sanctions, such as a bar or suspension in all capacities, would not be warranted in other cases involving supervisory failures. The appropriate sanctions depend on the facts and circumstances of each case.

[58] We also have considered and reject without discussion all other arguments of respondent.