BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Roy M. Strong Brownsburg, IN, Respondent.	DECISION Complaint No. E8A2003091501 Dated: August 13, 2008

The record contained insufficient evidence to prove that the charitable gift annuities at issue were securities for purposes of finding a violation of FINRA's private securities transaction rule. Held, findings reversed, case dismissed.

Appearances

For the Complainant: Richard S. Schultz, Esq., Leo F. Orenstein, Esq., Pamela Shu, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For Respondent: Robert L. Hartley, Esq.

Decision

Roy M. Strong ("Strong") appealed, and the Department of Enforcement ("Enforcement") cross-appealed, a May 18, 2007 Hearing Panel decision. The Hearing Panel found that Strong violated NASD Rules 3040 and 2110 when he sold charitable gift annuities for compensation without providing notice to, and obtaining prior approval from, his member firm.[1] The Hearing Panel suspended Strong for one year, fined him $25,000, and assessed costs of $3,940.15.

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

After a complete review of the record, we reverse the Hearing Panel's findings that Strong violated NASD Rules 3040 and 2110. To affirm the Hearing Panel's findings of violation, we must conclude that the charitable gift annuities that Strong sold are securities. Based upon the limited evidence in the record, however, we are unable to reach that conclusion. Although there are several compelling reasons to conclude that charitable gift annuities generally are securities, there is insufficient evidence in the record to conduct the necessary, fact-specific analysis of whether the annuities that Strong sold meet the criteria for a security. As a result, Enforcement failed to prove that the charitable gift annuities at issue in this case are securities. This failure warrants reversal of the Hearing Panel's findings and dismissal of the complaint.

I. Background

A. Strong's Employment History

Strong entered the securities industry in July 1993 when he registered with Intersecurities, Inc. ("Intersecurities") as an investment company and variable contracts products representative. In June 1996, Strong also became registered with Intersecurities as a general securities representative. Strong remained associated with Intersecurities through November 2003 when he was terminated for selling charitable gift annuities. After his termination from Intersecurities, Strong registered with another member firm. He remains associated with that firm.

B. Procedural History

FINRA commenced the investigation that led to the complaint in this matter after receiving a Uniform Termination Notice for Securities Industry Registration ("Form U5"), disclosing that Intersecurities terminated Strong for selling charitable gift annuities without authorization. On March 13, 2006, Enforcement filed a one-cause complaint alleging that Strong engaged in private securities transactions when he sold seven charitable gift annuities to eight customers. The Hearing Panel issued its decision on May 18, 2007, finding that Strong's sales of charitable gift annuities violated NASD Rules 3040 and 2110. The Hearing Panel suspended Strong for one year, fined him $25,000, and assessed $3,940.15 in costs. On June 8, 2007, Strong timely filed his notice of appeal. Enforcement filed its cross-appeal on June 14, 2007.

II. Strong Sold Charitable Gift Annuities

The relevant facts of this case are undisputed. Strong stipulates that he participated in the sales of seven charitable gift annuities to eight customers.[2] Strong's sales of the charitable gift

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[2] Charitable gift annuities are products that enable individuals to transfer cash or marketable securities to charitable organizations. *See NASD Regulatory & Compliance Alert*, Summer 2002 at 26/27; *NASD Notice to Members* 02-70 (October 2002). The charitable organizations then issue gift annuities to the individuals in exchange for a current income tax deduction and the organization's promise to make fixed annual payments for life. *See id.* At the deaths of the annuitants, the remaining funds are disbursed to the charity. *See NASD Regulatory & Compliance Alert*, Summer 2002 at 26/27.

annuities totaled $1,019,137.83. He earned $77,738.85 in commissions on the sales. The details of the sales are as follows:

- On December 31, 1996, Strong sold a charitable gift annuity issued by Mid-America Foundation ("Mid-America") to R&MAG for $330,588. He received $23,000 in commissions on the sale.

- On August 28, 1997, Strong sold a charitable gift annuity issued by Mid-America to R&GC for $20,000. He received $1,500 in commissions on the sale.

- On June 25, 1999, Strong sold a charitable gift annuity issued by National Heritage Foundation ("National Heritage") to OL for $103,947.02. He received $8,315.76 in commissions on the sale.

- On November 4, 1999, Strong sold a charitable gift annuity issued by National Heritage to BVM for $116,258.81. He received $9,300.70 in commissions on the sale.

- On September 17, 2000, Strong sold a charitable gift annuity issued by National Heritage to MVM for $16,300. He received $1,403.76 in commissions on the sale.

- On January 26, 2001, Strong sold a charitable gift annuity issued by National Heritage to MP for $107,044. He received $9,218.63 in commissions on the sale.

- On October 16, 2001, Strong sold a charitable gift annuity issued by ABC Hollister Foundation ("ABC Hollister") to R&MAG for $325,000. He received $25,000 in commissions on the sale.

In addition to stipulating to participation in the sales, Strong acknowledges that the charitable gift annuities were not on Intersecurities' approved product list. Strong also concedes that he failed to notify Intersecurities that he intended to sell the charitable gift annuities and that he did not obtain approval from Intersecurities to engage in the sales.[3] Indeed, three of Strong's sales contravened Intersecurities' express prohibition against selling charitable gift annuities.[4]

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[3] Between December 1996 and October 2001, Strong completed at least four outside business activities and annual regulatory questionnaires in which he affirmatively stated that he did not offer or receive remuneration for securities products that Intersecurities did not approve in writing.

[4] On March 15, 2000, November 20, 2000, and February 20, 2001, Intersecurities issued compliance bulletins that expressly prohibited registered representatives from selling charitable gift annuities without prior approval.

III. Discussion

A. NASD Rules 3040 and 2110[5]

NASD Rule 3040 prohibits associated persons from participating in a private securities transaction for compensation unless the associated person provides notice to, and obtains prior approval from, the member firm.[6] The rule defines "private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member." *See* NASD Rule 3040(e)(1). Strong admits that he sold the charitable gift annuities and that they were unapproved products. He also acknowledges that he did not provide notice to, and obtain prior approval from, Intersecurities to engage in the sales. Thus, the primary issue on appeal is whether the charitable gift annuities that Strong sold are securities.

B. The *Howey* Test Is the Required Analysis for Charitable Gift Annuities

The definition of "security" within the Securities Exchange Act of 1934 (the "Exchange Act") guides the determination of whether charitable gift annuities qualify as securities. *See* 15 U.S.C. 78c(a)(10) (defining security as, "any note, stock . . . investment contract . . . ."). Although charitable gift annuities are not enumerated in the Exchange Act under the term "security," the term "investment contract" has developed as a catch-all provision to cover a broad range of transactions, products, and devices that do not fit neatly into the conventional categories of the definition of a "security." *See SEC v. Edwards*, 540 U.S. 389 (2004) (recognizing "Congress' intent to regulate all of the 'countless and variable schemes devised by those who seek the use of the money of others on the promise of profits'"). *See also* Louis Loss & Joel Seligman, *Securities Regulations*, § 3-A-1(a)(i) (3d ed. 2006) (explaining that the remedial purposes underlying the federal securities laws support the emergence of investment contract as a catch-all for transactions that do not fit neatly into the conventional securities categories).

The term investment contract is not defined in the securities legislation. The United States Supreme Court, however, has held that an investment contract involves (1) an investment of money, (2) in a common enterprise, (3) with a reasonable expectation by the investors of profits, (4) to be derived solely from the managerial efforts of others. *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946) (establishing the *Howey* test for investment contracts); *Warfield v. Alaniz*, 453 F. Supp. 2d 1118, 1124 (D. Ariz. 2006) (holding that certain charitable gift annuities

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[5] A violation of another FINRA rule is a violation of NASD Rule 2110. *See Charles C. Fawcett, IV*, Exchange Act Rel. No. 56770, 2007 SEC LEXIS 2598, at *11-12 (Nov. 8, 2007) (stating that violations of FINRA rules are inconsistent with just and equitable principles of trade and constitute a violation of NASD Rule 2110.).

[6] NASD Rule 3040 provides, in pertinent part, "Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction . . . ." NASD Rule 3040(b).

sold by Mid-America were investment contracts and therefore securities). We apply the *Howey* test for investment contracts to analyze whether the charitable gift annuities that Strong sold are securities.[7]

C. Enforcement Failed to Prove that the Charitable Gift Annuities Are Securities

The application of the *Howey* test to the charitable gift annuities that Strong sold requires an evaluation of whether the terms, conditions, and features of each annuity meet each element of the *Howey* test. We are unable to determine whether each element of the *Howey* test is met in this case because there is insufficient evidence in the record to conduct a complete *Howey* analysis. Specifically, there is an absolute dearth of evidence to determine whether there is a common enterprise or whether the investors had a reasonable expectation of profits as it relates to the charitable gift annuities at issue.[8]

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[7] Enforcement argues, in the alternative, that the *Reves* family resemblance test applies to determine whether the charitable gift annuities at issue are securities. *See Reves v. Ernst & Young*, 494 U.S. 56 (1990). *Reves* analyzes which types of notes are securities within the meaning of the Exchange Act. *See id.* at 56. Because the term "note" is delineated in the Exchange Act, the *Reves* court determined that it would be inappropriate to apply the investment contract test to notes. *See id.* at 64. Thus, the Court developed other principles to define the term note within the meaning of the Exchange Act. *See id.* at 58 (rejecting the approaches of courts that have applied the investment contract test to notes). We conclude that notes and charitable gift annuities are distinct instruments and that it would be inappropriate to apply the *Reves* family resemblance test for notes to charitable gift annuities. Notes pay a specified sum of money based on the terms of the note. *See Reves*, 494 U.S. at 58-59. Amounts paid under charitable gift annuities are indeterminate because the annuities pay according to the length of the life of the annuitant. *See Warfield*, 453 F. Supp. 2d at 1123-24. The differences between these two products warrant application of distinct tests to determine whether each product qualifies as a security under the Exchange Act. *See Reves*, 494 U.S. at 63-64. We also consider and rely upon the fact that Arizona federal and state courts applied the *Howey* test to conclude that specific charitable gift annuities are securities. *See Warfield*, 453 F. Supp. 2d at 1124; *Ariz. Corp. Comm'n v. One Vision Children's Found., Inc.*, 2003 Ariz. Sec. LEXIS 27, at *3 (Ariz. Super. Ct. June 30, 2003).

[8] The evidence is sufficient to establish that the purchasers of the charitable gift annuities made an investment – they purchased the charitable gift annuities that Strong sold with payments of cash, property, or stock. *See Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 559-560 n.12 (1979) (expressly rejecting that a person's investment must take the form of cash only, rather than goods and services); *Warfield*, 453 F. Supp. 2d at 1123. The evidence also supports that any payments made to the annuitants would be derived solely from the managerial efforts of others. Strong testified that the customers had no involvement in the management of the charitable foundations or the management of the money that they gave the foundations. *See Warfield*, 453 F. Supp. 2d at 1124 n.6. This stand-alone proof, however, is insufficient to prove that the annuitants had a reasonable expectation of profits or that there was a common enterprise within the meaning of the *Howey* test. As a result, the evidence is insufficient to prove that the charitable gift annuities that Strong sold are securities.

Enforcement entered into evidence certain charitable gift annuity agreements, annual annuity illustrations, and annuity applications for each customer. These documents, however, provided insufficient evidence to determine how the foundations that issued the charitable gift annuities operated or whether the investors expected returns on their investments – information necessary to determine whether there was a common enterprise or whether the investors had a reasonable expectation of profits.

The lack of evidence in the record regarding Strong's representations to the investors and the operations of the foundations that issued the annuities make it impossible to determine whether these charitable gift annuities are securities. *See SEC v. Bennett*, 904 F. Supp. 435, 437 (E.D. Pa. 1995) (denying motion to dismiss and ordering fact discovery to determine whether charitable gift annuities are securities); *Dep't of Enforcement v. Baxter*, Complaint No. C07990016, 2000 NASD Discip. LEXIS 3, at *20 n.16 (NASD NAC Apr. 19, 2000) (dismissing cause of complaint where there was inadequate evidence to conclude whether interests in two limited liability companies were securities for purposes of NASD Rule 3040); *Dep't of Enforcement v. Meckler*, Complaint No. C01020003, 2002 NASD Discip. LEXIS 37, at *10-16 (NASD OHO Sept. 24, 2002) (finding insufficient evidence to determine whether investments were securities within the context of NASD Rule 3040). We, therefore, reverse the Hearing Panel's findings that Strong violated NASD Rules 3040 and 2110.

In so holding, we acknowledge that at least two courts have found that the particular charitable gift annuities at issue were securities. *See Warfield*, 453 F. Supp. 2d at 1124; *One Vision Children's Found., Inc.*, 2003 Ariz. Sec. LEXIS 27, at *3. The Commission has also suggested, in cases unrelated to this one, that specific charitable gift annuities are securities. *See Bennett*, 904 F. Supp. at 435 (Commission-initiated action that alleged that the defendant raised funds through the fraudulent offer and sale of unregistered charitable gift annuities); *New Life Corp.*, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 326, at *1-2 (Mar. 16, 1999) (no-action letter advising that any financial professional that sells charitable gift annuities for commissions, or any other special compensation based on the value of the donation, must be registered as a broker-dealer). In contrast, an Iowa state court determined that charitable gift annuities are not securities within the meaning of the Exchange Act. *See Riniker v. Locust St. Sec., Inc.*, 2006 Iowa App. LEXIS 1716, at *6 (Iowa Ct. App. May 10, 2006) (finding that charitable gift annuities are not securities under Iowa law or within the meaning of the Exchange Act). In this case, we simply do not have sufficient evidence to complete the required *Howey* analysis to determine whether the charitable gift annuities that Strong sold are securities within the meaning of the Exchange Act.

Unlike the Hearing Panel and Enforcement, we are unwilling to rely solely upon the court's analysis of certain Mid-America charitable gift annuities in *Warfield* to establish the elements necessary to prove the case against Strong. *See generally Warfield*, 453 F. Supp. 2d at

1124.[9] It has long been established that, "each case must be determined upon the basis of its own facts." *In re Unity Gold Corp.*, 3 S.E.C. 618, 625 (1938). Thus, the Hearing Panel's and Enforcement's sole reliance on *Warfield* to conclude that the charitable gift annuities in this case are securities is improper.

Enforcement was required to prove by a preponderance of the evidence that the charitable gift annuities that Strong sold are securities within the meaning of the Exchange Act. To meet this burden, Enforcement needed to proffer specific evidence about the representations that Strong made to the eight customers and evidence regarding the operations of each foundation at issue in this case – Mid-America, National Heritage, and ABC Hollister. The *Warfield* case, standing alone, provides insufficient evidence to meet that evidentiary standard.

First, *Warfield* provides no evidence about the representations that Strong made to the purchasers of the charitable gift annuities. Second, although the *Warfield* case involves charitable gift annuities from Mid-America, there is nothing on the face of the decision that describes the operations of Mid-America in sufficient detail to apply the *Howey* factors to the charitable gift annuities that Mid-America issued in this case. *See Warfield*, 453 F. Supp. 2d at 1123-24. Finally, as the *Warfield* decision involves only Mid-America-issued charitable gift annuities, it provides no basis to draw inferences about the operations of National Heritage or ABC Hollister.

We also emphasize that Enforcement could have pleaded alternatively that Strong's sales of charitable gift annuities violated NASD Rule 3030, which requires associated persons to provide prompt, written notice of outside business activities that do not involve securities. If Enforcement had alternatively pleaded a violation of NASD Rule 3030, we would not need to find that these charitable gift annuities were securities in order to find a violation. Alternative pleading of NASD Rules 3040 and 3030 would be particularly useful here, where there is such clear evidence of a blatant disregard of FINRA's notification requirements.

Based upon the evidence in the record, we find that Enforcement failed to prove that the charitable gift annuities that Strong sold are securities. Accordingly, we reverse the Hearing Panel's findings of violation and dismiss the complaint.

D. The Hearing Panel Did Not Abuse Its Discretion in Excluding Exhibits 57, 58, and 60

Enforcement also argues on appeal that the Hearing Panel improperly excluded exhibits 57, 58, and 60. Exhibits 57 and 58 are verified complaints and judgments in lawsuits involving

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[9] The Hearing Panel acknowledges the lack of evidence in this case. The Hearing Panel initially notes that, "none of the [charitable gift annuity] documents in the record mentions or describes how the foundations would generate income." The decision further explains that, "indeed, they do not even say they would generate income. Instead, someone reading the documents would be left with the impression that the charitable foundation would simply accept the donation, make annual payments to the donor and retain whatever, if any, money remained of the donation after the donor's death – all without charging anything for this service."

Mid-America and ABC Hollister, two of the three foundations that issued charitable gift annuities in this case. Exhibit 60 consists of financial statements and printouts from National Heritage's website, the third foundation that issued the charitable gift annuities. The Hearing Panel excluded all three exhibits on the basis of relevance because the exhibits did not explain the foundations' operations during the period in which Strong sold the annuities. We affirm the Hearing Panel's findings.

Under NASD Rule 9263, Hearing Officers "may exclude all evidence that is irrelevant, immaterial, unduly repetitious, or unduly prejudicial." NASD Rule 9263(a). NASD Rule 9263 grants Hearing Officers broad discretion to accept or reject evidence, thus, the NAC reviews the exclusion of evidence only for an abuse of discretion. *See Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558, at *51-52 (July 6, 2005); *see Dep't of Enforcement v. Shelley*, Complaint No. C3A050003, 2007 NASD Discip. LEXIS 8, at *21-25 (NASD NAC Feb. 15, 2007); *Meckler*, 2002 NASD Discip. LEXIS 37, at *15-16 (excluding as unduly prejudicial allegations where Enforcement offered no evidence to substantiate those allegations). Because this discretion is broad, the party arguing abuse of discretion assumes a heavy burden that can be overcome only upon showing that the Hearing Officer's reasons to admit or exclude the evidence were "so insubstantial as to render . . . [the admission or exclusion] an abuse of discretion." *Cf. Omnipoint Corp. v. FCC*, 213 F.3d 720, 723 (D.C. Cir. 2000) (stating that agency's determination will not be overturned unless the agency's reasons are so insubstantial as to render the determination an abuse of discretion).

Enforcement failed to demonstrate that the Hearing Panel abused its discretion in excluding exhibits 57, 58, and 60. As an initial matter, these exhibits fail to offer conclusive evidence of how Mid-America, National Heritage, and ABC Hollister operated during the period in which Strong sold the charitable gift annuities. *See Meckler*, 2002 NASD Discip. LEXIS 37, at *15-16 (finding that allegations, without more, are not probative). Moreover, Enforcement failed to prove that the specific charitable gift annuities that Strong sold are securities, and it would be improper to admit these exhibits to remedy that failure. We find, therefore, that there is an insufficient basis to reverse the Hearing Panel's decision to exclude exhibits 57, 58, and 60.

IV. Conclusion

We reverse the Hearing Panel's findings that Strong's sales of charitable gift annuities violated NASD Rules 3040 and 2110. Although we acknowledge that several courts have found that charitable gift annuities are securities, there was insufficient evidence in the record to conduct the required analysis as to whether the charitable gift annuities that Strong sold are securities. Accordingly, we reverse the Hearing Panel's findings and dismiss the complaint.[10]

On behalf of the National Adjudicatory Council,

Marcia E. Asquith

Marcia E. Asquith,
Senior Vice President and Corporate Secretary

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[10] We also have considered and reject without discussion all other arguments of the parties.